2015
AUDIT, ASSURANCE AND RELATED SERVICES
STUDY SUPPORT MATERIAL
CFAP - 6
Note:
“This study support material is based on ISAs edition 2014.”
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## AUDIT, ASSURANCE AND RELATED SERVICES

### Objective
To develop competence which is necessary for performing audit, assurance and other related services in accordance with the international and local pronouncements.

### Learning Outcome
On the successful completion of this paper candidates will be able to:

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CHAPTER 1

An introduction to audit and assurance

Contents
1 Introduction to the concept of assurance
2 Introduction to audit and audit-related services
3 Chapter review
INTRODUCTION

Learning outcomes

This short chapter provides a bridge from the CAF-9 Audit and Assurance level to the Certified Finance and Accounting Professional level. This chapter recaps the basic concepts underlying Audit and Assurance.

By the end of this chapter students will be able to:

- Explain the basic concepts of assurance, audit and levels of assurance
- Describe examples of audit-related services including reviews, agreed-upon procedures and compilations
1 INTRODUCTION TO THE CONCEPT OF ASSURANCE

Section overview

- Introduction
- Assurance
- Examples of non-audit assurance engagements
- Elements of an assurance engagement

1.1 Introduction

This study text is an advanced text on auditing and assurance services. It assumes that you have already studied the basics, although some revision of basic topics is included. The main aims of this text are to build on the knowledge you gained from your studies of audit and assurance, and:

- extend your basic awareness of professional codes and fundamental principles, so that you develop a detailed understanding of rules of professional conduct
- introduce practice management
- extend the application of procedures involved in planning, conducting and reporting on audit assignments and non-audit assignments, and deal with group audits and audit-related services
- provide a critical evaluation of procedures and reports so as to be able to exercise professional judgment when formulating audit opinion in real-life situations
- outline current issues and developments in assurance.

1.2 Assurance

In an assurance engagement, an assurance firm:

- is engaged by one party
- to give an opinion
- on a piece of information that has been prepared by another party.

The opinion is an expression of assurance, or comfort, about the information that has been reviewed.

A statutory audit is one form of assurance engagement. The shareholders of a company do not accept without question that the information provided in the financial statements by the management of the company is sufficiently accurate and reliable. The statutory audit provides assurance about the truth and fairness along with fair presentation of the information. This makes the financial statements more reliable for the user as credibility is added to the statements by the expressed opinion of the auditor.

Because of the amount of work carried out and independence of the auditor from both shareholders and management, a statutory audit provides a high (reasonable) level of assurance. Other assurance engagements may provide a lower (limited) level of assurance, or comfort, to the person receiving the opinion. The level of assurance given by other assurance engagements will depend on various factors that are discussed in later chapters.
1.3 Examples of non-audit assurance engagements

Examples of ‘non-audit’ assurance engagements might include reports on matters such as:

- corporate social responsibility
- environmental policy
- employment policies
- non-financial performance indicators
- review engagements on half-yearly financial statements
- prospective financial information.

Assurance engagements have become more significant in recent years due to the increase in the range of information provided by company directors in reports to the shareholders and other stakeholders on the one hand, and the resultant need for confidence in the extended information on the other. Auditors can provide assurance by giving an opinion about the information in these reports.

1.4 Elements of an assurance engagement

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

- A three party relationship:
  - Practitioner
  - Responsible party
  - Intended users
- Subject matter
- Suitable criteria
- Sufficient and appropriate evidence
- Assurance Report
## 2 INTRODUCTION TO AUDIT AND AUDIT-RELATED SERVICES

### Section overview

- Audit
- Audit-related services

### 2.1 Audit

ISA 200 states that the purpose of an audit (a form of assurance engagement) is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the auditor expressing an opinion on whether the financial statements of an entity are prepared, in all material respects, in accordance with an applicable financial reporting framework.

A financial reporting framework may be provided, for example, by country-specific legislation plus international financial reporting standards. The auditor must consider the financial reporting framework since that is the benchmark against which an auditor would measure the truth and fairness of the financial statements. The concept of materiality is also applied when considering the applicable financial reporting framework.

**Example: SRO 929 Issued by SECP**

In Pakistan, companies are required to follow a financial reporting framework based on their size, as described below:

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<th>Reporting Framework</th>
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<td>Medium-sized entity</td>
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<td>Economically-significant entity</td>
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<td>Listed entity</td>
<td>IFRS as applicable in Pakistan</td>
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In addition, public and private companies are also required to follow the presentation requirements of the Fourth and Fifth Schedule to the Companies Ordinance 1984, respectively. In Pakistan, local regulation overrides the application of IFRS; hence there can be situations (for examples banks and insurance companies) where the above requirements are not followed due to prevalence of local directives by regulators.

The audit opinion typically makes reference to whether the financial statements give a ‘true and fair view’ or ‘present fairly’ the financial position and results of the reporting entity.

Audits are long-established formalised processes, closely regulated by law and professional practice. Audits were developed because of the separation between the ownership of companies (by the shareholders) and stewardship (by the directors). In order to protect the shareholders from incorrect or misleading information by the directors, an audit is designed to provide a high level of assurance to the users of the financial statements.
2.2 Audit-related services

Audit-related services are engagements undertaken by an accountant or firm of accountants, to perform such assignments as:

- reviews of data
- agreed-upon procedures
- compilations.

**Review**

A *review* provides a low (moderate) level of assurance that the information under review is free from any material misstatement. The practitioner’s opinion is usually expressed in the form of *negative assurance*, which is an opinion that there is nothing obviously wrong in the information. For example, the opinion might be: ‘Nothing has come to our attention to suggest that the information is materially misstated’.

The higher level of assurance provided by an audit enhances the credibility provided by the assurance process. However, an audit is more time-consuming (and therefore more costly) than a review. A review, on the other hand, does provide a level of comfort, which despite being lower than the comfort provided by an audit, still enhances the credibility of financial information.

**Agreed-upon procedures**

Agreed-upon procedures are adopted in an engagement where the party (client) hiring the practitioner specifies the procedures that should be followed by the accountant in performing the engagement.

**Example: Agreed-upon procedures**

A company wishes to pay a bonus to staff as a reward for their loyalty. The bonus is to be based on their length of service.

The company hires a firm of accountants to perform the following ‘agreed-upon procedures’:

- Verify the date each employee joined the company
- Calculate the length of service for each employee.

The practitioner then presents the results in a report to management.

**Compilation**

With a compilation, the accountant is engaged to prepare information for the client, rather than audit or check the information prepared by someone else. For example, a firm of accountants may be asked by a client to prepare a tax computation. No assurance is provided in a compilation engagement.
3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:
- Explain the basic concepts of assurance, audit and levels of assurance
- Describe examples of audit-related services including reviews, agreed-upon procedures and compilations
The regulatory environment

Contents

1 The need for regulation of audit and assurance services
2 Professional standards
3 Corporate governance
4 Money laundering
5 Consideration of laws and regulations in an audit of financial statements: ISA 250
6 Chapter review
INTRODUCTION

Learning outcomes

Performance of audit - general

A (a) 1 Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with International Standards on Auditing.

A (a) 13 Consideration of laws and regulations.

Exam context

It is important that students have an understanding of the regulatory environment that surrounds various industries of a nation’s economy. This chapter provides details of that environment.

Students will learn about the need for regulation of audit and assurance services and also the background to professional standards including the standards setting process.

Students will learn the concepts of corporate governance in an audit setting and also the definition of and duties of an auditor with respect to money laundering.

The chapter closes with details of the requirements of ISA 250.

By the end of this chapter students will be able to:

- Explain the need for regulation of audit and assurance services
- Describe the role and structure of professional standards including the standard setting process
- Summarise the key features of corporate governance in relation to audit
- Explain what money laundering is and summarise the obligations and duties it places on the auditor
- Apply ISA 250 to the audit of financial statements
1  THE NEED FOR REGULATION OF AUDIT AND ASSURANCE SERVICES

Section overview

- The public interest
- Ethical regulation
- Legal regulation
- Professional regulation
- Harmonisation of the accountancy and auditing profession

1.1 The public interest

The key reason why audit and assurance services should be regulated is to serve the public interest. Assurance providers give an impartial, professional view on issues that matter to users of financial and other information. It is important that this view can be trusted. Therefore, assurance providers need to operate:

- within ethical boundaries
- to consistent standards and
- within the bounds of local laws and regulation.

You know from your previous studies that assurance providers are regulated by:

- the law of the land in which they operate
- the ethical standards of the land and the professional body to which they belong
- the professional standards adopted by their country, for example International Standards on Auditing (ISAs)

1.2 Ethical regulation

Assurance providers are given ethical guidance by:

- Professional bodies, for example, The Institute of Chartered Accountants of Pakistan (ICAP)
- Law
- International Federation of Accountants (IFAC)

You should already be familiar with some of the ethical guidance relevant to this syllabus from your earlier studies, which is revised later in Chapter 3.

1.3 Legal regulation

Most countries have legal requirements associated with some assurance providers, particularly auditors. Examples of these legal requirements in Pakistan can be found, for example, in the Companies Ordinance 1984, Banking Companies Ordinance 1962 and Insurance Companies Ordinance 2000.

1.4 Professional regulation

Auditors are required to carry out audits according to professional standards – International Standards on Auditing (ISAs) as applicable in Pakistan. Some assurance work is also covered by professional standards, although this is a
developing area and less guidance is available. In many cases, guidance given in auditing standards can be adapted for use in assurance services where there is no specific guidance for that service.

As assurance provision goes increasingly 'global' the harmonisation of such professional guidance has become necessary.

### 1.5 Harmonisation of the accountancy and auditing profession

The International Federation of Accountants (IFAC) is an international regulatory body for the profession but each country has its own regulatory regime for auditing, which may not necessarily apply the same principles of audit behaviour as those used by IFAC.

The same arguments that have been made in favour of the universal adoption of international accounting standards can also be made in respect of other regulatory aspects of the auditing and accounting profession.

- **Advantages** include the adoption of global auditing standards, which should improve the efficiency of the audit process for multinational companies and should improve transparency in audit reporting.

- **Disadvantages** include the problems of getting international agreement on auditing practices, and the need for many countries to change their local law to bring it in line with the agreed international practice.

A number of initiatives are taking place to harmonise the regulation of the auditing profession internationally. These include the following:

- Audits of all listed companies in the European Union should now be carried out in accordance with International Standards on Auditing.

- Moves to establish a more formal, statute-based corporate governance regime (such as Sarbanes-Oxley in the USA).

- The development of national regulatory models for the profession, headed by a single unified body.

The Securities and Exchange Commission (SEC) in the USA is a long-established example of a unified body. In the UK, the Financial Reporting Council (FRC) also has a unified role, and

- sets accounting standards
- sets auditing standards
- enforces and monitors compliance with those standards
- oversees the self-regulatory professional bodies.

It has been suggested that stricter regulation from an external authority (such as the SEC in the US and the FRC in the UK) results in more transparency and improvement in governance structures of the accountancy and audit profession.
2 PROFESSIONAL STANDARDS

Section overview

- The international standard-setting process
- The authority of national and international standards
- Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services
- ISA 200: Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing
- Public oversight

2.1 The international standard-setting process

IFAC
(International Federation of Accountants)

IAASB
(International Auditing and Assurance Standards Board)

IESBA
(International Ethics Standards Board for Accountants)

ISAs
International Standards on Auditing (ISAs) are set by the International Audit and Assurance Standards Board (IAASB), which is a part of IFAC.

A subcommittee of IAASB is asked to write an exposure draft of the new standard when IAASB considers that one is required. This draft is then ‘exposed’ to interested parties, who comment on the exposure draft. Interested parties include national standard setters (such as the Auditing Practices Board in the UK) and professional bodies, such as ICAP.

The comments are reviewed within the IAASB and the draft is amended as required. Finally a new ISA is issued.

In addition the IAASB also publishes:
- International Standards on Review Engagements (ISRE);
- International Standards on Assurance Engagements (ISAE);
- International Standards on Related Services (ISRS);
- International Standard on Quality Control (ISQC); and
- International Auditing Practice Note (IAPNs).

Code of Ethics for Professional Accountants
IFAC’s Code of Ethics for Professional Accountants is issued by the International Ethics Standards Board for Accountants (IESBA), which is also a part of IFAC. Similar to many accountancy bodies around the world who are members of IFAC, ICAP’s code of ethics is based on the IESBA’s Code of Ethics for professional Accountants, with minor modifications or specific additions for clarification made where necessary, considering the corporate professional environment of Pakistan.
2.2 The authority of national and international standards

International standards are drafted to be used internationally and promote consistency in audit and assurance practice. However, situations may arise where the requirements of the international standard clash with national standards.

In this situation, there are a number of matters that should be considered:

- ISAs are not designed to overrule national requirements, so auditors should follow national requirements.
- However, as ISAs represent international best practice, countries are encouraged by IFAC to change their national practice so that ISAs can be followed. For example, in the UK, since December 2004, all financial statements have been audited using the UK version of ISAs, known as ISAs (UK and Ireland). These are based on ISAs with any additional, UK-specific, provisions shown in shaded boxes.
- If there is no comparable guidance to the ISA in the country, then individual ISA practice can be adopted immediately.

For example in Pakistan, the present format of the audit report is the one prescribed by the Companies Rules 1985. This format is different from the unmodified opinion format provided in ISA 700; however, since local regulation overrules ISAs, audit firms in Pakistan use the format prescribed by the Companies Rules 1985.

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

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

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

In addition to this preface, certain ISREs, ISAEs, ISRSs and ISQC 1 are examinable in this paper. These are covered in later chapters.

As discussed above, the IAASB’s pronouncements do not override local laws or regulations. If local laws or regulations differ from, or conflict with, the IAASB’s standards then a professional accountant should not state that they have complied with the IAASB’s standards unless they have fully complied with all of those relevant to the engagement.
International Standards on Auditing (ISAs)

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

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

This structure arose out of the work carried out as part of the IAASB’s “Clarity Project” (see below).

International Standards on Quality Control (ISQCs)

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

Other International Standards

The other international standards (ISREs, ISAEs and ISRSs) follow the format of the original ISAs. They contain:
- basic principles and essential procedures (identified in bold type and by the word ‘should’), and
- related guidance in the form of explanatory and other material, including appendices.

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

Authoritative and non-authoritative material

The IAASB’s preface describes how the above standards (ISAs, ISREs, ISAEs, ISRSs and ISQC1) are ‘authoritative material’. This means that they MUST be followed when conducting engagements of those types.

The IAASB also publishes ‘non-authoritative’ guidance as follows:
- Consultation Papers – these are used to generate discussion with relevant stakeholders
- Staff Publications – these raise awareness of new and emerging issues
- International Auditing Practice Notes (IAPNs) – these provide practical assistance to auditors in applying the ISAs in performing an audit
- Practice Notes relating to other international standards – these provide practical assistance to auditors in applying, for example, ISAEs, ISREs or ISRSs.
Professional Judgement

The nature of the international standards requires the professional accountant to \textit{exercise professional judgment} in applying them.

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

The \textit{objectives} of the auditor, per ISA 200 are:

- to obtain \textit{reasonable assurance} about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. This allows the auditor to give an opinion on whether or not the financial statements have been prepared in accordance with the applicable financial reporting framework.

- to report on the financial statements and communicate as required by the ISAs, in accordance with the auditor’s findings.

Where the auditor is unable to obtain reasonable assurance and a qualified opinion is insufficient, the auditor must disclaim an opinion or resign. The different types of opinions are covered in a later chapter.

In line with what you should remember from your previous studies, ISA 200 requires the auditor to:

- comply with all ISAs relevant to the audit
- comply with relevant \textit{ethical requirements}
- plan and perform an audit with \textit{professional scepticism}
- exercise \textit{professional judgement} in planning and performing an audit
- obtain \textit{sufficient and appropriate audit evidence} to allow them to obtain reasonable assurance.

2.5 Public oversight

The global architecture of standard setting in the field of audit, assurance, ethics and education consists of a three-tier structure made up of:

- standard setting boards supported by IFAC
- independent oversight by the Public Interest Oversight Board (PIOB)
- accountability to a monitoring body of public authorities (Monitoring Group).

\textbf{Public Interest Oversight Board (PIOB)}

The PIOB is the global independent oversight body that seeks to improve the quality and public interest focus of the international standards formulated by the Standard Setting Boards supported by IFAC in the areas of audit and assurance, education and ethics. Through its oversight activities, the PIOB works to bring greater transparency and integrity to the audit profession, thereby contributing to the enhanced quality of international financial reporting.

The PIOB provides independent oversight throughout the entire process of standard setting to help ensure that standards development is fully responsive to stakeholder needs, accountable and transparent. The public interest responsiveness of standard development requires aligning the priorities of the profession with those of all stakeholders. This is the ultimate objective of the current architecture in place, of which the PIOB is an essential component.
Independent oversight is necessary for financial markets: investors want to know that the financial information on which they base their capital allocation decisions is credible and reliable. By overseeing the establishment and adherence to high-quality professional standards, the PIOB seeks to further the international adoption and implementation of such standards and improve the comparability of financial statements across the globe.

The Securities and Exchange Commission of Pakistan (SECP)

The Securities and Exchange Commission of Pakistan (SECP) was set up in pursuance of the Securities and Exchange Commission of Pakistan Act, 1997.

The SECP was initially concerned with the regulation of corporate sector and capital market. Over time, its mandate has expanded to include supervision and regulation of insurance companies, non-banking finance companies and private pensions.

The SECP has also been entrusted with oversight of various external service providers to the corporate and financial sectors, including chartered accountants, credit rating agencies, corporate secretaries, brokers, surveyors etc.

The SECP’s mission is:

- To develop a fair, efficient and transparent regulatory framework, based on international legal standards and best practices, for the protection of investors and mitigation of systemic risk aimed at fostering growth of a robust corporate sector and broad based capital market in Pakistan.

The SECP’s strategy is:

- To develop an efficient and dynamic regulatory body that fosters principles of good governance in the corporate sector, ensures proper risk management procedures in the capital market, and protects investors through responsive policy measures and effective enforcement practices.
3 CORPORATE GOVERNANCE

### Section overview
- The meaning and nature of corporate governance
- Directors’ and auditors’ responsibilities
- Pakistan’s Code of Corporate Governance – the audit committee
- The impact of audit committees on audit and assurance practice

#### 3.1 The meaning and nature of corporate governance

Corporate governance is the way in which companies are managed and controlled. In particular, it focuses on the role of directors and their responsibilities to shareholders and other stakeholders.

As a form of business entity, an important feature of companies is the segregation of ownership from management.

- One group (the directors) manage the business and make the important strategic decisions.
- A different group (the shareholders) finance the company and own it.

Directors are seen as ‘agents’ of the shareholders and as such:

- they should take decisions that are in the best interests of their shareholders, and
- they should be accountable to the shareholders for the way in which they have used the company’s resources.

### The need for regulation for good corporate governance

There is some regulation of corporate governance in company law. However, basic legal requirements have proved inadequate for protecting shareholders from losses, in a number of corporate scandals caused by directors of the company. As a result, more specific regulations or guidelines have been introduced to improve corporate governance.

#### Illustration: Collapse of Enron and Arthur Anderson

Enron was an American energy company that collapsed in 2001 following the discovery that over $20bn of debt had been successfully hidden from the published financial statements. Revenue was overstated by hundreds of millions of dollars and investors subsequently lost an estimated $70 billion.

The fraud was committed by manipulating the detailed accounting rules for dealing with subsidiaries. Losses and near-worthless assets were assigned to unconsolidated partnerships and ‘special purpose entities’.

The CFO and other executives successfully misled Enron’s board of directors, the audit committee and auditors (Arthur Anderson) about these risky accounting practices. Arthur Anderson was at the time one of the five largest global accounting practices. As well as being Enron’s auditors, Arthur Anderson’s consulting division did a lot of work for Enron. This led to allegations of conflicts of interest. The firm subsequently collapsed when they were found guilty of illegally destroying documents relevant to the Securities and Exchange Commission’s (SEC’s) investigation into Enron in an attempt to misrepresent their relationship with Enron.
Chapter 2: The regulatory environment

As a result of the collapse of Enron, Sarbanes-Oxley was rapidly passed into US law in 2002 to improve the quality of financial reporting and reduce the likelihood of similar future corporate scandals. Sarbanes-Oxley increased the penalties for destroying, fabricating or altering records in federal investigations or for attempting to defraud shareholders.

Regulations and guidelines vary from country to country. In some countries there are detailed ‘rules’, in others there are none. In Pakistan, guidance is provided by ‘The Code of Corporate Governance’ (the Code) which was first issued in 2002 and subsequently revised in 2012. The Code is issued by the Securities and Exchanges Commission of Pakistan (SECP) and forms part of the Listing Regulations of the three Stock Exchanges in Pakistan. The Code is applicable to all public listed companies. Similarly codes of corporate governance are also in place for public sector entities.

3.2 Directors’ and auditors’ responsibilities

In all aspects of corporate reporting there is a basic distinction between the role of the directors and the role of the auditors:

- The directors are responsible for the preparation of information that complies with the relevant regulations (including maintaining a system of internal controls to ensure the corporate reporting objective is met).
- The auditors are responsible for expressing an opinion on the truth and fairness of the financial statements by applying the applicable auditing and ethical standards.

It is good practice in accordance with ISA 210 Agreeing the terms of audit engagements to clarify the relative responsibilities of the directors and auditors in corporate governance matters.

3.3 Pakistan’s Code of Corporate Governance – the audit committee

Requirement for an audit committee

In many countries, listed companies are required or expected to have an audit committee. In the UK for example, having an audit committee is a requirement of the UK Corporate Governance Code for listed companies. In Pakistan the Securities and Exchanges Commission of Pakistan’s ‘Code of Corporate Governance’ (the Code) requires all listed companies to employ an audit committee.

The audit committee is a ‘sub-committee’ of the board of directors and it reports to the main board. In Pakistan, the Code requires:

- the board of directors of every listed company to establish an audit committee
- the audit committee to comprise at least of three members (all non-executive directors)
- the chairman of the committee to be an independent director, who shall not be the chairman of the board
- at least one member of the audit committee to have relevant financial skills/expertise and experience.
A key purpose of an audit committee is to establish a ‘buffer’ between the auditors and the executive directors, in order to minimise the risk that the auditors might come under undue pressure from the executive members of the board. (For example, the auditors may be influenced by the threat that the company will take away their audit work or non-audit work and so may be more inclined to agree with the opinions and arguments of the management.)

The audit committee should therefore help to ensure the independence of the external auditors.

The Code also provides the following guidance on audit committees for Pakistani listed companies:

**Frequency of meetings, attendance, terms of reference and reporting procedures**

The Audit Committee of a listed company shall meet at least once every quarter of the financial year. These meetings shall be held prior to the approval of interim results of the listed company by its Board of Directors and before and after completion of external audit. A meeting of the Audit Committee shall also be held, if requested by the external auditors or the Head of Internal Audit.

**Attendance at meetings**

The CFO, the Head of Internal Audit and external auditors represented by engagement partner or in their absence any other partner designated by the audit firm shall attend meetings of the Audit Committee at which issues relating to accounts and audit are discussed:

- Provided that at least once a year, the Audit Committee shall meet the external auditors without the CFO and the Head of Internal Audit being present;
- Provided further that at least once a year, the Audit Committee shall meet the head of internal audit and other members of the internal audit function without the CFO and the external auditors being present;
- Provided further that the chairman of the Audit Committee and engagement partner of external auditor or in their absence any other partner designated by the audit firm shall be present at the AGM for necessary feedback to the shareholders.

**Terms of reference**

The Board of Directors of every listed company shall determine the terms of reference of the Audit Committee. The Board shall provide adequate resources and authority to enable the Audit Committee to carry out its responsibilities effectively. The Audit Committee shall, inter alia, recommend to the Board of Directors the appointment of external auditors, their removal, audit fees, the provision by the external auditors of any service to the listed company in addition to audit of its financial statements. The Board of Directors shall give due consideration to the recommendations of the Audit Committee in all these matters; where it acts otherwise, it shall record the reasons thereof.

The terms of reference of the Audit Committee shall also include the following:

- determination of appropriate measures to safeguard the listed company’s assets;
- review of quarterly, half-yearly and annual financial statements of the listed company, prior to their approval by the Board of Directors, focusing on:
  - major judgmental areas;
• significant adjustments resulting from the audit;
• the going concern assumption;
• any changes in accounting policies and practices;
• compliance with applicable accounting standards;
• compliance with listing regulations and other statutory and regulatory requirements; and
• significant related party transactions.

- review of preliminary announcements of results prior to publication;
- facilitating the external audit and discussion with external auditors of major observations arising from interim and final audits and any matter that the auditors may wish to highlight (in the absence of management, where necessary);
- review of management letter issued by external auditors and management’s response thereto;
- ensuring coordination between the internal and external auditors of the listed company;
- review of the scope and extent of internal audit and ensuring that the internal audit function has adequate resources and is appropriately placed within the listed company;
- consideration of major findings of internal investigations of activities characterised by fraud, corruption and abuse of power and management's response thereto;
- ascertaining that the internal control systems including financial and operational controls, accounting systems for timely and appropriate recording of purchases and sales, receipts and payments, assets and liabilities and the reporting structure are adequate and effective;
- review of the listed company’s statement on internal control systems prior to endorsement by the Board of Directors and internal audit reports;
- instituting special projects, value for money studies or other investigations on any matter specified by the Board of Directors, in consultation with the CEO and to consider remittance of any matter to the external auditors or to any other external body;
- determination of compliance with relevant statutory requirements;
- monitoring compliance with the best practices of corporate governance and identification of significant violations thereof; and
- consideration of any other issue or matter as may be assigned by the Board of Directors.

**Internal audit**

- There shall be an internal audit function in every listed company. The Head of internal Audit shall functionally report to the Audit Committee and administratively to the CEO.
- A director cannot be appointed, in any capacity, in the internal audit function, to ensure independence of the internal audit function.
- The internal audit function may be outsourced by a listed company to a professional services firm or be performed by the internal audit staff of holding company. However, due care shall be exercised to ensure that
suitably qualified and experienced persons, who are conversant with the company's policies and procedures, are engaged in the internal audit. In the event of outsourcing the internal audit function, company shall appoint or designate a full-time employee other than CFO, as Head of Internal Audit, to act as coordinator between firm providing internal audit services and the board:

- Provided that while outsourcing the function, the company must not appoint its existing external auditors as internal auditors.
- All listed companies shall ensure that internal audit reports are provided for the review of external auditors. The auditors shall discuss any major findings in relation to the reports with the Audit Committee, which shall report matters of significance to the Board of Directors.

**External auditors**

- No listed company shall appoint as external auditors a firm of auditors which has not been given a satisfactory rating under the Quality Control Review program of the Institute of Chartered Accountants of Pakistan.
- No listed company shall appoint as external auditors a firm of auditors which or a partner of which is non-compliant with the International Federation of Accountants' (IFAC) Guidelines on Code of Ethics, as adopted by the Institute of Chartered Accountants of Pakistan.
- The Board of Directors of a listed company shall recommend appointment of external auditors for a year, as suggested by the Audit Committee. The recommendations of the Audit Committee for appointment of an auditor or otherwise shall be included in the Directors’ Report. In case of a recommendation for appointment of an auditor other than the retiring auditor the reasons for the same shall be included in the Directors’ Report.
- No listed company shall appoint its auditors to provide services in addition to audit except in accordance with the regulations and shall require the auditors to observe applicable IFAC guidelines in this regard and shall ensure that the auditors do not perform management functions or make management decisions, responsibility for which remains with the Board of Directors and management of the listed company.
- All listed companies in the financial sector shall change their external auditors every five years. Financial sector, for this purpose, means banks, non-banking financial companies (NBFC’s), modarabas and insurance/takaful companies; provided that all inter related companies/ institutions, engaged in business of providing financial services shall appoint the same firm of auditors to conduct the audit of their accounts.
- All listed companies other than those in the financial sector shall, at a minimum, rotate the engagement partner after every five years.
- No listed company shall appoint a person as an external auditor or a person involved in the audit of a listed company who is a close relative, i.e., spouse, parents, dependents and non-dependent children, of the CEO, the CFO, an internal auditor or a director of the listed company.
- Every listed company shall require external auditors to furnish a Management Letter to its board of directors within 45 days of the date of audit report; Provided that any matter deemed significant by the external auditor shall be communicated in writing to the board prior to the approval of the audited accounts by the board.
3.4 The impact of audit committees on audit and assurance practice

The existence of audit committees provides the external auditor with an independent reference point outside the executive directorship of a company. This may prove useful in the event of disagreements arising.

Simply by having an audit committee, the executive directors are likely to become more aware of their duties and responsibilities and hence discharge their responsibilities more effectively.

The existence of the committee may act as a deterrent against illegal acts committed by the executive directors such as fraud.

An audit committee may also discourage executive directors from acting against the interests of shareholders.

Other benefits of an audit committee may include:

- improving the effectiveness of the internal audit function by providing them with an independent reporting line
- improving the quality of financial reporting
- assisting the external auditor by providing an independent channel of communication
- increase stakeholder (and public) confidence in the financial statements

One possible disadvantage of audit committees is that they may be seen as overly bureaucratic and suppress the executive directors’ entrepreneurial leadership.
4 MONEY LAUNDERING

Section overview

- Definition of money laundering
- Regulation
- Obligations placed on professional firms
- Customer due diligence
- Anti-money laundering systems and controls
- Duty of confidentiality and money laundering
- Global dimension

4.1 Definition of money laundering

Money laundering can be defined as the process by which criminals attempt to conceal the true origin and ownership of the proceeds of their criminal activities. Criminal activities include drug trafficking, terrorism, theft, fraud and tax evasion.

Money laundering is a process by which money earned from criminal activities (‘dirty money’) is transferred and transformed so that it appears to have come from a legitimate source (‘clean money’). This typically occurs in three stages:

- **Placement** – the introduction (placement) of illegal funds into the financial system. E.g. using a cash-intensive business such as a betting shop to disguise illegal (dirty) money as legitimate revenue, or using numerous bank accounts to make lots of low-value cash deposits.

- **Layering** – disguising the original source of the funds by passing the money through a large number of transactions (layers).

- **Integration** – repatriation (integration) of the laundered funds back into the legitimate economy so they can then be used for purchases or investment.

If it is undertaken successfully, money laundering allows criminals to maintain control over the proceeds of their criminal activity and to provide a legitimate cover for their sources of income.

There are various criminal offences connected with money laundering. Examples include:

- possessing, in any way dealing with, or concealing, the proceeds of any crime. Examples of the proceeds of crime might include the following:
  - Tax evasion.
  - Offences that involve saved costs (as these could result from environmental offences or failure to follow health and safety regulations).
  - Retaining overpayments from customers.
  - Payments made overseas that are deemed to be bribes and would be illegal in Pakistan.

- attempting, conspiracy or incitement to commit the above offence

- aiding, abetting, counselling or procuring the commission of such an offence
an act which would constitute any of these offences if done in Pakistan

failure by a person in the regulated sector to inform the appropriate party of a knowledge or suspicion that another person is engaged in money laundering

making a disclosure to a third party which is likely to prejudice a money laundering investigation being undertaken (tipping off).

The last two offences are the ones that accountants may find themselves affected by even inadvertently, as accountants operate in the regulated sector and are therefore required to report suspicions of money laundering.

It is made more complicated by the fact that ‘suspicion’ is not defined in the law. However, it appears to be somewhere between mere speculation and actual proof.

There are various defences to charges of money laundering:

- a report had been made to the appropriate party
- there was an intention to make a report and a reasonable excuse (likely to include fear of physical violence or other menaces) for not having done so
- acquiring or using property for adequate consideration in good faith

4.2 Regulation

Due to the work of inter-governmental bodies such as the Financial Action Task Force on Money Laundering (FATF), many countries now have legal provisions in place designed to detect, report and ultimately prevent money-laundering activities. These provisions vary from country to country and include the US Patriot Act 2001 in the USA, the Money Laundering Regulations 2007 in the UK and various laws in Singapore including the ‘Corruption, Drug Trafficking and Other Serious Crimes Act 1992’ and the ‘Terrorism (Suppression of Financing) Act 2002. The following notes are based mainly on regulations in the UK, but similar regulations are applied by many other countries.

In Pakistan the Financial Monitoring Unit (FMU), State Bank of Pakistan (SBP) and Securities and Exchanges Commission of Pakistan (SECP) oversee the application of the Anti-Money Laundering Regulations 2008 and Anti-Money Laundering Act, 2010. This oversight mechanism is consistent with the recommendations of FATF in relation to customer due diligence (‘know your client’), record-keeping, due diligence of corresponding banks, reporting of suspicious transactions and compliance.

Those found guilty of offences of money laundering face imprisonment of between 1 to 10 years plus fines up to one million rupees.

4.3 Obligations placed on professional firms

Money laundering may be of particular relevance to accountants and in particular auditors, in cases where criminals establish companies and use transactions between their companies to ‘launder’ their dirty money.

Specific obligations for detecting and reporting suspicions of money laundering are placed on professional firms (for example, lawyers and accountants) and financial institutions. These requirements might include the following:

- Putting into place systems, controls and procedures to ensure that the firm is not used for money laundering purposes.
Appointing a Money Laundering Reporting Officer (MLRO), whose responsibility is to receive reports on suspected money laundering activities from other employees and report them to the appropriate authorities.

Establishing and enhancing the record-keeping systems (1) for all transactions (which must be kept for a minimum period, typically at least five years, with controls to ensure that they are not inadvertently destroyed) and (2) for verifying the identity of clients (by obtaining official documents, such as – for an individual – passport or driving license, supported by recent utilities bills, and – for a company – certificate of incorporation).

Establishing procedures within the firm for reporting any suspicion of money laundering by client companies.

Training and educating staff in procedures for detecting and reporting suspicions of money laundering activities.

These obligations are wide-ranging and auditors and other professionals need to be fully aware of the extent of their responsibilities in taking care of them.

Example: Money laundering

An international case involved a solicitor who was imprisoned for six months for failing to report their suspicion in relation to money paid to their firm by a client who was later convicted of drug trafficking. The solicitor misunderstood their obligation to report the suspicion, thus unintentionally committing an offence.

Guidance from professional bodies

In addition to any disciplinary action that may be taken by ICAP for breaches of the regulations, penalties for non-compliance with money laundering obligations can:

- make a firm liable (under criminal law) to fines, and
- make its principals (usually its partners) liable to possible imprisonment.

In response to the increased expectations of legislators and regulators in many countries with respect to the accounting profession’s role in detecting money laundering, IFAC has published a second paper on this topic.

This paper highlights:

- the causes and possible means of preventing money laundering
- the signs of money laundering activity
- the vulnerability of banks, non-bank financial institutions and other entities to money laundering
- governance-related issues (the relative responsibilities of directors and auditors for monitoring and reporting suspicions of money laundering).

4.4 Customer due diligence

Effective ‘customer due diligence’ (CDD) measures are an essential part of any system designed to prevent money laundering. For example, CDD measures should be carried out:

- when establishing a client relationship
- when carrying out an occasional transaction
- where there is a suspicion of money laundering or terrorist financing
where there are doubts concerning the veracity of previous identification information.

Firms are required to ensure CDD procedures are applied to all clients, both new and existing. Prior to entering a client relationship, firms in Pakistan must:

- identify and verify the client’s identity using documents or information from reliable and independent sources
- identify the beneficial owner of the client (where there is one), including understanding the ownership and control structure of the client and verifying, according to risk, the identity of the beneficial owner(s)
- obtain information on the purpose and intended nature of the client relationship

Verification of identity may in certain circumstances be conducted during the establishment of a client relationship if minimum interruptions are to be made to normal course of business and there is little risk of money laundering or terrorist financing occurring, provided the verification is completed as soon as practicable after contact is first established.

During a client relationship, firms must monitor activity on an ongoing basis. This includes scrutiny of transactions, source of funds and other elements of knowledge collected in the customer due diligence process, to ensure the new information is consistent with other knowledge of the client and keeping the documentation concerning the client and the relationship updated.

Firms can use a variety of tools and methods to conduct customer due diligence; the onus is on them to satisfy themselves and to be able to demonstrate to their anti-money laundering supervisory authority the appropriateness of their approach.

Since the entire process of money laundering involves the use of deception and at times, collusion between the perpetrators of the crime, it can be difficult to identify actual cases or all risks associated with money laundering. This is an area of increasing concern worldwide and audit firms must remain vigilant to any indicators of money laundering.

4.5 Anti-money laundering systems and controls

Indications of potentially suspicious transactions might include:

- transactions being routed through several jurisdictions without apparent business sense
- an excessive use of wire transfers
- transactions with large currency or bearer instruments
- high value deposits or withdrawals not normally associated with the type of account they flow through
- transactions of a secret nature
- a pattern of deposits followed by similar (and in some instances, the same) amounts being wired to another account or financial institution
- a number of deposits and/or withdrawals just below the monitoring threshold in short succession (often on the same day)
Businesses should establish appropriate risk-sensitive policies and procedures in order to prevent activities related to money laundering and terrorist financing. These could include policies and procedures which provide for:

- identification and scrutiny of complex or unusually large transactions, unusual patterns of transactions with no apparent economic or lawful purpose and other activities regarded by the regulated person as likely to be of the nature of money laundering or terrorist financing
- prevention of use of products favouring anonymity
- determination of whether a client is a politically exposed person (i.e. someone who has been entrusted with a prominent public function, or a relative or known associate of that person)
- customer due diligence
- internal reporting including appointment of an officer (i.e. MLRO) to receive any money laundering reports and a system for making those reports
- record keeping, including details of customer due diligence and supporting evidence for client relationships
- internal control, risk assessment and management, compliance monitoring, management and communication

In addition, businesses should take measures to make relevant employees aware of the law relating to money laundering and terrorist finance, and to train those employees in how to recognise and deal with transactions which may be related to money laundering or terrorist financing.

In order to ensure compliance is appropriately managed, businesses will need to ensure sufficient senior management oversight, appropriate analysis and assessment of the risks of clients and work/product types, systems for monitoring compliance with procedures and methods of communicating procedures and other information to personnel.

### 4.6 Duty of confidentiality and money laundering

The accountant’s normal professional duty of confidentiality to clients is not an adequate defence where money laundering is concerned.

In the case of reporting suspicions of money laundering, practitioners in most countries are afforded statutory protection against claims for breach of confidence where reports are made in good faith and to the appropriate authority. This will be so even in cases where the suspicions later prove to be unfounded and wrong.

An accountant may in fact find it hard not to commit the offence of ‘tipping off’ bearing in mind all the reporting requirements that an auditor has to fulfil. For example, if an auditor had a strong suspicion or knowledge of money laundering, they might want to resign their position. However, doing so would mean that they were required to report to the shareholders on their reasons (in a statement of circumstances) and also report any professional matters arising to their successor in a professional clearance letter. In such a circumstance, the auditor might be better placed not to resign at that time and should certainly take legal advice before doing so (remember that taking advice from a solicitor would not constitute tipping off because it is protected by legal privilege).

Accountants may find themselves in a position where they are prevented from making a report of a suspicion of money laundering because they have received information under a legal privilege. This will be rare.
4.7 Global dimension

Several countries have similar legislation to the FATF recommendations described above. For example, the US Patriot Act 2001 requires all financial institutions to establish anti-money laundering programmes to include development of internal policies, the appointment of a compliance officer, an ongoing employee training programme and an independent audit function.
5 CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS: ISA 250

Section overview

- Legal requirements of a company
- Responsibilities
- ISA 250 Consideration of laws and regulations in an audit of financial statements
- Action by the auditor in the event of non-compliance or suspected non-compliance by a client company
- Documentation

5.1 Legal requirements of a company

Companies are subject to laws and regulations in many areas such as:

- Company law
- Civil law (e.g. contract law)
- Tax laws
- Environmental law and regulation
- Employment laws, including post-employment benefit laws
- Health and safety regulations
- Social laws (e.g. use of child labour, harassment at workplace etc.)

5.2 Responsibilities

Responsibilities of management

It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity’s operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity’s financial statements.

Responsibilities of the auditor

The auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations. However, the auditor is responsible for identifying material misstatement of the financial statements due to non-compliance with laws and regulations.

ISA 250 distinguishes the auditor’s responsibilities in relation to compliance with two different categories of laws and regulations as follows:

- The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and pension laws and regulations.

Here, the auditor’s responsibility is to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations.
Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity’s ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements.

For this second category the auditor’s responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements as discussed below.

5.3 ISA 250 Consideration of laws and regulations in an audit of financial statements

ISA 250 Consideration of laws and regulations in an audit of financial statements requires the auditor to:

- obtain a general understanding of the applicable legal and regulatory framework and how the entity is complying with that framework. This is part of obtaining an understanding of the entity and its environment – here, the legal environment – as required by ISA 315

- obtain sufficient appropriate audit evidence in respect of compliance with those laws and regulations which might be expected to have a direct effect on material amounts and disclosures in the financial statements

- perform the following audit procedures to help identify such instances of non-compliance:
  - make enquiries of management as to whether the entity is complying with the relevant laws and regulations
  - inspect any correspondence with the relevant authorities

- during the audit, remain alert to the possibility that other audit procedures might bring instances of non-compliance to the auditor’s attention

- obtain written representations from management that all known instances of non-compliance or suspected non-compliance have been disclosed to the auditor

- document all identified or suspected instances of non-compliance and the results of discussions with management and/or other parties.

5.4 Action by the auditor in the event of non-compliance or suspected non-compliance by a client company

If the auditor identifies or suspects material areas of non-compliance by the company, the following procedures are required:

- Obtain an understanding of the nature of the act and the circumstances under which it has occurred.

- Evaluate the possible effect of the non-compliance on the financial statements.
For suspected non-compliance, discuss the matter with management. If compliance is not demonstrated, take legal advice.

If there is insufficient evidence of a suspected non-compliance, consider the impact on the audit report (this would constitute an ‘inability to obtain sufficient appropriate audit evidence’, also called “limitation on scope”, which is considered in a later chapter).

Consider whether or not the non-compliance impacts on other areas of the audit (for example, on the overall risk assessment).

Consider how to report the non-compliance – to those charged with governance and/or to shareholders and/or to the authorities.

5.5 Documentation

The auditor shall include in the audit documentation identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.
## 6 CHAPTER REVIEW

<table>
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<th>Chapter review</th>
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<td>Before moving on to the next chapter check that you can:</td>
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<tr>
<td>■ Explain the need for regulation of audit and assurance services</td>
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<td>■ Describe the role and structure of professional standards including the standard setting process</td>
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<td>■ Summarise the key features of corporate governance in relation to audit</td>
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<td>■ Explain what money laundering is and summarise the obligations and duties this places on the auditor</td>
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<td>■ Apply ISA 250 to the audit of financial statements</td>
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3

Professional ethics

Contents

1 The fundamental principles
2 Integrity, objectivity and independence
3 Confidentiality and conflicts of interest
4 Corporate financial advice
5 Chapter review
INTRODUCTION

Learning outcomes

Other assurance engagements and related services (including reporting on relevant services) – Related services

D (b) 4  Services under the provisions of corporate laws
D (b) 5  Services under the provisions of tax laws

Professional ethics, Quality Control and current development

E.1  Code of Ethics issued by The Institute of Chartered Accountants of Pakistan.

Exam context

Ethics is a fundamental component of every accountant’s life. You therefore need to be familiar with the underlying guidance and principles of ethics and be able to apply those principles in a given scenario.

This chapter is a continuation of the ethics you studied in the earlier CAF-9 Audit and Assurance paper. However, the ethical dilemmas encountered in this exam will be more complex, involve a greater degree of judgement and would require application skills rather than plain knowledge of the basic concepts. Furthermore the ethical dilemma may not be as obvious to spot as in previous exams.

By the end of this chapter students will be able to:

- Describe the fundamental principles of the ICAP Code of Ethics
- Apply the conceptual framework to identify threats to the fundamental principles and suggest appropriate safeguards across a range of common scenarios
1 THE FUNDAMENTAL PRINCIPLES

Section overview

- Introduction: rules of conduct for professional accountants
- The fundamental principles of the ICAP Code of Ethics
- The conceptual framework

1.1 Introduction: rules of conduct for professional accountants

The professional bodies that regulate the auditing profession set high standards of behaviour for their members (including students). Their codes of practice apply to all members, whether in public practice or not. The detailed rules of conduct vary between the professional bodies, but all the major bodies have codes that are broadly similar.

In setting a code of practice, each professional body is complying with one of its regulatory functions, which is to ensure that professional services related to accountancy and audit are performed only by ‘fit and proper’ persons who act with professional integrity and perform quality work.

ICAP has adopted the IESBA’s Code of Ethics into its own localised code called ‘The ICAP Code of Ethics for Chartered Accountants’ (the Code). The Code’s substance remains largely unchanged from the IESBA’s original code.

The Code must be followed by all members (including students) whether they are operating as external auditors or assurance providers or internal auditors. The Code also applies to the staff of an ICAP practice, regardless of whether they are members of ICAP, or any other professional body.

Although the guidance applies to all members, the examination is primarily concerned with how the rules apply to an external auditor or assurance provider.

1.2 The fundamental principles of the ICAP Code of Ethics

The five fundamental principles of the Code are set out below.

<table>
<thead>
<tr>
<th>Principle</th>
<th>Explanation</th>
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<tbody>
<tr>
<td>Integrity</td>
<td>A professional accountant should be straightforward and honest in all professional and business relationships.</td>
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<tr>
<td>Objectivity</td>
<td>A professional accountant should not allow bias, conflict of interest or undue influence of others to override his or her professional or business judgements.</td>
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<tr>
<td>Professional competence and due care</td>
<td>A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services.</td>
</tr>
</tbody>
</table>
A professional accountant should respect the confidentiality of information acquired as a result of professional or business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information should not be used for the personal advantage of the professional accountant or third parties.

A professional accountant should comply with relevant laws and regulations and should avoid any action which discredits the profession.

You need to know these five fundamental principles and what each of them means. An exam question may require you to discuss the relevance of the five fundamental principles to a particular situation in a case study.

1.3 The conceptual framework

The application of the fundamental principles set out above is considered by the ICAP Code within a conceptual framework. This framework acknowledges that these principles may be threatened in a broad range of circumstances.

The key threats to the fundamental principles are:

- **Self-interest threat.** This arises when the accountant or the audit firm has a financial interest or other interest in a matter. Typically this means that the accountant’s decisions may be influenced by self-interest and the accountant will therefore not act with objectivity and independence e.g. if the auditor earns a large proportion of their revenue from a particular client they may be unwilling to upset that client by issuing an unfavourable audit report.

  Circumstances that could give rise to self-interest threats for members include:
  
  - financial interests, loans or guarantees
  - incentive-based or contingent fee arrangements
  - concern over employment security
  - commercial pressure from outside the employing organisation
  - inappropriate personal use of corporate assets
  - close personal or business relationships
  - holding a financial interest in a client or jointly holding a financial interest with a client
  - undue dependence on fees from a client
  - a chartered accountant discovering a significant error when evaluating the results of a previous professional service performed by a member of the chartered accountant's firm.

- **Self-review threat.** This occurs when an accountant is required to review or re-evaluate (for a different purpose) a previous judgement they have made or action that they have taken. Self-review threats can also apply to
audit firms. For example if an audit firm prepared the financial statements for a client company and then acted as auditor, it would be reviewing its own work and would be reluctant to criticise or question it. This would be a threat to objectivity and independence.

Circumstances that could give rise to self-review threats for members include:

- business decisions or data being reviewed by the same person who made those decisions or prepared that data
- being in a position to exert direct and significant influence over an entity’s financial reports
- the discovery of a significant error during a re-evaluation of the work undertaken by the member
- reporting on the operation of financial systems after being involved in their design or implementation
- a member of the assurance team being, or having recently been, employed by the client in a position to exert direct and significant influence over the subject matter of the engagement
- performing a service for a client that directly affects the subject matter of an assurance engagement.

Advocacy threat. This occurs when the accountant is in a position where they are expected to defend or justify the position of the client, and act as an ‘advocate’ for the client’s position or point of view, for example in a legal case. This would be a threat to objectivity and independence.

Circumstances that may give rise to advocacy threats for members include:

- commenting publicly on future events
- situations where information is incomplete or where the argument being supported is against the law
- promoting shares in a listed company which is also an audit client
- acting as an advocate for an assurance client in litigation or dispute with third parties.

Intimidation threat. This occurs when the accountant is deterred from acting with objectivity due to threats against them or their firm. The nature of the threat may be a threat by the client that it will take work away from the audit firm unless it agrees with the point of view of the client management. Another example might be a strong finance director intimidating junior members of the audit team and persuading them not to report errors found during their testing.

Circumstances that may give rise to intimidation threats for members include:

- threat of dismissal or replacement of the member, or a close family member, over a disagreement about the application of an accounting principle or the way in which information is to be reported
- a dominant personality attempting to influence the member’s decisions
- the threat of litigation
pressure to inappropriately reduce the amount of work performed in order to reduce fees.

- Familiarity threat. This occurs when the accountant becomes too sympathetic with the client’s position due to close relationships, for example due to a long association over many years in carrying out the annual audit.

Circumstances that could give rise to familiarity threats for members include:

- where a member in a position to influence financial or non-financial reporting or business decisions has an immediate family member who could benefit from those decisions
- long association with business contacts influencing business decisions
- acceptance of gifts or preferential treatment, unless the value is clearly insignificant
- over-familiarity with the management of the organisation such that professional judgment could be compromised
- a former partner of the firm being a director or officer of the client or an employee being in a position to exert direct and significant influence over the subject matter of the engagement.

Members are required to identify, evaluate and respond to such threats. If identified threats are anything but clearly insignificant, members must implement safeguards to eliminate the threats or reduce them to an acceptable level so that compliance with the fundamental principles is not compromised.

If the threat cannot be reduced to an acceptable level with safeguards then the practitioner must either resign from or decline the engagement.
2 INTEGRITY, OBJECTIVITY AND INDEPENDENCE

Section overview

- The requirement for independence
- Threats to independence – key areas
- Financial interests (s290.104)
- Loans and guarantees (s290.127)
- Close business relationships (s290.133)
- Family and personal relationships (s290.136)
- Employment with assurance clients (s290.144)
- Recent service with an assurance client (s290.148)
- Long association of senior personnel with assurance clients (s290.155)
- Provision of non-audit services (s290.157)
- Fees and pricing (s290.202)
- Gifts and hospitality (s290.208)
- Actual and threatened litigation (s290.209)
- Safeguarding independence
- Making referrals
- Mini case studies

2.1 The requirement for Independence

For an audit report to be of value, the auditor:

- must be independent, and also
- must be seen to be independent.

The opinion of an auditor must be an independent opinion given by a professional person with appropriate skills in audit work, and the opinion must not be influenced by anyone else, and in particular must not be influenced by the opinions and views of the management of the company whose financial statements have been audited.

In order that a member’s audit report is of value auditors must have ‘independence of mind’ and be ‘independent in appearance’. These principles of both being and being seen to be independent are at the centre of the role played by independence in auditing.

Illustration: Independence of mind and independence in appearance

Independence of mind describes a state of mind that permits the auditor to express a conclusion without being affected by influences or prejudices that compromise their professional judgment. This allows the auditor to act with integrity and exercise objectivity and professional scepticism.

Independence of appearance means the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information (including any safeguards applied) would reasonably conclude that a firm’s, or a member of the assurance team’s,
integrity, objectivity or professional scepticism has been compromised. For example, if an auditor owned shares in an audit client then a reasonably informed third party could safely assume that the auditor will not be truly objective as they would not want to see the value of their investment in the client reduced.

The presumption is that if an auditor is not independent in appearance then they cannot possibly think with objectivity (i.e. be independent of mind). Even if this may not technically be true it is a presumption that must be held in order to protect the reputation of auditors.

Independence of the auditor is a matter of public confidence in the audit process.

- Auditors need to be fully aware of situations that may damage their independence and objectivity. Such situations are referred to as threats to auditor independence.

- Any threats to independence may be reduced by safeguards that are taken by an audit practice (audit firm).

The ICAP Code takes the form of guidance on independence, rather than specific rules. It is left to the individual member to apply judgement about how the guidance should be applied in practice.

The guidance sets out a number of general categories of threat to independence, and then goes on to list specific threats and associated guidance.

2.2 Threats to independence – key areas

Threats to the fundamental principles are matters that could result in the accountant or audit firm acting without integrity, without sufficient competence, without ensuring confidentiality or in a way that discredits the profession. However, threats to the fundamental principles are largely threats to the independence and objectivity of the accountant or the audit firm.

Although the ICAP Code provides a conceptual framework, which recognises that it is impossible to define every situation that creates threats and specify the appropriate safeguards, specific guidance is provided in a number of key areas where independence may be under threat, or may be seen to be under threat.

The main areas are:

- financial interests
- loans and guarantees
- close business relationships
- family and personal relationships
- employment or former employment with assurance clients
- long association of senior personnel with assurance clients
- provision of non-audit services
- fees and pricing
- gifts and hospitality
- actual and threatened litigation.
2.3 Financial interests (s290.104)

A financial interest in an assurance client exists where shares or debt instruments are held either directly or indirectly. A direct financial interest is one held by an individual or the assurance firm or by a trust controlled by them. An indirect financial interest is one held by an individual or the assurance firm via a trust not controlled by them. Such a holding may create a self-interest threat.

Neither an assurance team member (nor their immediate family) or an assurance firm must hold a direct financial interest or a material indirect financial interest. Therefore the only safeguards would be to:

- dispose of any direct financial interest
- dispose of any indirect financial interest or reduce the holding to such a level that it is no longer material
- remove the individual from the assurance team
- resign from the audit.

If holdings are acquired by an individual as a gift or inherited:

- they should be disposed of as soon as practicable, or
- the individual should be removed from the assurance team.

2.4 Loans and guarantees (s290.127)

If the assurance client is a bank or similar institution, no threat to independence is created where the loan is made on normal terms to the assurance firm or a member of the assurance team.

If the assurance client is a not a bank or similar institution the self-interest threat would be so great that no safeguard could reduce the threat to an acceptable level, unless the loan is immaterial to both the firm/member and the client.

2.5 Close business relationships (s290.133)

A commercial or common financial interest between an assurance firm or a member of the assurance team and a client or its management may create self-interest and intimidation threats. The Code gives the following examples of such relationships:

- A material financial interest in a joint venture with the assurance client or its senior management.
- Arrangements to combine services or products, marketed with reference to both parties.
- The firm acting as a distributor or marketer of the client’s products or services or vice versa.

If the relationship relates to the assurance firm, unless the financial interest is immaterial and the relationship clearly insignificant to the firm, the Code states that there are no safeguards which could reduce the threat to an acceptable level. Therefore, the only possible courses of action are to:

- terminate the business relationship
- reduce the level of the relationship so that the financial interest becomes immaterial and the relationship insignificant, or
- refuse the assurance engagement.
If the relationship relates to a **member of the assurance team**, as opposed to the firm, unless the financial interest is immaterial and the relationship clearly insignificant to the individual, the only appropriate **safeguard** would be to remove the individual from the assurance team.

The **purchase of goods and services** from an assurance client by the firm or a member of the assurance team would not generally create a threat to independence provided:

- the transaction is in the normal course of business, and
- on an arm’s length basis.

However, the nature or number of such transactions could create a **self-interest threat** and safeguards would need to be applied such as:

- eliminating or reducing the transactions
- removing the individual from the assurance team
- discussing the issue with the audit committee or appropriate senior management at the client.

For example, a new member of an audit team may have bought goods or services from the audit client in the past, on normal commercial terms and at normal prices. This does not create any problem. However, if the audit team member intends to continue using the goods or services of the client to a **significant extent**, there may be some threat of a loss of independence. If so, the individual should be asked not to buy from the client entity in the future; if the individual does not wish to do this, he or she should probably be taken off the audit team.

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**Example: commercial transaction with an audit team member**

An audit firm has a client company, Zoomco, which operates a motor racing circuit. The audit firm has discovered that the audit manager for the Zoomco audit keeps a racing car at Zoomco’s circuit and uses the race track regularly. Because they are the audit manager, Zoomco allows them 50% off normal charges for garaging the car and for use of the race track.

What is the ethical position and what measures should the audit firm take to deal with this situation?

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**Answer**

The transaction between Zoomco and the audit manager is a normal commercial transaction for Zoomco, but it is not at arm’s length because the audit manager gets 50% off normal prices. The transaction may not be material for Zoomco, but it is likely to be material for the audit manager.

Consequently, there has been a breach of the ethical code by the audit manager. The audit manager has created a self-interest threat (and possibly a familiarity threat) by entering into the transaction with Zoomco.

- The ethics partner of the audit firm should be consulted and asked to assess the materiality of the transaction between Zoomco and the audit manager and to consider whether disciplinary action is appropriate.
- The audit manager should be removed immediately from the Zoomco audit team and replaced by someone else.
Those charged with governance of Zoomco (the board of directors) or the audit committee should be told about the action that the audit firm has taken and the reasons why the action was necessary.

In view of the threat to the objectivity and independence of the former audit manager, the audit plan for the Zoomco audit should be reviewed and amended if this is considered necessary.

The ethics partner may also wish to check whether the former audit manager has entered into commercial arrangements on favourable terms with any other audit client.

2.6 Family and personal relationships (s290.136)

Family and personal relationships between a member of the assurance team and a director, officer or certain employees at the client may create self-interest, familiarity or intimidation threats, depending on the specific circumstances. The significance of these threats will depend on:

- the member’s responsibilities on the assurance engagement
- the closeness of the relationship, and
- the role of the family member at the assurance client.

Clearly, a greater threat will exist where, say, the wife of one of the partners at the assurance firm is the finance director at the client than if, say, an audit junior’s sister is the receivables ledger clerk at a client.

Where an immediate family member (i.e. spouse or dependent) of a member of the assurance team is:

- a director, officer or employee of the assurance client, and
- is in a position to exercise direct and significant influence over the subject matter of the assurance engagement

then the only appropriate safeguard is to remove the individual from the assurance team. So, in the example above, that particular partner should have no involvement with the assurance engagement at his wife’s company. Even then, this may not be a sufficient safeguard if all the partners enjoy a close relationship and the only safe approach may be not to take on that company as a client at all.

For a close family member (parent, non-dependent child, brother or sister) in the same position safeguards might include:

- removing the individual from the assurance team
- where possible, structuring the responsibilities of the assurance team in such a way that the member of the assurance team does not deal with matters which are the responsibility of the family member (so, in the example above, the audit junior would not be assigned to the receivables section of the audit)
- putting in place policies and procedures to allow assurance staff to communicate to senior staff at the assurance firm any independence issues which concern them.

Threats are not restricted to the family relationships defined above. It is the assurance firm’s responsibility to consider any other personal relationships which might have a bearing on independence and consider what safeguards need to be put in place.
2.7 Employment with assurance clients (s290.144)

Individuals who have previously been on the assurance team could leave the assurance firm to work for the assurance client. A significant self-interest, familiarity or intimidation threats could arise depending on:

- the seniority of the individual when they were on the assurance team
- the position they have taken up at the client
- the amount of future involvement they will have with the assurance team (as a member of the client’s staff)
- the length of time that has passed since they were on the assurance team

This will be the case particularly if strong personal or financial links remain between the individual and the remaining members of the assurance team or the assurance firm.

The Code specifies that:

- the individual concerned must not be entitled to any benefits or payments from the firm, unless these are fixed, pre-determined arrangements
- any amounts owed to the individual (for example, in the case of an ex-partner) must not be so significant that they could threaten independence
- the individual must no longer take part (or appear to take part) in the firm’s business

For a listed client:

- No listed company shall appoint a person as the CEO, the CFO, an internal auditor or a director of the listed company who was a partner of the firm of its external auditors (or an employee involved in the audit of the listed company) at any time during the two years preceding such appointment or is a close relative, i.e. spouse, parents, dependents and non-dependent children, of such partner (or employee).

Other safeguards might include:

- modifying the assurance plan (perhaps to increase the amount of work on the area the ex-team member will be involved with)
- assigning an assurance team of sufficient expertise compared to the individual who has left (i.e. a team which will not be intimidated by the ex-team member)
- arranging for an additional professional accountant to review the work done
- carrying out a quality control review of the engagement.

Similar threats could also arise where a member of the assurance team knows they are to join the client in the future or has entered negotiations to do so. If the individual were to remain on the assurance team, objectivity could be impaired as the individual might be keen not to upset their potential future employer (self-interest threat). Safeguards would include:

- the firm having policies and procedures in place to require individuals to notify the firm when they are entering into serious negotiations with an assurance client
- removing the individual from the assurance team.
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2.8 Recent service with an assurance client (s290.148)

If a former director, officer or employee of an assurance client becomes a member of the assurance team there may be self-interest, self-review or familiarity threats. This will particularly be the case if, as a member of the assurance team, the individual has to report on work they carried out. They may also be reluctant to criticise the work of former colleagues.

The Code specifies that individuals who worked for an assurance client as a director, officer or employee in a position to exert a direct and significant influence over the subject matter of the engagement during the period covered by the assurance report should not be assigned to the assurance team.

If they were employed prior to this period the level of threat will depend upon:

- the amount of time elapsed
- the individual’s position with the client
- the role of the individual on the assurance team.

Safeguards might include:

- arranging for an additional professional accountant to review the work done by the individual
- discussing the matter with the audit committee or appropriate senior management at the client.

Example: recent service with an assurance client

Sadeeq served as the finance director of Ramble, an assurance client for three years prior to joining Ramble’s auditors, Tahir & Co., in March 2015 as a partner. Sadeeq is prohibited from being a member of the audit team for Ramble’s 2015 statutory audit because they were employed at the audit client (Ramble) in a position to exert direct and significant influence over the subject matter during the period under review.

2.9 Long association of senior personnel with assurance clients (s290.155)

Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat. The level of threat will depend upon:

- the length of time that the individual has been on the assurance team
- the role of the individual on the assurance team
- the structure of the firm
- the nature of the assurance engagement.

Safeguards might include:

- rotating senior staff of the assurance team; for example changing the audit engagement partner every five years
- arranging for an additional professional accountant to review the work done by the senior staff
- carrying out independent quality control reviews.

However, because the threat could be so great for an audit client, the Code specifies the following for the audit of listed clients (as required by the
Pakistan Securities and Exchanges Commission’s Code of Corporate Governance):

- All banks and development finance institutions (DFIs) are required to ensure that the external auditors are rotated on expiration of five years. In case of banks / DFIs having two audit firms jointly auditing their accounts and both of them complete their five years period at the same time, one of them will be rotated on completion of five years and the other one in the next year.

- All listed companies in the financial sector shall change their auditors every five years. Financial sector for this purpose means Non-Banking Finance Companies (NBFCs), Modarabas and Insurance Companies.

- All listed companies other than those mentioned above shall at a minimum rotate the engagement partner after every five years.

- A partner rotating after five years should not resume the lead engagement partner role until a further period of time, normally two years, has elapsed.

2.10 Provision of non-audit services (s290.157)

The provision of non-audit services is now common among audit firms of all sizes. Most auditors recognise the potential threat to their independence and they try to deal with the problem through their internal organisational structure.

- Larger firms will operate in a number of separate departments, each with its own partners and members of staff. By dividing the work of the audit firm into different functions, employees involved in audit work will not be the same as those involved in providing, say, consultancy advice to the same client.

- In some of the largest practices, the consultancy department has been legally separated from the accounting/auditing arm of the firm as a further step towards preserving auditor objectivity and independence.

- A similar approach is often taken by smaller audit firms. Although these firms may not be large enough to be organised in separate departments, efforts are usually made to ensure that different members of staff and partners are responsible for different services provided to clients.

Example: non-audit work and safeguards

An audit firm has completed the annual audit for a client company and the audit team has identified a number of weaknesses in internal controls that have been notified to the client’s management. As a result the client has asked the firm to carry out a review of its financial IT systems.

What are the ethical issues to consider in this situation and how might the problems be dealt with?

Answer

The engagement would involve non-audit work. The audit firm can accept this engagement subject to certain conditions:

- The management of the client company must recognise that they have the responsibility for internal controls in the company. This responsibility cannot be passed on to the auditors.
The engagement team will not be required to act in a management capacity in any way. For example, they must not be given any responsibility for the implementation of any improvements in internal control that they recommend.

There must be sufficient controls against a self-review threat. For example, the individuals assigned to the engagement team to do the work should not include anyone who will also be a member of the audit team.

The ICAP Code recognises that the independence of an assurance firm may be threatened when the firm carries out a large amount of non-assurance work for an entity that is also its assurance client. This is particularly true where an audit firm carries out non-audit services for its audit client.

The non-audit work may provide a large amount of income that makes the audit firm economically dependent on the company (self-interest threat).

In addition, employees of the audit firm who carry out the audit may be required to audit the work that has been done for the company by colleagues in the audit firm. It might be difficult for them to find faults with the work that has been done by other employees of the firm (self-review threat).

The ICAP Code considers various categories of non-assurance work, including:

- Preparing accounting records and financial statements
- Valuation services
- Taxation services
- Internal audit services
- IT systems services
- Temporary staff assignments
- Litigation support services
- Legal services
- Recruitment of senior management
- Corporate finance and similar services.

**General guidance on non-assurance services**

Although non-assurance services are generally considered acceptable, subject to appropriate safeguards, the following activities are prohibited by the Code:

- Authorising, executing or completing a transaction.
- Deciding which recommendation of the firm should be implemented.
- Reporting, in a management role, to senior management of the client.

Any of the above would involve the firm acting in a management capacity and therefore constitute a threat to the firm’s objectivity.

Appropriate safeguards for other activities would include the following:

- The firm having policies and procedures such that an individual is prevented from making any management decision on behalf of the client.
- Discussing independence issues with the audit committee or senior management at the client.
The firm having policies covering oversight responsibility for the provision of other work to assurance clients.

Involving an additional professional accountant in a review of independence or an aspect of the engagement.

The client acknowledging responsibility for the results of the work performed by the firm.

Disclosing to the audit committee or similar body the nature and extent of fees charged.

Personnel carrying out the non-assurance services not taking part in the assurance engagement.

### Preparing accounting records and financial statements

Preparing accounting records and financial statements and then auditing them creates a significant self-review threat. This may also apply where an assurance engagement involves reviewing subject matter (such as forecasts) prepared by the firm itself.

In providing such assistance, firms must not make management decisions such as:

- deciding on or changing journal entries without the client’s approval
- authorising or approving transactions
- preparing source documents or originating data (including decisions on valuation assumptions).

The provision of advice on accounting principles and presentation in the financial statements given during the course of an audit will not generally threaten the firm’s independence. Such advice is considered to be part of the normal audit process.

For non-listed clients, accounting or book-keeping services, including payroll services, of a routine or mechanical nature may be provided with appropriate safeguards such as:

- the service not being performed by a member of the audit team
- the firm having policies and procedures such that an individual is prevented from making any management decision on behalf of the client
- requiring the source data for accounting entries to be originated by the client
- requiring the underlying assumptions to be originated and approved by the client
- obtaining the client’s approval for any changes to the financial statements.

### Valuation services

A self-review threat might arise where an audit firm performs a valuation of an item which is to be included in the financial statements to be audited. Therefore, audit firms should not provide valuation services where:

- the matter is material to the financial statements, and
- involves a significant degree of subjectivity.
In other cases, appropriate **safeguards** might include:

- the client acknowledging responsibility for the results of the work
- an additional professional accountant reviewing the work done
- the client confirming their understanding of and approving the underlying assumptions and methodologies used
- the individuals carrying out the work not being involved in the audit.

**Taxation services**

Such services include compliance work, tax planning, the provision of advice and assistance in the resolution of tax disputes. Such assignments are not considered by the ICAP Code to threaten independence.

**Internal audit services**

A **self-review threat** might arise where an audit firm provides internal audit services to an audit client. The following **safeguards** must be applied:

- the client being responsible for the internal audit activities (using a designated, preferably senior management, employee) and acknowledging its responsibility for the system of internal controls
- the client and audit committee approving the scope, risk and frequency of the work
- the client being responsible for evaluating recommendations and deciding which are to be implemented
- the client evaluating the adequacy of the procedures performed
- the findings and recommendations being reported to the audit committee or similar body.

In addition, the firm should consider whether such services should only be provided by individuals not involved in the audit.

**IT systems services**

Where such services provided by the audit firm involve the design and implementation of Financial Information Technology Systems (FITS) a **self-review threat** might arise. Without the following **safeguards** the Code considers that this threat will probably be too significant for the work to be accepted:

- The client acknowledging its responsibility for the system of internal controls.
- The client designating a competent employee, preferably senior management, to be responsible for management decisions in respect of the design and implementation of the system.
- The client making all such management decisions.
- The client evaluating the adequacy and results of the design and implementation of the system.
- The client being responsible for the operation of the system and the data generated by it.
Temporary staff assignments

If the audit firm lends staff to an audit client there is a potential self-review threat where the individual will be in a position to influence the preparation of the accounts or financial statements. Such assistance may be given provided that the individual will not be involved in:

- making management decisions
- approving or signing agreements or similar documents
- exercising discretionary authority to commit the client to certain actions.

Safeguards should include:

- the individuals loaned having no subsequent audit responsibility for any area they were involved in during their assignment
- the client acknowledging its responsibility for directing and supervising loaned staff.

Litigation support services

Such services may include:

- acting as an expert witness
- calculating estimated damages
- assistance with document management and retrieval

and could create a self-interest threat, depending on the materiality of the amounts involved and the subjectivity of the matter concerned.

Safeguards might include:

- the service not being performed by a member of the assurance team
- the firm having policies and procedures such that an individual is prevented from making any management decision on behalf of the client
- the involvement of independent experts.

Legal services

The threat will depend on the nature of the service, whether the provider is also a member of the assurance team and the materiality of the matter. Safeguards are likely to include those listed under general non-assurance services above.

Acting for an audit client in the resolution of a dispute or litigation where the amounts involved are material to the financial statements creates such significant advocacy and self-review threats that the work should not be taken on.

Recruitment of senior management

The recruitment of senior management for an assurance client may create current or future self-interest, familiarity and intimidation threats. The level of the threat will depend on the role of the person to be recruited and the type of assistance sought.

The firm may review CVs and draw up a short-list of candidates for interview but the decision as to who is hired must be made by the client.
Corporate finance and similar activities

Certain types of corporate finance services may create such significant advocacy and self-review threats that the work should not be taken on. Assurance firms should not:

- promote, deal in or underwrite an assurance client’s shares
- commit an assurance client to the terms of a transaction or complete a transaction on an assurance client’s behalf.

In other cases, safeguards, such as not making management decisions and using individuals who are not members of the assurance team, should be considered.

2.11 Fees and pricing (s290.202)

Relative size of fees

Where the total fees generated by an assurance client represent a large proportion of an assurance firm’s total fees, the dependence on that client and concern about the possibility of losing that client may create a self-interest threat.

Specific safeguards might include:

- discussing the extent and nature of fees with the audit committee or other appropriate persons at the client
- taking steps to reduce dependency on that client (for example, by refusing lucrative non-audit services or taking those on and resigning as auditor)
- having external quality control reviews
- consulting a third party, such as ICAP or another professional accountant.

IFAC’s Code of Ethics (commonly adopted in accountancy institutes around the world) states that the public may perceive that independence is impaired where the fees for audit and other recurring work paid by one client, or a group of connected clients, exceeds 15% of the income of the audit practice for listed clients. It may be particularly difficult for new audit practices to satisfy this requirement; therefore, particular care on independence is required in these circumstances. The ICAP Code has not (yet) adopted a specific threshold.

Overdue fees

If fees from an assurance client remain unpaid for a long time, a self-interest threat may arise. This will certainly be the case if a significant part of the overdue amount is not paid before the next year’s report is issued.

The Code therefore recommends that payment of such fees should be required before the report is issued. Other safeguards might include:

- discussing the level of outstanding fees with the audit committee or other appropriate persons at the client
- involving an additional professional accountant who did not take part in the assurance engagement to provide advice or to review the work performed.

Pricing

When an assurance firm obtains an assurance engagement at a significantly lower level than that charged by the previous firm, or quoted by other firms (known as “low-balling”) a self-interest threat arises. This threat will not be reduced to an acceptable level unless:
- the firm is able to demonstrate that appropriate time and qualified staff are available, and
- all applicable assurance standards and quality control procedures are being complied with.

Note that the ICAP Code requires Chartered accountants in practice to comply with provision ATR-14 denoting minimum hourly charge-out rates and fees for audit engagements.

**Contingent fees**

Contingent fees are fees that are calculated on a pre-determined basis, relating to the outcome or result of a transaction or the work performed. A contingent fee may be an engagement on a 'no win no fee' basis, or on the basis that the audit firm will receive a percentage amount of the money it succeeds in saving or making for the client.

Clearly a contingent fee creates both self-interest and advocacy threats. These threats are considered insurmountable and therefore the Code does not allow contingent fee arrangements.

For example, if an audit firm is asked to provide an assurance report in support of a loan application, it may be offered a fee which is only payable by the client if the application is successful. This would be a contingent fee and this fee arrangement must be refused.

Similarly a fee for taxation services that will be calculated as a percentage of the tax saved for the client would be a contingent fee and is not permissible.

Fees should be charged on the basis of the experience of the person doing the auditor assurance work and the time spent on the work.

### 2.12 Gifts and hospitality (s290.208)

Accepting gifts or hospitality from an assurance client may create self-interest and familiarity threats.

The Code specifies that gifts or hospitality should only be accepted where the value is clearly insignificant.

Those in a position to influence the conduct and outcome of the audit and immediate family members of such persons shall not accept hospitality from the audited entity, unless it is reasonable in terms of its frequency, nature and cost.

### 2.13 Actual and threatened litigation (s290.209)

In some cases, a client entity (or some of its shareholders) may threaten the audit firm with litigation as a result of something the audit firm, or a member of the audit team, has (or has not) done. Actual or threatened litigation could create self-interest or intimidation threats. The significance of the threat will depend on the materiality of the litigation, the nature of the engagement and whether the litigation relates to a previous assurance engagement.

**Safeguards** should include:

- disclosing the extent and nature of the litigation to the audit committee or senior management of the client entity
- if the litigation involves a member of the assurance team, removing that individual from the assurance team
appointing an additional professional accountant to review the work done and assess the nature of the litigation threat.

### 2.14 Safeguarding Independence

The responsibility for safeguarding independence is shared between:
- the individual auditor (or audit practice) and
- the profession as a whole.

**The responsibilities of Individual auditors and audit practices**

There should be a culture of independence and a belief in auditors’ independence that is shared by all partners and employees in an audit firm. It has been suggested by some commentators that detailed rules and regulations to preserve independence can be avoided if all auditors accept the concept that ‘a good auditor is an independent auditor’.

Where possible, there should be rotation of the engagement partner (the partner in charge of the audit) and of senior staff. Rotation means that an individual should not be involved in the annual audit of the same client company for more than a maximum number of years.

In addition, an audit firm should have the following procedures in place:

- **Appropriate training**, including training in how to maintain an independent opinion during audit work.

- **Quality control procedures**. A firm should have procedures for quality control to ensure that independence is considered in respect of all work undertaken by the audit firm.

- **Consultation procedures**. A firm should have internal procedures for consultation, whereby questions arising in relation to independence can be discussed.

If an auditor becomes aware of a situation that may be seen to threaten their independence, appropriate action should be taken to resolve the issue. The action to be taken will depend on the circumstances, but might include any of the following:

- It may be possible to remove the threat to independence by a simple action, such as not accepting an offered gift or for an audit partner to dispose of shares that they hold in a client company, and so on.

- Sometimes, it may be necessary to reject a proposed appointment as auditor. For example, an audit firm may have to reject its appointment as auditor of a new client company where the guidance on fee income level would be breached (because the fee income from the client would exceed the maximum limits established by the professional guidelines).

- With an existing client, if an independence issue cannot be resolved, the ultimate action is to resign from the audit of the client.

**The responsibilities of the profession**

Professional bodies expect their members to comply with codes of conduct relating to independence and will take disciplinary action as appropriate. Such action might lead to a fine, reprimand or exclusion from membership.
The profession and other interested parties regularly suggest new practices and procedures designed to improve auditor independence. Suggestions include:

- the regular rotation of auditors, to avoid too close a relationship developing between the auditor and the client over a long period of time
- the use of audit committees.

The responsibility for safeguarding independence is seen as shared between the individual auditor (or audit practice) and the profession as a whole.

**Safeguards – Code of Ethics**

The Code of Ethics categorises safeguards as follows:

- safeguards created by the profession, legislation or regulation
- safeguards in the work environment
- safeguards created by the individual.

**Safeguards created by the profession, legislation or regulation include:**

- educational, training and experience requirements for entry into the profession
- continuing professional development requirements
- corporate governance regulations
- professionals standards (such as ISAs)
- professional or regulatory monitoring and disciplinary procedures (such as ICAP’s own disciplinary procedures)
- external review by a legally empowered third party (such as a regulator appointed by the Government) of the reports or information produced by a member.

**Safeguards in the work environment include:**

- the employer’s own systems of monitoring and ethics and conduct programmes (such as an internal training or a mentoring programme)
- recruitment procedures, ensuring that only high-calibre, competent staff are recruited
- appropriate disciplinary processes
- strong internal controls
- leadership that stresses the importance of ethical behaviour and which expects employees to behave ethically
- policies and procedures to implement and monitor the quality of employee performance
- policies and procedures to implement and monitor the quality of engagements
- documented policies regarding the identification of threats to compliance with the fundamental principles, the evaluation of those threats and the implementation of appropriate safeguards
- communication of such policies and procedures and training on them
the use of different partners and engagement teams for the provision of non-assurance services to assurance clients
policies and procedures to stop individuals who are not members of an engagement team from inappropriately influencing the outcome of the engagement
policies and procedures to give employees the power to report ethical issues to senior staff at the employing firm, without fear of retribution from those about whom they are making the report
discussing ethical issues with the client
disclosing to the client the nature of the services provided and the fees charged (this could be done via the audit committee)
consultation with another appropriate professional accountant.

Safeguards created by the individual include:
complying with continuing professional development requirements
keeping records of contentious issues and approach to decision-making
having a broader perspective on how other organisations operate by forming business relationships with other professionals
using an independent mentor
keeping in contact with legal advisors and professional bodies.

2.15 Making referrals
An audit firm may enter into an arrangement with another entity, whereby the other entity agrees to pay a fee to the audit firm for referring clients. For example a software company may specialise in selling accounting software packages or writing bespoke accounting software. It may enter an arrangement with an audit firm whereby the audit firm will receive a fee every time that it refers a client to the software firm with a view to buying a software package or software services. This type of arrangement could create a self-interest threat for the audit firm. However, it is permissible, provided that suitable safeguards are in place. Suitable safeguards might include the following:
When making a referral, the audit firm should notify the client that it will receive a fee for the referral. This means that the client will be made fully aware of the financial benefit for the audit firm.
The audit firm should monitor the quality of the products or services provided. In the case of referrals to a software company, this means having to keep the quality of the software packages and services under review, to make sure that they meet appropriate standards. (It is important that audit clients should not be referred to someone who provides poor-quality goods or services.)
The firm should also obtain verification from all staff involved with the audit of a client who is referred, that they do not personally have any financial interest in the company or other entity to which the referrals are made.

Furthermore, a Chartered Accountant in public practice may purchase all or part of another firm on the basis that payments will be made to individuals formerly owning the firm or to their heirs or estates. Such payments are not generally regarded as commissions or referral fees.
2.16 Mini case studies

Case study 1: Tahir and Shafique
A Pakistani audit firm, Tahir and Shafique, is faced with the following situations:

Situation 1
Mr Tahir is one of the audit firm’s partners. He and his wife have been invited by the managing director of Entity X to a weekend of celebrations in Dubai to mark the 20th anniversary of the incorporation of Entity X. Mr Tahir has been the engagement partner throughout this time.

Situation 2
The firm has been approached by the directors of Entity Y, with a view to being appointed as auditors. One of the firm’s audit managers, Mr Kashif, is company secretary of Entity Y, although he takes no part in its management. His parents are the sole directors and shareholders of Entity Y.

Situation 3
The finance director of Entity Z, a private limited company, has requested that only certain staff are to be included on the audit team to prevent unnecessary interruption to the entity’s accounting department during the audit. In particular, he has requested that Dawood, who has been the accountant in charge of the audit for the last two years, be assigned to the audit and that the team contain no new trainees.

Required
What threats to objectivity are present in each of these situations and how should the audit firm deal with them?

Answer
Situation 1
The fact that Mr Tahir and his wife have been invited to a ‘free’ weekend in Dubai represents a threat to the firm’s independence, because it would be perceived that they are too close to Entity X and therefore not truly independent.

The offer should be refused as goods, services or hospitality should only be accepted when the value is clearly insignificant, which it is not to Mr Tahir and his wife in this case.

Even if the invitation is declined, there is a potential problem with regard to the length of time that Mr Tahir has been the engagement partner – 20 years. He is by now likely to be over-familiar with the client, and may be too trusting and/or sympathetic. The firm should strongly consider safeguards to independence in this situation such as rotating Mr Tahir away from this engagement.

Situation 2
Mr Kashif takes no part in the management of Entity Y. However, if he is involved with the audit there may be actual or perceived threats to his objectivity as his immediate family members, his parents, are the directors of Entity Y.

The firm must ensure that Mr Kashif is not part of the audit team and is not in a position to influence any members of the audit team. If this cannot be demonstrated, then the firm should not accept the audit engagement.
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Situation 3
The key ethical issues that arise in this situation are familiarity and possible intimidation.

There is a risk that if Dawood is assigned to the audit over too long a period he might become unduly familiar with the client and its staff and lose his objectivity in relation to the assignment.

The finance director’s request could amount to intimidation if there is any question that the audit would be withdrawn if the request was not complied with. Best practice is that audit firms should not allow clients to dictate staffing issues as it is important that audit firms staff their teams in the most appropriate way in terms of safeguarding against ethical threats, quality control on the audit and technical expertise.

If the firm considers it not appropriate to comply with the finance director’s request, they should not do so, while assuring them that if different staff are assigned, they are required by professional standards to have obtained a good knowledge of the business and to be directed, supervised and reviewed well, hopefully therefore causing minimum disruption to operations.

Case study 2: Happy Days
Your firm is the auditor of Happy Days, an entity which provides hospitality packages at racecourses around a single country. The managing director of Happy Days has suggested the following to your managing partner:

- All members of the audit team are to be offered two free tickets to a major event at the racecourse of their choice.
- Last year’s audit senior should be seconded to the organisation for a six-month period. The current year’s audit is not yet underway.

Required
Discuss which, if any, of the above proposals would be acceptable to your firm (and if not state why not), and set out the main safeguards, if any, which would be required.

Answer
Free tickets – not acceptable. The ICAP Code states that gifts or hospitality should only be accepted where the value is clearly insignificant (self-interest threat). This would be likely to be a considerable “perk” for audit team members and, in any case, would not give an appearance of independence.

Secondment – acceptable with the following safeguards.

- The senior should not be involved in future audits (as there would be self-review and familiarity threats).
- The composition of the current year’s audit team should be reviewed to ensure that the secondee would not be likely to have significant influence over the members of that team (through personal relationships) (familiarity and intimation threats).
- The secondee should not be in a position to influence management decisions and management must take responsibility for all such decisions.
CONFIDENTIALITY AND CONFLICTS OF INTEREST

Section overview

- The basic principle
- Recognised exceptions to the duty of confidentiality
- Improper use of information
- Confidentiality of working papers
- Conflicts of interest

3.1 The basic principle

The ICAP Code of Conduct applies IFAC’s Code of Ethics regarding confidentiality. In both codes the duty of confidentiality is a fundamental principle of professional behaviour that information obtained in the course of professional work should not be disclosed to others or used unless:

- disclosure is permitted by law and consent has been obtained from the party to whom the duty of confidentiality is owed; or
- disclosure is required by law; or
- there is a professional duty or right to disclose, when not prohibited by law.

Part of the rationale behind this requirement is that auditors need full and frank disclosure of information from a client in order to carry out their duties. If the client is not assured of confidentiality of this information, they may be unwilling to provide all relevant information to the auditor.

Each of these three situations is discussed in more detail below.

3.2 Recognised exceptions to the duty of confidentiality

Disclosure permitted by law and authorised by the client or employer

For example:

- when an auditor is asked to report to a bank in relation to compliance with a loan covenant the auditor will seek the client’s authorisation before disclosing confidential information to the bank;

- when an auditor is asked to report to a listing authority (stock exchange) in relation to listing rules, again the auditor will seek the client’s authorisation before disclosing confidential information to the listing authority.

Disclosure required by law

An ICAP member may be required by law to disclose confidential information to an appropriate legal authority. In such circumstances the requirements of the law override the duty of confidentiality.

The ICAP Code of Conduct provides the following illustrations of when disclosure is required:

- Producing documents or other evidence in the course of legal proceedings; or
- Disclosure to the appropriate public authorities of infringements of the law that come to light.
One specific example is money laundering, where an ICAP member is required by law to make disclosure to the relevant legal authorities if they know, or have reason to suspect that a client has committed

- terrorism
- drug trafficking, or
- any other money laundering activity.

**Professional duty or right to disclose, when not prohibited by law**

Disclosure of confidential information is also permitted when an accountant has a professional duty or right to disclose, when not prohibited by law.

The ICAP Code of Conduct gives a number of illustrations of when this applies:

- To comply with the quality review of a member body or professional body
- To respond to an inquiry or investigation by a member body or regulatory body
- To protect the professional interests of a Chartered Accountant in legal proceedings (for example when it is reasonably necessary to protect the interests of the member in making a defence against an official accusation of professional negligence)
- To comply with technical standards and ethics requirements.

**Other considerations**

In deciding whether or not to disclose confidential information, Chartered Accountants should consider the following points:

- Whether the interests of all parties, including third parties whose interests may be affected, could be harmed if the client or employer consents to the disclosure of information by the Chartered Accountant;
- Whether all the relevant information is known and substantiated, to the extent that it is practicable; when the situation involves unsubstantiated facts, incomplete information or unsubstantiated conclusions, professional judgment should be used in determining the type of disclosure to be made, if any; and
- The type of communication that is expected and to whom it is addressed; in particular, Chartered Accountants should be satisfied that the parties to whom the communication is addressed are appropriate recipients.

It is possible that a member may be in doubt as to whether they have a right or duty to disclose information. Under such a circumstance they should seek legal advice or consult with ICAP for advice.

### 3.3 Improper use of Information

An ICAP member should not use, or appear to use, confidential information gained in the course of professional work for their personal advantage or for the advantage of a third party.

For example:

- A member should not deal in the shares of a client company in such a way that it might seem that information obtained in a professional capacity has been used for their personal advantage (so-called ‘insider dealing’).
Where a member has confidential information from Client 1, which affects an assurance report on Client 2, they cannot provide an opinion on Client 2 that they already know, from this other source, to be untrue. If the member is to continue as auditor to Client 2, they must carry out normal audit procedures to enable the same information to be obtained from another source. Under no circumstances should there be any disclosure of confidential information outside the firm. Ultimately the auditor may have to resign.

3.4 Confidentiality of working papers

An accountant’s working papers, which contain confidential client information, are the property of the accountant and should not normally be made available to outside parties.

However, situations may arise where government agencies (for example, tax authorities) ask to see the accountant’s working papers relating to a particular client. In such situations, the accountant should act in the best interests of their client. If they feel that releasing the papers is in the best interests of their client, and the client has no objections, then the papers should be made available. Ultimately, the tax authorities are likely to have legislative powers to obtain the papers. Any lack of co-operation on behalf of the auditor or their client may add to any existing suspicions.

Occasionally, the authorities may ask to see a sample of working papers from a firm of accountants but not in relation to any particular client. This may occur when the authorities have doubts about the quality of the work performed by that practice. Again, a ‘best interest’ approach should be adopted, allowing the authorities to review the papers if the accountant judges that this is in the best interests of the practice and its clients.

An appropriate practical compromise may be achieved in this situation by arranging for an independent accountant to review the work and issue a report to the authorities.

3.5 Conflicts of Interest

Conflicts between members and clients

ICAP members or firms should not accept or continue an engagement where there is a conflict of interest between the member or firm and its client. The test is whether or not a “reasonable and informed third party” would consider the conflict of interest as likely to affect the judgement of the member or the firm.

Examples of this might be:

- when members compete directly with a client
- the receipt of commission from a third party for the introduction of a client (for example, an accounting firm may be paid a commission by another entity, such as a firm of brokers, for introducing the entity to its client companies).

Safeguards

Accountant should have procedures in place to:

- identify possible conflict of interest situations
- evaluate the possible problem, and
where necessary, take action to manage or avoid the conflict.

Possible procedures include the following:

- Review relationships with all clients on a regular basis.
- Take care to consider potential conflicts of interest when deciding whether or not to take on new clients.
- If a potential conflict is identified, decide on an appropriate course of action. An appropriate course of action may be any of the following:
  - Notify the clients involved and discuss the matter with them.
  - Set up ‘Chinese walls’ to manage the problem. A Chinese wall is set up by using different members of staff on the assignments for each of the clients and locating them in different offices. The two groups of staff act independently of each other and do not communicate with each other except in an official capacity.
  - Consider resigning (or declining the new engagement offered) in respect of one of the two competing clients.

**Conflicts between competing clients**

A firm might act for two clients that are in direct competition with each other. The firm has a professional duty of confidentiality and so will not disclose confidential information about one client company to its competitor. Again, the test is whether a “reasonable and informed third party” would consider the conflict of interest as likely to affect the judgement of the firm.

The approach that the accounting firm should take will be a matter of judgement and should reflect the circumstances of the case. Where the acceptance or continuance of an engagement would **materially prejudice the interests of any client**, the appointment should not be accepted or continued.

In other cases, possible **safeguards** might include the following:

- Giving careful consideration to whether or not it is appropriate to accept an assurance engagement from a new client that is in direct competition with an existing client, it may be appropriate to decline the offer from the potential new client.
- Careful management of the clients, for example by ensuring that different members of staff are used on the two engagements.
- Full and frank disclosure to the clients of the potential conflict, together with suitable steps by the firm to manage the potential conflict of interest.
- Procedures to prevent access to information (such as physical separation of the teams and confidential and secure data filing). Such an approach is known as creating “Chinese walls”.
- Establishing clear guidelines on security and confidentiality and the use of confidentiality agreements.
- Regular review of safeguards in place.
- Advising one or both clients to seek additional independent advice.
4 CORPORATE FINANCIAL ADVICE

Section overview

- Advising clients involved in take-over bids or share issues

4.1 Advising clients involved in take-over bids or share issues

Auditors are often asked to give corporate finance advice. However, as you saw earlier, certain types of corporate finance services may create such significant advocacy and self-review threats that the work should not be taken on, such as:

- promoting, dealing in or underwriting an assurance client’s shares
- committing an assurance client to the terms of a transaction or completing a transaction on an assurance client’s behalf.

Where clients are involved in a contested take-over bid, the auditors could find themselves in a position where they are potentially acting for both parties.

In this situation:

- there is a danger that the firm cannot give objective professional advice in the best interests of both parties (a possible lack of independence)
- the firm may be in possession of confidential information relating to each party, with a risk that the information may inadvertently become available to the other party (a possible breach of confidentiality).

Guidelines in this area are as follows:

- There is no reason, in principle, why firms should not act for both parties when a contested takeover bid occurs. However, a firm should not be the sole or main advisor to both parties.
- If the accountants are in possession of material confidential information and feel that their position in this respect is questionable, they should take advice from the appropriate financial regulatory authority (for example, the stock exchange involved in the take-over or the national regulator of the financial markets).

Similar conflicts of interest may arise in connection with issues of shares to the public, because the accountants may be advising both the company issuing the shares and potential investors (such as companies interested in buying an investment in the shares or investment institutions).
5  CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Describe the fundamental principles of the ICAP Code of Ethics
- Apply the conceptual framework to identify threats to the fundamental principles and suggest appropriate safeguards across a range of common scenarios
## Professional responsibility and liability

### Contents

1. Auditors' liability and the expectations gap
2. Fraud and error: ISA 240
3. The auditor’s liability
4. Managing the auditor’s liability
5. Chapter review
INTRODUCTION

Learning outcomes

Performance of audit - general

A (a) 11 Responsibility to consider fraud

Exam context

This chapter relates to practice management. Students need to understand where an auditor’s liability may arise (both criminal and civil) and how to manage that liability.

Students will re-visit the expectations gap in the concept of liability and also learn the application of ISA 240 in depth.

By the end of this chapter students will be able to:

- Explain what the expectation gap is and how it arises
- Apply the provisions of ISA 240
- Describe where an auditor’s liability may arise (both criminal and civil) and explain how it can be managed
1 AUDITORS’ LIABILITY AND THE EXPECTATIONS GAP

Section overview

- Introduction
- The expectations gap
- Closing the expectations gap
- IAASB Q&A: Professional scepticism in an audit of financial statements

1.1 Introduction

This chapter deals with a number of aspects of law and regulation under which auditors:

- may have penalties imposed on them for a criminal offence, or
- may have legal claims made against them (for ‘damages’) for negligence.

The potential liability of auditors has become an important topic in recent years, due to the growing complexity of the business and legal environment and an increase in legal actions against auditors.

One explanation put forward to explain the high number of legal actions against auditors is the ‘expectations gap’.

1.2 The expectations gap

The expectations gap is the difference (or ‘gap’) between:

- what the users of financial statements and other members of the public think that the auditors should do, and
- what the auditors are actually required by the law and the profession to do.

There are three main elements in the expectations gap:

- A **standards gap**. This occurs because of a perception that auditing standards are more prescriptive than they actually are, and that auditors have wide-ranging rules that they must follow:

- A **performance gap**. This occurs because of a perception that audit work has fallen below the required standards.

- A **liability gap**. This arises from a lack of understanding about the auditor’s liability and who the auditor may be liable to.

In addition, there is a perception that auditors have a responsibility for detecting all **frauds**, whenever they occur.

High levels of expectation about what auditors should do may lead to legal action against auditors if this level of expectation is not met. To reduce the frequency and cost of legal action, and to maintain the image of the audit profession in the mind of the public, it is in the interests of the profession to take steps to close the expectations gap.
1.3 Closing the expectations gap

A number of strategies exist that could assist in closing the expectation gap and are discussed below.

- The profession should attempt to improve the general level of knowledge and understanding about the audit process. One such attempt has been made with the issuance of ISA 700, the auditing standard on auditor’s reports. This requires the audit report to include an explanation of the nature of an audit.

  The revised ISA 700 (see later chapter on current affairs) extends the description of the nature of an audit and provides more useful and relevant information about the audit to users.

- Controls over the auditing profession are important in enhancing public confidence. For example:

  * The European Union requires the audit of companies whose shares are quoted on a stock market in the EU to be conducted in accordance with international auditing standards (ISAs);
  * National oversight bodies such as PCAOB (Public Company Accounting Oversight Board) in USA and FRC (Financial Reporting Councils) in the UK monitor the compliance of audit firms in their conduct of audits by performing audit inspections;

- Significant guidance for auditors and management aimed at increasing quality and addressing issues such as going concern has been issued by standard setters, professional bodies and regulators. There has been an increased focus on corporate governance and the role that audit committees play in companies, reducing inconsistencies and enhancing the quality of audits.

- Open and candid communication between internal and external auditors, financial management and the audit committee is increasingly being seen as critical in helping reduce the expectation gap. Such communication helps the audit committee to perform their governance role with the necessary transparency and realistic expectations that will help achieve effective risk management.

- Enhanced communication between the parties and confirmation of their respective roles and responsibilities should be presented in the audit committee and directors’ reports to the shareholders. This will ensure that users become much more aware of the various parties’ roles and responsibilities beyond the understanding they gain just from the audit report.

- The expectation gap will hopefully narrow further as financial reporting participants work together even more effectively to improve the deterrence and detection of financial reporting fraud.

The level of success in narrowing the expectation gap is likely to vary considerably between territories depending on factors such as culture, ethics, the level of incidence of governance mechanisms beyond the minimum required by law and regulation and the quality, availability and transparency of corporate reporting.

One thing that is certain is that audit committees are well positioned to play a vital role in reducing the expectation gap given their open and direct relationship with all the key parties including shareholders, board of directors, internal audit and
external audit. This is also because audit committees include an appropriate mix of independent and/or non-executive directors to add the necessary transparency and impartiality which is required for stakeholders’ confidence in the overall financial reporting process and the audit itself.

1.4 IAASB Q&A: Professional scepticism in an audit of financial statements

The IAASB issued a Q&A-style briefing paper on professional scepticism in 2012 which articulates the meaning and application of professional scepticism in the audit of financial statements.

The Q&A focuses on considerations in the ISAs and the IAASB’s quality control standard that are of particular relevance to the proper understanding and application of professional scepticism during an audit of financial statements.

Q&A

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<th>Question</th>
<th>Answer</th>
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<tr>
<td>1. What is professional scepticism?</td>
<td>The ISAs define professional scepticism as “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.” They explicitly require the auditor to plan and perform an audit with professional scepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.</td>
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<td>2. Why is professional scepticism important in audits of financial statements?</td>
<td>Professional scepticism plays a fundamentally important role in the audit and forms an integral part of the auditor’s skill set. Professional scepticism is closely interrelated with professional judgment. Both are essential to the proper conduct of the audit and are key inputs to audit quality. Professional scepticism facilitates the appropriate exercise of professional judgment by the auditor, particularly regarding decisions about, for example:</td>
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- The nature, timing and extent of audit procedures to be performed.

- Whether or not sufficient appropriate audit evidence has been obtained and whether or not more needs to be done to achieve the objectives of the ISAs.

- The evaluation of management’s judgments in applying the entity’s applicable financial reporting framework.

- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.
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| 3. What can be done by audit firms and auditors to enhance the awareness of the importance of professional scepticism and its application? | Professional scepticism within the engagement team is also influenced both by the actions of the firm’s leadership and the engagement partner, and by the culture and business environment of the firm. The ISAs and ISQC 1 include requirements and guidance designed to help create an environment at both the firm and engagement levels in which the auditor can cultivate appropriate professional scepticism. For example:  
- Auditors must consider the integrity of the principal owners and management during engagement acceptance (ISQC 1)  
- The auditor must consider the reasonableness of significant assumptions used by management for accounting estimates giving rise to significant risks (ISA 540)  
- ISA 240 (relating to fraud) notes that the auditor must maintain an ongoing questioning mind and be alert to the possibility of fraud  
- When considering going concern (ISA 570) the auditor must consider the reasonableness of assumptions and whether management’s plans are feasible in the circumstances  
- Another area where professional scepticism is particularly important is in relation to auditing significant unusual or highly complex transactions (ISA 330)  
- The auditor is required to document how they have applied professional scepticism (ISA 230). |
| 4. At what stage in the audit process is professional scepticism necessary? | Professional scepticism is relevant and necessary throughout the audit, even though reference to it is not repeated within each ISA, including:  
- Engagement acceptance – integrity of owners and management  
- Identifying and assessing risks of material misstatements  
- Designing nature, timing and extent of further audit procedures that are responsive to assessed risks of material misstatement, and evaluating audit evidence  
- Forming the audit opinion. |
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<td>5. How does professional scepticism relate to the auditor's responsibilities with respect to fraud?</td>
<td>Due to the characteristics of fraud, including the fact that fraud may include sophisticated and carefully organised schemes designed to conceal it or may involve collusion, the auditor’s professional scepticism is particularly important when considering the risks of material misstatement due to fraud. ISA 240 places special emphasis on professional scepticism.</td>
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<td>6. In addition to fraud, are there other aspects of an audit where professional scepticism may be particularly important?</td>
<td>Professional scepticism is important and necessary throughout the entire audit process. The auditor’s professional scepticism becomes particularly important when addressing areas of the audit that are more complex, significant or highly judgmental such as: - Accounting estimates e.g. fair value - Going concern – e.g. management’s plans for future actions - Related party relationships and transactions – e.g. business rationale - Consideration of laws and regulations - When auditing significant unusual or highly complex transactions.</td>
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<tr>
<td>7. How can the application of professional scepticism be evidenced?</td>
<td>Professional scepticism is often demonstrated in the various discussions held by the auditor during the course of an audit. For example, the auditor’s communication with TCWG includes, where applicable, why the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework not to be most appropriate to the particular circumstances of the entity. Documentation remains critical. The ISAs require auditors to document discussions of significant matters with management, TCWG, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. Such documentation helps the auditor demonstrate how significant judgments and key audit issues were addressed and how the auditor has evaluated whether sufficient and appropriate audit evidence has been obtained. Examples of circumstances where it is particularly important to prepare documentation:</td>
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<td>- Significant decisions from engagement team discussions regarding fraud</td>
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<td>- Identified or suspected non-compliance with laws and regulations</td>
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<td>- Basis of auditor’s conclusions about estimates</td>
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<td>- Identifying information that is inconsistent with the auditor’s final conclusions on a significant matter</td>
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<td>- Reasonableness of areas of subjective judgments</td>
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8. Do regulators and oversight bodies of audit firms and those charged with governance have a role to play in supporting sceptical behaviour among auditors?

The ISAs do not set forth requirements for regulators and oversight bodies of the audit firms, or for TCWG. However because of the critical role that those stakeholders serve in achieving audit quality, they are in a position to further challenge auditors.
2 FRAUD AND ERROR: ISA 240

Section overview

- The distinction between fraud and error
- Responsibilities of management and auditors for fraud and error
- Risk assessment procedures
- Responding to assessed risks
- The auditor's procedures where fraud or error is suspected
- Professional scepticism and fraud
- Reporting fraud

2.1 The distinction between fraud and error

ISA 240 The auditor’s responsibilities relating to fraud in an audit of financial statements regulates this area. It makes the following distinction between fraud and error:

**Fraud**: may be defined as intentional acts involving the use of deception to obtain an unjust or illegal advantage. This may involve:

- fraudulent financial reporting
- misappropriation of assets.

Both types of fraud can result in material misstatements in the financial statements.

Fraudulent financial reporting includes:

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

Fraudulent financial reporting often involves management override of controls.

Misappropriation of assets includes:

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

**Error** may be defined as:

- unintentional misapplication of accounting policies
- oversights
- unintentional clerical errors, or
- misinterpretation of facts.
The key distinction between fraud and error is therefore whether the effect on the financial statements is deliberate (fraud) or unintentional (error). However, there may be little or no difference between fraud and error as far as the impact on the audit is concerned. In both cases the auditor will be concerned about the impact on the ‘true and fair view’ presented by the financial statements.

The main difference between fraud and error may arise in relation to any national reporting requirements. There may be requirements to report suspicions of fraud, but not error.

### 2.2 Responsibilities of management and auditors for fraud and error

**Responsibilities of management**

Management is responsible for preparing financial statements that show a ‘true and fair view’. This role is reinforced by principles of good corporate governance, which require management to set up appropriate systems and controls. **Management** is therefore responsible for the prevention and detection of fraud and error.

**Responsibilities of the auditor**

The auditor is responsible for reporting on whether the financial statements show a ‘true and fair view’. The auditor is therefore only concerned with fraud and error that has a material effect on the true and fair view.

The auditor’s responsibility is to obtain reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.

It is not the primary responsibility of the auditor to prevent or detect fraud or error, although the audit may act as a deterrent to fraud. Auditors may also discover error or fraud during the course of their audit work, but they are by no means certain to do so whenever error or fraud has occurred.

It must be recognised that some material misstatements caused by fraud or error may go undetected, because of the inherent limitations in any audit and the fact that deliberate attempts may be made to conceal fraud from the auditor.

ISA 240 states the responsibilities of management and the auditor as follows:

- ‘The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.’
- ‘An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.’

### 2.3 Risk assessment procedures

The auditor is required by ISA 240 to carry out certain risk assessment procedures:

- The auditor shall make inquiries of management regarding:
  - Management’s assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments;
• Management’s process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist;
• Management’s communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and
• Management’s communication, if any, to employees regarding its views on business practices and ethical behaviour.

The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.

For those entities that have an internal audit function, the auditor shall make inquiries of appropriate individuals within the function to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud.

Unless all of those charged with governance are involved in managing the entity, the auditor shall obtain an understanding of how those charged with governance exercise oversight of management’s processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.

Unless all of those charged with governance are involved in managing the entity, the auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud.

2.4 Responding to assessed risks

ISA 240 describes responses to address the risks of material misstatement due to fraud at both the overall and assertion level. For example:

In accordance with ISA 330, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level.

In determining the overall response, the auditor should:
• assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement;
• evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management’s effort to manage earnings; and
- incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures.

- Assertion level responses include:
  - testing the appropriateness of journal entries.
  - reviewing accounting estimates for bias.
  - evaluating significant transactions that are outside the normal course of business for the entity.

Depending on the nature of the circumstances the auditor should also consider whether it is appropriate to continue the engagement or whether they should withdraw. They may need to seek legal advice in order to establish an appropriate course of action.

2.5 The auditor’s procedures where fraud or error is suspected

Irregularities

The auditor may identify irregularities during the execution of the audit. These may be situations in which rules, laws or the usual way of doing things have not been followed, or something was identified that the auditor was not expecting. Irregularities may occur for many reasons, for example due to fraud, error or even legitimate business reasons. The auditor must investigate the irregularity to establish whether it reflects a misstatement.

Fraud risk factors

ISA 240 states that fraud involves:

- Incentive or pressure to commit fraud – for example, management may be under pressure from sources outside or inside the entity to achieve an expected (and perhaps unrealistic) earnings target or financial outcome. This may be necessary to trigger a management bonus, or to avoid breaching a loan covenant.

- The opportunity to commit fraud – for example, a perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.

- Rationalisation for committing a fraudulent act. Some individuals may possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. For example, someone may feel aggrieved that they did not receive a bonus they think they were entitled to and hence rationalise theft as taking ‘what is owed’.
The fraud triangle

The above-mentioned factors are what are also sometimes known as components of the 'fraud triangle' as developed by Donald R. Cressy in their 1950’s research into why people commit fraud.

The fraud triangle

Pressure
Opportunity
Rationalisation
Fraud Triangle

Examples of the three factors include:

- **Pressure**
  - Financial – major bills, high level of debt or simple greed;
  - Personal – gambling or other addiction;
  - Work-related – feeling overworked and underpaid; passed over for a promotion.

- **Opportunity**
  - Trust – person has reached a certain level within the organisation;
  - Internal controls – either weak or non-existent.

- **Rationalisation**
  - Justification - “I’m only borrowing the money. I’ll give it back when my financial situation improves.”
  - Lack of ethics – “Management isn’t honest, so why should I be?”

**ISA 240 Appendix 1 - fraud risk factors**

Appendix 1 of ISA 240 provides examples of fraud risk factors. Note that whilst extensive, the list of examples is not meant to be exhaustive and other examples of risk factors might exist for a particular client.

Some examples of risk factors relating to misstatement arising from fraudulent financial reporting include:

- **Incentives/pressures**
  - Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as a high degree of competition or market saturation, accompanied by declining margins, or operating losses making the threat of bankruptcy, foreclosure or hostile takeover imminent.
  - Excessive pressure exists for management to meet the requirements or expectations of third parties due, for example, to the need to obtain additional debt or equity financing to stay competitive or the marginal ability to meet exchange listing requirements or debt repayments (or other debt covenant requirements).
• Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from, for example, significant financial interests in the entity or personal guarantees of debts of the entity.
• There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

- **Opportunities**
  - The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting, for example, where there are significant related-party transactions not in the ordinary course of business, significant unusual or highly complex transactions (especially those close to period end) or use of business intermediaries for which there appears to be no clear business justification.
  - The monitoring of management is not effective, for example as a result of domination of management by a single person, or the ineffectiveness of the oversight provided by those charged with governance.
  - There is a complex or unstable organizational structure for example evidenced through high turnover of senior management, legal counsel or those charged with governance.
  - Deficient internal control components as a result of, for example, inadequate monitoring of controls, high turnover rates or employment of ineffective staff in accounting and information technology.

- **Attitudes/rationalizations**
  - Ineffective communication of the entity's values or ethical standards by management.
  - Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
  - Low morale among senior management.
  - Disputes between shareholders in a closely held entity.
  - Relationship between management and the current or predecessor auditor is strained, for example due to frequent disputes, unreasonable demands, restrictions placed on the auditor with inappropriate deadlines, or domineering management behaviour in dealing with the auditor.

Some examples of risk factors relating to misstatement arising from misappropriation of assets include:

- **Incentives/pressures**
  - Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.
  - Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those
employees to misappropriate those assets. For example, adverse relationships may be created by the following:
- Known or anticipated future employee layoffs.
- Recent or anticipated changes to employee compensation or benefit plans.
- Promotions, compensation, or other rewards inconsistent with expectations

- Opportunities

• Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
  - Large amounts of cash on hand or processed.
  - Inventory items that are small in size, of high value, or in high demand.
  - Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
  - Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

• Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
  - Inadequate segregation of duties or independent checks.
  - Inadequate oversight of senior management expenditures, such as travel and other re-imbursements.
  - Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
  - Inadequate job applicant screening of employees with access to assets.
  - Inadequate record keeping with respect to assets.
  - Inadequate system of authorization and approval of transactions (for example, in purchasing).
  - Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
  - Lack of complete and timely reconciliations of assets.
  - Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
  - Lack of mandatory vacations for employees performing key control functions.
  - Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
Audit, Assurance and Related Services

- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

- Attitudes/rationalizations
  - Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
  - Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
  - Behaviour indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
  - Changes in behaviour or lifestyle that may indicate assets have been misappropriated.
  - Tolerance of petty theft.

Illustration: Fraud risk factors
A recent depression in the oil price has severely impacted ConstructaCo’s performance. There is now a risk that a profit-warning may need to be issued and directors’ bonuses will not be paid.

Sadeeq, the finance director, is subsequently under pressure from the other directors to find a way to report inflated profits including a net margin of at least 5.3%.

Due to weak internal controls, Sadeeq uses a number of accounting techniques to fraudulently present the financial statements, including:

- Accounting for profits early on long-term contracts;
- Deferring the recording of a number of expenses to the subsequent accounting period (incorrect cut-off); and
- Releasing a large warranty provision one year early.

Sadeeq recently commented to a fellow director:

“Whilst it’s necessary to ensure bonuses are paid so we don’t lose key executives to our competitors, we also need to protect employees from short-term panic in the market as they are all shareholders of the company. The situation will reverse next year as the oil price rebounds”.

ConstructaCo’s situation demonstrates a number of fraud risk factors such as:

Pressure
- The need to deliver a return on investment of 5.3% to ensure directors’ bonuses are paid; and
- The need to inflate profits to avoid a profit warning.

Opportunity
- Weak internal controls which enable fraudulent accounting to occur.

Rationalisation
- The need to retain key executives and protect employees;
- The situation will reverse next year.
Having identified the risks of material misstatement due to fraud the auditor must then, per ISA 330, design and perform further audit procedures to address those risks.

If an external auditor discovers fraud, it must be reported to an appropriate level of management as soon as practicable. The auditor must also consider whether there is any statutory duty to report to the authorities.

**Procedures when fraud or error is suspected**

The auditor should take the following steps when fraud or error is suspected:

- Identify the extent and possible impact on the financial statements of the fraud or error. Document the facts fully in the audit files. Additional testing may be required to establish the likely extent of any misstatement.

- Consider the possible impact on other areas of the audit and on the overall assessment of audit risk. This may result in a revision to the original audit plan.

- The findings should be discussed with management, regardless of the extent of the problem, and management should be kept informed of developments.

- The auditor should determine the action that management should take. This should include the possibility of seeking legal advice if fraud is suspected.

- The auditor should normally communicate on a formal basis to management at an appropriate level. In the case of a company, the auditor communicates formally with the board of directors or the audit committee. However, if management themselves are involved in a suspected fraud, the auditor should consider taking legal advice to decide the best course of action. In extreme cases, the auditor may feel it is appropriate to resign.

- The auditor should consider the impact on their audit report to the shareholders, in terms of any impact on the true and fair view presented by the financial statements.

- The auditor should consider whether there is any requirement to report to appropriate authorities. This must be considered in the context of the auditor’s duty of confidentiality to their client.

**2.6 Professional scepticism and fraud**

In accordance with ISA 200, the auditor shall maintain professional scepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor’s past experience of the honesty and integrity of the entity’s management and those charged with governance.

- The audit team should discuss the possibility of fraud in the context of the specific characteristics of the audit engagement.

- Discussions should be held with management on the procedures (controls) in place to detect or prevent fraud.

- The risks of possible fraud should be identified and its possible impact on the financial statements should be evaluated.

- Audit procedures should be designed to obtain evidence that fraud, which may impair the financial statements, has not occurred, or has been detected and corrected (or disclosed in the financial statements).
2.7 Reporting fraud

Written representations

The auditor shall obtain written representations from management and, where appropriate, those charged with governance that:

- They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;
- They have disclosed to the auditor the results of management’s assessment of the risk that the financial statements may be materially misstated as a result of fraud;
- They have disclosed to the auditor their knowledge of fraud, or suspected fraud, affecting the entity involving:
  - Management;
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the financial statements; and
- They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity’s financial statements communicated by employees, former employees, analysts, regulators or others.

Communications to Management and Those Charged with Governance

If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:

- management;
- employees who have significant roles in internal control; or
- others where the fraud results in a material misstatement in the financial statements,

the auditor shall communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit.

Communications to Regulatory and Enforcement Authorities

If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity such as a regulator or enforcement authority. Although the auditor’s professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor’s legal responsibilities may override the duty of confidentiality in some circumstances.
3 THE AUDITOR’S LIABILITY

Section overview

- Introduction
- Criminal liability
- Civil liability

3.1 Introduction

Legal claims made against auditors fall within one of two legal strands:

- The auditor may be prosecuted by the authorities for a criminal act, and be criminally liable if found guilty. (The penalty may be a fine, or possibly imprisonment for a guilty individual.)
- The auditor may be liable under civil law. A ‘civil’ legal action may be brought against an auditor by another person who has suffered loss or damage because of the auditor’s actions. The person bringing the legal action usually seeks a money payment (‘damages’) from the auditor, to recover their losses they have suffered.

The precise details about an auditor’s criminal and civil liabilities vary from one country to another, depending on national legislation. Whilst ICAP students study Pakistani law relevant to accountants in full in module CAF3 Business Law and CFAP2 Corporate Laws, this section addresses the areas of Pakistani law most directly relevant to Pakistani auditors, in particular liability arising through auditor negligence.

Note that the legal system relating to Pakistani auditors is based on the English legal system with its two main strands:

- Criminal law (e.g. fraudulent trading or insider dealing); and
- Civil law (e.g. contract law and the law of tort)

and laws being established by:

- Statute (e.g. Companies Ordinance 1984); and
- Common law (i.e. precedents set by rulings in previous legal cases).

Whilst the common law cases described below are not necessarily Pakistani cases, they still remain the reference point in today’s Pakistani legal system relevant to auditors.

3.2 Criminal liability

Examples of when the auditor may be criminally liable include:

- Where they accept appointment as auditor under a statutory provision without being qualified to act.
- Where they are involved in fraud, such as falsifying accounting documents or records.
- Where they are guilty of ‘insider dealing’. The criminal law of many countries makes it an offence for a person with inside knowledge of price-sensitive information to use or pass on that information. Insider dealing is also prohibited under the IFAC and ICAP rules of professional conduct.
Auditing practices should take suitable steps to reduce the risk of insider dealing. For example, it is normal practice for audit firms to impose restrictions on the amount of shares that their staff may hold in client companies and to require staff to declare all their shareholdings.

Criminal liability may also arise for certain offences relating to:
- the winding up of a company
- tax law
- financial services legislation, in areas such as dealing in investments or giving investment advice
- Money laundering (as discussed in Chapter 2).

3.3 Civil liability

A major threat faced by the auditing profession is the possibility of legal claims against auditors as a result of negligent (or ‘careless’) auditing.

Contract law and the law of tort

An auditor may face legal claims for losses suffered as a result of negligent auditing under two separate branches of law: contract law and the law of tort. A summary of the position is as follows:

**Contract law**

A company has a contract with its external auditor for the provision of audit services. It can therefore sue the auditor for breach of contract if the auditor is negligent in carrying out the terms of the contract.

Note that only the company can sue the auditor for a breach of contract. Other persons (third parties) who might want to sue an auditor, such as banks, creditors and shareholders, do not have a contract with the auditor; therefore they cannot bring a legal action under the law of contract.
When a legal action is brought against an auditor by a company for breach of contract (negligence), the action is usually initiated by the board of directors of the company.

**Standards of skill and care**

When carrying out their duties for a client, the auditors must exercise reasonable care and skill. IFAC and ICAP’s codes of ethics require that members should carry out their professional work with **professional competence and due care** and with proper regard for the technical and professional standards expected of them as members.

The degree of skill and care expected of an auditor in a particular situation depends on the circumstances. There is no general standard of skill and care; the auditor is expected to react to the situation and the particular circumstances that they are facing.

In general, if the auditor has followed auditing standards and can demonstrate this in their working papers, they will not usually be found guilty of negligence. This is why it is so important for the auditor to ensure that they maintain adequate working papers and obtain sufficient, relevant and reliable evidence to support their audit opinion.

**Liability in tort**

Only the client company can sue the auditor in the **law of contract**, because only the company has a contract with the auditor. Third parties who feel they may have suffered as a result of negligent auditing have to rely on a different branch of law – the **law of tort**. An important question is: ‘To what extent can others rely on the civil law, and bring an action for negligence against the auditors of a company?’

A **tort can be defined** as a ‘civil wrong’ other than that arising under contract law, giving rise to a claim for damages. (A civil wrong is wrongdoing that is not a criminal offence, but which allows the injured person to bring an action in civil law against the wrongdoer.) **Negligence** is just one of many branches of tort.

Examples of other persons who may suffer loss because of an auditor’s negligence and relying on financial statements that do not give a true and fair view are:

- A bank that lends money to a company, and the company subsequently defaults and fails to make payments of interest or repayments of the loan principal
- A supplier who has given credit to the company, whose debts have to be written off as ‘bad’
- Another company who relies on the financial statements when deciding to make a takeover bid for the audited company
- An investor who relies on the financial statements to buy shares in the company, and the share price falls when the true state of the company later becomes apparent

**Making a successful claim for auditor negligence (law of tort)**

If a person is to make a successful claim against the auditor in the tort of negligence, **three conditions** must be satisfied.
Negligence requires

(1) A duty of care exists
(2) That duty is breached
(3) Loss or damage results

- **Condition (1)** – The auditor must owe a duty of care to the person who has suffered a loss due to the auditor’s negligence. The existence of a duty of care has proved the most troublesome of the three conditions to establish, in cases brought before the courts. This is considered in more detail below.

- **Condition (2)** – The duty of care must have been breached. The party bringing the claim against the auditor has to show that the auditor did not exercise a reasonable degree of care in the circumstances, so that the duty of care was breached. A typical method used in court cases to prove that a duty has been breached is to call another firm of auditors as expert witnesses. The expert witnesses are asked to give their view on whether the audit was performed correctly.

- **Condition (3)** – A loss or damage must result from breach of the duty of care. Proving that this condition has been met is usually a question of demonstrating that the person making the claim suffered a financial loss as a result of the negligent auditing. For example, if a bank lent money to a company on the basis of audited accounts that were subsequently found to contain material errors or omissions, and the company subsequently defaulted on its loan, the bank can demonstrate a measurable financial loss.

**Establishing the existence of a duty of care (law of tort)**

Most of the major court cases on auditor negligence have been concerned with the question of whether the auditor owes a duty of care to the ‘plaintiff’. (The plaintiff is the person making the claim for damages.) The cases summarised below, taken from UK law, show how the view of the courts on this question has developed over time, since the 1950s. As mentioned earlier, these cases also form the common law precedent in Pakistan today.

You should concentrate on the principles involved, rather than the details of the cases. Whilst some of the cases do not deal specifically with auditors, the principle established by the court is however applied by the courts to auditors in similar situations.
Illustration: *Candler v Crane Christmas* (1951)

In this case, Candler sued the accountants Crane Christmas when they lost money they had invested in a company. Crane Christmas had prepared the accounts, and it was alleged that they had been negligent in doing so. But were the accountants liable to Candler?

The court ruling was that although the accounts were negligently prepared, Candler could not recover their losses from the accountants because they did not have a contract with them.

Therefore, in the 1950s, the legal view was that an auditor did not owe a duty of care to third parties who were not in a contractual relationship with the auditor.

Illustration: *Hedley Byrne v Heller & Partners* (1964)

This is a case dealing with banks, but it was seen as relevant to all professionals, including auditors and accountants. The plaintiff, Hedley Byrne, lost money when a bank reference from the defendant (Heller & Partners, a bank) turned out to have been negligently produced. The bank indicated in its reference that a mutual client was a good credit risk when this was not the case.

The court ruled that although Hedley Byrne did not have a contract with the bank, Heller & Partners, they could recover their losses due to the negligence and loss involved, because the bank knew the plaintiff by name. However, the bank did not have to pay any damages due to a general disclaimer in its letter (that gave the reference) absolving it from any liability.

This legal decision affected auditors, because the court has decided that if a third party (with whom the auditor did not have a contract) could show that it relied on the work of an auditor which later turned out to be wrong, the auditor might be liable for damages for negligence. However, this principle was only extended to plaintiffs that the auditor actually knew by name. Unidentified third parties were not able to claim against the auditor for negligence.

Illustration: *JEB Fasteners v Marks Bloom* (1980)

In this case, the plaintiff acquired the share capital of a company. The audited accounts, due to the negligence of the auditors, did not show a true and fair view of the state of affairs of the company. It was accepted that, at the time of the audit, the defendant auditors did know of the plaintiffs, but did not know that they were contemplating a take-over bid.

Whilst recognising that the auditors owed a duty of care in this situation, the court decided that the auditors were not liable because the plaintiff had not actually suffered any loss. It was proved that the plaintiffs would have bought the share capital of the company at the agreed price, no matter what the accounts of the company had shown.


*This is seen as a leading case in English law in the area of ‘to whom does the auditor owe a duty of care’.*

Fidelity plc was taken over by Caparo Industries. Fidelity’s accounts had been audited by Touche Ross. Caparo alleged that the accounts overstated the profits of Fidelity plc and that they had relied on the audited accounts of Fidelity when deciding to purchase shares in the company and make a takeover bid.
The court held that a duty of care was not owed to potential investors in a company, or persons making a takeover bid, because of:

- a lack of proximity (a lack of ‘closeness of relationship’) between the auditor and a potential investor, and
- the fact that it would not be just and reasonable to impose a duty on the auditor to such investors.

In the above case, the court identified the auditor’s functions as being:

- to protect the company itself from errors and wrongdoing - not to protect the shareholders of the company from error; and
- to provide shareholders with information such that they can scrutinise the conduct of a company’s affairs and remove or reward those responsible (the directors).

The auditor does not exist to aid investment decisions.

Out-of-court settlements

Large claims against auditors in high-profile cases (such as Enron) receive a high level of publicity. Many other cases are not widely publicised, often because they are settled ‘out of court’. This involves the parties who are in dispute reaching a negotiated settlement, rather than taking their case to court.

The advantages of out-of-court settlements are that:

- it avoids the cost and time involved in a court case
- it may avoid adverse publicity for the auditor
- the final settlement may be lower (because both sides save legal costs, and the plaintiff might agree to a lower settlement to avoid the cost and the risk of losing the case)

The disadvantages of out-of-court settlements are that:

- the final responsibility may be left undecided, so the legal position remains unclear
- it may encourage others to take action against auditors
- insurance premiums may rise.

Example:

An audit firm has been the auditor of Entity AZ for a number of years. Its audit team has recently discovered that during that time, the managing director of AZ has been consistently overvaluing inventories. Entity B has recently purchased a major stake in Entity AZ, relying on the audited financial statements to do so.

Required

What possible defence might the audit firm use if it is sued by Entity B after a successful takeover?
Answer
The audit firm can claim that it did not owe a duty of care to Entity B.
If the audit work has been performed to expected standards, the firm should be able to claim that the audit work was performed with diligence and care, and in accordance with ISAs. The audit work could not reasonably have detected the fraud given its nature and the seniority of the individual committing the fraud.
The firm might also be able to claim that Entity B has not suffered any financial loss as a result of its reliance on the audited financial statements.

Use of disclaimers in audit reports
A disclaimer is not a requirement of an audit report, but some audit reports include one. A disclaimer states that:
- the auditor's report is intended for use of the company and the company's shareholders as a body, and
- no responsibility is accepted by the auditor to anyone except the company or the shareholders as a body for the content of the report.

The purpose of a disclaimer is to reduce the risk of legal claims by 'third parties' against the auditor for negligence.
The main problem with a disclaimer however is that a disclaimer cannot guarantee protection for an auditor against third party claims, because the circumstances of each individual claim may be different.
4 MANAGING THE AUDITOR’S LIABILITY

Section overview

- Avoiding liability
- Meeting claims: professional indemnity insurance
- Fidelity Guarantee Insurance
- Limiting liability

4.1 Avoiding liability

Clearly, it is preferable to avoid claims arising for negligent auditing. Firms can minimise the risks of being sued by ensuring that their staff perform high-quality audit work. Auditors should therefore:

- follow appropriate auditing standards
- use effective quality control procedures
- train staff to an appropriate level of knowledge and skill
- adopt robust client acceptance procedures
- issue appropriate disclaimers
- ensure that the firm is up-to-date with modern auditing methods.

4.2 Meeting claims: professional indemnity insurance

If successful legal claims are made (or if out-of-court settlements are reached, where the audit firm agrees to make a payment to settle the dispute) the auditor will have to pay damages. If the damages are so large that they are more than the firm can afford, the law in some countries may also allow claims to be made against the personal assets of partners of the audit firm.

The threat of very high claims for damages, beyond the financial means of the audit firm, applies to the major audit firms as well as smaller firms.

The professional accountancy bodies take the view that the image of the profession would be seriously damaged if claims awarded against auditors and accountants are not met because of a lack of financial resources. As a result, professional bodies often require members in practice to carry professional indemnity insurance (PII).

PII is an insurance policy that provides cover against all civil liabilities that are incurred as a result of the conduct of the firm’s business. Money is paid out by the insurance firm on these policies if the firm itself is unable to pay.

However, the requirement for compulsory PII has the following disadvantages:

- It may increase the frequency and size of claims made against firms, which are seen to have large amounts of funds at their disposal to meet claims.
- It may encourage more careless auditing.
- It imposes a high cost on audit firms. These costs of insurance are likely to increase as the general level of legal claims rises.
4.3 Fidelity Guarantee Insurance

Fidelity Guarantee Insurance is another tool that can be used to limit an auditor’s professional liability. Fidelity Guarantee Insurance provides protection for an employer (in this case the audit firm) against direct financial losses suffered due to an employee’s dishonesty, theft and/or fraud in the course of their employment.

4.4 Limiting liability

Because of the high costs of legal claims and professional indemnity insurance, a number of suggestions have been made for finding other ways of limiting claims against auditors.

- One suggestion is that there should be a statutory limit on claims, either a maximum percentage of the audit fee or a maximum fixed amount.
- Another suggestion is that auditors should be permitted to agree a ‘cap’ (limit) on their liability with their clients, so that a company cannot make a claim against its auditors for more than the agreed amount (cap).
  
  For example, a company and its auditors in the UK can now agree to a specified monetary sum as a cap on the auditors’ liability.

- The use of ‘limited liability partnerships’ whereby an audit firm that is structured as a limited liability partnership cannot lose more than its total fixed capital. This is similar to limited liability for companies.

- The use of the equivalent of PII for directors of client companies. This may expose the directors of companies to legal actions by other parties, rather than the audit firm, because the plaintiffs will know that the directors can afford to pay any successful claims for negligence.

- Including disclaimers of liability to parties other than the company and its shareholders in the auditors’ report.
5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Explain what the expectation gap is and how it arises
- Apply the provisions of ISA 240
- Describe where an auditor’s liability may arise (both criminal and civil) and explain how it can be managed
Certified Finance and Accounting Professional
Audit, Assurance and Related Services

CHAPTER 5

Practice management

Contents

1 Quality control: ISA 220 and ISQC 1
2 Changes in professional appointment
3 Obtaining and charging for professional work
4 Agreeing the terms of audit engagements: ISA 210
5 Chapter review
INTRODUCTION

Learning outcomes

Performance of audit - general
A (a) 3 Agreeing the terms of Audit engagement.

Professional ethics, Quality Control and current development
E 2 Quality control – ISQC 1, ISA 220, quality control framework of ICAP, Quality Assurance Board of ICAP.
E 3 Acceptance and continuance of client including legal, professional and ethical consideration relating to appointment and removal of auditor.

Exam context
This chapter continues the theme of practice management introduced in the previous chapter.

You need to fully understand the system of quality control used in an accountancy firm incorporating ISQC1, ISA 220 and also have an overview of the quality control framework of ICAP.

You also need to understand the commercial, legal and ethical parameters around changes in professional appointment and the process of obtaining and charging for professional work.

By the end of this chapter students will be able to:

- Describe the components of a system of quality control applied to a firm of accountants performing audit and assurance engagements
- Explain the process around changes in professional appointment including the legal, commercial and ethical considerations
- Apply ISA 210 in agreeing the terms of an engagement
- Summarise the procedures for agreeing the terms of non-audit engagements
1 QUALITY CONTROL: ISA 220 AND ISQC 1

Section overview

- The need for a quality control system in accountancy firms
- Quality control procedures
- Quality control arrangements for individual engagements: ISA 220
- Quality control arrangements at the overall firm level: ISQC 1
- Quality control procedures specific to individual engagements
- Quality control in large accountancy firms and small accountancy firms
- IAASB Q&A: Applying ISQC 1 proportionately with the nature and size of a firm
- The IAASB’s Framework for Audit Quality
- Quality control framework of ICAP

It is important to remember that a firm of external auditors is a business, whose objective is to make a profit. This business is subject to regulation, such as the regulation of quality control and fees regulations, and the nature of the regulations may influence the way the business is managed.

This chapter looks at ‘business’ aspects of running an audit practice that are sometimes referred to as ‘managing the client-auditor relationship’.

1.1 The need for a quality control system in accountancy firms

The IFAC and ICAP codes of ethics both require that members should perform their professional work with due skill and care and with a proper degree of technical competence.

Audit work may be performed by members of a large team of auditors (the ‘engagement team’). If so, the members may have different levels of knowledge and experience. To satisfy the professional requirements for due skill and care and technical competence, audit firms need to have a strong system of quality control.

Good procedures for quality control should reduce the risk for the audit firm that it will:

- issue an incorrect audit opinion, and
- be sued for negligence.

The consequences of poor audit work and legal action by the client could be any (or all) of the following:

- legal damages and legal costs
- the loss of the client
- adverse publicity and damage to the reputation of the audit firm
- disciplinary proceedings by a professional body such as ICAP

It is also important for the audit profession as a whole that all audit firms should have good procedures for quality control. If the profession as a whole gained a reputation for poor quality audits, its public image would be damaged.
1.2 Quality control procedures

Quality control procedures can be considered at two levels:

- each individual audit engagement
- the audit firm as a whole.

1.3 Quality control arrangements for individual engagements: ISA 220

The objective of the auditor as set out in ISA 220 Quality control for an audit of financial statements is to implement quality control procedures at the engagement level to provide reasonable assurance that:

- the audit complies with professional standards and applicable legal and regulatory regulations, and
- the audit report issued is appropriate.

This means that quality control procedures should be implemented that are applicable to the individual audit engagement.

ISA 220 places the responsibility for key quality control matters on the engagement partner. The engagement partner has responsibility for the overall quality of the audit and is required to put procedures in place to ensure that:

- ethical standards are complied with and appropriate action taken if there is evidence to the contrary
- independence requirements are met, including:
  - identifying circumstances and relationships that might give rise to threats to independence
  - assessing the impact of breaches of the firm’s independence policies and procedures and whether such breaches create a threat to independence
  - taking suitable action to eliminate identified threats or to withdraw from the engagement if appropriate
- procedures are in place to deal with the acceptance of new engagements and the continuance of existing engagements
- the audit is carried out by an audit team with the appropriate competence and capabilities
- appropriate management of the engagement is in place, including the direction and supervision of staff and the review of audit work. On or before the date of the audit report the engagement partner must, through a review of audit documentation and discussion with the audit team be satisfied that sufficient, appropriate evidence has been obtained to support the conclusions reached
- adequate consultation has taken place on difficult or contentious matters and the conclusions from such consultation implemented
- an appropriate monitoring system is in place
- the following matters are documented:
  - issues in respect of compliance with ethical requirements and how they were resolved
  - conclusions on compliance with independence requirements
• conclusions in respect of new and continuing engagements
• the nature and scope of conclusions from consultations undertaken.

For audits of listed companies, and any other audits where the firm has determined that an engagement quality control review is required, the engagement partner is also required to appoint an engagement quality control reviewer, who:

- performs an objective evaluation of the significant judgements made by the audit team and the conclusions reached, including:
  - discussion of significant matters with the engagement partner
  - review of the financial statements and the proposed audit report
  - review of selected audit documentation relating to significant judgments
  - an evaluation of the conclusions reached and whether the proposed audit report is appropriate
- considers the engagement team’s evaluation of the firm’s independence in relation to the audit engagement;
- considers whether appropriate consultation has taken place on difficult or contentious matters; and
- considers whether audit documentation selected for review reflects the work performed and the conclusions reached.

The engagement quality control reviewer is required to document confirmation that:

- the firm’s procedures in respect of engagement quality control reviews were followed
- the review was completed on or before the date of the audit report
- they are not aware of any unresolved matters that would cause them to believe that the significant judgements made by the audit team and the conclusions they reached were inappropriate.

More detail on many of the above procedures is given in a later section.

1.4 Quality control arrangements at the overall firm level: ISQC 1

Quality control policies and procedures at a firm level are set out in ISQC 1 Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements.

The objective of the firm as set out in ISQC 1 mirrors that of the auditor in ISA 220. The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that:

- the firm and its personnel comply with professional standards and applicable legal and regulatory regulations, and
- reports issued by the firm are appropriate.
The quality control procedures that are applied within an audit firm will reflect the nature and size of the audit practice. However, personnel within the firm who are responsible for establishing and maintaining quality control procedures must have an understanding of the entire text of ISQC 1. As the firm must meet the requirements of ISQC 1, it should have a system in place which addresses each of the following elements:

- Leadership responsibilities for quality
- Ethical requirements
- Acceptance and continuance of engagements
- Human resources
- Engagement performance
- Monitoring
- Documentation

The requirements of ISQC 1 in each of these areas are considered in turn below.

**Leadership responsibilities for quality**

ISQC 1 requires the firm to establish policies and procedures designed to promote an internal culture recognising that quality is essential. Ultimate responsibility for quality control policies and procedures should rest with the firm’s CEO (or equivalent) or managing board of partners (or equivalent).

Any person who has operational responsibility for quality control should have appropriate experience and ability and the necessary authority.

**Ethical requirements**

ISQC 1 requires the firm to establish policies and procedures to provide it with reasonable assurance that the firm and its staff:

- comply with relevant ethical requirements, and
- maintain independence where required to do so by those requirements.

The firm should:

- communicate its independence requirements to staff, and
- identify and evaluate circumstances and relationships that create threats to independence, assessing the impact of such threats and applying safeguards or withdrawing from the engagement if appropriate.

The policies and procedures should include requiring:

- staff to notify the firm of circumstances and relationships that might create a threat to independence
- staff to notify the firm of any breaches of independence of which they have become aware
- the firm to communicate such breaches to the engagement partner and other relevant staff
- the engagement partner to advise the firm of action to be taken.

At least annually, the firm should obtain written confirmation from all staff of compliance with the firm’s policies and procedures on independence.
The firm should also establish criteria for determining the use of safeguards to reduce the familiarity threat to an acceptable level when the same senior personnel have been used on an assurance engagement for a long time. For listed entity clients, there must be rotation of the engagement partner after a specified period, in compliance with relevant ethical requirements.

**Acceptance and continuance of engagements**

ISQC 1 requires the firm to establish policies and procedures to provide it with reasonable assurance that the firm will only take on or continue work where the firm:

- is competent to perform the engagement
- has the capabilities (including the necessary resources) to do so
- can comply with the relevant ethical requirements, and
- has considered the integrity of the client and does not have information which would lead it to conclude that the client lacks integrity.

The policies and procedures should include requiring the firm to:

- obtain sufficient information to make such decisions (for new or existing engagements)
- consider potential conflicts of interest (and therefore whether it should accept the engagement)
- document all identified issues and how they were resolved.

These requirements mean that there should be a review of proposed new clients and (at regular intervals) of existing clients, to make sure that the firm will be independent, that there are no conflicts of interest and the firm has the technical competence to do the audit work.

When an audit firm accepts an audit engagement from a new client, suitable procedures should therefore be carried out to ensure that:

- the firm will be independent and there are no conflicts of interest
- the firm has the technical competence to do the work
- professional clearance has been obtained from the previous auditors of the new client
- appropriate anti-money laundering (client identification) procedures are performed.

Before the start of the audit each year, the engagement partner for the audit should:

- ensure that all members of the audit team are independent of the client and there are no conflicts of interest; and
- be satisfied with the ethical integrity of the client entity and its management.

**Human resources**

ISQC 1 requires the firm to ensure:

- it has sufficient personnel with the competence, capabilities and commitment to ethical principles to meet its overall quality control objectives, and
that for each engagement an appropriate engagement partner and team are assigned.

Policies should therefore exist for the recruitment, training and development of staff. The firm should ensure compliance with ISAs and audit staff should have a good knowledge of accounting standards and local/national statutory accounting regulations.

The firm’s technical auditing procedures should be set out in a manual and reinforced by training. Newsletters and/or meetings could be used as a means of ensuring that professional staff are kept up-to-date on current developments.

Work should be assigned to staff that are competent to perform that work. There should be procedures for ensuring that an audit team collectively has the appropriate level of technical knowledge for the audit engagement and includes individuals with:

- experience of audits of a similar complexity, and
- an ability to apply professional judgement.

**Engagement performance**

Policies and procedures are required to include:

- those to promote consistent quality engagement performance
- supervision responsibilities
- review responsibilities (on the basis that more experienced team members review the work of less experienced team members)
- guidance on consultation to ensure that:
  - appropriate consultation takes place on difficult or contentious matters
  - sufficient resources are available for such consultation
  - the nature, scope and conclusions of the consultation are documented (by both parties)
  - conclusions arising from the consultation are implemented.
- guidance on engagement quality control reviews to ensure that:
  - an engagement quality control review is required for audits of all listed entity clients
  - criteria are established to determine which other engagements should be subject to an engagement quality control review
  - the review covers certain procedures (the same as set out in ISA 220 – see above)
  - engagement quality control reviewers are eligible to carry out such reviews via technical qualifications, experience, authority and objectivity from the engagement
  - engagement quality control reviews are properly documented (again, as also set out in ISA 220)
- procedures for dealing with any differences of opinion between the engagement team and those consulted or between the engagement partner and the engagement quality control reviewer
procedures in respect of completion of the final audit files on a timely basis and the confidentiality and safe custody of such documentation for an appropriate period.

**Monitoring of quality control procedures**

The firm is required to establish a monitoring process designed to provide it with reasonable assurance that its quality control system is relevant, adequate and operating effectively. This process should include inspecting, on a cyclical basis, at least one completed engagement for each engagement partner.

Responsibility for the monitoring process should be given to a partner or other appropriate person with sufficient experience and authority. When monitoring reviews (also referred to as ‘cold reviews’) are carried out they should not be performed by those involved with the engagement or the engagement quality control review.

The firm should:

- **evaluate the effect of any deficiencies** found to determine if they do indicate a failing in the firm’s quality control system
- **communicate such deficiencies** to relevant personnel, together with appropriate remedial action.

**Appropriate remedial action** might include:

- action in relation to individual engagements or employees
- communication of findings to those responsible for training and professional development
- changes to the firm’s quality control system
- disciplinary action, especially against repeat offenders.

If the results of monitoring procedures indicate that:

- an inappropriate report may have been issued, or
- procedures were omitted during the engagement

the firm should determine what further action is needed. This might include obtaining legal advice.

The firm should produce an **annual report** for partners setting out:

- the monitoring procedures performed
- the conclusions drawn
- any systematic deficiencies found and remedial action taken.

The monitoring system should include procedures for dealing with complaints and allegations against the firm. These should include establishing channels through which employees can come forward without fear of reprisals.

**Documentation of quality control procedures**

The following matters are required to be documented.

- Evidence of the operation of each element of the system of quality control.
- Complaints and allegations made against the firm and how these were resolved.

Documentation must be retained for a sufficient period of time, as a minimum to comply with relevant laws and regulations.
1.5 Quality control procedures specific to individual engagements

The quality control procedures applied to the conduct of each individual audit engagement will be based around the effective management of the audit team working on that engagement. This will involve the:

- direction of audit staff;
- supervision of audit staff, and
- review of their audit work.

**Direction of audit staff**

The direction of audit staff is the responsibility of the engagement partner for the audit. Direction is achieved by the following methods:

- The audit team members should be informed of the work they are expected to carry out and the objectives that the work is intended to achieve.
- There should be a well-prepared audit work programme and staff should be familiar with the overall audit plan.

In addition, the members of the audit team should understand:

- their responsibilities
- the nature of the business of the client company
- risk-related issues
- problems that may arise with the audit and how these problems should be dealt with if they do occur
- the detailed approach to the performance of the audit work.

The members of the audit team should:

- maintain an objective state of mind and retain their independence
- perform their work with due care, and
- raise any questions they might have with more experienced members of the audit team.

**Supervision of audit staff**

Supervision should continue throughout the audit. It includes the following:

- Tracking the progress of the audit.
- Monitoring the competence of team members, including:
  - whether they have sufficient time to carry out their work
  - whether they understand their instructions
  - whether they are carrying out their work in accordance with the audit plan.
- Addressing significant issues that arise during the audit, assessing how significant they are and modifying the audit approach accordingly.
- Identifying where there is a need for an audit team member to consult more experienced members of the team.
- Monitoring the behaviour of team members (particularly inexperienced junior members of the team), to ensure that they maintain ethical standards.
Review of audit work

Review of audit work is a key aspect of quality control. All audit work should be reviewed, ideally by an auditor with a higher level of competence and experience than the audit team member who performed the audit work.

Within the engagement team, an audit engagement partner is required to perform a review on each audit (often preceded by a manager’s review). Quality control procedures also include certain requirements for reviews to be performed by experienced practitioners outside of the immediate engagement team as follows:

- **Peer review**: This is a review carried out by another partner in the assurance firm.

- **Engagement quality control review (EQCR)**: Often referred to as a hot review, an EQCR is a peer review performed before the audit report is signed. This forms part of the quality control procedures specific to an individual assignment and is a requirement of audits performed on all public interest entities (plus any other circumstances when the audit firm judge that it is necessary, for example on a recently promoted partner’s first audit).

- **Monitoring review**: Often referred to as a cold review, this is a peer review performed after the audit report is signed. This forms part of the monitoring of quality control procedures.

The purpose of audit review is to check whether:

- the audit work was carried out to proper professional standards
- the objectives of the audit have been achieved
- the work carried out during the audit and the audit evidence are suitably documented, and that the audit evidence supports the conclusions that have been reached.

The review of the audit work should cover:

- the audit planning process
- audit procedures, including:
  - documentation (the audit working papers)
  - the audit tests performed and the audit evidence gathered
  - compliance with the audit work programme
  - the resolution of problems encountered on the audit
- whether the conclusion reached is consistent with the audit evidence obtained and documented.

The review process itself should also be documented.

**Review by the engagement partner (and audit manager)**

As discussed above, before the audit report is issued, the engagement partner needs to be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the audit report to be issued. They should therefore:

- review the audit documentation, and
- hold discussions with the audit team.
This process is usually referred to as the **partner's review**. It should be scheduled into the audit plan, towards the completion of the audit.

Before the partner’s review, the audit senior should try to ensure that every file is complete and cross-referenced, in order to cut down the number of points that might be raised by the partner’s review.

The partner’s review will usually be preceded by a **manager review**, in the hope that the audit manager will identify some matters that can be resolved before they come to the attention of the engagement partner.

**Assessing the adequacy of quality control**

An examination question that asks you to discuss the adequacy of quality control in an audit will probably expect you to identify weaknesses in the conduct of the audit, such as:

- poor or inadequate planning of the audit, such as a failure to identify the key audit risks
- giving complex audit work to relatively inexperienced members of the audit team
- inadequate supervision
- inadequate review of the audit working papers by the audit manager.

**Example: quality control issues**

An audit firm has just carried out the annual audit for a client company. The audit manager has just learned that during the audit planning process, a junior member of the audit team, who is an IT graduate from a major university, gave advice to the client about improvements that could be made in the client’s finance and accounting IT systems.

What professional and ethical issues exist in this situation?

**Answer**

The situation raises some questions about quality control in the audit.

- **Junior members of an audit team must be given suitable directions about their responsibilities, and their activities should also be properly supervised.** In this situation, a junior member considered that they were allowed to offer advice to the client, which clearly should not be the case. This suggests poor direction and supervision in the audit.

- **The junior member obviously believed that they could offer advice directly to the client.** In practice, if any member of the audit team identifies weaknesses in the client’s internal controls their findings should be reported to a senior member of the audit team, who should then decide the appropriate action to take. Failure by the junior team member to report their findings to a senior auditor also raises a concern about quality control. The firm may require much better training of staff about audit responsibilities and procedures.

It is important to establish the details of the advice that the junior team member has given to the client, and to find out whether the client has acted on that advice yet. The audit partner should discuss the situation with the client’s management in order to find out whether the advice has been acted upon. If the client has acted on the advice and this advice was poor, the audit firm may be liable.
1.6 Quality control in large accountancy firms and small accountancy firms

Quality control in large firms

Large international practices operate in several countries, with local partnerships and offices further down the chain of control. Local partnerships and offices within a large practice will have access to:

- regional and national training programmes
- the firm’s comprehensive audit manual
- a central technical department, available to answer technical questions from any office or local partnership
- in-house technical publications
- the firm’s standardised audit documentation
- a formal system of inter-office reviews.

Quality control in small firms

The need for quality control in a small firm is just as important as for large firms. However, many of the facilities listed above are not available to small firms, because they cannot afford them. Alternative arrangements for quality control might include:

- reciprocal arrangements for review and consultation with other audit firms
- the use of audit manuals and standardised documentation from third parties or professional bodies
- external training and sending staff on courses provided by third parties or professional bodies.

1.7 IAASB Q&A: Applying ISQC 1 proportionately with the nature and size of a firm

In October 2012 the IAASB issued guidance to assist in the application of ISQC 1 within small firms.

ISQC 1 applies to:

- audits and reviews of financial statements; and
- other assurance and related services engagements

irrespective of the size of client or engagement. However, the IAASB’s Q&A demonstrates how the application of ISQC 1 can be applied proportionately with the nature and size of a firm whilst remaining compliant with ISQC 1 without adding significant additional burden.

Key points raised in the Q&A that may assist small firms in applying ISQC 1 include the following:

- Firms only need to comply with the relevant requirements. So for example, if a practitioner does not offer audit services then there is no requirement to implement ISQC 1’s audit services requirements.
- Another example is the absence of the need to apply staff assignment and review procedures when the engagement team consists of just one person.
Firms are allowed to engage external resources in order to satisfy ISQC 1 requirements with respect to fulfilling monitoring and engagement quality control review obligations.

Communication may be less formal than in larger firms allowing them to adopt simpler processes in a less structured manner (whilst still complying with ISQC 1).

ISQC 1 explains that smaller firms may use more informal methods in the documentation of their systems of quality control such as manual notes, checklists and forms.

Some requirements of ISQC 1 may be easier for smaller firms to implement. For example, in relation to the requirement that addresses the importance of promoting an internal culture recognizing that quality is essential, smaller firms may be able to achieve this simply through leading by example and various communications between staff and leadership as they occur on a regular basis.

The approach to establishing quality control policies and procedures in a smaller firm may be less formal and structured. For example, smaller firms may employ less formal methods in carrying out performance evaluations for their staff.

ISQC 1 requires an engagement quality control review for all audits of financial statements of listed entities. This requirement does not apply if the firm does not perform such engagements.

1.8 The IAASB’s Framework for Audit Quality

Introduction and objectives

Global financial stability is supported through high quality reporting. Audits can help foster trust in the quality of reporting. This highlights the importance of audit quality - a topic of continuous debate - and of relevance to all stakeholders in the financial reporting supply chain.

With this in mind the IAASB developed the Framework for Audit Quality which it launched in February 2014. The Framework describes in a holistic manner the different elements that create the environment for audit quality at the engagement, firm, and national levels, as well as relevant interactions and contextual factors.

The objectives of the Framework for Audit Quality include:

- Raising awareness of the key elements of audit quality;
- Encouraging key stakeholders to explore ways to improve audit quality; and
- Facilitating greater dialogue between key stakeholders on the topic.

The IAASB expects that the Framework for Audit Quality will generate discussion in the financial reporting supply chain, and positive actions to achieve a continuous improvement to audit quality.

Elements

The elements of the Framework for Audit Quality include:

- Inputs
- Processes
Outputs

Interactions

Contextual factors

While the primary responsibility for performing quality audits rests with auditors, audit quality is best achieved in an environment where there is support from other participants in the financial reporting supply chain.

Inputs

Quality audits involve auditors:

- exhibiting appropriate values, ethics and attitudes; and
- being sufficiently knowledgeable, skilled, experienced, and having sufficient time allocated to them to perform the audit work.

Within each of these categories quality attributes are further organised between those that apply at the engagement, firm, and national level.

Processes

Quality audits involve auditors applying a rigorous audit process and quality control procedures that comply with laws, regulations and applicable standards. In this regard various quality attributes are further organised between those that apply at the engagement, firm, and national level.
**Outputs**

Quality audits result in outputs that are useful and timely. Outputs are described in relation to the full reporting supply chain and they include outputs from:

- the auditor
- the audit firm
- the entity
- audit regulators

Outputs include reports and information that are formally prepared and presented by one party to another, as well as outputs that arise from the auditing process that are generally not visible to those outside the audited organization.

**Interactions**

Quality audits involve auditors interacting properly with the stakeholders in the financial reporting supply chain. The interactions between the following key stakeholders are described within the Framework:

- Auditors
- Management
- Those charged with governance
- Users
- Regulators

These interactions, including both formal and informal communications, will be influenced by the context in which the audit is performed and allow a dynamic relationship to exist between inputs and outputs.

While each separate stakeholder in the financial reporting supply chain plays an important role in supporting high-quality financial reporting, the way in which the stakeholders interact can have a particular impact on audit quality.

**Contextual factors**

Quality audits involve auditors who respond properly to contextual factors. Contextual factors are described as having the potential to impact the nature and quality of financial reporting and, either directly or indirectly, audit quality.

These include:

- Business practices and commercial law
- Laws and regulations relating to financial reporting
- The applicable financial reporting framework
- Information systems
- Corporate governance
- Financial reporting timetable
- Broader cultural factors
- Audit regulation
- Litigation environment
- Attracting talent
- Financial reporting timetable.
1.9 Quality control framework of ICAP

Introduction
The ICAP Council formed the Quality Control Review (QCR) Committee in 1987 with the primary objective of establishing an independent quality control review framework in respect of audits of financial statements conducted by audit firms. The QCR Committee was converted into the Quality Assurance Board in 2005.

The QCR Program is a key part of ICAP’s regulatory framework, established to develop and maintain compliance of professional standards amongst the firms engaged in the audit of limited companies particularly listed entities, as the Code of Corporate Governance requires that a satisfactory QCR rating is mandatory for CA firms to conduct an audit of listed and economically significant companies.

The primary objective of the QCR process continues to be monitoring the compliance by audit firms with appropriate levels of professional standards in the performance of the audit function. The secondary objective is to provide guidance to practitioners to assist them to improve their standards.

The framework for the QCR Program was initially issued in 2003 and subsequently revised in 2006, 2009 and 2015.

Quality Assurance Board
The Quality Assurance Board (QAB) was established to independently undertake the implementation and oversight of the Quality Control Framework. The board is responsible for (inter alia):

- deciding QCR ratings for firms
- monitoring the QCR Program
- raising firms’ awareness of the objective of quality control and the related quality control standards
- assisting, coordinating and recommending training programs to help improve quality control systems in firms.

The board is assisted by the Quality Assurance Department (QAD) in discharging its responsibilities.

Statutory QCR rating
ICAP perceives liaison with the regulatory authorities of Pakistan as essential to the ongoing success of its QCR Program.

The Securities and Exchange Commission of Pakistan (SECP), through the Listing Regulations of the three Stock Exchanges namely Karachi, Lahore and Islamabad, has made it mandatory for listed companies to appoint those firms of Chartered Accountants as their external auditors that have been given satisfactory QCR rating by the Institute.

Accordingly, no listed company shall appoint as external auditors a firm of Chartered Accountants which has not been given a satisfactory rating under the Quality Control Review Program of ICAP.

The scope of QCR Programme has been further extended by SECP vide its SRO 268(I)/2012 dated March 16, 2012. Now all non-listed companies, falling under the definition of ‘Economically Significant Companies’ are required to appoint QCR rated firms as their statutory external auditors.
Overview of the QCR programme

Under the QCR Program, both engagement reviews and overall firm reviews are performed.

- In ‘Engagement Reviews’ the audit engagements performed by the firm are reviewed to determine whether the audit reports issued by the firm in respect of the reviewed clients were supported by appropriate audit evidence.
- With a ‘Firm Review’, the overall system of quality within a firm involved in the audits of listed entities is reviewed within the scope of ISQC 1.

Key features of the framework

- QCR is applicable to firms that carry out statutory audit engagements.
- The QCR review cycle is two and a half years. In certain cases early review may be required.
- Coverage of all locations and at least 25% of audit partners of a firm is mandatory.
- Review of additional file(s) in case of existing QCR rated firms.
- Complete confidentiality and anonymity of the reviewed firms, office locations, audit engagements selected for review and engagement partners reviewed is maintained by QAD while submitting QCR reports to the Board for its consideration and approval.
- All Board members and QAD staff members are required to sign Statements of Confidentiality and Independence annually.
- "Risk Based Selection" of audit working paper files is done for QCR, however, preference is given to listed, economically significant and public interest entities.
- The Board may refer a member to the Investigation Committee in the following circumstances:
  - The Board finds that the member is prima facie grossly negligent in issuing an audit report or performance of an audit; or
  - The firm has conducted an audit of a listed company and economically significant company without obtaining a satisfactory QCR rating.

The review process

The review process followed by QAD is as follows:

- **Step 1** – An audit firm submits a list of its audit clients to QAD.
- **Step 2** – Dates are agreed for the QCR.
- **Step 3** – QAD reviewer visits the firm under review.
- **Step 4** – The reviewer selects a client (or clients) from the list provided at the time of their visit.
- **Step 5** – In the case of an auditor of a listed entity, a review of the firm’s system of quality control under ISQC-1 is also carried out.
- **Step 6** – The reviewer notes the observation(s) on a “Review Findings Form” which is signed by both the reviewer and the engagement partner.
Step 7 – A draft QCR report is prepared and sent to the firm for comments.

Step 8 – After incorporating comments of the firm, if any, the draft QCR report is presented to QAB consisting of findings noted in the review. To maintain confidentiality, name of firm, engagement partner, client and other information are not disclosed in the draft QCR report.

Step 9 – After QAB approval, the final QCR report is issued to the firm in which the firm is informed whether the audit report(s) issued by the firm in respect of the reviewed client(s), was supported or not supported by appropriate audit evidence.
2 CHANGES IN A PROFESSIONAL APPOINTMENT

Section overview

- Why a change might arise
- Procedures before accepting a new audit appointment
- Deciding whether to accept a new audit appointment
- Books, documents and records
- Insurance Ordinance, 2000
- The Banking Companies Ordinance, 1962
- Accepting engagements other than audit

2.1 Why a change might arise

An ICAP member may be asked to accept a new audit appointment in a situation where the existing auditor will not be reappointed. This may be for any of the following reasons:

- The current firm is too small to cope with the demands of an expanding client (who now operates from multiple locations, in different towns or countries).
- There may be a change in the composition of the company’s board of directors, and the new directors wish to appoint an auditor of their own choice.
- There may be a perceived lack of independence, possibly one that has just arisen.
- There may have been a disagreement between the directors and the ‘old’ audit firm (for example, over the accounting treatment of an item in the financial statements).
- There may have been a loss of confidence in the existing audit firm.

In theory, the auditor is appointed by the shareholders. However, in practice recommendations are made by the directors to the shareholders when they consider that there should be a change of auditors.

If the outgoing auditor feels that the change is for a reason that should be brought to the attention of the shareholders (for example, in the case of a dispute) then national legislation (s253 of the Companies Ordinance 1984 in Pakistan) allows them to make representations to the shareholders.

2.2 Procedures before accepting a new audit appointment

Before accepting an appointment, the audit firm should take the following steps:

- It should assess whether there are any professional problems attached to accepting the engagement. These might include, for example, problems of lack of independence, or a lack of technical expertise, or a conflict of interest.
- It should ensure that resources are available to complete the audit assignment; in particular it must ensure that there will be sufficient staff (of the right level of expertise) available at the right time.
It should take up references on the proposed client company and its directors, if they are not already known to the auditors. This is usually referred to as **client screening**.

It should communicate with the incumbent (existing) auditors, if there are any, to discuss the appointment, the client and the audit work and to find out whether there is any reason why the proposed audit appointment should not be accepted. The method of communication is referred to in ICAP's Code of Conduct as **professional enquiry** (see below).

### Client Identification

In order to comply with anti-money laundering regulations, the audit firm should carry out client identification procedures. The purpose of these procedures is to confirm that the client ‘is they say they are’, and that there are no grounds for suspicion that the client may be involved in money laundering activities.

- If the client is a company or other business entity, documentary evidence of the identity of the entity should be obtained – for example a certificate of incorporation in the case of a company.

- Evidence should also be obtained to confirm the address of the entity, such as letter head.

- If the client is an individual, evidence of identity can be obtained from a passport or driving licence, and evidence of address (possibly) from a recent utility bill.

- The audit firm should consider whether the business of the potential new client ‘makes commercial sense’. For example, it would not make sense for a very large company to be engaged in operating a number of dry cleaning shops, because the size of the company would be too large for the nature of its business operations. When this happens, the client’s declared business may simply be a front or cover for hidden illegal activities.

In most cases, the client identification procedures should be a formality, and the client may be surprised that they are necessary. The audit firm should explain the regulatory purpose of client identification, to remove any doubts or concerns that the new client may have.

### Professional enquiry

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

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

- When a member is first approached by a prospective client to act or be nominated, they should explain that they have a professional duty to communicate with the existing auditor or advisor.

- Client permission is required for any such communication. If the client refuses to give its permission, the appointment as auditor should not be accepted.
If the client does not give the current auditor permission to reply to any relevant questions, the current auditor should communicate this fact to the prospective auditor who should subsequently not accept appointment.

If the current auditor does not provide any information relevant to the appointment, the new auditor should accept or reject the engagement based on other available knowledge.

The existing auditor or adviser should answer without delay the communication from the prospective auditor. If there are no matters of which the latter should be aware, the existing auditor or adviser should write to say that this is the case.

If, however, there are such matters they should inform the prospective auditor of those facts within their knowledge of which, in their opinion, the prospective auditor should be aware. It is not sufficient to state that unspecified facts exist.

The existing auditor or adviser might prefer to explain these facts orally and the prospective auditor or adviser should be prepared to confer with the existing auditor or adviser if the latter so desires, and each should make their own record of such a discussion.

If an issue of conflicting viewpoints between the client and themselves has been raised by the existing auditor in their reply, the prospective successor should discuss the conflict with the client and satisfy themself either that the client’s view is one which they can accept as reasonable or that the client will accept that the incoming auditor or adviser might have to express a contrary opinion.

Where the existing auditor or adviser does not respond within a reasonable time, the prospective successor should endeavour to contact the existing auditor by some other means, for instance, by telephone, facsimile or email.

Should this fail, and where the prospective successor has no reason to believe that there are untoward circumstances surrounding the change, they should send a final letter by recorded delivery service stating that unless they receive a reply within a specified time they will assume that there are no matters of which the existing auditor is aware that should be brought to their attention. A member who accepts nomination in such circumstances is not precluded from complaining to the Institute that the existing auditor did not respond to their enquiry letter.

If the prospective auditor is satisfied that they can properly act, and are prepared to accept nomination/appointment, they should so inform the client in writing.

Unpaid Fees
A member in public practice should not accept an audit assignment previously carried out by another member, without first ensuring that the other member has been properly removed from office as auditor and that all outstanding fees due to the other member have been fully paid.

ICAP’s technical release no.16 (ATR-16) states that ICAP members shall be deemed guilty of professional misconduct if they accept the appointment as auditor (for statutory audits to be performed under the Companies Ordinance 1984 or other statute) where the undisputed audit fee of the prospective client due to a fellow Chartered Accountant has not been paid.
Confidentiality

The prospective auditor should ordinarily treat in confidence any information provided by the existing auditor. However, it may be essential to the fulfilment of a prospective auditor’s obligations that they should disclose such information. It may, for example, be unavoidable for the prospective auditor to disclose to officers or employees of the client matters brought to their attention by the predecessor firm, which needs to be properly investigated. Such disclosure should be no wider than is necessary.

Defamation

An existing auditor might need to communicate matters to a prospective auditor that are potentially damaging to a client (or to an individual concerned with the client’s business) during ‘professional enquiry’ e.g. statements regarding management’s integrity.

Auditors will normally be protected against any defamation claim against them relating to professional enquiry so long as they have followed professional and ethical guidelines when making such communications.

This type of protection is called ‘qualified privilege’ and means that the auditor would not be liable to pay damages for defamatory statements even if they turn out to be untrue, provided that they are made without malice.

Joint auditor

A member whose firm is nominated as a joint auditor should communicate with all existing auditors and be guided by similar principles to those set out in relation to nomination as an auditor. Where it is proposed that a joint audit appointment becomes a sole appointment, the surviving auditor should communicate formally with the outgoing joint auditor.

Vacancy

A member whose firm is invited to accept nomination on the death of a sole practitioner auditor should endeavour to obtain such information as they may need from the late practitioner’s alternative (where appropriate), the administrators of the estate or other relevant sources.

Additional work

A member invited to undertake recurring or non-recurring work, which is additional to and related to continuing work carried out by another Chartered Accountant or adviser should normally notify that other Chartered Accountant of the work they have been asked to undertake.

- It is generally in the interest of the client that the existing auditor be aware of the nature of the additional work being undertaken. The existing Chartered Accountant will be provided with the opportunity to communicate with the member to provide information, lack of which might otherwise prevent the additional work from being carried out effectively. Additionally, such notification could affect the way an existing Chartered Accountant discharges their continuing responsibilities to their client.

- Notification should always be given to the existing Chartered Accountant.

- Provision of all opinions on the application of accounting standards or principles clearly requires particular sensitivity to avoid adversarial positions between an auditor and other Chartered Accountants wherever possible.
2.3 Deciding whether to accept a new audit appointment

An accountancy firm may occasionally decide that to accept a new audit appointment would threaten the firm’s reputation and might also raise serious ethical issues.

Example: accepting a new audit appointment

Gudrat Company is an owner-managed company. It has asked your firm to become its auditors. The following information has been obtained about the company, mainly from the company’s current auditors.

(1) The current auditors have just resigned from the audit because they no longer have sufficient resources to carry out the audit work for Gudrat. They had taken on the audit two years earlier, after the previous auditors had resigned due to a dispute about fees. The current auditors commented that the company’s management liked to keep a close control over costs, and they had agreed to do the audit for a lower fee.

(2) The current auditors had discovered a number of internal control weaknesses in Gudrat and had reported them to management, but nothing appeared to have been done by management to improve the control system.

(3) There were ongoing disputes with the tax authorities about the amount of tax payable by Gudrat on profits for the previous three years.

(4) Gudrat Company has a poor public relations image. It is currently under investigation by both the police authorities and the regulatory authorities for alleged breaches of regulations, and some of these had been widely reported.

(5) The company is ambitious and plans to expand its business in the next year or so. It expected to obtain bank loans to finance most of the expansion.

What issues should the audit firm consider when deciding whether or not to accept the new audit appointment?

Answer

The following matters may be considered.

- Reputation. The audit firm may decide that it does not wish to be associated with a client company whose public relations image is poor. The bad reputation of the company may transfer to its auditors.

- Advocacy threat. The criminal or regulatory investigation may lead to legal action, and the audit firm may be faced with an advocacy threat, and be expected to defend the company against the allegations that have been made against it.

- Aggressive management. Gudrat Company has aggressive managers who are willing to argue with auditors and who want to keep costs as low as possible. There is a high risk of continuing disputes over audit fees.

- Audit risk. If the company applies for new bank loans, it will probably be required to submit audited financial statements to the bank as part of the loan application. The management of Gudrat have a strong interest in presenting financial statements that show strong profits and a healthy statement of financial position. The risk that the financial statements may be misstated could therefore be high. (The audit firm would probably wish
to consider including a disclaimer in their audit report, to reduce the risk of liability to a bank for ‘negligent’ auditing in the event that the financial statements turn out to be misstated and the errors are not identified by the auditors.)

- High audit risk is also suggested by the weak internal controls and failure by management to improve controls.
- The high audit risk means that a new auditor would want to conduct a very careful audit of the opening balances: this would add to the cost and time required for the audit, which Gudrat management may refuse to accept.

However there is no evidence of fraud (or suggestion of fraud) by anyone in the company, and the audit firm may decide to accept the audit appointment, subject to agreement about fees. Acceptance of a new audit client is a matter of judgement.

2.4 Books, documents and records

Client books and records: right of lien

Once a new auditor has been appointed, the outgoing auditor should arrange for the transfer of any books and records belonging to the client that are in their possession.

However, where fees remain unpaid, the outgoing auditor may wish to exercise a legal right of lien over those client books and records.

- A lien is a right to retain possession of property belonging to another until amounts due are paid.
- Auditors have a ‘particular’ (as opposed to a ‘general’) lien. This means that the right of lien is only in respect of those books and records on which the auditor has performed audit work.

In order for the lien to be applied:

- the documents must have come into the auditor’s possession lawfully, and
- an invoice must have been sent to the client company for the fees owing, and there must be no dispute over fees.

Unfortunately, in some countries, legal decisions have been taken that mean a lien cannot be exercised over books and records which the client is required to keep by law. In many cases, this legal requirement applies to most of the client’s books and records. Consequently, these legal decisions may significantly reduce the effectiveness of the right of lien.

Auditor working papers

Audit working papers are documents prepared by the auditors for the purpose of carrying out their audit work. In general, these belong to the auditors, unless there is a provision to the contrary in the engagement letter or in national law.

However, the outgoing auditor will be expected to provide the proposed new auditor with information that is sufficient for a reasonable handover of audit responsibilities. The precise nature of this information will depend on the stage that the audit has reached when the responsibility for the audit passes from the outgoing audit firm to the new one.
2.5 **Insurance Ordinance, 2000**

Section 48 of the Insurance Ordinance 2000 requires every insurer to appoint an auditor who is:

- approved by the Securities and Exchanges Commission of Pakistan (‘the Commission’) as qualified to perform audits of insurance companies; and
- authorised under the Companies Ordinance to perform audits of public companies.

Section 49 of the Insurance Ordinance 2000 refers to ‘special audits’ and states:

- The Commission may at its discretion appoint an auditor, approved by the Commission as qualified to perform audits of insurance companies but not being the auditor, or a partner of the auditor appointed by the insurance company concerned, to perform an investigation of such accounts and statements, books and records of an insurer as the Commission may direct.
- An auditor appointed under this section shall have a right of access to all such books of account, registers, vouchers, correspondence and other documents of the insurer, and shall be entitled to require from the directors and officers of this insurer such information and explanation, as may be necessary for the performance of their functions and duties under this section.
- Every report prepared by an auditor or auditors appointed under this section shall be submitted to the Commission.
- An auditor appointed under this section shall be paid by the insurer such fees as may be prescribed.
- The fee payable by an insurer under this section shall be paid to the auditor within such time as may be specified by the Commission.

2.6 **The Banking Companies Ordinance, 1962**

Section 34 of the Banking Companies Ordinance 1962 requires every banking organisation incorporated in Pakistan, and those incorporated outside Pakistan transacting business through branches in Pakistan, to prepare an annual balance sheet and profit and loss account.

Section 35 also states:

- The balance sheet and profit and loss account shall be audited by a person who is duly qualified, under the Chartered Accountants Ordinance, 1961, or any other law for the time being in force, to be an auditor of companies and is borne on the panel of auditors maintained by the State Bank for the purposes of audit of banking companies.
- An auditor shall hold office for a period of three years and shall not be removed from office before the expiry of that period except with the prior approval of the State Bank.
- If the State Bank is not satisfied with the performance of the auditor of a banking company or the auditor has not fulfilled any of the requirements laid down in this section the State Bank after giving the auditor an opportunity of being heard may:
  - revoke the appointment of external auditors of the banking company;
  - downgrade the category of the auditor in the panel of the auditors; and
• remove the auditor from the panel of the auditors for a maximum period of five years.

2.7 Accepting engagements other than audit

The procedures for accepting non-audit engagements are very similar to those for accepting audit engagements and include:

- **Ethical considerations** – e.g. does the firm have staff who are technically competent to perform the engagement? Might there be a conflict of interest with an existing client? There can be instances where a proposed appointment for a non-audit engagement, for example advice on business restructuring or accounting assistance, could potentially conflict the auditor’s need to apply professional scepticism as part of the audit due to the increased self-interest. Such non-audit engagements need to be thoroughly reviewed prior to acceptance.

- **Commercial considerations** – e.g. does the engagement fit with the strategy of the firm at an appropriate and fair fee level?

- **Client identification** – e.g. the firm should apply client due diligence (know your client) procedures to all new clients, not just audit clients.

- **Communication** – it may or may not be appropriate and/or feasible to communicate with another practitioner in the same way an incoming auditor is required to communicate with the existing auditor. Protocol will depend on the particular circumstances of the non-audit engagement.
3 OBTAINING AND CHARGING FOR PROFESSIONAL WORK

Section overview

- Obtaining professional work
- Advertising and publicity
- Fees
- Tendering
- Credit control within an accountancy firm

3.1 Obtaining professional work

Audit practices will want to increase the size of their client base as a means of increasing the profits of the practice. This can be achieved by:

- promoting their (good) reputation in the business community
- recommendations from existing clients
- advertising
- publicity and promotion (such as sponsorship activities).

3.2 Advertising and publicity

When a professional accountant in public practice solicits new work through advertising or other forms of marketing, there may be a threat to compliance with the fundamental ethical principles. For example, a self-interest threat to compliance with the principle of professional behaviour is created if services, achievements, or products are marketed in a way that is inconsistent with that principle.

Advertising and publicity activities by accountancy firms are therefore regulated by IFAC and ICAP through their codes of ethics and conduct respectively.

Advertising and publicity - ICAP Code of Ethics

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

250.1 Undue publicity to be avoided

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

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

A Chartered Accountant preparing or authorizing the issue of matter falling within this Section should do so with a due sense of responsibility to the profession and to the public as a whole. In particular such material should be in good taste both as to content and presentation and should not belittle services offered by others, whether members or not, either by claiming superiority for the services of a particular Chartered Accountant or otherwise. The same attitude should be adopted towards activities mentioned in subsequent paragraphs.
Chapter 5: Practice management

250.2 Advertising for solicitation must be avoided

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

- All announcements, communications and public notices should:
  - be aimed at informing the recipients or the public in an objective manner;
  - conform to the basic principles of legality, decency, clarity, honesty and truthfulness; and
  - not project an image, which is inconsistent with that of a professional person bound to high ethical and technical standards.

- Activities which may expressly be considered not to meet the above criteria and are therefore prohibited include those that:
  - create false, deceptive or unjustified expectations of favourable results;
  - imply the ability to influence any court, tribunal, regulatory agency or similar body or official;
  - consist of self-laudatory statements that are not based on verifiable facts;
  - make comparisons with other professional accountants in practice;
  - contain testimonials or endorsements;
  - contain any other representations that would be likely to cause a reasonable person to misunderstand or be deceived; and
  - make unjustified claims to be an expert or specialist in a particular field of accountancy.

3.3 Fees

General principles

The question of setting a ‘price’ for the provision of a service is always a sensitive matter, because of disputes that may arise if the fees are unreasonable.

In establishing the fee for professional work, the accountant should follow professional guidance. In any case they must ensure they do not breach any of the fundamental ethical principles.

For example, a self-interest threat to professional competence and due care may be created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards for that price. Safeguards against threats may include:

- making the client aware of the terms of the engagement and, in particular, the basis on which fees are charged and which services are covered by the quoted fee (through the engagement letter); and
- assigning appropriate time and qualified staff to the task.

Promotional material

Where reference is made in promotional material to fees:

- this must not be misleading with regard to the precise range of services and the time commitment covered
comparison may be made to the fees of others, provided that this is not misleading and that it follows local regulations or legislation.

discounts on existing fees may be offered, or a free consultation at which the level of fees will be discussed. However, the discount should not be so low that it constitutes lowballing, as described above.

**Introductions**

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

**3.4 Tendering**

**Introduction**

Tendering is a commercial process widely-used by companies (especially larger companies) when they wish to change auditors. Tendering involves two or more audit firms being invited by a company to submit a proposal for its audit work. The invitation may or may not include the existing auditor.

A company may also invite firms to tender for the audit work when the term of the appointment for the current audit firm has come to an end. In this case, if the current auditor wishes to be re-appointed, it will have to go through a tendering process.

**Initial considerations**

Tendering should commence only when a firm has been approached by a prospective client. In any case, a firm should not submit a tender for the work unless it can give satisfactory answers to the following questions:

- Does the firm have the expertise to carry out this audit?
- Does the firm have (or could it have) sufficient staff available at the appropriate time?
- Are there any ethical reasons why the firm could not act (for example, a problem with independence, or a conflict of interest)?
- Are there any problems, of which the firm is aware, with the current audit or auditors?

Specifically in relation to a tender, the firm should also ask itself:

- Why has it been asked to tender?
- Could it (and should it?) offer to do the audit for a lower fee than other firms are likely to quote?
- Are there any reasons why this audit is particularly attractive to the firm? For example, will the work be carried out at a quiet time of year, or is the company in an industry area where the firm wishes to develop its audit experience and expertise?
- What audit risks might arise with this particular client?

**The tendering process**

The principal benefit to the client of a tendering process should be lower audit fees, because several firms are competing for the work.
In response to the pressure to reduce their fees, audit firms have become more efficient and lowered their costs. Even so, the tendering process can still be ‘high risk’ for a firm. For example:

- The firm needs to be confident that the client is one that it can deal with professionally and economically if the tender is accepted.
- If the tender is not accepted, the time and cost involved in the tendering process (which may be considerable) has been wasted. The firm needs to be sure that a sufficiently high proportion of its tenders will be successful, to justify the costs.

The tendering process should be broken down into the following stages (assuming that a firm is submitting a tender for the audit of a new client):

- Collect background information about the possible new client. (This is necessary when evaluating any new client, whether the fee is to be set by tender or by any other method.)
- Establish the precise scope of the work to be performed and the specific requirements of the prospective client.
- Carry out a preliminary audit risk assessment and prepare a preliminary plan for the audit. The plan must cover the staffing requirements and the time requirements for the work.
- Estimate a fee.
- Prepare a **submission document** for the potential client. The contents of this document will typically include:
  - an outline of the key characteristics of the firm
  - clarification of the nature of the audit work or other non-audit work to be performed
  - a statement of the requirements of the client and how the firm will comply with them
  - an outline of how the work will be performed
  - the proposed fee and the basis of its calculation
  - the range of other services which the firm could offer to the client.
- If required, prepare and give a presentation to the potential client.

**Evaluating the tender**

In evaluating the tender, the client (company) is likely to consider the following issues:

- Fees
- The services that the firm is able to provide
- Geographical locations and coverage of the firm’s offices
- Expertise of the firm and its staff
- Reputation of the firm
- Whether the senior management of the company think that they will be able to work well (on a personal level) with the potential engagement partner and key audit staff
- The formal presentation itself by the audit firm
- The extent to which the company wants to change its audit firm and its dissatisfaction with the current audit firm.
Lowballing

Lowballing is the practice of tendering for the audit work at a very low fee, with the objective of winning the audit. If it is successful in obtaining the audit, the firm will hope that:

- it will be able to raise the audit fee in future years, or
- it will be able to recover losses on the audit fee by providing other, more lucrative non-audit services.

Although there is no evidence that lowballing leads to a poor-quality audit, the fact that it exists does nothing to improve the reputation of the auditing profession. The existence of low fees may suggest to the business community and to the general public that audit work is of a low quality. All fees should be sufficiently adequate to compensate a firm for the work that it carries out. With this in mind, the ICAP Code of Ethics requires Chartered accountants in practice to comply with provision ATR-14 denoting minimum hourly charge-out rates and fees for audit engagements.

3.5 Credit control within an audit firm

An audit firm does not just charge fees. It has to collect the fees that it charges. A failure to invoice clients promptly or a failure to collect payment within a reasonable time after the invoice date would be an indication of poor credit management. Any such management weaknesses should be corrected if they occur.

Occasionally, non-payment of fees may be due to the fact that the audit client is in financial difficulties and cannot pay.

- Overdue fees are a threat to the independence and objectivity of the auditor, because it might be argued that audit work has been provided free of charge. If the unpaid amount has been overdue for a long time, it could be regarded as a form of loan by the audit firm to the client.
- The risk to auditor independence could be significant if the unpaid amount is material.
- When a client is in temporary financial difficulties it is permissible for an auditor to make commercial arrangements for staged payments of the fees due. The client should be made aware, however, of the ethical problems that non-payment or late payment create for the audit firm.
- For future audits, if the audit engagement is retained, the auditor should pay particular attention to the going concern assumption. If the client still has continuing cash flow problems, the going concern assumption may be challenged.

When unpaid fees are owed by a client and the period of late payment is in excess of what might be regarded as commercially acceptable, the audit firm should consider whether it would be ethically appropriate to resign as auditors.

- The ethics partner of the firm should be asked to assess the ethical threat to the firm’s independence and integrity.
- If the decision is to continue as auditor of the client, the reason should be documented.
- The most recent audit papers should be checked to ensure that sufficient appropriate evidence was obtained to support the going concern assumption in the financial statements.
4 AGREEING THE TERMS OF AUDIT ENGAGEMENTS: ISA 210

Section overview

- The objective of the auditor
- The content of the engagement letter
- Annual review of the engagement letter
- Acceptance of a change in the terms of the engagement
- Agreeing the terms of non-audit engagements

4.1 The objective of the auditor

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

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

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

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

**Response if preconditions are not present**

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

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

- a limitation on the scope of the audit is imposed by management such that the auditor would be unable to obtain sufficient appropriate audit evidence and express an opinion on the financial statements, or
- the financial reporting framework to be used in the preparation of the financial statements is unacceptable, or
- management do not agree to the above responsibilities (the ‘premise’) stated in the preconditions.
The only exception allowed by ISA 210 for accepting or continuing the engagement to the above is when law or regulation requires the auditor to do so.

4.2 The content of the engagement letter

The auditor is required to agree the terms of the audit engagement with management (or those charged with governance) and record the agreed terms in an audit engagement letter.

The engagement letter must include reference to the following:

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

Because it specifies what the auditor will be doing and what the auditor’s exact responsibilities will be, the engagement letter is also seen to be an important way of reducing the ‘expectation gap’. This is the difference between:

- the view of the role and responsibilities of the auditors that is held by the users of financial statements, and
- the auditor’s actual (statutory) role and responsibilities.

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

- Regulations, ISAs and ethical pronouncements.
- The fact that because of the inherent limitations of an audit and the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected even though the audit was properly planned and performed in accordance with ISAs.

- Arrangements regarding the planning and performance of the audit, including the composition of the audit team.
- The expectation that management will provide written representations.
- The basis on which fees are computed and any billing arrangements.
- A request for management to acknowledge receipt of the engagement letter and to agree to its terms.
- Arrangements concerning the involvement of other auditors, experts or internal auditors (or other staff of the entity).
- Any restriction of the auditor’s liability when such possibility exists.

Best practice also recommends that the engagement letter should include an explanation of the auditor’s responsibility with regard to anti-money laundering checks and procedures.

4.3 Annual review of the engagement letter

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

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

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

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity’s business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

At times, despite the existence of one or more of the above situations, a change in the documented terms of engagement may not be considered necessary where for example, the audit committee or the board of directors has been provided with explanation or clarification regarding a particular matter (for example, change in reporting requirements not likely to have a significant impact on the financial statements). Therefore, the above is not a comprehensive list of situations where the terms of engagement must be modified; rather it serves as an indicative list only.

### 4.4 Acceptance of a change in the terms of the engagement

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

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

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

### 4.5 Agreeing the terms of non-audit engagements

Standards covering engagements other than audits of historical financial information follow similar principles to ISA 210 in requiring practitioners to agree the scope and terms of an engagement with a client in advance and in an engagement letter. We look at three non-audit standards below.
Review engagements

ISRE 2400 *Engagements to review historical financial statements* states that the practitioner shall agree the terms of the engagement with management or those charged with governance, as appropriate, prior to performing the engagement.

The agreed terms of engagement shall be recorded in an engagement letter or other suitable form of written agreement, and shall include:

- The intended use and distribution of the financial statements, and any restrictions on use or distribution where applicable;
- Identification of the applicable financial reporting framework;
- The objective and scope of the review engagement;
- The responsibilities of the practitioner;
- The responsibilities of management;
- A statement that the engagement is not an audit, and that the practitioner will not express an audit opinion on the financial statements; and
- Reference to the expected form and content of the report to be issued by the practitioner, and a statement that there may be circumstances in which the report may differ from its expected form and content.

Assurance engagements

ISAE 3000 *Assurance engagements other than audits or reviews of historical financial information* states:

- The practitioner should agree on the terms of the engagement with the engaging party. To avoid misunderstandings, the agreed terms are recorded in an engagement letter or other suitable form of contract. If the engaging party is not the responsible party, the nature and content of an engagement letter or contract may vary. The existence of a legislative mandate may satisfy the requirement to agree on the terms of the engagement. Even in those situations an engagement letter may be useful for both the practitioner and engaging party.

Agreed-upon procedures

ISRS 4400 *Engagements to perform agreed-upon procedures regarding financial information* states:

- The auditor should ensure with representatives of the entity and, ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement. Matters to be agreed include the following:
  - Nature of the engagement including the fact that the procedures performed will not constitute an audit or a review and that accordingly no assurance will be expressed.
  - Stated purpose for the engagement.
  - Identification of the financial information to which the agreed-upon procedures will be applied.
  - Nature, timing and extent of the specific procedures to be applied.
  - Anticipated form of the report of factual findings.
Chapter 5: Practice management

- Limitations on distribution of the report of factual findings. When such limitation would be in conflict with the legal requirements, if any, the auditor would not accept the engagement.

- It is in the interests of both the client and the auditor that the auditor sends an engagement letter documenting the key terms of the appointment. An engagement letter confirms the auditor’s acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the auditor’s responsibilities and the form of reports to be issued.

- Matters that would be included in the engagement letter include the following:
  - A listing of the procedures to be performed as agreed upon between the parties.
  - A statement that the distribution of the report of factual findings would be restricted to the specified parties who have agreed to the procedures to be performed.

- In addition, the auditor may consider attaching to the engagement letter a draft of the type of report of factual findings that will be issued.
## 5 CHAPTER REVIEW

<table>
<thead>
<tr>
<th>Chapter review</th>
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<tr>
<td>Before moving on to the next chapter check that you can:</td>
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<tr>
<td>- Describe the components of a system of quality control applied to a firm of accountants performing audit and assurance engagements</td>
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<tr>
<td>- Explain the process around changes in professional appointment including the legal, commercial and ethical considerations</td>
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<tr>
<td>- Apply ISA 210 in agreeing the terms of an engagement</td>
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<tr>
<td>- Summarise the procedures for agreeing the terms of non-audit engagements</td>
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The audit approach

Contents

1. Audit methodology
2. Risk-based strategies
3. Systems-based strategies
4. Balance sheet (substantive) strategies
5. Chapter review
INTRODUCTION

Learning outcomes

Performance of audit - general
A (a) 5 Risk assessment procedures and response to risks
A (a) 6 Internal controls (including test of controls)
A (a) 10 Substantive tests (including Analytical Procedures)

Exam context

It is critical that audit and assurance students appreciate the different strategies that can be adopted in performing an audit.

In this chapter students will gain a thorough understanding of the modern risk-based approach to auditing which represents the fundamental approach adopted in ISAs. You will also study in some depth the system of internal controls, also very relevant to modern audit strategy. Finally students will study the more traditional 'balance sheet approach'.

By the end of this chapter students will be able to:

- Summarise the different types of audit strategies and factors that impact which strategy is adopted
- Explain the business risk approach and be able to identify and assess business and financial risks
- Describe the systems-based approach and articulate the components of a system of internal control
- Summarise the balance sheet approach
Chapter 6: The audit approach

1 AUDIT METHODOLOGY

Section overview

- A choice of audit methodologies
- Summary of available audit methodologies
- Factors in the choice of audit strategy

1.1 A choice of audit methodologies

The audit strategy describes the overall approach that the auditor will take to gather sufficient, appropriate evidence in an audit. A detailed audit plan can then be developed in the context of the audit strategy. The strategy may adopt a range of methodologies depending on the particular circumstances of the audit.

Several possible methodologies are available for developing the audit strategy, including:

- an audit-risk approach
- a business risk (top-down) approach
- a systems-based approach
- a transaction-cycle approach
- a balance sheet approach (substantive testing).

These methodologies are not necessarily mutually exclusive and they are likely to be used in combination to form the overall audit strategy. For example, although most of the work on a particular audit might be ‘systems-based’ and focused in the highest business risk areas, the auditor will also carry out some substantive testing on all material balances and transactions.

The different approaches describe the emphasis of the audit strategy and where the auditor expects to find most of the evidence that they need to reach an audit opinion about the ‘fair presentation’ or ‘true and fair view’ in the financial statements.

1.2 Summary of available audit methodologies

The main audit methodologies/strategies are summarised in the following table. They will be described in more detail in the rest of the chapter.

<table>
<thead>
<tr>
<th>Methodology / strategy</th>
<th>Outline of approach</th>
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<tr>
<td>Risk-based strategies (audit-risk and business risk)</td>
<td>An assessment is made of the likelihood of material misstatements in each area of the financial statements. This is based on the auditors’ understanding of the business risks faced by the client.</td>
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<td></td>
<td>Areas that are assessed as high-risk are audited extensively (using the various methodologies described below).</td>
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<td>Areas assessed as low-risk are given a low level of attention in the audit, thus saving time.</td>
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<tr>
<td>Methodology / strategy</td>
<td>Outline of approach</td>
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<td>‘Business risk’ and ‘audit risk’ are linked in that the areas most susceptible to material misstatement (and hence audit risk) are likely to arise from areas of greatest business risk.</td>
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<tr>
<td>Systems-based approach</td>
<td>The audit focus is on the application of tests of control to the systems that produce the figures in the financial statements, rather than on the figures themselves.</td>
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<td></td>
<td>The systems-based approach is driven by the transaction cycles including sales, purchases, payroll and other expenses.</td>
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<td>A systems-based approach is supported by some degree of substantive testing due to the unavoidable limitations or weaknesses in internal control systems. (The amount of substantive testing required will depend on the auditor’s judgement about the effectiveness of the internal controls).</td>
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<td>The systems-based approach is also supported by the use of analytical procedures.</td>
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<td>It is more cost-effective than a fully substantive testing (balance sheet) approach, but there is still a danger of doing too much unnecessary auditing of areas where controls operate well.</td>
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<tr>
<td>Transaction cycle approach</td>
<td>The transaction cycle approach is similar in many ways to the systems-based approach because it is based on the same transaction cycles (sales, purchases, payroll and other expenses).</td>
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<tr>
<td></td>
<td>However, the ‘transaction cycle’ approach adopts substantive procedures to test the transactions that occur throughout the cycle, rather than testing the controls over the cycles.</td>
</tr>
<tr>
<td></td>
<td>Systems-based and transaction cycle approaches are often combined within the overall audit strategy.</td>
</tr>
<tr>
<td>Balance sheet (substantive) approach</td>
<td>The balance sheet approach is fundamentally based on the accounting equation. The basic premise is that if current year-end and prior year-end net assets are fairly presented then it is easier to gain audit comfort on the intervening profit and loss and other changes in equity, thus resulting in reduced procedures on the income statement.</td>
</tr>
<tr>
<td></td>
<td>This approach focuses on applying substantive tests to a large number of transactions and account balances recorded in the accounting system of the client in order to prove year-end balances.</td>
</tr>
</tbody>
</table>
Chapter 6: The audit approach

**Methodology / strategy**  
**Outline of approach**

- If the auditor focuses purely on recorded transactions and balances then under-statement may not be detected (i.e. the auditor may ignore transactions that have not been recorded). Therefore, directional testing must be employed as part of the substantive procedures based on whether the test addresses over- or under-statement.

- This approach can be time-consuming and costly for the audit of large companies.

- This approach is appropriate where systems and controls are weak or not operating effectively, thus rendering substantive tests on transactions and balances necessary to reach an opinion about the financial statements.

- It is widely used for the audit of smaller entities where controls are less likely to be developed or effective.

- There is a danger of spending too much time auditing transactions or balances that are not material and/or have a low risk of material misstatement.

- There is also a risk that misstatements in the financial transactions will not be detected unless all transactions and balances are tested, not just a sample.

**1.3 Factors in the choice of audit strategy**

The development of an audit strategy will depend on a number of factors, including:

- the nature and size of the client’s business: a business risk approach is best-suited for large companies, and a balance sheet approach is usually the most suitable for small companies

- the control procedures and control environment in place: a systems-based approach is most suitable when there is a strong control environment and internal control system

- the audit methods and techniques favoured by the audit firm: for example, larger audit firms may favour a business risk approach.

You may be asked to select and justify an audit strategy for a particular client in the examination, in which case, students would be considering factors such as these.
2 RISK-BASED STRATEGIES

Section overview

- The development of audit strategy and practices
- The meaning of the business risk approach
- The nature of the business risk approach
- Internal business risks and external business risks
- Risk evaluation
- Advantages and disadvantages of the business risk approach
- Comparison of business risk and financial statement risk
- Business risk approach - comprehensive example

2.1 The development of audit strategy and practices

Auditing practice has developed significantly over recent years. The main reasons have been:

- the increasing size and complexity of business units, and the challenges created for the audit process by size and complexity
- an attempt to improve the efficiency of the audit process.

The first major development in the 'normal' audit approach was a switch from an emphasis on substantive testing to a systems-based approach, that concentrates much more on internal control systems and the testing of systems and controls, and normally relies much less on substantive testing.

Then the concept of the ‘risk-based’ audit developed. In a risk-based audit, the auditor concentrates most of the audit work on areas of high overall audit risk. (As you know, audit risk is a combination of inherent risk, control risk and detection risk.)

More recently, larger audit practices in particular have developed a ‘business risk’ approach to audit work.

**Business risk is the threat that an event or development may adversely affect the ability of the entity to achieve its objectives.** It is the risk of an adverse development that could have a major impact on the company’s business, such as the loss of a major customer, or an increase in the cost of a key commodity. An adverse business event is likely to affect the company’s business significantly, and so should be expected to affect its financial statements.

Business risks are risks faced by management of the client entity, which could have an impact on the financial statements (including the going concern assumption).
2.2 The meaning of the business risk approach

The business risk approach involves the auditor looking at the business as a whole and carrying out an evaluation of the risks to which it may be exposed.

The auditor identifies the business risks which may have an impact on the financial statements of the client company. The general approach is to:

- identify the key business risks
- evaluate their possible impact on the financial statements
- plan the approach to the audit around the key business risks that have been identified as having a material impact on the financial statements.

This approach cannot work effectively unless the auditor has a good understanding of the client’s business and the environment in which it operates. (Understanding the client’s business and business environment is a requirement for all auditors, in ISA 315 Identifying and assessing the risks of material misstatement through understanding the entity and its environment.)

2.3 The nature of the business risk approach

The business risk approach starts at an earlier stage than the ‘conventional’ audit risk model, which is based on inherent risks and control risks (and detection risks). [The audit risk model is addressed in more detail in the next chapter].

By looking at the nature of the client’s business, the auditor should develop an understanding of the events and circumstances that may affect the entity’s ability to meet its objectives. By understanding business risks, the auditor should also develop a better understanding of the inherent risks and the control risks facing the client.

The business risk approach is sometimes referred to as a ‘top down’ approach to an audit.

- The approach starts ‘at the top’ with the business, which generates the financial transactions.
- The approach ends ‘at the bottom’ with the financial statements which record the outcome of the business transactions.

The business ‘drives’ the financial statements.

This is a ‘high level’ approach to the audit, and has similarities with business management and strategy. Using this approach to an audit successfully depends on having adequate and up-to-date information about the client’s business and business environment.

For this reason, the larger auditing practices that use the business risk approach will often organise their audit teams into specialised industry groups, or may have industry experts available or may construct specialised databases for particular industries.

When the auditor takes a business risk approach they need to be aware not only of the current position of the client’s business, but also of possible future developments that may affect its goals and objectives.

The auditor is interested in business risk not for its own sake, but in the light of its possible impact on the financial statements.
2.4 Internal business risks and external business risks

With the business risk approach, the auditor must identify key business risks for the client company. Business risks may arise from the external environment in which a company operates, or from within the company itself.

External business risks

Examples of external business risks might include the following:

- The possible loss of a major contract as a result of a dispute with the customer.
- Long-term decline in demand for the company’s products, and failure to invest in research and development of new products.
- The impact of a new competitor moving into the market.
- The impact of proposed changes in laws and regulations: for example where a company needs a licence to operate (as in financial services) there may be a risk that the licence will be withdrawn or will not be renewed.
- The effect of recently discovered new technology.
- The effect of changes in the macro-economy, such as changes in interest rates or exchange rates, or a downturn in the economy (lower economic growth, or possibly an economic recession).
- The impact of natural hazards (such as storms and flooding that may affect the company’s ability to maintain operational capacity).
- Threats from competitors to a company’s patents or copyrights.

Internal business risks

Examples of internal business risks might include the following:

- Risks arising from ineffective employees or weak management.
- The risks from a lack of customer care and attention to customer needs: poor customer awareness will eventually have an effect on sales demand.
- Poor financial management (such as excessive levels of gearing, poor cash management and poor working capital control).
- Lack of finance for capital expenditure on equipment replacement or modernisation.
- Risks due to systems weaknesses or system failures: internal control weaknesses.
- Risks from over-reliance on one or a few key individuals.
- The risk of fraud or the misappropriation of assets.

The internal and external risks listed above are examples of risk, not a comprehensive list of business risks. In an examination question, you may be expected to identify key business risks (both external and internal) from the nature of the business and the facts given to you in the question. See the comprehensive example at the end of this section.
2.5 Risk evaluation

Not all risks are of equal significance. The significance of a risk to the auditors depends on two factors:

- The ‘impact’ that it will have on the financial statements if an adverse event occurs. It is the ‘size’ of the risk. In an auditing context, this could be broadly interpreted as the ‘materiality’ of the risk.
- The likelihood or probability that an adverse event will occur so that the risk becomes ‘reality’.

Auditors may use a standard model to assist them to rank risks in order of importance. The model below is widely used in management and strategy areas – it is not specifically an auditing model.

<table>
<thead>
<tr>
<th>High likelihood</th>
<th>Low likelihood</th>
</tr>
</thead>
<tbody>
<tr>
<td>High impact</td>
<td>Category 1 risk</td>
</tr>
<tr>
<td>Low impact</td>
<td>Category 3 risk</td>
</tr>
</tbody>
</table>

Most of the emphasis in an audit will be placed on risks in Category 1, where the impact of an adverse event and the probability that it will happen are both high. The least emphasis will be placed on risks in Category 4, because the impact of an adverse event will be small and the probability of it happening is low. Ranking risks in categories 2 and 3 in order of seriousness/priority will depend on the judgement of the auditor.

2.6 Advantages and disadvantages of the business risk approach

The business risk approach has some advantages and also some disadvantages.

**Advantages**

- The approach requires the auditors to acquire an in-depth knowledge of the client’s business. This should make the auditors more knowledgeable, and able to make a better judgement about the client’s financial statements.
- When the business environment is changing rapidly, a business risk approach keeps the auditor up-to-date.
- Evidence suggests that major audit problems are more likely to result from business-related problems than from internal control weaknesses.
- A business risk approach may allow the auditor to ‘add value’ by making effective recommendations to improve the performance of the client’s business.
- Audit costs may be reduced, because there is less audit testing, which saves time, especially the time of junior audit staff.
- The approach may benefit the auditor’s own business, because its use of a ‘modern’ business risk approach may differentiate the firm’s audit services from those of its competitors.

**Disadvantages**

- The business risk approach requires audit staff with suitable experience, including partners and managers. The time of these individuals is expensive. This may offset some of the cost savings (mentioned above) from a reduced need for junior audit staff.
The business risk approach requires a closer involvement by the auditor in the client’s business. This may raise questions about auditor independence.

Some auditors feel uneasy about the ‘broad’ view taken by the business risk approach, and consider a systems-based view to be more appropriate for reaching an opinion on the financial statements.

The approach may be effective only for the audits of larger companies.

2.7 Comparison of business risk and financial statement risk

Business risk is a risk that the business entity will fail to meet its objectives. Financial statement risk is the risk that the financial statements will not give a true and fair view, due to misstatements and omissions.

There is normally a close connection between these two categories of risk.

- When there is a significant business risk, failure by management to deal with the risk could affect items in the financial statements. For example a risk from declining sales demand for a product should raise questions about the obsolescence of product inventories and the realistic useful economic life and net realisable value of the non-current assets that make the product. The going concern assumption may be challenged, if the product has been a major source of income and profit in the past.

- Weaknesses in internal control are a business risk which could result in misstatements in the financial statements.

Example: Business risk and financial statement risk

An audit team has just completed the audit of an important client. One of the risks they identified was as follows:

The client’s new research laboratory was threatened with closure due to failure by the company to obtain official planning permission for its construction. The laboratory was therefore constructed illegally, and there was the risk that it would have to be demolished.

- The business risk was the risk that the laboratory would be forced to close, for regulatory reasons.

- The financial statement risk was that if this were to happen, the value of the laboratory (and possibly all the equipment within it) would be overstated in the accounts and should be written down substantially in value, possibly to Rs. nil.

Both business risk and financial statement risk should be assessed by the auditor, in order to assess the elements of the financial statements where misstatement is most likely to happen.

2.8 Business risk approach - comprehensive example

For your examination you need the ability to read a case study or scenario and:

- identify and explain business risks that are apparent in the information you are given; plus

- explain how these business risks impact financial statement risk and hence impact the audit.
Attempt your own answer to the following example before reading the answer provided.

**Example: Business risks**

Sting, a limited liability company, was incorporated in Ruritania on 1 June Year 1. In July, the company exercised an exclusive right that it had been granted by the government of Sordobia to provide daily flights direct between Zob (the capital city of Sordobia) and Polletta (the main commercial city of Ruritania).

The service has been widely advertised in the national newspapers of both countries as 'prompt, efficient and reliable'. As a result of these flights, it is expected that the travelling time between Zob and Polletta will be reduced by about eight to ten hours. This shortened travelling time should increase the volume of commerce and trade between the two countries.

Sting operates a refurbished 30-year-old aircraft. This is leased from an international airline and registered with the Sordobian Airways Authority (SAA). The SAA has a strict requirement that the engines of all aircraft on its register should be overhauled every two years. The overhaul of an aircraft engine usually puts the aircraft out of operational activity for up to five weeks.

The aircraft can carry 20 First Class, 50 Business Class and 80 Economy Class passengers. It also has a large hold for transporting cargo, in addition to passenger luggage.

On-board meals for the three-hour journey are prepared in Zob under a contract with an airport catering company. Market research by Sting has shown that passengers are in general dissatisfied with the quality of in-flight food, especially on the Polletta to Zob flight.

Sting employs 12 full-time cabin crew attendants whose training in air-stewardship includes first aid training and medical procedures in the event that passengers are taken ill or injured during a flight. The captain and co-pilots for the aircraft are provided under contract by the international airline that leases the aircraft to Sting.

Flight tickets are sold by Sting (by telephone and at its offices and airport reception desks) and by travel agents in Ruritania and Sordobia. On several occasions there has been over-booking of Economy Class seats. When this happens, customers are upgraded to Business Class. At the moment there is spare capacity in First Class and Business Class on all flights. Ticket prices for each class depend on several factors, such as whether the tickets are refundable (so that customers get their money back if they cancel their trip), exchangeable (so that customers can exchange tickets on one flight for tickets on an earlier or later flight). Ticket prices also vary with the day of the week and time of year.

Sting has extensive insurance cover, including employer's liability insurance (against the risk of accidents to employees) and passenger liability insurance (against the risk of liability to passengers for death, injury, extensive flight delays and other risks)

**Required**

Identify and explain the business risks and associated financial statement risks facing Sting.
**Answer**

The business objective of Sting is to make profits from the provision of a daily air service between the two cities.

An analysis of business risks should identify what risks exist within the business of Sting that might threaten the successful achievement of this objective, and in doing so have an impact on the financial statements of Sting.

<table>
<thead>
<tr>
<th>Key word or phrase in the text of the scenario</th>
<th>Business risk indicated</th>
<th>Associated financial statement risk</th>
</tr>
</thead>
</table>
| **Exclusive right**                           | Sting has a right to operate the flights, but there are presumably terms and conditions attached to this right that Sting must comply with. The risk is a risk of non-compliance with the terms and conditions, which might put into doubt the company’s continued right to operate the flights. | If Sting has breached the terms of the exclusive rights deal:  
- liabilities may be understated relating to undisclosed penalties  
- there may be significant uncertainty as to whether Sting remains a going concern should it lose its licence |
| **Exclusive right**                           | Sting is currently operating a monopoly, but this may not always be the case and potential future competition could significantly affect the company’s business. |  
- The value of landing slots may be overstated and financial projections misstated if future exclusivity is no longer guaranteed. |
| **Widely advertised ... as ‘prompt, efficient and reliable’** | Sting might not live up to its own advertising and might disappoint customers, affecting its business. | If Sting has failed to meet contractual operational targets:  
- Liabilities may be understated relating to unrecorded provisions for fines and customer refunds.  
- Sting might lose its operating licence which would raise uncertainty about whether the going concern basis remains appropriate. |
| **30 year-old aircraft**                     | The age of the aircraft could cause operating problems if it needs frequent repair. The relatively old age might also mean that fuel consumption (and therefore costs) is higher. |  
- Profit might be overstated if repairs and maintenance expenses have been capitalised rather than expensed. |
<table>
<thead>
<tr>
<th>Key word or phrase in the text of the scenario</th>
<th>Business risk indicated</th>
<th>Associated financial statement risk</th>
</tr>
</thead>
</table>
| Leased                                        | Sting will have no means of operating its service if it does not keep up the lease payments. | If Sting has breached the terms of its operating leases:  
- Liabilities may be understated relating to unrecorded provisions for penalties and unpaid interest.  
- There may be uncertainty about Sting’s ability to continue as a going concern if the lessor breaks the leases early.  
Lease expenses may be incorrectly classified in the financial statements. |
| Overhaul of an engine usually puts the aircraft out of operational activity for up to five weeks. | Sting must have the engine overhauled regularly under the regulations of the SAA, but this will mean a break in its services as there is only one plane. | If Sting has failed to regularly overhaul its aircraft:  
- Liabilities may be understated relating to unrecorded regulatory penalties and/or compensation payable in the event of litigation faced due to negligence.  
- Sting may be unable to continue as a going concern if it does not have the financial and operational resources to rectify the situation. |

Note that a case study might include information about problems that are not sufficient to justify the attention of the auditors. There are arguably three examples here: the quality of in-flight food, over-selling Economy Class tickets and having to upgrade some passengers to Business Class, and the need to obtain insurance.
3 SYSTEMS-BASED STRATEGIES

Section overview

- The nature of a systems-based approach to an audit
- What makes an effective system of internal controls?
- The control environment
- The entity’s risk assessment process
- The information system
- Control activities
- Monitoring of controls
- Internal controls - illustration
- How the auditor uses internal controls
- The auditor’s evaluation of internal controls
- Summary of the approach to reliance on internal controls

3.1 The nature of a systems-based approach to an audit

A *systems-based approach* to an audit focuses on the internal control system of the client company and the adequacy of its internal controls over the major transaction cycles (sales, purchases, payroll and other expenses).

A *transaction-cycle approach* focuses on substantively testing the transactions that occur throughout those same transaction cycles.

As part of their risk assessment exercise, the auditor is required by ISA 315 to ‘obtain an understanding of the entity and its environment, including its internal controls.’

It is the responsibility of management to put in place a suitable system of internal control, to address identified financial statement risks, operational risks and compliance risks. Effective internal controls, provided that they are implemented properly, should ensure:

- reliable financial reporting
- the effectiveness and efficiency of operations
- compliance with appropriate laws and regulations.

**The effectiveness of Internal controls: testing the controls for effectiveness**

With a systems-based approach, the auditor *aims to rely* on the accounting systems and the related internal controls to ensure that transactions are properly recorded.

- His assumption is that if the systems and the internal controls are adequate, the transactions should be processed correctly, and the financial statements should therefore give a true and fair view.

- The audit emphasis is therefore, as much as possible, on the systems that process the transactions rather than on the transactions themselves.

Before the auditor can rely on the systems and controls that are in place, they must establish what those systems and controls are, and carry out an evaluation of the effectiveness of the controls.
3.2 **What makes an effective system of internal controls?**

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

- the control environment
- the entity’s risk assessment process
- the information system
- control activities (internal controls)
- the review and monitoring of controls.

3.3 **The control environment**

The ‘control environment’ is often referred to as the general ‘attitude’ of management and employees in the organisation towards internal controls.

The control environment has been defined by the Institute of Internal Auditors as follows: ‘the attitude and actions of the board [of directors] and management regarding the significance of control within the organisation. The control environment provides the discipline and structure for the achievement of the primary objectives of the system of internal control. The control environment includes the following elements:

- integrity and ethical values
- management’s philosophy and operating style
- organisational structure
- assignment of authority and responsibility
- human resource policies and practice
- competence of personnel.

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

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

**Evaluating the control environment**

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

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

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

3.4 The entity’s risk assessment process

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

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

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

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

3.5 The information system

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

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

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

The information system therefore consists of:

- infrastructure (physical and hardware components) – manual accounting systems may have little infrastructure.
- software (in IT-based accounting systems)
- people
- procedures
- data.
3.6 Control activities

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

Control activities are the specific procedures designed:
- to prevent errors that may arise in processing information, or
- to detect and correct errors that may arise in processing information.

Categories of control activities (internal controls)

Internal controls include the following types: (In the examination, if you are asked to suggest suitable internal controls within a given system the items in this list should provide a useful checklist.)

- **Authorisation controls.** These require that all significant transactions must be authorised by a manager at an appropriate level in the organisation.

- **Physical controls** over assets. These are controls for safeguarding assets from unauthorised use, or from theft or damage. An example is limiting access to inventory areas to a restricted number of authorised personnel.

- **Arithmetic controls.** These are checks on the arithmetical accuracy of processing. An example is checking invoices from suppliers, to make sure that the amount payable has been calculated correctly.

- **Accounting controls.** These are controls that are provided within accounting procedures to ensure the accuracy or completeness of records. An example is the use of control account reconciliations to check the accuracy of total trade receivables or total trade payables.

- **Management controls.** These are controls applied by management. They include supervision by management of the work of subordinates, management review of performance and control reporting (including management accounting techniques such as standards setting, variance analysis, budgeting and budgetary control).

- **Segregation of duties.** This type of control is explained below.

**Segregation of duties**

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

- If several individuals are involved in the completion of an overall task, this increases the likelihood that errors will be detected when they are made. Individuals can often spot mistakes of other people more easily than they can identify their own mistakes.

- It is more difficult for a person to commit fraud, because a colleague may identify suspicious transactions by a colleague who is trying to commit a fraud.
3.7 Monitoring of controls

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

3.8 Internal controls - Illustration

**Illustration: Internal controls**

**The scenario**

Waqar Wheels is a listed car dealership with over thirty showrooms across Pakistan and headquarters in Karachi. The directors introduced a code of ethics and conduct four years ago which it updates regularly and implements enthusiastically with routine training session and a robust disciplinary procedure. Monthly ‘all-staff’ newsletters remind employees about core ethical values and the need to maintain strong internal controls across all business processes.

The directors take both employee and customer safety very seriously. A number of staff were dismissed following serious breaches of the code of conduct.

Waqar Wheels employs an experienced internal audit department. It also has a number of non-executive directors on its board of directors. Waqar Wheels complies fully with the code of corporate governance applicable to listed companies in Pakistan.

A risk committee comprising three experienced members of the board of directors was established four years ago. The committee is responsible for assessing the business risks faced by Waqar Wheels and working with senior management to ensure appropriate internal controls are employed across the business.

For example, sales representatives are allowed to offer discounts of up to 6% without manager approval. However, discounts above 6% must be authorised by a showroom manager. The sales system automatically checks whether an approval is required and prevents any sale being recorded without an approval code. Regional sales managers receive a weekly report detailing all discounted sales above 6% to check that they were authorised.

**Analysis of the system of internal controls**

- **Control environment** - Waqar Wheels has a strong control environment with directors who take internal controls seriously. They employ an internal audit department and vigorously implement codes of ethics and conduct, reinforcing their control-focused attitude with regular all-staff communications. The directors also ensure full compliance with the code of corporate governance.

- **The entity’s risk assessment process** – Waqar Wheels has a risk committee comprising three experienced directors who are responsible for assessing business risks faced by the company. The committee works with senior management to ensure a robust system of internal controls is implemented.

- **The Information system** – The scenario made reference to a ‘sales system’ for recording sales and discounts. The ‘sales system’ is part of the overall information system used to record transactions at Waqar Wheels.

- **Control activities** – Sales discounts above 6% must be authorised by a showroom manager prior to recording the sale. This is an example of an authorisation control.
Chapter 6: The audit approach

3.9 How the auditor uses internal controls

When a client operates an effective system of internal control the most efficient method of generating audit evidence normally involves the testing of controls where possible (rather than substantive procedures). ‘Systems-based’ techniques therefore complement the business risk approach described above in an effort to maximise audit efficiency and focus testing on the higher risk areas.

The auditor relies on the accounting systems and the related controls to ensure that transactions are properly recorded. The audit emphasis is therefore, as much as possible, on the systems processing the transactions rather than on the transactions themselves.

Understanding the controls

ISA 315 requires the auditor to obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor’s professional judgment whether a control, individually or in combination with others, is relevant to the audit.

ISA 315 requires the auditor to:

- gain an understanding of each of the five elements of the client’s internal control system, and
- document the relevant features of the control systems.

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

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

Example: Walk-through procedures

In a walkthrough test over the sales transaction, the auditor would select a sales transaction and start from the receipt of a Sales Order from a customer. The auditor would then review each document (e.g. order, invoice, goods despatch note, customer acknowledgement of receipt) and process (e.g. review of order, preparation and approval of sales invoice etc.) until the final customer’s acknowledgment of receipt of goods, thereby ensuring that the system of sales as understood is in fact also implemented in the same way.

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

Assessing the effectiveness of controls

The degree of effectiveness of an internal control system will depend on the following two factors:
The design of the internal control system and the individual internal controls. Is the control system able to prevent material misstatements, or is it able to detect and correct material misstatements if they occur? Do the internal controls appear to be adequate and effective ‘on paper’?

The proper implementation of the controls. Controls are not effective unless they are implemented properly. So are the controls operated properly by the client’s management and other employees?

The outcome of this evaluation helps the auditor to assess the control risk. This is the risk that the internal controls will fail to prevent or detect and correct errors in the financial statements. This evaluation will allow the auditor to decide on the extent to which they can take a systems-based approach to the audit.

3.10 The auditor’s evaluation of internal controls

The auditor may judge that the control risk is high, or that the control risk is low because the internal controls are effective.

If the auditor assesses the control risk as very high, they will probably take the view that a systems-based audit approach will not be appropriate. They will therefore move on to detailed testing of transactions and balances (and take a substantive testing approach to the audit).

Before they can assess the control risk as low, the auditor must be satisfied that the controls are well-designed and should be effective (in other words, they seem effective ‘on paper’). Even if the controls appear to be acceptable on paper, the auditor cannot rely on them and perform a systems-based audit unless they are confident that the controls are actually working in practice. In this situation, the next stage in the audit process is to carry out tests of controls.

If the outcome of the tests of control indicates that controls are actually operating effectively, the audit can use a systems-based approach, with a reduced amount of substantive testing. Even if the internal control system seems to be effective, the auditor will never rely 100% on their assessment of the controls. They will always do some substantive testing before reaching their conclusion about the financial statements.

This is because of the limitations that are inherent in all control systems. It is impossible to avoid the risk of control failure that is caused by:

- human error (and a failure to apply a control properly)
- obsolescence of controls
- over-riding of controls by management (which is a deliberate decision to ignore a control), and
- the possibility of collusion and fraud.

Auditors will always supplement their work on systems with some substantive testing. The amount of this testing will depend on the auditor’s evaluation of the effectiveness of the controls.

The performance of tests of controls does not guarantee that few substantive procedures would be carried out; in fact, if the performance of tests of controls reveals that the internal controls within a particular type or class of transaction are not operating effectively, the auditor will increase the nature, timing and extent of their substantive audit procedures.
3.11 Summary of the approach to reliance on internal controls

The auditor's use of a systems-based approach to an audit is summarised in the following flowchart:

- **Planning and risk assessment**
- **Assessment of internal controls as weak**
  - Extensive substantive testing
  - Poor controls
- **Assessment of internal controls as strong**
  - Tests of controls
  - Good controls
  - Reduced substantive testing
- **Overall review of financial statements**
- **Issue audit report**
4 BALANCE SHEET (SUBSTANTIVE) STRATEGIES

Section overview

- Substantive tests
- The balance sheet approach
- Directional testing
- Smaller entities

4.1 Substantive tests

When an auditor assesses the control risk as high, they will not be able to adopt a systems-based approach to the audit. Instead they will carry out extensive substantive testing.

**Substantive tests** are audit procedures performed to detect material misstatements in the figures reported in the financial statements. They are designed to obtain evidence about the financial statement assertions. They include:

- tests of detail on transactions, account balances and disclosures, and
- analytical procedures.

Examples of tests of details include inspection of third party evidences such as suppliers’ statements or invoices, obtaining confirmations and/or recalculating items such as depreciation or rent expense for the year.

Similarly, examples of analytical procedures include ratio analysis, comparison with past trends, industry information or company budgets and corroboration with the information obtained from other substantive procedures.

4.2 The balance sheet approach

The **balance sheet approach** is also an approach to the audit based wholly on substantive testing. However, unlike the transaction cycle approach, with the balance sheet approach the auditor concentrates primarily on:

- testing balances, as opposed to
- testing balances and transactions.

It is an approach that is often well-suited to small companies and to companies where assets and liabilities are substantial in relation to transactions (e.g. investment companies).

This approach is based on the following accounting equation:

**Opening net assets + Profit for the year = Closing net assets**

The theory is that if the opening and closing statements of financial position are 'correct' then the profit for the year must also be correct.
4.3 Directional testing

Directional testing is the concept applied to substantive testing to differentiate between testing for misstatements (over- or under-statement) or omissions (under-statement).

- When testing for misstatements the audit sample will be selected from the accounting records (i.e. recorded transactions).
- When testing for omissions the audit sample will be selected from outside the accounting records e.g. bank statements or supplier statements.
- The testing is therefore said to be performed in opposite directions when testing for omissions rather than misstatements.

4.4 Smaller entities

ISAs apply to the audits of all entities – whatever their size. However, additional considerations specific to audits of smaller entities are included within the application and other explanatory material of a ISAs, where appropriate. These additional considerations assist in the application of the requirements of the ISA in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of the ISAs.

Definition: Small entity

The IAASB’s Glossary of terms defines a smaller entity as one which typically possesses the following characteristics:

- Concentration of ownership and management in a small number of individuals (often a single owner-manager)
- One or more of the following:
  - Uncomplicated transactions
  - Simple record-keeping
  - Few lines of business/products
  - Few internal controls
  - Few levels of management with responsibility for a broad range of controls
  - Few personnel, many having a wide range of duties

Many of the control activities that would typically be found in a large company may be inappropriate, too costly or impractical for a small entity. Segregation of duties is an obvious example of this. Smaller entities do not have enough employees for an ‘ideal’ segregation of duties.

Often, control systems in smaller entities are based on a high level of involvement in day-to-day operations by the directors or owners of the company. Authorisation controls and review controls, with the owner-manager personally authorising many transactions, might therefore be a key feature of the control systems in smaller entities.
Although the active involvement of an owner-manager might mitigate risks arising from a lack of segregation of duties, the auditor will often see the involvement of an owner-manager in day-to-day operations as only a partial substitute for ‘normal’ control systems. The following problems may arise in such types of businesses:

- There may be a lack of evidence as to how systems are supposed to operate. The auditor will need to rely more on inquiry than on review of documentation.
- There may be a lack of evidence of the application of controls in practice (for example, authorisations may not be documented).
- Management may override whatever internal controls are in place.
- Management may lack the expertise necessary to control the entity effectively and efficiently.
- There is unlikely to be any independent person within the management team as there would be within “those charged with governance” in a larger entity.

The attitudes and actions of the owner-manager will be key to the auditor’s risk assessment. There is unlikely to be a written code of conduct so a culture of integrity and ethical behaviour, as demonstrated by management example, will be important.

The auditor needs to understand and evaluate whatever controls are in place and plan their audit work accordingly. However, it is likely that a lower level of reliance will be placed on controls in a smaller entity, which means that a considerable amount of substantive testing will be needed.
## CHAPTER REVIEW

### Chapter review

Before moving on to the next chapter check that you can:

- Summarise the different types of audit strategies and factors that impact which strategy is adopted
- Explain the business risk approach and be able to identify and assess business and financial risks
- Describe the systems-based approach and articulate the components of a system of internal control
- Summarise the balance sheet approach
Certified Finance and Accounting Professional
Audit, Assurance and Related Services

CHAPTER 7

Planning

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INTRODUCTION

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Exam context

Planning is a fundamental phase of any audit and assurance engagement. This chapter expands on the basic introduction to planning that students studied previously and provides comprehensive notes on the audit plan, audit strategy, audit risk and materiality.

Given the ever increasing relevance of computers to both practitioners and their clients in Pakistan and beyond, the chapter closes with a section on computers in auditing.

By the end of this chapter students will be able to:

- Describe how to plan an audit engagement
- Explain the various components of audit risk
- Discuss the principles and application of materiality
- Articulate the relevance of computers to auditing
- Describe and critically assess general and application computer controls
- Explain the audit approach for NFPOs
1 AUDIT PLANNING

Section overview

- ISA 200: Overall objectives of the independent auditor
- The need to plan
- ISA 300: Planning an audit of financial statements
- Audit strategy and plan
- Information required to effectively plan an assignment
- Understanding the entity and its environment

1.1 ISA 200: Overall objectives of the independent auditor

As you saw in your earlier studies, the objectives of the auditor, per ISA 200 are:

- to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. This allows the auditor to give an opinion on whether the financial statements have been prepared in accordance with the applicable financial reporting framework.

- to report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor’s findings.

Where the auditor is unable to obtain reasonable assurance and a qualified opinion is insufficient, the auditor must disclaim an opinion or resign. The different types of opinions are covered in a later chapter.

ISA 200 requires the auditor to:

- comply with all ISAs relevant to the audit
- comply with relevant ethical requirements
- plan and perform an audit with professional scepticism
- exercise professional judgement in planning and performing an audit
- obtain sufficient and appropriate audit evidence to allow them to obtain reasonable assurance

1.2 The need to plan

A plan is a course of action, decided in advance, to achieve a stated goal or objective. A plan is necessary for each audit so that the auditor can decide in advance what needs to be done so that (by the required date for completion of the audit) they will be able to express an opinion on the truth and fairness of the financial statements and achieve the objectives of ISA 200.

The extent and type of audit work performed is determined largely by the professional judgement of the auditor. The planning process enables the auditor to apply their judgement to the circumstances of the particular audit to decide how the audit will be conducted.
A starting point for the audit plan is deciding which audit strategy to adopt. The auditor will need to consider, amongst other things:

- audit risk (including control risk)
- materiality
- the use of computers, and the effect that the client’s computer-based system might have on their audit approach.

### 1.3 ISA 300: Planning an audit of financial statements

The auditor’s work on planning is regulated primarily by ISA 300 *Planning an audit of financial statements*, which requires the auditor to plan the audit so that the audit work will be performed in an effective manner. An overall audit plan should be developed, detailing the expected scope of the audit and how the audit should be conducted.

ISA 300 states that:

- an audit should be planned so that it is performed effectively
- the auditor should establish an overall audit strategy, and
- the audit plan should include measures for the direction, supervision and review of audit work.

### 1.4 Audit strategy and plan

#### The overall audit strategy

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

- Determining the characteristics of the engagement that define its scope such as:
  - the financial reporting framework used (for example, international financial reporting standards)
  - any industry specific reporting requirements
  - the location of the components of the entity (for example, there might be overseas branches).

- Ascertaining the reporting objectives of the engagement, such as reporting deadlines and the nature of communications required.

- Considering important factors which will determine the focus of the audit team’s efforts, such as:
  - materiality thresholds
  - high risk areas of the audit
  - the audit approach (for example, whether the auditor is planning to rely on the entity’s internal controls)
  - any recent developments in relation to the entity, the industry or financial reporting requirements (for example, the application of a new IAS / IFRS or a new regulation by the Government may sometimes have a significant impact on the amounts and/or disclosures in the financial statements; these need to be considered at the planning stage to develop an appropriate audit strategy).
The above will then allow the auditor to decide on the nature, extent and timing of resources needed to perform the engagement. In particular the auditor should consider:

- where experienced members of staff may be needed (for example, on high risk areas)
- the number of staff to be allocated to specific areas (for example, extra staff may be needed for attendance at the year-end inventory count)
- when the resources are needed (for example, are more staff needed at the final audit than at the interim audit)
- how such resources are to be managed, directed and supervised (for example, the timing of team briefing meetings and manager and partner reviews of work performed by other members of the audit team).

The audit plan

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

The audit plan will set out:

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

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

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

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

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

1.5 Information required to effectively plan an assignment

Relevant Information

ISA 300 Planning an Audit of Financial Statements requires the auditor to prepare an audit strategy and an audit plan. ISA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment requires that the auditor has sufficient understanding of the entity and its environment in order to understand the risks of material misstatement within the client’s financial statements.

In order to satisfy the requirements of both of these ISAs the auditor will need to access a wide number of information sources. Remember that every assignment and client is different so the auditor (and you in the exam!) will need to use initiative and judgement in assessing relevant and reliable information to assist in the planning.
Note that during the ‘planning’ phase we are not yet performing the responses to the assessed risks of material misstatement – i.e. the detailed audit tests. These occur at a later stage (as directed by ISA 330 The Auditor’s Responses to Assessed Risks) so the auditor must balance efficiency and sufficiency during the planning phase to ensure they do not invest time in information and matters that are not relevant to the planning of an assignment.

A common exam requirement involves a scenario that misses out some information that would be relevant to the auditor either for planning or executing the audit. You may be asked to identify any additional information required. For example:

- Obtain a copy of a new loan agreement with the bank to ensure that details of any overdraft limit and debt covenants are understood and whether any breaches have occurred;
- Review legal correspondence between the client and its legal advisors regarding an incident that occurred during the year to establish the impact of the incident on the financial statements;
- Review details of any significant new sales contracts agreed with key clients;
- Obtain a copy of prior years’ financial statements in order to review the accounting policies used and any provisions and contingent liabilities recognised in the accounts relating to construction contracts, financial instruments, pension obligations and legal cases.

**Non-relevant Information**

Remember that the objective of the audit is to identify whether material misstatement exists in the financial statements. Therefore information relating to immaterial matters or operational matters that will not assist in concluding whether a material misstatement exists in the financial statements may not be relevant for audit planning.

You will encounter other types of non-audit engagement in this syllabus such as reviews, assurance engagements, compilations and agreed-upon procedures where information not relevant to audit planning may still be relevant to other types of assignment.

1.6 Understanding the entity and its environment

In order to prepare the overall audit strategy and audit plan, the auditor will need to form an understanding of the entity and its environment. This will involve considering such factors as:

- the industry in which the entity operates
- the nature and competence of its management
- the entity’s internal control system
- its current financial performance
- reporting requirements and deadlines
- any recent developments.

This is a requirement of ISA 315 Identifying and assessing the risks of material misstatement through understanding the entity and its environment.
The **objective** of the auditor under ISA 315 is to **identify and assess the risks of misstatement**, whether due to fraud or error, through understanding the entity and its environment, including its internal controls.

This risk assessment process will then provide a basis for designing and implementing responses to those assessed risks. The responses to the assessed risks will take the form of audit procedures.

ISA 315 **requires** the auditor’s risk assessment procedures to include the following:

- **Inquiries** of management and others (i.e. asking questions and getting answers).

- **Analytical procedures**, which involves the study of ratios and trends to identify the existence of unusual transactions or events or amounts, ratios or trends that might have implications for the audit (information technology may be of use here in calculating changes to balances in the financial statements from previous years and graphing trends).

  For example, an analysis of payables days compared to previous years might indicate that the company is having difficulty in paying its debts. As a result, the auditor may plan to do more work on this area.

- **Observation and inspection** (for example, inspecting internal control manuals or business plans).
2 AUDIT RISK

Section overview

- Risk-based approach to auditing
- The audit risk model
- Inherent risk
- Control risk
- Detection risk
- Audit risk assessment: a summary
- The connection between business risk, risks of material misstatement and audit risk

2.1 Risk-based approach to auditing

A key feature of modern auditing is the ‘risk-based’ approach that is taken in most audits. At the planning stage, as required by ISAs 300 and 315, the auditor will identify and assess the main risks associated with the business to be audited. The auditor will then design and implement appropriate responses to those assessed risks in accordance with ISA 330 *The auditor’s responses to assessed risks* including:

- Overall responses
- Audit procedures responsive to the assessed risks of material misstatement at the assertion level (i.e. appropriate mix of tests of controls and/or substantive procedures)

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

The auditor shall also consider whether external confirmation procedures (covered by ISA 505 *External confirmations*) are to be performed as substantive audit procedures and the timing and extent of those procedures.

The risk-based approach to auditing should enable the auditor to then conclude whether a ‘true and fair view’ is presented by the financial statements.

2.2 The audit risk model

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

*Audit risk* is the risk (chance) that the auditor reaches an inappropriate (wrong) conclusion on the area under audit. For example, if the audit risk is 5%, this means that the auditor accepts that there will be only a 5% risk that the audited item will be mis-stated in the financial statements, and a 95% chance that it is materially correct.

The audit process is designed to give a *high level of assurance* about the information that is subject to audit. However, the audit process does not give an absolute level of assurance, that the information is 100% correct.

The implication of this is that the auditor will seek to reduce the level of audit risk to an ‘acceptable’ level, but will not attempt to eliminate audit risk entirely.
If the auditor is to ‘manage’ risk effectively, they need to be able to measure the risk attached to any given audit situation, and establish a maximum acceptable limit to the audit risk. This led to the development of the audit risk model.

![Audit risk model diagram]

This model can be stated as a formula:

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

where:
- \(AR\) = Audit risk
- \(IR\) = Inherent risk
- \(CR\) = Control risk, and
- \(DR\) = Detection risk.

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

### 2.3 Inherent risk

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

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

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

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

**The assessment of inherent risk**

The auditor’s assessment of inherent risk will be based mainly on:

- the knowledge gained from previous audits, and
- an assessment of the current environment within which the entity operates.

It is normal practice to assess inherent risk at two ‘levels’:  
- the financial statement level, and  
- the account balances and transactions level.
At the financial statement level, the auditor will consider the inherent risk in the client's business, such as:

- the integrity, skills and abilities of the management
- the nature of the business
- industry-wide and macroeconomic factors.

At the account balances and transactions level, the auditor will consider:

- the degree of subjectivity involved in the account balance or the transaction
- the degree of complexity of a transaction and how it is processed
- the characteristics of the client’s assets and the level of risk that they may be misappropriated.

Example: Inherent risk

It is difficult to provide a comprehensive list of inherent risks, but you may be required to identify one or more such risks within a case-study type of examination question.

Example 1
A large oil spill causes ecological devastation to the natural environment impacting many local industries including tourism, fishing and associated supply-chain and support businesses. The company faces a number of legal claims which will take a number of years to settle.

In this situation there is high inherent risk as the financial statements will contain numerous estimates and provisions which are highly material and important to the accounts.

Example 2
Following the economic downturn and a subsequent drop in profits there is pressure on a client to raise new debt finance four months after the year-end in order to continue as a going concern.

In this situation there is increased inherent risk as the directors may be motivated to misstate the financial statements in order to influence the banks decision in their favour.

Example 3
Suppose that the CEO of an audit client company is also a majority shareholder of the company, and you are aware that they intend to sell some of their shares soon after the financial statements are approved and issued.

In this situation there would be an inherent risk at the financial statement level, arising from the fact that the CEO/majority shareholder has a personal interest in presenting favourable financial statements – the reported profit for the year or the reported statement of financial position – and may therefore have deliberately ‘window dressed’ (misstated) the draft financial statements.

Example 4
A boutique investment company has recently started trading in complex derivative financial instruments across fixed income and equities markets. The investment company has no prior experience of this type of trading.

Inherent risk is increased as the financial statements will contain balances with complex financial accounting requirements of which the client has no prior experience.


2.4 Control risk

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

In preparing an audit plan, the auditor needs to make an assessment of control risk for different areas of the audit. Evidence about control risk can be obtained through ‘tests of control’ for each of the major transactions cycles.

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

It is unlikely that control risk will be zero because of the inherent limitations of any internal control system.

**(Note:** Control risk can be reduced by introducing new controls or better controls. However, the design and implementation of controls is the responsibility of the management of the company. Management may introduce better controls to reduce the control risk in next year’s audit, perhaps on the recommendation of the auditors, but control risk cannot be reduced for the current year’s audit).

2.5 Detection risk

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

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

In preparing an audit plan, the auditor will usually:

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

In other words, the detection risk can be managed by the auditor in order to control the overall audit risk. As noted above, inherent risk cannot be controlled because it operates independently of controls. Control risk can be reduced by improving the quality of internal controls; however, recommendations to the client about improvements in its internal controls can only affect control risk in the future, not control risk for the financial period that is subject to audit. Audit risk can be reduced by increasing testing and reducing detection risk.
2.6 Audit risk assessment: a summary

The implications of this approach for the audit work can be summarised as follows:

To achieve a 'target' level of AR

- If IR x CR is high:
  - DR must be decreased to low
  - High level of audit testing is required
  - Larger sample sizes

- If IR x CR is low:
  - Higher DR can be accepted
  - Lower level of audit testing
  - Smaller sample sizes

In the left hand column the auditor needs to achieve a low detection risk to compensate for the high IR x CR. This is likely to require extended testing and hence larger sample sizes.

In the right hand column the auditor is comfortable to accept high detection risk because they have assessed IR x CR to be low. In this case they are unlikely to need to extend testing significantly and hence can adopt smaller sample sizes.

2.7 The connection between business risk, risks of material misstatement and audit risk

It is important to understand the connection between business risk, the risk of material misstatement and audit risk. The connection between business risk and risk of material misstatement was mentioned in a previous chapter. The connection is explained in more detail here.

**Business risk**

Business risk is any risk that threatens the ability of a business entity to achieve its objective, which can usually be stated as the objective of maximising profit or maximising wealth. Anything that threatens this objective is therefore a risk that profits might be lower. In extreme cases, it could mean a risk that losses will be very large and the going concern status of the business entity might be called into question.

Business risks can be divided into two categories.

- A risk might have a low probability of happening, or if an adverse event does occur, the resulting loss might be small. Where the probability of loss
is low and the severity of the loss would be low, the risk can be regarded as acceptable. The cost of control measures to reduce the risk would not justify the benefits from the lower risk.

- A business risk is an applicable risk when the financial impact of the risk could be high.

For applicable risks, management should decide on a suitable plan or strategy for managing the risk. The chosen strategy might be any of the following.

- **Reduce the risk** by introducing more internal controls.
- **Transfer the risk**, for example by insuring against it.
- **Avoid the risk** entirely, by withdrawing from the business operations to which the risk relates.
- **Accept the risk**, and take no action to reduce it or transfer it.

**Business risk and the risks of material misstatement**

For the auditor, the significance of business risk is the impact that it could have on the financial statements. Most business risks increase the likelihood that the financial statements could be materially wrong. Some business risks can be linked to specific risks of material misstatement such as the risk of:

- an understatement of bad debts or the allowance for doubtful debts
- over-stating the value of inventory (where net realisable value is less than cost)
- over-stating the value of a non-current asset (tangible or intangible) due to a failure to recognise impairment.

Some business risks do not create any specific risk of material misstatement, although the risk might ultimately lead to going concern problems for the business entity.

**Audit risk and risks of material misstatement**

Business risk is risk that management must deal with. Audit risk is a risk that is faced by the auditor. It is the risk that the auditor will give an inappropriate audit opinion when the financial statements are materially wrong (mis-stated).

Audit risk follows on from risk of material misstatement. The auditor should, therefore, assess the risks of material misstatements as a step towards assessing the audit risk.
Business risk could lead to…

Risks of material misstatement affects…

Audit risk results from:

1. **Inherent risk**: risk of a misstatement where there is no internal control to prevent it

2. **Control risk**: risk that existing internal controls will fail to detect or prevent a material misstatement

3. **Detection risk**: Risk that substantive testing will fail to detect a misstatement.

You may be required in the exam to identify the main audit risks in a case study. Within the case study, there may be inherent risk, control risk and even detection risk (for example there might be only a short amount of time and limited resources to perform the audit).

It is probable, however, that most of the audit risks will be identifiable as risks of material misstatements. The types of risk to consider will include the following:

- **Risk of over-statement of revenue** or other income. There may be some risk that revenue has not been recognised in accordance with the requirements of IAS18 *Revenue*, and is over-stated. This risk will occur when customers make staged payments (for example staged payments for contract work) or pay deposits in advance (for example customer bookings for holidays): revenue should not be recognised until the goods or services have been provided, not when the payment is received.

- **Risk of over-statement of current assets**. For example, there may be some doubts about whether amounts receivable will actually be recovered. A company may fail to make a sufficient allowance for irrecoverable amounts and when this happens receivables and profit will be over-stated. Another example may be the risk of over-statement of inventories, due to the timing of the physical inventory count or the procedures used in the inventory counting process.

- **Risk of over-statement of non-current assets**. There may be a risk that some non-current assets are over-stated in value, when there is some reason to suppose that impairment has occurred (for example impairment to a building due to fire or flood damage).

- **Risk of under-statement of liabilities**. There may be a risk that some liabilities are not fully stated, particularly provisions. For example, a warranty provision might be necessary to cover the cost of post-year-end repairs or refunds against sales made before year end. If such a provision was missing then liabilities would be under-stated and profits over-stated.
It is also possible that an exam question includes a scenario where the company makes a provision for the cost of repairs to fire damage, when the losses were insured, but ignores the amount recoverable through the insurance claim. In this case profit (and other receivables) would be under-stated.

- **Risk of understatement of operating expenses.** As a general rule there is usually a fairly consistent ratio from one year to the next between elements of cost and sales revenue. For example the ratio of administrative expenses to revenue and the ratio of sales and distribution costs to expenses are often fairly consistent from one year to the next. Some changes may occur, but not usually large changes. So for example if sales revenue is increasing but the ratio of administrative costs to sales is falling sharply, this could indicate a risk of under-statement of operating expenses.

- **Risk from accounting estimates.** The auditor should check accounting estimates carefully. These depend upon management judgement and when estimates are a material amount there will be a significant risk of misstatement.

- **Failure to comply with the requirements of specific accounting standards.** An exam question may provide details about the accounting treatment of items that are the subject of specific accounting standards, such as contingent liabilities, deferred tax, share-based payments and related party transactions. You may be required to discuss the risks of misstatement or non-disclosure due to a failure to comply properly with the requirements of the accounting standard.

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### Example: Risks of material misstatement

Zarma, a limited liability company, manufactures ‘high-tech’ computer-controlled equipment for use in other production industries. Its directors and senior managers are also the company’s shareholders. On 1 July Year 7 they accepted an offer from a US corporation to buy Zarma’s own manufacturing equipment and technology, which is protected by patent rights.

Management notified the employees, suppliers and customers that Zarma would cease all manufacturing activities on 31 August Year 7. All the factory workers and most of the employees in the accounts and administration departments were made redundant, and the same was duly completed on 31 August.

Most of the employees who remained in employment with the company after 31 August were made redundant from 31 October Year 7. However, the company retained a small head office operation, consisting of the chief executive officer, the marketing and sales directors, the chief accountant and a small accounting and administrative support team. This head office unit will continue to operate for a few more years until the company’s operations are wound down completely.

Before the sale, Zarma operated from twelve premises. Eight of these were put on the market on 1 August. Three of the other premises are held on leases that will expire in the next three to five years. Under the terms of the lease agreements, none of these premises can be sub-let and the leases cannot be sold. A small head office building will continue to be occupied and used until the lease expires in three years’ time. Zarma accounts for all its tangible non-current assets at depreciated cost.

All the products sold by Zarma carry a one-year warranty. Until 31 August, the company sold extended two-year and five-year warranties, but extended warranties were not offered on any products sold from 1 September.
Zarma sold its products through national and international distributors, under three-year agreements. Zarma also had annual contracts with its major suppliers for the purchase of components. So far, none of the distributors or suppliers has initiated legal proceedings against Zarma for breach of contract. However, some distributors are withholding payments from Zarma on their account balances, awaiting settlement of the large penalty payments that they claim are now due to them from Zarma.

**Required**

Using the information provided, identify and explain the risks of material misstatement to be taken into account in planning the final audit of Zarma in respect of the year ended 30 September Year 7.

**Answer**

**Tutorial note**

There are some points that you should note about this question, for answering examination questions on risks of material misstatement.

- The ‘question’ refers to **risks of material misstatement**. Any comments about general business risks will not gain marks in an examination unless you link them directly to risks of material misstatement.

- The ‘question’ asks about risks of material misstatement in relation to the **final audit of Zarma**. This means that general comments about risks of material misstatement, or comments about risks of material misstatement that are not relevant to Zarma, would not earn you any marks in an examination.

It is particularly important when discussing risks of material misstatement to ensure that the risks you identify are specifically linked to the financial statements.

For example, Zarma manufactures ‘high-tech’ products. A business risk associated with this is that inventory might quickly become obsolete. This means that there is a risk of material misstatement, that **so inventory might be overstated in the financial statements**. It is important in answering an examination question on risk of material misstatement that you should identify the risks of material misstatement, not (just) the business risk. The implication for planning the audit is that audit work should be directed at testing for a possible overvalue of the inventory due to obsolescence.

**Suggested ideas for a solution**

The risks of material misstatement that might be identified are set out in the table below. The left-hand column identifies the words or phrases in the case study that should enable you to identify the risks.
<table>
<thead>
<tr>
<th>Key words or phrases in the case study</th>
<th>Risks of material misstatement</th>
</tr>
</thead>
<tbody>
<tr>
<td>manufactures ‘high-tech’ computer-controlled equipment</td>
<td>The company operates in a high-tech environment and inventories might be subject to obsolescence (business risk). Therefore inventories in the financial statements might be overstated (risk of material misstatement).</td>
</tr>
<tr>
<td>offer from a US corporation to buy Zarma’s own manufacturing equipment</td>
<td>This will affect the way that items are presented in the financial statements. Profits or losses on sales must be disclosed separately, for example.</td>
</tr>
<tr>
<td>cease all manufacturing activities on 31 August Year 7</td>
<td>Financial statements should therefore not be prepared on a going concern basis, but on a different basis, such as a break-up basis.</td>
</tr>
<tr>
<td>made redundant</td>
<td>If redundancy payments have not been paid at year end, provisions for redundancy payments will be needed in the financial statements.</td>
</tr>
<tr>
<td>small accounting … team</td>
<td>This may increase errors in processing accounting transactions towards the end of the year. Segregation of duties (as an internal control) might have been affected.</td>
</tr>
<tr>
<td>Eight [premises] were put on the market on 1st August</td>
<td>This will affect the way that the premises are presented in the financial statements – as assets held for sale.</td>
</tr>
<tr>
<td>leases that will expire in the next three to five years. … none of these premises can be sub-let and the leases cannot be sold.</td>
<td>Full provision should be made for these onerous contracts in the financial statements. (This does not apply to the head office building which is still being used)</td>
</tr>
<tr>
<td>…warranty</td>
<td>Provisions will be needed in the financial statements for these warranties.</td>
</tr>
<tr>
<td>national and international distributors, under three-year agreements</td>
<td>The financial statements will need to include a provision for costs associated with breaching these agreements</td>
</tr>
</tbody>
</table>
Example: Business risks and risks of material misstatement

Fitkeeper, a limited liability company, operates twelve fitness centres around Pakistan. The facilities at each centre are of a standard design and each centre contains a heated twenty-five metre swimming pool, a sauna, a gymnasium and a fitness lounge. Each centre also provides supervised childcare facilities. The day-to-day operations of each centre are the responsibility of a centre manager, who is required however to manage the centre in accordance with strict company policies. The centre manager is also responsible for preparing and submitting monthly accounting returns to head office in Karachi.

By law, each centre must have a licence to operate from the local government authority. Licences are granted for periods of four years and are renewable at the end of each four-year period subject to satisfactory inspection reports from the inspecting authority. The average annual cost of a licence is Rs. 95,000.

All customers of the centres are enrolled as ‘members’. Members pay a Rs. 1,500 joining fee, plus Rs. 800 per month for ‘peak’ membership or Rs. 400 per month for ‘off-peak’ membership. Fees are payable annually in advance. All fees are stated to be non-refundable.

One of the fitness centres was closed between May and August in the financial year just ended, after a serious accident in the sauna involving chemicals. The centre was re-opened at the end of August, but head office management issued an instruction to all the fitness centre managers that the sauna facilities should be shut down until further notice.

Head office also issued the fitness centre managers with revised guidelines for the minimum levels of supervision for child care. This followed complaints from some dissatisfied members to the local government authority. Centre managers have been finding it difficult to provide the additional supervision specified in the revised guidelines and some of them have recommended strongly that the childcare facilities should be withdrawn.

Each centre operates early morning fitness sessions for members that run from 07.00 to 08.00 on four days each week. Every centre has had problems with late arrivals by staff, and many members have complained strongly that they have turned up for sessions that were shortened in length or did not run at all.

Training staff is costly and time-consuming but staff retention rates in the fitness centres are poor. In addition, staff turnover rates among the centre managers are also high. Most leavers complain of excessive directions imposed on them by head office and by company policy.

Three of the fitness centres are expected to have run at a loss for the year to 31 December (just ended) due to falling membership. Fitkeeper has invested heavily in building a hydrotherapy pool at one of these centres, with the aim of attracting members who are past retirement age. Completion of construction is behind schedule and costs to date are far in excess of the original budget. The pool is now expected to open within the next two months.

The company has experienced cash flow difficulties in the current year. As a consequence, head office management have decided to defer by at least one year the replacement of gym equipment in most of its centres.

Required

(a) Identify and explain the business risks that should be assessed by the management of Fitkeeper.

(b) Identify how each of the business risks identified in (a) may be linked to a risk of material misstatement.
Answer

Tutorial note
You should approach a solution to this question in two stages.

(1) Identify business risks. Note that part (a) refers to business risks relevant to Fitkeeper, so comments about audit risk will not gain any marks in an examination.

(2) Having identified a business risk, consider the impact of this risk on the financial statements. You should comment on the risk of material misstatement associated with the business risks you identify in part (a), so introducing different risks in part (b) will not gain marks in an examination.

Suggested ideas for a solution
The business risks and the risks of material misstatement that might be identified are set out in the table below. The left-hand column identifies the words or phrases in the case study that should enable you to identify the risks.

<table>
<thead>
<tr>
<th>Words or phrase indicating a risk</th>
<th>Business risk indicated</th>
<th>Risk of material misstatement indicated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard design</td>
<td>Operational risk is increased by standard design of each centre, because a problem with one facility at one centre is likely to be repeated at all the centres.</td>
<td>Asset values might be affected – for example, non-current assets might be overstated if they have been impaired by lack of use (e.g. saunas – see below). Asset impairment has probably not been recognised.</td>
</tr>
<tr>
<td>each centre must have a licence to operate</td>
<td>An operational risk exists, because a centre cannot operate if its licence is withdrawn.</td>
<td>Each centre’s licence must be accounted for properly, i.e. capitalised.</td>
</tr>
<tr>
<td>Fees are payable annually in advance</td>
<td>Financial risk is increased by payments in advance because cash has to be available to fund services later when they are due.</td>
<td>Deferred income must be calculated correctly in the financial statements.</td>
</tr>
<tr>
<td>serious accident in the sauna involving chemicals</td>
<td>Serious accidents may prompt investigation by the local government authority, leading to fines or penalties or loss of licence.</td>
<td>Provisions should be recognised for any fines that might be pending. If any centre’s licence is affected by such events, the licence may be impaired.</td>
</tr>
<tr>
<td>revised guidelines</td>
<td>Compliance risk that the fitness centres cannot meet the new guidelines</td>
<td>If failure to comply leads to punitive action by the local government authority, it may be necessary to make provisions for fines/penalties.</td>
</tr>
<tr>
<td>Words or phrase indicating a risk</td>
<td>Business risk indicated</td>
<td>Risk of material misstatement indicated</td>
</tr>
<tr>
<td>-------------------------------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>many members have complained strongly</td>
<td>Risk that falling membership will continue</td>
<td>Fees payable in advance are said to be non-refundable. This might be incorrect, and a provision might be required for refunds of fees.</td>
</tr>
<tr>
<td>Three ... fitness centres are expected to have run at a loss</td>
<td>Risk that more centres will become loss-making.</td>
<td>Possible need to consider the going concern status of the company, or at least to test the fitness centres for impairment as cash-generating units.</td>
</tr>
<tr>
<td>construction behind schedule and costs to date far in excess of budget</td>
<td>Risk that the new hydrotherapy pool will not attract the expected new members</td>
<td>The value of the asset should be considered. There might be a loss of value due to impairment even before it has opened for use.</td>
</tr>
<tr>
<td>defer by at least one year the replacement of gym equipment</td>
<td>Risk of more customer dissatisfaction and loss of members</td>
<td>Risk that depreciation might be charged for equipment that is already fully depreciated.</td>
</tr>
</tbody>
</table>
3 MATERIALITY

Section overview

- General principles
- Materiality thresholds
- ISA 320: Materiality in planning and performing an audit

3.1 General principles

The IASB’s Framework for the preparation and presentation of financial statements states that “information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.”

ISA 320 Materiality in planning and performing an audit deals with the auditor’s responsibility to apply the concept of materiality when planning and performing the audit. The revised ISA makes it clear that materiality depends on the size and nature of an item judged in the surrounding circumstances.

It is important to appreciate that the assessment of materiality is always based on the judgement of the auditor applied to the circumstances of a particular case. There are guidelines on materiality – but no rules.

Materiality is relative

Materiality is a relative factor. What, and what amount, will be material in the financial statements of one company may not be material in the financial statements of another.

Example:

An unrecorded sales invoice of Rs. 100,000 is unlikely to be material to the income statement/statement of comprehensive income of a multinational company with revenue of many millions of dollars. However, it would probably be considered material to a small company with annual revenue of, say, Rs. 3,000,000.

Despite this, such an error must still be considered carefully even in the context of a large company as one error could indicate the existence of others which could, in total, be material.

3.2 Materiality thresholds

In order to deal with materiality on a consistent basis, most audit firms set their own materiality thresholds’. Their audit staff are trained to use these thresholds to ‘measure’ whether or not an item is material. Materiality thresholds vary from one firm to another, but will typically fall within the following ranges:

<table>
<thead>
<tr>
<th>Metric</th>
<th>Materiality threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>0.5-1%</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>5-10%</td>
</tr>
<tr>
<td>Gross assets</td>
<td>1-2%</td>
</tr>
<tr>
<td>Net assets</td>
<td>2-5%</td>
</tr>
</tbody>
</table>
The ‘danger’ of materiality thresholds is that they are used simply to ‘measure’ whether an item is material, without considering important other factors as well. Other factors that the auditor should consider in evaluating materiality may include the following:

- **The nature of the item involved** – The valuations of some items in the financial statements are more subjective than others and depend on estimation. The more subjective the item, the more flexible the auditor should be in assessing the materiality of possible misstatements. The auditor will have to take a very different view on materiality when considering a warranty provision (which is a subjective estimate), compared with the approach taken when auditing share capital, which is capable of precise measurement.

- **The significance of the item** – Some items may be insignificant in terms of their monetary amount, but may nevertheless be of particular interest to the users of the financial statements. An example might be bonus payments to directors.

- **The impact of the item on the view presented by the financial statements.** A small and apparently insignificant error or omission may be material if, by correcting it:
  - a reported profit is converted into a reported loss, or
  - the correction significantly alters the trend of profits (growth rate in profits) over the past few financial years.

### 3.3 ISA 320: Materiality In Planning and Performing an Audit

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

- when planning and performing the audit, and
- when evaluating the effect of misstatements on the financial statements and therefore on their audit opinion (covered in a later chapter under ISA 450 Evaluation of misstatements identified during the audit).

**At the planning stage,** the auditor must determine materiality for the financial statements as a whole. As discussed above, this is often set as materiality thresholds. If lower thresholds are required for some areas (for example, directors’ remuneration) these must also be set at this stage.

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

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

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

Section overview

- Controls in computer-based information systems: general controls and application controls (revision)
- On-line systems, EDI, E-commerce and M-commerce
- Computer-assisted audit techniques (CAATs)
- The impact of IT on modern auditing

4.1  Controls in computer-based information systems: general controls and application controls (revision)

In a computer-based system, the internal controls will consist of both manual procedures (such as physically locking a room) and procedures designed into computer programs (such as passwords). Such controls fall into two categories:

- general controls, and
- application controls.

The auditor needs to be satisfied that these controls are effective.

General controls

General controls are controls over the environment in which the computer-based information system is designed, developed, operated and maintained.

The main categories of general control that an auditor would expect to find in a computer-based information system are summarised in the table below.

<table>
<thead>
<tr>
<th>Control area</th>
<th>Controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development of computer-based information systems and applications</td>
<td>• Appropriate standards should be established and enforced for designing, developing, programming and documenting each new system.</td>
</tr>
<tr>
<td></td>
<td>• Suitable testing procedures should be carried out on each new system.</td>
</tr>
<tr>
<td></td>
<td>• The design of a new system should be approved formally by the management of the system user.</td>
</tr>
<tr>
<td></td>
<td>• There should be a segregation of duties between system designers and system testers (to reduce the risk of error or fraud)</td>
</tr>
<tr>
<td></td>
<td>• There should be suitable staff training in the design and testing of systems.</td>
</tr>
<tr>
<td>Documentation and testing of program changes</td>
<td>• Formal testing procedures should be applied for any change to a current program.</td>
</tr>
<tr>
<td></td>
<td>• There should be formal authorisation procedures for program changes.</td>
</tr>
<tr>
<td></td>
<td>• There should be suitable staff training in making and testing program changes.</td>
</tr>
</tbody>
</table>
**Control area** | **Controls**
---|---
**Prevention or detection of unauthorised program changes** | - There should be a segregation of duties between programmers and computer system operators
- All program changes must be fully documented.
- Access to program files must be restricted
- Program logs should be used to record access to program files and programs.
- There should be anti-virus software and back-up copies of program files should be kept, to prevent or detect or deal with ‘malicious’ changes to programs.

**Prevention of the use of incorrect programs or data files** | - Standard operating procedures should be established and operations should be performed by suitably-trained staff
- The scheduling of ‘jobs’ for a computer centre should specify the program files and data files to be used.
- There should be effective supervision of computer centre operations.
- Reviews of operations should be carried out regularly by management

**Prevention of unauthorised amendments to data files** | - There must be restricted access to data files, limited to authorised personnel
- Transaction logs should be kept of all uses of data files and these should be reviewed by management

**Ensuring continuity of operations** | - Secure back-up copies should be kept of program files and data files
- Measures should be implemented for the protection of equipment against fire, power failure and other hazards
- Disaster recovery programmes should be in place, in the event of a major disaster that puts the main computer system out of action.
- There should be suitable maintenance and service agreements for all major externally-acquired software.

These general controls should apply to most or all of the entity’s computer-based information system applications, not just to computerised accounting systems. If general controls are weak, it is unlikely that the processing undertaken by the system will be complete and accurate.

**Application controls**

Application controls are specific controls over each specific computerised accounting application or system. The purpose of application controls is to provide assurance that:

- processed transactions have been properly authorised, and
- the processing of data is complete, accurate and timely.

In a manual processing system, internal controls vary according to the application. For example, internal controls over inventory are different from the controls over payroll processing. Similarly, application controls in a computer-based information system will vary depending on the nature of the application.
However, application controls for different computer applications share a number of common features, regardless of the particular application involved.

In particular, the auditor will place a high degree of emphasis on controls over input. For application controls to be effective, it is essential that input must be complete and accurate. If the input is not correct, the output from the application cannot be expected to be correct.

A list of application controls that might be found in a computer system is set out below.

<table>
<thead>
<tr>
<th>Control area</th>
<th>Controls</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Input</strong></td>
<td><strong>Authorisation</strong></td>
</tr>
<tr>
<td></td>
<td>▪ Data for input should be authorised before input.</td>
</tr>
<tr>
<td></td>
<td>▪ Data is input only by authorised personnel.</td>
</tr>
<tr>
<td><strong>Completeness</strong></td>
<td>There should be checks to ensure that all data has been processed. Checks might consist of:</td>
</tr>
<tr>
<td></td>
<td>▪ Document counts (for example, counting the number of invoices)</td>
</tr>
<tr>
<td></td>
<td>▪ Control totals</td>
</tr>
<tr>
<td></td>
<td>▪ Checking output to input</td>
</tr>
<tr>
<td></td>
<td>▪ Review of output against expected values (for example, is the total payroll cost broadly in line with expectations)</td>
</tr>
<tr>
<td><strong>Accuracy</strong></td>
<td>There should be some checks within the computer software on the validity of input data items (data validation checks). These may include:</td>
</tr>
<tr>
<td></td>
<td>▪ Check digits for key code items, such as supplier codes, customer codes and employee identification numbers</td>
</tr>
<tr>
<td></td>
<td>▪ Range checks (a check on whether a particular value or figure is feasible and within a realistic range of values)</td>
</tr>
<tr>
<td></td>
<td>▪ Existence checks (a check on whether a particular code exists)</td>
</tr>
<tr>
<td></td>
<td>▪ Review and reconciliation of output</td>
</tr>
<tr>
<td></td>
<td>▪ Use of control totals</td>
</tr>
<tr>
<td><strong>Processing</strong></td>
<td>There should be checks that all input has been processed and that processing is complete. Checks might include:</td>
</tr>
<tr>
<td></td>
<td>▪ Control totals</td>
</tr>
<tr>
<td></td>
<td>▪ Batch totals (where the computer counts the number of transactions in a processed batch and this is checked against a manual record of the number of items in the batch)</td>
</tr>
<tr>
<td></td>
<td>▪ Manual review</td>
</tr>
<tr>
<td></td>
<td>▪ On-screen warning that processing is not complete</td>
</tr>
<tr>
<td><strong>Master files and standing data</strong></td>
<td>Management review of master files and standing data</td>
</tr>
<tr>
<td></td>
<td>▪ Regular updates of master files</td>
</tr>
<tr>
<td></td>
<td>▪ Record counts</td>
</tr>
</tbody>
</table>
4.2 On-line systems, EDI, E-commerce and M-commerce

On-line systems

On-line systems are a feature of many businesses and offer a number of operational advantages to entities that use them.

- They permit the immediate entry of transactions from many different locations, instead of having to submit transactions to a central computer centre for processing. For example, if a retailing company operates an on-line system for sales, sales transaction data can be input immediately for centralised processing through terminals in each retail store.

- In the same way, centralised master files (such as master files for inventory) are updated immediately. This means that subsequent users of the system can use the up-to-date versions of master files.

- On-line systems allow users to make inquiries and obtain immediate responses, by having access to master files or reference files. (For example, users are able to give immediate answers to customers about prices of products or the current status of their order).

Although on-line systems are usually efficient and effective for the user, they create additional problems for the auditor who needs to assess the effectiveness of the system controls. There should be sufficient general controls and application controls to minimise the risks that arise from using on-line systems.

General controls in an on-line system could include the following:

- There must be effective controls over access to the system and its files. This is because in on-line systems, transactions are processed as soon as they are input.

- There should be controls written into the system software to prevent or detect unauthorised changes to programs.

- Transaction logs should be used to create an ‘audit trail’. An audit trail refers to the ability of the auditor to trace a transaction through all its processing stages. An audit trail may not exist in paper form in computer systems. The computer program should, therefore, be written in such a way as to generate the audit trail for any transaction, on request.

- Firewalls should be used for systems that have access to the Internet. Firewalls are hardware or software devices that prevent unauthorised access to a system from an Internet user.

Application controls in an on-line system could include the following:

- Pre-processing authorisation (such as logging on to the system, and the use of user names and passwords).

- Data validation checks in the software, to check the completeness and accuracy of processing (such as checking that a product code has been entered with the correct number of digits).

- ‘Balancing’ – checking control totals of data submitted from remote terminals before and after processing.
Electronic data Interchange (EDI) systems

Electronic data interchange (EDI) systems are systems that allow the electronic transmission of business documents, such as invoices or payroll information, between different computer systems. The EDI system provides a form of ‘translation’ service, so that the data transmitted from one computer system is changed into a form that can be read by the other computer system, without any need for human intervention.

EDI systems may operate:

- within the organisation (for example, the sales department may use EDI to transfer copies of customer orders electronically to a separate computer system of the accounting department), or
- externally (for example, a company may use EDI to submit payroll data for processing to the computer system of a payroll agency, or may submit purchase orders for inventory electronically to the computer system of a supplier).

EDI systems can improve the operational efficiency of an entity, but they may generate the following problems for the auditor who has to assess the efficiency of the system controls:

- The lack of a paper audit trail.
- An increased level of dependency on the computer systems of the organisation and possibly the computer systems of other entities. Any failure or control weakness in one computer system may have an impact on the computer system that is being audited.
- There may be a risk of loss or corruption of data in the process of transmission.
- There will be security risks in the transmission of data.

Auditors should expect to find effective controls in place to minimise the risks inherent in EDI systems. Typically, controls will cover such matters as:

- controls over the transmission of data (such as the encryption of data before transmission, acknowledgement systems and the use of authentication codes for senders of data)
- monitoring and checking of output
- virus protection systems
- contingency plans and back-up arrangements.

E-commerce

E-commerce is any commercial activity or trading that takes place between computers that are connected over a public network. The most common example is the sale and purchase of goods over the Internet, for example Amazon.com.

The auditor should consider the following areas:

- The skills and knowledge needed by the auditor to understand the effect of e-commerce on the entity’s activities – the more complex the activities the greater the skills and knowledge required.
- The extent of the knowledge of the business needed by the auditor. E-commerce may have a significant impact on the traditional business environment – increasing security risks and geographical markets.
Additional business risks arising from e-commerce – loss of transaction integrity, security risks, the use of inappropriate accounting policies (e.g. in respect of the capitalisation of website development costs,) legal and regulatory risks.

Internal control considerations – internal controls may exist but there may not be an adequate audit trail.

M-commerce

Mobile e-commerce (m-commerce) describes online sales transactions that use wireless electronic devices such as mobile phones, laptops and hand-held computers. M-commerce is a type of e-commerce and has seen many vendors adapt their websites to make them easier to use with smaller screened devices.

4.3 Computer-assisted audit techniques (CAATs)

CAATs can be defined as any technique that enables the auditor to use computer systems as a source of generating audit evidence. They involve the use of computer techniques by the auditor to obtain audit evidence.

- CAATs are often necessary in the audit of computer-based information systems because these systems may not provide an adequate audit trail.
- In addition, processing is ‘invisible’ because it is electronic. Therefore, the auditor needs to ‘get inside the computer’ to check the completeness and accuracy of the processing. CAATs allow the auditor to achieve this.

Two commonly-used types of CAATs are:

- audit software, and
- test data.

The use of CAATs normally requires staff who have at least a basic understanding of data processing and the application of systems analysis techniques.

Audit software

Audit software is computer programs used by the auditor to extract information from a client’s computer-based information system, for use in the audit.

The main types of audit software include:

- interrogation programs, to access the client’s files and records and extract data for auditing
- interactive software, for use in interrogation of on-line computer systems
- ‘resident code’ or ‘embedded software’, to monitor and review transactions as they are being processed by the client’s programs. This type of software is called embedded audit facilities.

The main use of audit software is in substantive audit testing.
Example:
Audit software is used to extract and analyse information in the entity’s computer-based information systems for use in the audit work. Here are some examples.

- Account analysis. Audit software may be used to interrogate the client’s data files for the general ledger and extract from the files all items above Rs. 50,000 in the repairs expense account.
- Preparing an aged listing of receivables (an aged debtors list), if these are not already produced by the client as a matter of operational routine. The audit software can interrogate the trade receivables file, and produce a list and analysis in date order of unpaid invoices.
- Calculating ratios and making comparisons. Audit software can be used to assist the auditor with analytical procedures (which are described in a later chapter).

Test data
An auditor may use test data to process a sample of transactions through the client’s computer-based information system, and compare the results (output) obtained from the processing with the pre-determined results that the auditor would expect.

Test data is used primarily for tests of control and is particularly useful for testing preventative controls. The technique provides evidence that specific application controls are operating effectively in a given system.

One of the problems with using test data is that it can only give audit evidence about the computer system at the time the test data is processed. The test data cannot provide assurance that the system and its controls operate(d) effectively at any other time. This problem can be addressed by the use of embedded audit facilities.

Embedded audit facilities
Embedded audit facilities may also be called ‘resident audit software’ or an ‘integrated audit module’. It is audit software that is built into the client’s computer system, either temporarily or permanently.

The purpose of embedded audit facilities is to allow the auditor to carry out tests at the time that transactions are being processed, in ‘real time’.

Procedures are written into the entity’s computer-based information system and these generate data for audit purposes every time the system is run. In order to obtain audit data without the risk of corrupting the client’s operational data files with the test data, it is usual to establish an extra ‘dummy’ department. The test data results are allocated to this dummy department and the test data is, therefore, kept separate from the client’s operational data. Only the auditor should have access to the data stored in this dummy department.

Embedded audit facilities can be very useful for the auditor of on-line computer systems where:
- data is continually processed and master files are being continually updated, and/or
- it is difficult, if not impossible, for the system to provide a satisfactory audit trail for following transactions through the system.
An embedded audit facility may also print out details of the transactions it has monitored, or copy them to a computer file, so that the auditor can study the transactions.

**Advantages of CAATs**

CAATs have many advantages (which is why many audit firms use them).

- They give auditors an ability to test the completeness and accuracy of the electronic processing itself (the computer software), rather than relying only on testing the accuracy and completeness of inputs and outputs.
- They give the auditor an ability to test a larger number of transactions in a relatively short amount of time: testing larger amounts of data reduces the overall audit risk.
- They allow the auditor to test the effectiveness of controls that are programmed into the computer software.

**Disadvantages of CAATs**

CAATs give the auditor the ability to audit the processing of transactions in a computer-based information system. However, the value of using CAATs should be assessed on a cost-benefit basis. CAATs should only be used if the benefits from their use exceed the costs.

The costs related to the use of CAATs may include:

- purchasing or developing the programs
- keeping the programs up-to-date, for changes in hardware and software
- training audit staff in their use. CAATs are of no value unless auditors are properly trained in how to use them.
- obtaining time on the client’s computer systems to run the CAATs.

**4.4 The impact of IT in modern auditing**

IT and e-commerce have revolutionised the business environment in recent years making it increasingly important for the auditor to ‘scale-up’ their IT audit ability. IT and e-commerce are now fundamental components of many audit clients’ systems and processes which can impact the auditor’s risk assessment and risk response.

- Auditors more commonly need IT specialists on the audit team.
- Big Data and Data Analysis increasingly impacts the audit vis-a-vis identification of key risks, evaluation of audit evidence and support in conclusion and reporting.
- Enhanced applications of ISA 520 concepts are emerging around testing thresholds, variance analysis and precision. This can help increase both the quality and efficiency of the audit as clients’ business models and processes change.
- Paper documents are rapidly disappearing from commercial transactions (and hence as audit evidence) meaning that auditors increasingly need to rely on systems, controls and electronic audit evidence.
- Developments in global communications infrastructure have led to the emergence of new products that are delivered electronically such as e-books, computer programs, music recordings, videos, training, consulting and reporting. This creates complexities around revenue recognition, customs and taxation and hence leads to further areas of audit risk for the auditor to consider.
5 NOT-FOR-PROFIT ORGANISATIONS

Section overview

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

5.1 Auditing of not-for-profit organisations

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

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

Example: Charity and public sector audits

A charity organisation or government department is an example of an NFPO:

- They have certain defined beneficiaries, since they were established for the purpose of providing benefits to them – e.g. starving children (charity) or the public at large (public hospitals)
- They raise funds from the public – charity donations and government tax revenues
- They seek to spend those funds as effectively as possible to help the beneficiaries.

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

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

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

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

5.2 NFPOs: the audit approach

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

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

<table>
<thead>
<tr>
<th>Audit area</th>
<th>Comments</th>
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</table>
| Planning          | Consider:  
|                   |   the objectives and scope of the audit work  
|                   |   any local regulations that apply  
|                   |   the environment in which the organisation operates  
|                   |   the form and content of the final financial statements and the audit opinion  
|                   |   key audit areas, including risk. |
| Risk              | Carry out an audit risk analysis under the usual headings of inherent risk, control risk and detection risk:  
|                   |   inherent risk (reflecting the nature of the entity's activities and the environment)  
|                   |   control risk (internal controls, and the risk that these may be inadequate: controls over cash collection and cash payments may be a key area for an NFPO such as a charity, because large amounts of cash may be collected from the public by volunteers)  
|                   |   detection risk (the risk that the auditor will fail to identify any material error or misstatement in performing the audit). |
| Internal control  | Key areas of internal control in an NFPO might include:  
|                   |   segregation of duties (although this may be difficult in a small NFPO with only a few employees)  
|                   |   authorisation of spending  
|                   |   cash controls  
|                   |   controls over income (donations, cash collections, membership fees, grants)  
|                   |   the use of funds only for authorised purposes. |
| Audit evidence    |   A substantive testing approach (rather than a systems based approach) is likely to be necessary in a small NFPO, because of weaknesses in its internal control system.  
|                   |   Key areas may include:  
|                   |     – the completeness of recording transactions, assets and liabilities  
|                   |     – the possibility of misuse of funds.  
|                   |   Analytical procedures may be used to 'make sense' of the reported figures.  
|                   |   There should be a review of the final financial statements, including a review of the appropriateness of the accounting policies. |
Chapter 7: Planning

Audit area | Comments
---|---
Reporting | If a report on an NFPO is required by law, the standard external audit report covered in a later chapter can be used.
| If the audit is performed on a voluntary basis, the report needs to reflect the agreed objective of the audit. However, it is good practice for the report to follow the general structure laid down by ISA 700:
  - addressee
  - scope of the report
  - responsibilities of auditors versus the responsibilities of management
  - the audit work done
  - the audit opinion
  - date, name and address of auditor.

Other factors to consider include:

- Cash may be significant in small NFPOs and controls are likely to be limited.
- Income could be a risk area, particularly where money is donated or raised informally.
- There may be an inability to obtain sufficient appropriate audit evidence if obtaining audit evidence is a problem; this could occur due to the fact that many activities of an NFPO may not have appropriate evidence (or any evidence at all) such as in organisations engaged in disaster relief activities or similar charitable work like food provision and on-spot medical facilities.
- There may be a lack of predictable income or identifiable relationship between expenditure and income which could make analytical review less appropriate.
- Restricted funds may exist where the organisation is only allowed to use certain funds for specific purposes.
- There may be sensitivity to key statistics such as the proportion of revenue used in administration (particularly for a charity).
6 CHAPTER REVIEW

<table>
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<th>Chapter review</th>
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<tr>
<td>Before moving on to the next chapter check that you can:</td>
</tr>
<tr>
<td>▪ Plan an audit engagement</td>
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<tr>
<td>▪ Explain the various components of audit risk</td>
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<tr>
<td>▪ Discuss the principles and application of materiality</td>
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<tr>
<td>▪ Articulate the relevance of computers to auditing</td>
</tr>
<tr>
<td>▪ Describe and critically assess general and application computer controls</td>
</tr>
<tr>
<td>▪ Explain the audit approach for NFPOs</td>
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8

Audit evidence

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1 Audit testing
2 Audit documentation: ISA 230
3 Related parties: ISA 550
4 Written representations: ISA 580
5 Using the work of an auditor’s expert: ISA 620
6 The external auditor’s reliance on the work of the internal auditor: ISA 610
7 The audit of accounting estimates: ISA 540
8 The audit of specific areas of the financial statements
9 Transaction cycles
10 Chapter review
INTRODUCTION

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A (a) 8  Sampling and other means of testing
A (a) 9  Audit evidence (including Specific considerations for Selected Items)
A (a) 10 Substantive tests (including Analytical procedures)
A (a) 14 External confirmations
A (a) 15 Related parties
A (a) 16 Audit documentation
A (a) 19 Management representation

Performance of audit - specific

A (b) 2  Fair value measurements and accounting estimates
A (b) 4  Work of expert and internal auditor

Audit and Reporting on Specialised Areas

C 4  Auditing Financial Instruments

Exam context

In this comprehensive chapter students will study much of what is required during the fieldwork stage of an audit. Whilst a number of ISAs are re-visited from earlier studies, students will now be exposed to the full cross-section of ISAs relevant to performing an audit, all of which are examinable at this level.

The chapter also incorporates specific guidance on testing the various transaction cycles such as revenue/receivables and purchases/payables.

By the end of this chapter students will be able to:

- Explain the fundamental requirements of audit testing in the context of ISAs 500, 520, 530 and 230
- Describe the requirements of a number of other fieldwork-driven standards including ISAs 501, 540, 580, 610 and 620
- Summarise the audit approach relevant to a number of key IASs and IFRSs
- Explain how to audit the various transaction cycles such as revenue/receivables and purchases/payables
1 AUDIT TESTING

Section overview

- Gathering audit evidence
- ISA 500 and the financial statement assertions
- Directional testing
- Sampling: ISA 530
- Analytical procedures: ISA 520

1.1 Gathering audit evidence

The outcome of an audit is a report, which usually expresses an opinion. The contents of the report and the auditor’s opinion may subsequently be challenged. If this happens, the auditor must be able to justify what they have written. In other words, the report and opinion must be supportable by the auditor, if challenged.

The auditor will therefore collect evidence on which to base the report and opinion.

Definition: Audit evidence
This is any information used by the auditor to arrive at the opinion on which their report is based. It includes information in the accounting records and other information.

The auditor carries out procedures known as ‘audit tests’ in order to create this evidence. These tests could be:
- tests of controls, and/or
- tests of detail (tests of transactions and balances).

It is unlikely that the auditor’s tests will be applied to all the transactions that have been undertaken by the entity during the financial period under audit. The audit evidence will typically be drawn from a sample of transactions.

Definition: Audit sampling
This is the application of audit procedures to less than 100% of the population of transactions and balances, such that all units have a chance of selection. Again, this is revised later in this section.

Analytical procedures are also carried out, but not typically on a sample basis. These are revised later in this section. Analytical procedures together with tests of detail are referred to as substantive procedures.

The tests, the evidence from the tests, and the conclusions that have been drawn must all be documented in the audit files.
1.2 ISA 500 and the financial statement assertions

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

- obtain sufficient, appropriate audit evidence
- in order to be able to draw reasonable conclusions
- on which to base their audit opinion.

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

Other requirements of ISA 500 are as follows:

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

Use of an expert by management

When assessing the objectivity of an expert employed by management, issues for the auditor to consider would include whether:

- the expert has a financial interest in the audit client, for example a shareholding
- the expert has a personal relationship with a senior manager in the audit client
- the fee paid for the expert’s services was a fair commercial price.

When assessing whether the work of management’s expert provides sufficient and appropriate evidence for audit purposes:

- The auditor should review the terms on which the expert was engaged by the audit client, such as the objective and scope of the expert’s work and whether the expert was notified that their work may be relied on by the auditors.
The auditor should obviously study the content of the expert’s report and the conclusions that the expert reached. Any assumptions used by the expert may be significant (for example in making an asset valuation) and the auditor should compare those assumptions with their own understanding of the audit client’s business.

The auditor should ‘challenge’ the assumptions used by the expert and, if required, may reach a conclusion that the assumptions used by a management’s expert are unreasonable. Such circumstances may lead to the auditor deploying his/her own expert (covered by ISA 620).

The auditor may also need to check the methods used by the expert. For example for the valuation of investment property, the method of valuation used should be consistent with the requirements of IAS 40.

If the expert has been used to provide a valuation, the date of the valuation should be close to the end of the financial year of the audit client (so that it is up-to-date and current).

There may be additional evidence that the auditor could obtain to confirm the evidence provided by the expert. For example, if a property valuation expert has been used by the audit client to value a number of properties, the auditor may be able to obtain some additional evidence of the reliability of the valuations in a number of ways:

- By inspecting some of the properties to assess their condition.
- By checking the cost of similar assets acquired by the audit client during the financial year.
- For assets acquired during the year, by comparing their cost with the end-of-year valuation: unless there has been a large rise or fall in property values during the year, current valuation should be fairly close to original cost.
- By checking events after the reporting period: if any of the properties have been sold since the end of the year, their sale value should be compared with their end-of-year valuation. They ought to be similar amounts.
- By obtaining representations from management that the key assumptions used in arriving at estimated values are reasonable.

Use of fair value accounting may require more frequent use of experts by the auditor.

**Sufficient and appropriate audit evidence**

<table>
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<th><strong>Definition: Sufficient and appropriate</strong></th>
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<tr>
<td><strong>Sufficient</strong> relates to the <strong>quantity</strong> of evidence. There must be enough audit evidence to support the auditor’s conclusion or opinion.</td>
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<tr>
<td><strong>Appropriate</strong> relates to the <strong>quality</strong> (relevance and reliability) of the evidence.</td>
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The auditor will need to exercise their professional judgement on both of these aspects, in deciding whether there is enough evidence to support a conclusion and assessing the quality of each item of evidence:

- When is there enough evidence to support a conclusion?
- What is the quality of a given piece of evidence, and is this sufficient to justify the audit opinion?
The two characteristics of quantity and quality are also inter-related.

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

**The reliability of audit evidence**

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

- **Audit evidence is more reliable when it is obtained from independent sources outside the entity under audit.** As specified above, ISA 500 requires that the auditor should be satisfied as to the accuracy and reliability of any internal evidence used in reaching a conclusion. Internally generated audit evidence is more reliable when the related controls are effective.

- **Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.** For example, observation of the operation of a control by the auditor is more reliable than inquiry about the operation of that control.

- **Audit evidence is more reliable when it exists in documentary form.** This could be paper, electronic or other medium. For example, a written record of a meeting made at the time is more reliable than a subsequent oral representation of the matters discussed.

- **Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies, or documents that have been filmed, or otherwise transformed into electronic form.** This is because the reliability of those other forms may depend on the controls over their preparation and maintenance.

**Procedures for generating audit evidence**

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

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

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

- Inspection (of assets and records)
- Observation
- Inquiry
- External confirmation
- Recalculation
- Reperformance
- Analytical procedures.
The table below explains these seven main procedures, and gives examples of how they are used and applied.

<table>
<thead>
<tr>
<th>Procedure</th>
<th>Explanation/application</th>
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| Inspection (looking at an item)  | Of tangible assets  
|                                  | Of entries in accounting records  
|                                  | Of documents (e.g. invoices )                                                                                                                                   |
| Observation                      | Watching a procedure (e.g. physical inventory counts, distribution of wages, opening of mail)  
|                                  | Limited to the point in time when the observation takes place  
|                                  | The person performing the procedure may act differently when being observed                                                                                       |
| Inquiry                          | Seeking information from knowledgeable persons inside or outside the entity,  
|                                  | Evaluating responses to those inquiries, and  
|                                  | Corroborating those responses with other audit evidence                                                                                                          |
| External confirmation            | A specific type of inquiry – seeking confirmation from a third party (e.g. a bank or trade receivable). This is specifically covered by ISA 505 *External confirmations*. |
| Recalculation                    | Checking the mathematical accuracy of documents or records (e.g. adding up the list of year-end trade receivables)                                              |
| Reperformance                    | Independently carrying out procedures or controls, which were originally performed by the client (e.g. reperforming the aging of year-end trade receivables) |
| Analytical procedures            | Evaluating and comparing financial and/or non-financial data for plausible relationships and investigating unexpected fluctuations  
|                                  | For example, comparing last year’s gross profit percentage to this year’s and ensuring any change is in line with expectations |

**The financial statement assertions**

Modern auditing theory takes the view that the financial statements are made up of a numbers of *assertions* or representations. The auditor should therefore generate evidence designed to reach a conclusion about each of these assertions.

The major assertions contained in a set of financial statements (set out in ISA 315) are as follows.

- **Completeness**: There are no unrecorded assets, liabilities, equity interests, transactions or events or any undisclosed items.
Occurrence: Transactions and events recorded and disclosed in the financial statements took place during the accounting period and relate to the entity.

Accuracy: Transactions or events have been recorded at the proper amounts and disclosed properly.

Classification and understandability: Information is appropriately presented and described and the disclosures are clear.

Valuation and allocation: Assets, liabilities and equity interests are included at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Rights and obligations: The entity holds or controls the rights to disclosed assets and disclosed liabilities are those of the entity.

Existence: Assets, liabilities and equity interests exist.

Cut-off: Transactions and events have been recorded in the correct period.

Classification: Transactions and events have been recorded in the proper accounts.

The auditor should therefore generate evidence designed to reach a conclusion on the reliability of each of these assertions.

1.3 Directional testing

Directional testing is an audit approach, developed in the 1980s, to provide a framework for the conduct of an audit. Directional testing has a number of advantages. The main advantages are that:

- it helps the auditor to clarify the audit objectives
- it focuses the audit work on areas of high audit risk
- it links together the results of audit tests.

Directional testing has its foundation in the fundamental principle of double entry book-keeping whereby for every debit entry there is a credit entry.

If the trial balance balances, but a debit or a credit entry is misstated, there must be a second misstatement somewhere in the trial balance figures.

**Example:**

If non-current assets are overstated by Rs. 2m, but the trial balance balances, then one of the following errors must have happened to explain how the situation has arisen.

- Possibility 1. Another asset is understated by Rs. 2m.
- Possibility 2. Liabilities are overstated by Rs. 2m.
- Possibility 3. Income is overstated by Rs. 2m.
- Possibility 4. Expenditure is understated by Rs. 2m.
- Possibility 5. A combination of any as all Possibilities 1 – 4 has occurred, amounting to Rs. 2m.
Chapter 8: Audit evidence

The nature of directional testing

The following conclusions follow on from the points raised in the above example.

- By testing debit balances (in the client’s accounting system) **directly for overstatement**, total credit balances will also be tested - **indirectly - for overstatement**.
- By testing credit balances **directly for understatement**, total debit balances will also be tested - **indirectly - for understatement**.

Directional testing is, therefore, based on the following approach to the audit.

- If all asset balances and expenses for the year (**debits**) are tested directly for **overstatement**, and
- all liability balances and income for the year (**credits**) are tested directly for **understatement**
- then misstatement in the opposite directions (overstatement of credit balances and understatement of debit balances) will be tested indirectly.

The main focus of directional testing is therefore:

- test debits for overstatement and
- test credits for understatement.

This is because:

- in the statement of financial position, assets are more likely to be overstated and liabilities are more likely to be understated
- a misappropriation or fraud will often result in an overstatement of an asset or expense. For example, the theft of cash may be ‘hidden’ fraudulently by writing it off, by means of the ledger entry: Dr Expense and Cr Cash.

Testing for overstatement of debit balances

A **test for overstatement** starts with the monetary amount recorded in the financial statements. The direction of testing is then ‘**backwards**’ to its source. Such tests seek to confirm **existence** (account balances) and **occurrence** (classes of transactions).

For example, in testing purchases for overstatement, balances in the financial statements will be traced back to signed goods received notes as evidence that the goods were received.

Testing for understatement of credit balances

A **test for understatement** starts at the source and traces transactions ‘**forwards**’ to the financial statements. These tests are aimed at ensuring the **completeness** (and accuracy) of recorded transactions and balances. For example, in testing sales for understatement, signed despatch notes are traced through to sales in the financial statements to check that the sale was recorded.
Example:

**Testing trade receivables balances for over-statement/existence**

A starting point for testing will be the entity’s list of receivables balances (the list of customers owing money) as at the end of the reporting period. The auditor wants to check that these receivables do, in fact, exist. One way of doing this is to write directly to customers on the list asking them to confirm the amount that they owe the entity.

Alternatively, if the auditor is checking documentation within the client entity, they can take a sample of receivables from the list of balances and vouch their existence back through the accounting records, from receivables ledger to sales day book (receivables day book) to goods despatch note and invoice.

**Testing trade payables balances for understatement/completeness**

To test payables for completeness, there is no point in taking as a starting point the entity’s list of payables balances – because this may not be complete and the auditor is testing for completeness.

Instead, the auditor may write to regular suppliers who might possibly be year-end payables, based on the total amount of purchases from the supplier during the year. If the supplier is not on the list of trade payables, or is listed as a payable for only a small amount, the auditor can ask the supplier to confirm this fact. This is often referred to as testing the ‘reciprocal population’.

Alternatively, if the auditor is checking documentation within the client entity, they may take as a starting point a sample of documents indicating that goods have been purchased or received – such as a sample of goods received notes – and then trace the purchase through the system from purchase invoice to purchases day book (payables day book) to payables ledger.

### 1.4 Sampling: ISA 530

ISA 530 *Audit sampling* states that the objective of audit sampling is to give the auditor a **reasonable basis for their conclusion about the population from which the sample is drawn**. The auditor is not interested in the result from the sample itself – they are only interested in it as a basis for reaching a conclusion about the whole population under test.

However, there is always a risk that the auditor will reach a different conclusion based on the sample than they would have reached had they tested the entire population. This is referred to as **sampling risk**. To reduce this risk (and therefore detection risk) to a minimum the sample must be designed in such a way as to be **representative** of the whole population.

In setting their sample size the auditor will need to take into account the **expected misstatement** (for tests of details) or **rate of deviation** (for tests of controls). This assessment will be based on their experience in this area from previous audits and on any related areas on the current audit. The results of the sample (projected for tests of detail) will be compared to **tolerable misstatement/rate of deviation**.

**Definition: Tolerable misstatement**

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

Following on from the above, the **tolerable rate of deviation** is a rate of deviation from prescribed control procedures which the auditor is prepared to accept and still be able to conclude that the financial statements are not materially misstated.

1.5 Analytical procedures: ISA 520

In addition to performing analytical procedures as risk assessment procedures (as described in ISA 315), the auditor, in terms of ISA 520, may apply analytical procedures as substantive procedures. The auditor must also use analytical procedures to assist in forming an overall conclusion on the financial statements.

One of the basic objectives of analytical procedures is to allow the auditor to assess whether the reported figures 'make sense' in the context of known business facts. If the analysis indicates that there are some figures or ratios that do not make sense (there are some ‘anomalies’), these require further investigation by the auditor.

Further investigation could entail further analytical procedures at a greater level of disaggregation or other substantive procedures to corroborate with the audit evidence obtained through analytical procedures.

The nature and purpose of analytical procedures

‘Analytical procedures’ are defined by ISA 520 *Analytical procedures* as “Evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.”

The analysis usually considers both **comparisons** and **relationships**.

Financial information in the draft financial statements is often **compared with a benchmark**. For example, ratios, trends and relationships for the current financial year are compared with:

- prior periods (historical data)
- budgets and forecasts (future-oriented data)
- predictive estimates (in other words, estimates of the expense or income that might have been predicted, such as a prediction of the annual depreciation charge)
- (more rarely) industry averages (ratios for business entities in the industry as a whole).

Typically, **relationships** are used in analytical procedures to analyse:

- items of financial information that are expected to adhere to a predicted pattern (such as gross profit margins: any significant change in this margin compared with the previous years should be investigated)
- relationships between financial and non-financial information that might be predictable (such as payroll costs per employee).

Using analytical procedures in the audit process

Analytical procedures can be used at three stages in the audit process.

- They **must** be used in planning the nature, timing and extent of other audit procedures.
- They may be used as a substantive procedure when their use is more effective or efficient than detailed substantive tests of transactions and balances.
- They must be used at the overall review stage, to allow the auditor to conclude whether the financial statements as a whole are consistent with their knowledge of the business.

Analytical procedures are not concerned only with the analysis of trends. The auditor must use analytical procedures to reach a conclusion about the financial statements. It is not sufficient for the auditor to calculate and summarise ratios for this year and previous years, and to record the trends over time. Analytical procedures are also concerned with:

- the investigation of changes away from expected trends, and
- the corroboration of explanations as to why these changes have happened when they were not expected to.

**Example: Analytical procedures 1**

An auditor has calculated the gross profit percentage for a client company. This year the gross profit is 25% of sales, but last year it was 20%. The auditor is not aware of any change in the nature of the client’s business and they had been expecting the gross profit percentage to remain constant at about 20%.

The finance director of the client company gives the explanation that purchase prices have fallen in the past year or so, relative to sales prices. The auditor should not accept this explanation as a proper explanation without finding evidence to corroborate it.

It is possible that purchase prices have fallen in relation to sales prices. However, a possibility that the auditor needs to eliminate is that purchase prices have not fallen, but the client company’s management have included an excessively high figure for closing inventory in the statement of financial position, in order to increase profits.

A closer investigation of purchase prices should confirm the finance director’s explanation, or leave the auditor with a suspicion that there is something unusual in the financial statements and that a proper explanation has yet to be found.

**Example: Analytical procedures 2**

As a reasonableness check the auditor might calculate an expected value for an item then compare it to its actual value. For example, an expected income statement charge for straight-line depreciation might be generated using a formulae such as:

\[
\text{Expected Inc. Statement charge} = (\text{Cost} + \text{Additions} - \text{Disposals}) \times \text{depreciation \%}
\]

**Example: Analytical procedures 3**

Crowne Ltd. is a mobile phone retailer operating a chain of stores across Pakistan. During the current year, two of the stores were closed leaving 10 existing stores which have now extended their product range to include trendy new ‘keep-fit’ smart watches.
An extract from the draft financial statements shows the following:

<table>
<thead>
<tr>
<th></th>
<th>Draft 20X6</th>
<th>Actual 20X5</th>
<th>YOY change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rs. million</td>
<td>Rs. million</td>
<td></td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>751</td>
<td>509</td>
<td>48%</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(598)</td>
<td>(387)</td>
<td>55%</td>
</tr>
<tr>
<td>Gross profit</td>
<td>153</td>
<td>122</td>
<td>25%</td>
</tr>
<tr>
<td><strong>Statement of financial position</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td>257</td>
<td>235</td>
<td>9%</td>
</tr>
<tr>
<td>Current assets</td>
<td>157</td>
<td>102</td>
<td>54%</td>
</tr>
<tr>
<td>Trade payables</td>
<td>89</td>
<td>64</td>
<td>39%</td>
</tr>
<tr>
<td>Other payables</td>
<td>45</td>
<td>40</td>
<td>13%</td>
</tr>
<tr>
<td><strong>Other Info</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GP margin</td>
<td>20%</td>
<td>24%</td>
<td></td>
</tr>
<tr>
<td>Payables days</td>
<td>54</td>
<td>60</td>
<td></td>
</tr>
</tbody>
</table>

**Required**

Comment on how the above figures might impact your audit of trade payables.

**Answer**

*Observation:* Gross profit margin has fallen from 24% to 20%. Revenue has increased by 48% whereas cost of sales has increased by 55%.

- The overall performance and business strategy must be discussed with management. The auditor needs to understand the impact of the expansion into the new product line (the ‘keep-fit’ watches) and the closure of the two stores on sales mix and profit margins.
- The auditor needs to understand whether there have been any changes in the existing supply chain (e.g. new credit terms and/or new suppliers for the phone lines) as well as the impact of incorporating a new supply chain for the 'keep-fit' watches.
- Consider whether accounting errors might have occurred such as:
  - Misclassification between purchases and other expenses
  - Cut-off errors on goods received which might misstate purchases and trade creditors
- Explanations to the above enquiries should be corroborated with further audit procedures on trade creditors. The existence of accounting errors would increase the level of audit work required on trade creditors.

*Observation:* Trade payables has increased by 39% whereas cost of sales has increased 55%. Trade payables days has fallen from 60 to 54.

- The auditor needs to understand payment terms of the new suppliers of the ‘keep-fit’ watches to establish what ratios are reasonable.
- The extent of testing on supplier statement reconciliations and payments made after the period-end may need to be extended.
There is a risk that liabilities and cost of sales are understated due to cut-off errors or goods received not invoiced (or recorded).

Observation: Other payables have risen by 13% which seems inconsistent with the fact that two stores were closed during the year.

This could mean that some trade creditors have been misclassified as ‘other creditors’. The auditor should either test the controls around classification, or perform substantive testing to check purchases are correctly classified.

The extent of use of analytical procedures

Several factors should determine the extent to which the auditor can use analytical procedures as a form of audit evidence. ISA 520 requires the auditor to:

- Determine the suitability of particular substantive analytical procedures for given assertions – i.e. how effective they will be in detecting a particular type of material misstatement. This usually depends on the closeness of relationships between items of data. Analytical procedures are more appropriate when relationships are plausible and predictable. For example, there is normally a close relationship between sales commission and sales revenue, whereas the relationship between administration costs and sales revenue is less close and so less predictable.

- Develop an expectation of recorded amounts or ratios and evaluate whether that expectation is sufficiently precise to identify a misstatement. How effectively this can be done depends on factors such as:
  - the accuracy with which amounts can be predicted
  - the extent to which information can be disaggregated (e.g. sales split out by product line)
  - the availability of information.

Precision would vary from account to account and also for the same account between different industries. For example, an auditor of a company that pays a fixed monthly rent for its premises would easily be able to work out the expected annual rent expense (by multiplying the monthly rent with 12); however, it would be more difficult to come up with a precise prediction for payroll expense for the year for a company that has 1,000 employees.

- Evaluate the reliability of the data from which the expectation has been developed. If data is unreliable then it will be of little use. The auditor should consider such factors as:
  - the source of the information
  - comparability of the information available (broad industry data may not be suitable for an entity with more specialised products)
  - the nature and relevance of the information available (budgets may not be suitable if they have been prepared as goals rather than expectations)
  - controls over the preparation of the data.

- Determine what level of difference from expected amounts is acceptable without further investigation (i.e. link to materiality).
Investigation of fluctuations

Fluctuations are significant changes in a financial ratio or a trend, compared with previous financial years.

When carrying out analytical procedures, the auditor is primarily concerned with identifying the unexpected and reasons to explain why anything unexpected has happened. If the unexpected has occurred and cannot be explained, further investigation by the auditor will be necessary.

Trends or deviations that do not fit with known business facts should be discussed with client staff and explanations must be obtained. It is often more useful to the auditor to discuss matters with several of the client’s staff, who are responsible for non-financial as well as for financial operations.

Explanations must not be accepted at face value but should be corroborated by:

- other audit evidence, or
- the auditor’s knowledge of the client and the industry in which it operates.

Therefore, if the auditor finds:

- fluctuations or relationships which are inconsistent with other information, or
- unacceptable levels of differences from expected amounts

then ISA 520 requires them to:

- make inquiries of management and verify management’s responses, and
- perform other audit procedures as necessary.
2 AUDIT DOCUMENTATION: ISA 230

Section overview

- Audit documentation (audit working papers)
- Reasons for preparing sufficient and appropriate audit documentation
- Form, content and extent of audit documentation
- Computer-generated audit working papers
- Ownership, custody and confidentiality of audit working papers

2.1 Audit documentation (audit working papers)

All audit work must be properly documented and held in the audit file (also known as audit working papers). This documentation provides a record of:

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

The documentation must provide:

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

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

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

The auditor is also required to document:

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

2.2 Reasons for preparing sufficient and appropriate audit documentation

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

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

Documentation prepared at the time the work is performed is likely to be more accurate than documentation prepared later.
Other purposes of audit documentation include the following.

- Assisting the audit team to plan and perform the audit.
- Assisting supervisors in directing and supervising audit work.
- Ensuring members of the audit team are accountable for their work.
- Keeping a record of matters of continuing significance to future audits.
- Enabling an experienced auditor, with no previous connection with that audit, to conduct quality control reviews or other inspections i.e. by understanding the work that has been performed and the conclusions that have been reached.
- Providing strong evidence when defending a case where the auditor’s liability is questioned at a forum including a court of law, where the auditor is required to prove the nature, timing and/or extent of procedures carried out (for example, in a case of professional negligence where a fraud had been uncovered in the auditee company after issuance of the audit opinion).

### 2.3 Form, content and extent of audit documentation

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

- audit programs
- analyses
- summaries of significant matters
- letters of confirmation and representation
- checklists
- summaries and minutes of meetings between the auditor and management and/or those charged with governance, and
- correspondence.

Traditionally, it has been normal practice to maintain two types of audit files, a permanent file and a current file.

**Permanent file**

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

- The legal constitution of the company.
- Other important legal documents such as loan agreements.
- A summary of the history, development and ownership of the business.
- A record of the accounting systems and procedures used by the client.
- Copies of the financial statements for the previous years, with key financial ratios and trends.
This information is of continuing significance, and it is therefore important that the auditor should review the contents of the permanent file regularly and update it as appropriate.

**Current file**

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

- The final financial statements and auditor’s report.
- A summary of audit adjustments, including those not included in the final reported figures.
- Audit planning documentation.
- Audit control material (time budgets, review points, points for consideration by the engagement partner).
- Audit letters.
- For each ‘audit area’ (such as inventory, sales and payroll):
  - an audit plan (detailing the work to be done on that area)
  - details of items selected for testing, the tests performed, problems that were encountered (and how these problems were resolved) and the conclusion reached by the auditor on that area of operations/the financial statements
  - ‘lead schedules’: these give the figures for the audit area that will appear in the final financial statements.

All audit working papers should clearly show the following (where relevant) and for each audit area as appropriate:

- the name of the client
- the accounting period
- a file reference
- the name of the person preparing the working paper
- the date the paper was prepared
- the name of any person reviewing the work and the extent of such review
- the date of the review
- a key to/explanation of the audit ticks or symbols used in the working papers
- a listing of any errors or omissions identified
- the auditor’s conclusion on the area

ISA 230 requires the auditor to assemble the *final audit file* (s) on a timely basis after the date of the audit report (ordinarily not more than 60 days). This usually excludes drafts of working papers or financial statements, or notes that reflect incomplete or preliminary thinking. After the assembly of the final audit file has been completed, the auditor **must not delete or discard audit documentation** before the end of its retention period (see below).
If it does become necessary to modify existing or add new documentation after this stage, the auditor must document:

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

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

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

The auditor must document:

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

### 2.4 Computer-generated audit working papers

Auditors often use computer software to improve the efficiency of preparing audit working papers. These software packages can be used to help the auditor to prepare:

- analysis schedules (especially where the audit firm uses standardised working papers)
- lead schedules, and
- draft financial statements.

These schedules and statements can usually be cross-referenced and updated automatically as the audit proceeds, to allow for adjustments that the auditor makes.

The advantages of these computer software packages for auditors are as follows.

- The working papers are neat, easy to read and in a standard format.
- There is a lower risk of error by the auditor in processing adjustments.
- The audit review process by senior managers or the audit partner can be carried out remotely, without the necessity for the manager or partner to visit the client’s premises to carry out the review.

The automatic processing of adjustments by the auditor, using software, may result in significant savings in time (and cost).

### 2.5 Ownership, custody and confidentiality of audit working papers

The audit firm has ownership of the audit working papers. The papers are not a part of the client’s accounting records and do not belong to the client.

The auditor needs to decide how long to keep the audit files. ISQC1 requires a minimum period of **five years** from the date of the audit report, or group audit report if later (and relevant). Several countries have their own mandated ‘record retention periods’ which can override the requirements of ISQC1. For example, in Pakistan, all records for companies are generally required to be kept for a period of at least 10 years.

Auditing standards require the auditor to ensure that working papers are kept safe and that their contents are kept confidential. Confidential information should only be made available to third parties in accordance with ethical guidelines.
3 RELATED PARTIES: ISA 550

Section overview

- Related parties and related party transactions
- The impact on the audit of related party relationships and transactions
- The requirements of ISA 550

3.1 Related parties and related party transactions

**Related parties** are individuals or organisations that might have, or might be expected to have, an undue influence on the company that is being audited. Examples of related parties include:

- the directors and key management of a company
- their families
- other companies controlled by directors, key managers and members of their close family
- other companies in the same group.

**Definition: Related party**

ISA 550 defines a related party as either:

(i) a related party as defined in the applicable financial reporting framework; or

(ii) where the applicable financial reporting framework establishes minimal or no related party requirements:

   a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;

   b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or

   c. Another entity that is under common control with the reporting entity through having:

      i. Common controlling ownership;

      ii. Owners who are close family members; or

      iii. Common key management.

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

Related party transactions are material transactions between the client company and a related party of the company.

It is the responsibility of the client company’s management to record and disclose all material **related party transactions**, because these transactions may be carried out on more favourable terms than similar transactions with an independent third party.
Chapter 8: Audit evidence

The approach required by IAS 24 *Related party disclosures* is to disclose the relevant amounts of related party transactions and the nature of the related party relationships, so that the users of the financial statements can decide for themselves whether these transactions might have resulted in a manipulation or distortion of the financial statements.

ISA 550 *Related parties* deals with the auditor’s responsibilities in respect of related party transactions. It was revised (and redrafted) in July 2008 for two main reasons.

- The increased public attention given to accounting for related party relationships, because a number of major corporate scandals (such as Enron in the US) have involved related parties.
- The previous version of ISA 550 was mainly procedural in nature and did not discuss the risks of material misstatement that may arise from the existence of related party relationships and transactions.

The requirements of ISA 550 are discussed below.

### 3.2 The impact on the audit of related party relationships and transactions

Although many related party transactions are in the normal course of business and therefore may carry no higher a risk of material misstatement than ordinary transactions, in some circumstances related party transactions may lead to higher risks. For example:

- related parties may operate through complex structures and relationships and the resulting transactions may therefore also be complex
- accounting systems may not be effective at identifying and summarising related party transactions and balances
- related party transactions may not be conducted on normal market terms – some may even be conducted with nil consideration.

The objectives of the auditor with regard to ISA 550 are to obtain:

- an understanding of the entity’s related party relationships and transactions, and
- sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements.

The understanding must be sufficient for the auditor to be able to:

- recognise fraud risk factors arising from related party relationships and transactions
- conclude whether the financial statements achieve fair presentation in respect of related party relationships and transactions.

There is an increased risk of fraud in this area as related party relationships may present a greater opportunity for collusion, concealment or manipulation by management. It is therefore particularly important that the auditor approaches this area of the audit with professional scepticism.
3.3 The requirements of ISA 550

Most material misstatements linked to related party transactions arise from failure by the management of the client company to disclose related party relationships and transactions to the auditor.

ISA 550 therefore sets out a minimum set of risk assessment procedures specifically directed towards the identification of related party relationships and transactions that have not been identified or disclosed by management.

Risk assessment procedures

As part of the risk assessment procedures required by ISAs 240 and 315 the auditor is required to perform the following procedures in order to understand the entity’s related party relationships and transactions:

- Consider the risk of material misstatement due to fraud or error arising from related party relationships and transactions.
- Make inquiries of management in respect of:
  - the identity of related parties
  - the nature of relationships with those related parties
  - the nature of any transactions entered into with those parties during the period.
- Obtain an understanding of the internal controls in operation over:
  - the identification of, accounting for and disclosure of related party relationships and transactions
  - the authorisation and approval of significant related party transactions
  - the authorisation and approval of significant transactions outside the normal course of business.

Identifying related parties and related party transactions

In making inquiries of management in respect of the identity of related parties, the auditor will obtain a list of related parties from the directors, and consider if this list is complete. Tests for completeness could include the following:

- Review working papers for previous years, to look for names of known related parties.
- Review the company’s procedures for identifying related parties.
- Inquire about the relationships between directors and other entities (for example, does any director own another company, and have there been any transactions between that company and the client company?)
- Review shareholder records for the names of major shareholders.
- Review minutes of shareholder meetings (general meetings of the company).
- Ask any other audit firms involved in the audit about related parties (if the audit is the audit of a group of companies and more than one firm of auditors is involved) or ask previous auditors of the company about their knowledge of related parties.
- Conduct market research and personnel analysis to find out key relationships of the Company’s directors with other entities and/or
individuals. Sometimes, directors or key management personnel can participate in initiatives such as charitable work or join companies as non-executive directors or in an advisory role; such relationships need to be examined in detail.

The auditor may have difficulty in obtaining a complete list of related parties. This is because their main source of information about related parties is the client’s management, who may wish to keep related party relationships hidden. Particular problem areas where the disclosure of related parties may be incomplete are:

- close family relationships
- where the related party is another business entity which is owned or influenced by a director of the client company: however two companies are not necessarily related parties just because the same individual is a director or shareholder in both – the key issue is whether the individual is in a position of influence in both companies.

The auditor may also have difficulty in identifying all related party transactions that have occurred, unless the client entity has recorded them separately. Related party transactions may be 'hidden' within all the other transactions recorded in the accounts of the entity.

During the audit the auditor must remain alert, when inspecting records or documents, for information which might indicate the existence of previously unidentified or undisclosed related party relationships or related party transactions. The auditor is also specifically required to inspect the following:

- Any bank and legal confirmations obtained as part of their audit work.
- Minutes of shareholder and management meetings.
- Any other records or documents the auditor considers necessary in the specific circumstances.

If the auditor identifies significant transactions outside the entity’s normal course of business they must inquire as to the nature of these transactions and whether related parties could be involved. This is because these carry a higher risk of involving related parties who have previously been unidentified or undisclosed. ISA 550 states that any significant related party transactions outside the entity’s normal course of business must be treated as giving rise to significant risks of material misstatement.

The whole audit team should be made aware of information obtained about the entity’s related parties so that they can identify any previously undisclosed transactions with related parties.

If any fraud risk factors are found these must be taken into account when the auditor identifies and assesses the risks of material misstatement due to fraud in accordance with ISA 240. A key fraud risk factor identified by ISA 550 is the existence of a party who exerts dominant influence over the entity. Any such party (an individual or a company) is likely to be able to override the views of the entity’s management and force the entity to enter into a transaction in which the dominant party has an interest.

Indicators that a person or entity might be a dominant party include:

- the party vetoing significant business decisions of the entity
- significant transactions being referred to the party for final approval
- little or no debate among management in respect of business proposals made by the party
transactions involving the party (or its close family members) are rarely independently reviewed or approved.

**Responses to the risks of material misstatement**

As discussed in a previous chapter, the auditor is required by ISA 330 to respond to assessed risks. In the context of the assessed risks of material misstatement arising from related party relationships and transactions ISA 550 requires the following audit procedures.

If the auditor discovers previously unidentified or undisclosed related parties or (significant) related party transactions they must:

- Determine whether the underlying circumstances confirm the existence of those relationships or transactions.
- Communicate the relevant information to the audit team.
- Request management to identify all transactions with the newly identified related parties.
- Inquire as to why the entity’s system failed to identify or disclose these related party relationships or transactions.
- Perform appropriate substantive procedures on the newly identified related parties or significant related party transactions.
- Reconsider the risk of there being unidentified or undisclosed related parties or (significant) related party transactions and perform additional procedures as necessary.
- If the non-disclosure appears intentional, evaluate the implications for the audit.

If the auditor discovers significant related party transactions outside the entity’s normal course of business they must:

- Inspect the underlying contracts or agreements to evaluate whether:
  - the contracts etc. were entered into in order to engage in fraudulent financial reporting or to hide the misappropriation of assets (a lack of business rationale might indicate this)
  - the terms of the contracts etc. are consistent with management’s explanations, and
  - the transactions have been properly accounted for and disclosed.
- Obtain evidence that the transactions were properly authorised.

If management has made a statement in the notes to the financial statements that a related party transaction was made on the same terms as an arm’s length transaction, the auditor must obtain evidence to support this assertion.

**Materiality of related party transactions**

ISA 450 *Evaluation of misstatements identified during the audit*, which is covered in a later chapter, requires the auditor to consider both the **size and the nature** of a misstatement, and the **particular circumstances of its occurrence**, when evaluating whether a misstatement is material.

In the context of related party transactions, this means that much smaller transactions in monetary terms may be material as the significance of the transaction to the users of the financial statements may not depend solely on the
recorded amount of the transaction but also on the nature of the related party relationship.

It may be tempting to assume that materiality means ‘large’, but in the case of related party transactions, a transaction could be material if it has a value as low as Rs. 0 (for example, a transaction involving the sale of the company’s assets to a related party for a very low price; or the Chief Executive’s or Directors’ remuneration which may be immaterial to the financial statements by monetary value but is usually an area of interest and concern for shareholders in the AGM).

**Other requirements**

**Written representations** must always be obtained by the auditor from the directors about related parties and related party transactions. The directors are in the best position to know the identities of any related parties. The written representation from the directors must cover:

- the completeness of the information that has been provided about the identity of related parties and related party relationships and transactions,
- the adequacy of accounting for and disclosure of such related party relationships and transactions in the financial statements.

Unless all of those charged with governance are involved in managing the entity, the auditor **must communicate to those charged with governance** significant matters arising during the audit in connection with the entity’s related parties.

The names of all identified related parties and the nature of the related party relationships must be **documented**.

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**Example: Audit matters and audit evidence**

The draft statement of financial position of ABC Company includes an amount of Rs. 300,000 owed by DE Company. The total assets of ABC Company are Rs. 200 million.

The auditor has obtained the following audit evidence:

- DE Company is controlled by the chairman of ABC Company, who is its majority shareholder.
- The draft financial statements of ABC Company do not provide any disclosures about the Rs. 300,000 transaction, on the grounds that it is immaterial.
- There is no information about the nature of the transaction, but the Rs. 300,000 had been included in receivables at the end of the previous financial year.

**Required**

What further measures should the auditor take?
Answer
The auditor should first establish whether DE Company is a related party of ABC Company. From the information available it would seem that it is a related party, because the chairman of ABC Company, as a majority shareholder in DE Company, would appear to be in a position of influence in both companies.

Although the amount receivable is not material in terms of value (in relation to the value of total assets of ABC), the materiality of related party transactions should not be judged only on the basis of value. The nature of the transaction is also relevant for judging materiality. The auditor needs to obtain more information. The chairman should be asked to provide more details. In addition, the auditor should review the written terms of the transaction (if there are any), and should obtain a written representation from the chairman about the nature of their influence over DE Company, whether the amount receivable by ABC Company is likely to be recoverable and when it is likely to be paid. The auditor should also review board minutes of ABC Company for any recorded discussions by the board of the transaction with DE Company.

If the auditor takes the view that the transaction is a related party transaction, they should notify management of the need for disclosure in the financial statements. Disclosure is required of the nature and amount of the transaction, the amount of any balances (and details of any security given) and any allowances that have been made for an irrecoverable amount. Since the amount was receivable one year ago, the auditor should also consider the expected date of payment, and whether the balance is more in the nature of a long-term loan receivable than a current asset.
4 WRITTEN REPRESENTATIONS: ISA 580

4.1 Definition and objectives
ISA 580 defines a written representation as a written statement by management provided to confirm certain matters or to support other audit evidence.

The objectives of the auditor in this area, per ISA 580, are to:
- obtain written representations from management that it has fulfilled its responsibilities in respect of the financial statements and the audit
- obtain written representations as appropriate to support other audit evidence
- respond appropriately to written representations provided by management or if management refuse to provide the written representations requested.

ISA 580 requires the auditor to obtain appropriate written representations from management (often referred to as “management representations”) in the form of a letter of representation, addressed to the auditor.

These written representations may be an important source of audit evidence.

4.2 Written representations as audit evidence
If the auditor considers that written representations are needed to support other audit evidence they must request such other written representations.

During the course of the audit, management will make many representations to the auditor. Some of these will be unsolicited but some will be given in response to specific inquiries from the auditor. The auditor will have recorded such verbal discussions with management in the audit working papers. However, verbal evidence is not strong audit evidence. In order to improve the quality of this evidence, the auditor will ask for any significant discussions to be confirmed in writing.

Such representations are likely to be needed:
- to support the auditor’s understanding of management’s intention or judgment (for example, in respect of future plans for the business or a specific matter such as the net realisable value of inventory), or
- in respect of the completeness of a specific item (for example, that all liabilities have been provided for).

However, although such written representations provide necessary audit evidence, they do not provide sufficient appropriate evidence on their own.
If a written representation is contradicted by other audit evidence, the auditor should:

- consider whether the risk assessment of that area is still appropriate
- consider whether additional audit procedures are needed
- if there are concerns about the integrity of management, document those concerns and consider withdrawing from the audit.

The auditor is also required by specific other ISAs to request certain other written representations. These requirements are illustrated in the example letter set out below.

4.3 Written representations about management’s responsibilities

The auditor is also required by ISA 580 to obtain certain other written representations from management. In these representations management acknowledges that:

- it has fulfilled its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
- it has provided the auditor with all relevant information
- all transactions have been recorded and are reflected in the financial statements.

Again, these points are illustrated in the example letter set out below.

4.4 Form and contents of the letter of representation

The letter of representation is:

- usually drafted by the auditor (as they know the areas on which they require written representations)
- addressed to the auditor
- dated as near as practicable (but not after) the date of the audit report.

The following example of a letter of representation shows the minimum contents of such a letter. However, remember that the auditor may also need to request management to provide written representations about specific assertions in the financial statements.

Example of a letter of representation

(Entity Letterhead)

(To Auditor)  (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Ltd for the year ended 31 December 31 20X5 for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or give a true and fair view) in accordance with International Financial Reporting Standards.

We confirm that (to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves):
Financial statements

We have fulfilled our responsibilities for the preparation and presentation of the financial statements as set out in the terms of the audit engagement dated...... and, in particular, the financial statements are fairly presented (or give a true and fair view) in accordance with International Financial Reporting Standards.

Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable. (ISA 540)

Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of International Financial Reporting Standards. (ISA 550)

All events subsequent to the date of the financial statements and for which International Financial Reporting Standards require adjustment or disclosure have been adjusted or disclosed. (ISA 560)

The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (ISA 450)

[Any other matters that the auditor may consider appropriate. E.g.

- Whether the selection and application of accounting policies are appropriate; and

- Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognised, measured, presented or disclosed in accordance with that framework:
  - Plans or intentions that may affect the carrying value or classification of assets and liabilities;
  - Liabilities, both actual and contingent;
  - Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral; and
  - Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.]

Information provided

We have provided you with:

- all information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements
- additional information that you have requested from us; and
- unrestricted access to those within the entity.

All transactions have been recorded in the accounting records and are reflected in the financial statements.

We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (ISA 240)
We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:

- management
- employees who have significant roles in internal control; or
- others where the fraud could have a material effect on the financial statements. (ISA 240)

We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity’s financial statements communicated by employees, former employees, analysts, regulators or others. (ISA 240)

We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements. (ISA 250)

We have disclosed to you the identity of the entity’s related parties and all the related party relationships and transactions of which we are aware. (ISA 550)

[Any other matters that the auditor may consider appropriate. E.g.

- We have communicated to the auditor all deficiencies in internal control of which management is aware.]

4.5 Refusal to provide requested written representations

If management refuse to provide requested written representations the auditor must:

- discuss the matter with management
- re-evaluate the integrity of management and reconsider the impact on other representations and audit evidence, and
- take appropriate action, including considering the effect on the audit report.

In exceptional circumstances the auditor may need to consider withdrawing from the engagement (unless prevented from doing so by law or regulation). The auditor should consider seeking legal advice.
5 USING THE WORK OF AN AUDITOR’S EXPERT: ISA 620

Section overview

- Definition of an expert
- Assessing the need for an expert
- Assessing the work of an expert

5.1 Definition of an expert

**Definition: Auditor’s expert**

The term ‘expert’ is used here in the sense of an individual or an organisation that possesses skills, knowledge and experience in **fields other than accounting or auditing**.

The auditor may use the work of an expert to provide knowledge relevant to the audit, which the audit firm itself does not possess. ISA 620 *Using the work of an auditor’s expert* gives a number of examples where experts may be used by an auditor. These include:

- legal opinions
- specialist valuation areas, such as property or pension liabilities
- the analysis of complex or unusual tax compliance issues
- valuation of specialised-nature assets such as oil reserves, mining resources etc.

Note that the ISA covers the work of the **auditor’s** expert – the expert is employed by the auditor, not by the entity. The situation where management use the work of an expert was covered above, under ISA 500.

The **objective** of ISA 620 is to allow the auditor to:

- decide whether to use the work of an expert, and
- assess whether that work is adequate.

5.2 Assessing the need for an expert

There is a cost attached to the use of an expert by the auditors. The expert will charge a fee for the professional service they provide. The use of an expert should therefore be evaluated on a cost/benefit basis.

When deciding whether they need to use an expert to assist them in obtaining sufficient appropriate evidence, the auditor should consider such factors as:

- the nature, significance and complexity of the matter
- the risk of material misstatement
- the availability of alternative sources of audit evidence.

5.3 Assessing the work of an expert

ISA 620 requires the auditor to apply the procedures set out below when using the work of an expert. The auditor shall:

- obtain an understanding of the expert’s field of expertise, sufficient to allow the auditor to determine the nature, scope and objectives of the expert’s work and evaluate the adequacy of that work
- agree terms of engagement with the expert, including:
the nature, scope and objectives of the expert’s work
the respective responsibilities of the expert and the auditor
the form of the expert’s report
confidence requirements

- evaluate the adequacy of the expert’s work, including the:
  - reasonableness of the expert’s conclusions
  - consistency of those conclusions with other audit evidence
  - reasonableness of significant assumptions and methods used - this is usually the most time-consuming part of the auditor’s involvement in the expert’s work since the auditor is discussing and challenging the key assumptions with an objective to form an unbiased, independent view of the subject matter. Examples include challenging the discount rate, salary increments rate or expected remaining working life of employees used as assumptions in valuing a pension liability.
  - relevance, completeness and accuracy of source data.

Generally, the auditor is assessing whether the expert’s work constitutes sufficient and appropriate audit evidence.

If the auditor decides that the work of the expert is not adequate they are required to:

- agree additional work with the expert, or
- perform other appropriate additional audit procedures.

The auditor has sole responsibility for the audit opinion issued and this is not reduced in any way by their use of an expert. Therefore they should not refer in their report to the use of an expert, unless that is required by law or regulation. Even then, or if the auditor refers to the expert’s work in their report because it is relevant to an understanding of a modified opinion, then they must make it clear that such a reference does not reduce their responsibility for that opinion in any way.

This approach reinforces the point made earlier, that the auditor remains fully responsible for the report produced, even if evidence on which it is based was produced by others. The auditor therefore cannot simply accept work performed by experts. That work must be evaluated in the same way as other audit evidence is evaluated.

The competence, capabilities and objectivity of an expert may be assessed in one or more of the following ways:

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with other auditors or others who are familiar with that expert’s work.
- Knowledge of that expert’s qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.

The objectivity of the expert is probably more of an issue when the expert has been employed by the audit client, as discussed earlier in this chapter.
6 THE EXTERNAL AUDITOR’S RELIANCE ON THE WORK OF THE INTERNAL AUDITOR: ISA 610

Section overview
- Reliance on internal audit: the external auditor’s problem
- ISA 610 (Revised): Using the work of internal auditors
- Evaluating internal auditors’ work
- Using the work of internal auditors
- Direct assistance

6.1 Reliance on internal audit: the external auditor’s problem

In many instances the work of the external auditors and internal auditors may overlap, particularly when the internal audit department carry out financial audits. In principle, the external auditors may be able to reduce the amount of testing and checking they carry out for the external audit, by relying on work that has already been carried out by the internal auditors. Reliance by the external auditor on the work of the internal auditors, where it is appropriate to do so, should lead to a more efficient and cost-effective audit.

However, the external auditor has a problem. The external auditor is responsible for their opinion on the financial statements, even if they have relied on the work of others such as internal auditors and external experts. The responsibility for relying on work done by the internal auditors rests entirely with the external auditors.

The external auditors must therefore be satisfied that they can rely on the work of the internal auditors to support the external audit opinion. The external auditors must therefore decide whether to rely on work done by the internal auditors, and if so, in what respects.

6.2 ISA 610 (Revised): Using the work of internal auditors

Relationship between ISAs 315 (Revised) and 610 (Revised)

ISA 315 (Revised) Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment addresses how the knowledge and experience of the internal audit function can inform the external auditor’s understanding of the entity and its environment and identification and assessment of risks of material misstatement. ISA 315 (Revised) also explains how effective communication between the internal and external auditors also creates an environment in which the external auditor can be informed of significant matters that may affect the external auditor’s work.

ISA 315 (Revised) requires that when planning the audit the external auditor must assess the effectiveness of the internal audit function and determine whether they wish to use the work of the audit client’s internal audit function. Even where the internal audit function is deemed ineffective, it may still be useful to be aware of the internal audit conclusions. The effectiveness of internal audit will have a great impact on how the external auditors assess the whole control system and the assessment of audit risk.
ISA 610 (Revised) Using the work of internal auditors deals specifically with the external auditor’s responsibilities when choosing to use the work of internal auditors. This includes:

- using the work of the internal audit function in obtaining audit evidence; and
- using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.

**Definition: Direct assistance**

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

ISA 610 (Revised) does not apply if the entity does not have an internal audit function and where an internal audit department exists but both their responsibilities and activities are not relevant to the audit or the external auditor does not expect to use the work of the function in obtaining audit evidence. Furthermore, the requirements relating to direct assistance do not apply if the external auditor does not plan to use internal auditors to provide direct assistance.

Note that in some jurisdictions (e.g. UK, Ireland and Pakistan) the external auditor may be prohibited or restricted to some extent, by law or regulation, from using the work of the internal audit function or using internal auditors to provide direct assistance.

When ISA 610 (Revised) is applied the objectives of the external auditor are:

- to determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent

and having made that determination:

- if using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and
- if using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

**Why were ISAs 315 and 610 revised?**

ISAs 315 and 610 were revised to:

- clarify guidance to external auditors in the use of internal audit for external audit purposes;
- require the external auditor to read internal audit reports and re-perform some of the work in areas where the external auditor plans to rely on internal audit work;
- clarify circumstances when the work of internal audit cannot be used (see ‘evaluating internal auditors’ below); and
- establish more robust safeguards against the undue use of internal audit work in order to execute an efficient audit.
Three specific requirements of auditors now include:
- to evaluate internal audit’s objectivity, competence and level of discipline (ISA 610);
- to make enquiries of internal auditors regarding their knowledge of the entity, risk and control (ISA 315); and
- to read internal audit’s reports (ISA 610).

### 6.3 Evaluating internal auditors’ work

To determine whether the internal auditor’s work is adequate for their purposes, the external auditor is **required to evaluate** the internal audit function and its procedures. A decision can then be taken as to whether the work of the internal auditors can be used as part of the evidence on which the external audit opinion will be based.

The table below summarises the criteria against which the internal audit function will be assessed.

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Comment</th>
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| **Objectivity**                   | - What is the status of the internal audit function within the entity?  
- To whom does it report? Does it have access to those charged with governance?  
- Is it free of any conflicting responsibilities (e.g. any operational responsibilities)?  
- Do those charged with governance oversee employment decisions regarding the internal audit function?  
- Are there any restrictions placed on the internal audit function?  
- Do management act on the recommendations of the internal audit function? |
| **Competence**                    | - Are the internal auditors members of relevant professional bodies?  
- Do they have adequate technical training and proficiency?  
- Are there established policies for hiring and training internal auditors?  
- Do the internal auditors possess the required knowledge of financial reporting?  
- Do the internal auditors possess the required industry expertise; can they come up with company and industry specific risks and recommendations? |
| **Systematic and disciplined approach** | - Is internal audit work properly planned, supervised, reviewed and documented?  
- Does the function have appropriate quality control procedures, audit manuals, work programmes and other relevant documents? |
If any of the above factors regarding objectivity, competence and systematic and disciplined approach are lacking, ISA 610 (Revised) states that the external auditor shall not use the work of the internal audit function.

Examples of work of the internal audit function that can be used by the external auditor include:

- Testing of the operating effectiveness of controls;
- Substantive procedures involving limited judgment;
- Observations of inventory counts;
- Tracing transactions through the information system relevant to financial reporting;
- Testing of compliance with regulatory requirements;
- In some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group (where this does not conflict with the requirements of ISA 600).

6.4 Using the work of Internal auditors

In addition to the general assessment of the internal audit function, ISA 610 also requires the external auditor to **evaluate each specific piece of work** performed by internal audit before it is used as external audit evidence.

As a basis for determining the areas and extent to which work of the internal audit function can be used, the external auditor shall consider the nature and scope of the work that has been performed and its relevance to the external auditor’s overall audit strategy and audit plan.

The external auditor is **required** to evaluate whether:

- the work was properly planned, performed, supervised, reviewed and documented;
- sufficient, appropriate evidence was obtained to enable auditors to draw reasonable conclusions;
- appropriate conclusions were reached, consistent with any reports prepared;
- any exceptions or unusual matters were properly resolved.

Agreeing certain matters in advance should make it more likely that the external auditor will be able to rely on the work of internal audit. It may therefore be useful for the external auditor to agree the following in advance with internal audit:

- the timing of such work
- the nature of the work performed
- the extent of audit coverage
- materiality and performance materiality
- methods of item selection and sample sizes
- documentation of work performed
- review and reporting procedures.
Chapter 8: Audit evidence

Having evaluated the internal auditor’s specific areas of work, the external auditor will then perform further procedures on some (or all) of the specific areas. Procedures may include:

- making inquiries of appropriate individuals within the internal audit function;
- observing procedures performed by internal audit;
- reviewing the internal audit function’s work program and working papers;
- reperforming a sample of the internal audit function’s procedures to validate conclusions reached by the internal audit function.

The exact nature, timing and extent of testing of specific work of the internal audit function will depend upon:

- the external auditor’s judgement of the risk and materiality of each area concerned;
- the preliminary assessment of the internal audit function; and
- the evaluation of specific work of the internal audit function.

Whilst reperformance provides more persuasive evidence regarding the adequacy of the work of the internal audit function compared to the other procedures mentioned above, it does not necessarily need to be applied in all audit areas. Some reperformance is required on the body of work of the internal audit function as a whole which the external auditor plans to use. This is more likely to be focused on areas where most judgement was required and/or in areas of higher risk of material misstatement.

Communication with those charged with governance

ISA 610 (Revised) requires the external auditor to communicate the planned use of the work of the internal audit function to those charged with governance for their understanding of the proposed audit approach.

Documentation

The external auditor is required to document their conclusions about the adequacy of the internal audit function and its work, and the audit procedures performed by them on that work.

6.5 Direct assistance

Consider the use of internal auditors to provide direct assistance

If the external auditor plans to use internal auditors to provide direct assistance on the audit (and is not prohibited from doing so by law or regulation) they must evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance. This evaluation must include inquiry of the internal auditors regarding interests and relationships that may create a threat to their objectivity.

Internal auditors may not provide direct assistance if:

- there are significant threats to the objectivity of the internal auditor; or
- the internal auditor lacks sufficient competence to perform the proposed work.
When determining the nature and extent of direct assistance work to be assigned to internal audit, the external auditor shall consider:

- the amount of judgement involved;
- the assessed risk of material misstatement;
- the external auditor’s evaluation of the existence of threats to the objectivity and level of competence of the internal auditors who will be providing such assistance;
- whether, in aggregate, using internal auditors to provide direct assistance to the extent planned, together with the planned use of the work of the internal audit function, would still result in the external auditor being sufficiently involved in the audit, given the external auditor’s sole responsibility for the audit opinion expressed.

ISA 610 (Revised) precludes the use of internal audit to perform direct assistance procedures that:

- involve making significant judgements in the audit;
- relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited;
- relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or
- relate to decisions the external auditor makes in accordance with ISA 610 (Revised) regarding the internal audit function and the use of its work or direct assistance.

**Communication with those charged with governance**

ISA 610 (Revised) requires the external auditor to communicate the planned use of internal audit in providing direct assistance to those charged with governance.

**Using Internal auditors to provide direct assistance**

Prior to using internal auditors to provide direct assistance, the external auditor shall:

- obtain written agreement from an authorised representative of the entity that the internal auditors will be allowed to follow the external auditor’s instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and
- obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with ISA 220 Quality Control for an Audit of Financial Statements. In so doing:

- the nature, timing and extent of direction, supervision, and review shall recognise that the internal auditors are not independent of the entity and be responsive to the outcome of the evaluation of the amount of judgement involved, the assessed risk of material misstatement and the evaluation of the existence and significance of threats to the objectivity and level of competence of the internal auditors providing direct assistance; and
The review procedures shall include the external auditor checking back to the underlying audit evidence for some of the work performed by the internal auditors. This is an important additional step to ensure objectivity and impartial judgment was exercised by the internal auditor.

The direction, supervision and review by the external auditor of the work performed by the internal auditors must be sufficient in order for the external auditor to be satisfied that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work.

In directing, supervising and reviewing the work performed by internal auditors, the external auditor shall remain alert for indications that the external auditor’s evaluations of the existence and significance of threats to the objectivity and level of competence of the internal auditors providing direct assistance are no longer appropriate.

**Documentation**

The external auditor is required to document:

- The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance;

- The basis for the decision regarding the nature and extent of the work performed by the internal auditors;

- Who reviewed the work performed and the date and extent of that review in accordance with ISA 230;

- The written agreements obtained from an authorised representative of the entity and the internal auditors; and

The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.
7 THE AUDIT OF ACCOUNTING ESTIMATES: ISA 540

Section overview

- The nature of accounting estimates and the audit problem
- ISA 540: Auditing accounting estimates
- ISA 501: Audit evidence – specific considerations for selected items (litigation and claims)
- IAASB Alert: Challenges in auditing fair value accounting estimates in the current market environment

7.1 The nature of accounting estimates and the audit problem

In the financial statements, estimated figures are used in situations where it is not practical or not possible to obtain a more precise measurement of an item. ISA 540 defines an audit estimate as: ‘an approximation of a monetary amount in the absence of a precise means of measurement.’ Accruals, prepayments and depreciation are all examples of areas where estimates are widely used. Other examples are the estimation of deferred tax, the estimate of losses or profits on long-term construction contracts, and provisions for the settlement of unfinished legal disputes.

Estimates are made for the financial statements by the management of the entity, using their judgement. The audit problem is therefore fairly clear. How does the auditor satisfy himself that the estimates made by management for inclusion in the financial statements are reasonable? The audit risk can be high.

7.2 ISA 540: Auditing accounting estimates

ISA 540 Auditing accounting estimates, including fair value accounting estimates, and related disclosures is concerned with the audit of all accounting estimates, including those involving fair values. It requires auditors to obtain sufficient appropriate audit evidence as to whether:

- accounting estimates (whether recognised or disclosed in the financial statements) are reasonable, and
- whether the related disclosures are adequate.

Because of the number of major corporate scandals in recent years about aggressive ‘earnings management’, ISA 540 (revised and redrafted in accordance with the IAASB’s clarity project) introduces requirements for greater rigour and scepticism in the audit of accounting estimates. It encompasses a risk based approach, focusing on those estimates that have high estimation uncertainty.

ISA 540 gives the following examples of accounting estimates.

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

Outcome of long-term contracts

Additional examples of situations where fair value accounting estimates may be required include:

- complex financial instruments, which are not traded in an active and open market
- share-based payments
- property or equipment held for disposal
- certain assets or liabilities acquired in a business combination, including goodwill and intangible assets
- transactions involving the exchange of assets or liabilities.

Audit evidence relating to such estimates is often of relatively poor quality, because of the nature of the items involved. This means that the auditor will require a higher volume of this lower quality evidence, particularly where the estimated item may be material or the audit risk is relatively high.

**Fair value measurements**

Items measured at fair value, such as property, financial instruments, employee benefits and share-based payments are often significant items in the statement of financial position.

**Definition: Fair value**

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

*Source: IFRS 13*

The IAASB issued IFRS 13 Fair value measurement in 2011 which employs a ‘fair value hierarchy’ of three levels of inputs:

- **Level 1** inputs are quoted prices for identical assets or liabilities in active markets which are accessible for the measurement date
- **Level 2** inputs are also observable, either directly or indirectly, but represent inputs other than quoted market prices
- **Level 3** inputs are unobservable inputs for the asset or liability.

The auditor needs to recognise the audit risk in fair value measurements:

- **Inherent risk.** Many fair value measurements are largely subjective and imprecise, and there is unavoidable inherent risk in their measurement. Valuation models may be used, but these are often complex and may be unreliable (for example, in the case of non-marketable financial instruments, or models to assess the amount of liabilities to a company's pension fund). The inherent risk is much less when an open market exists for the items measured at fair value.

- **Control risk.** There is some risk that the entity’s systems may fail to prevent or detect valuation errors. Fair value measurements are often made by external experts, outside the normal course of routine business operations, and the controls over the valuation process are therefore likely to be weak.
Detection risk. The auditor should try to minimise detection risk, but the auditor may lack the knowledge and expertise to verify fair value measurements. This means that the auditor may need to rely on the work of an external expert, increasing the risk that errors in fair value measurements will not be discovered.

Accounting estimates: auditing procedures

As part of their risk assessment procedures ISA 540 requires the auditor to obtain an understanding of the following.

- The requirements of the applicable financial reporting framework (for example, international accounting standards) in respect of accounting estimates, including related disclosures.

- How management identify transactions or events that could result in an accounting estimate being recognised or disclosed in the financial statements.

- The nature of the estimates. In the case of a liability, this involves obtaining an understanding of the obligation for which an estimate is needed: for example in the case of a provision for costs of warranties or guarantees, what are the terms of the warranties or guarantees that have been given by the client to its customers?

- The auditor should also review the procedures used by management to make their estimates, including:
  - the method used for estimating (for example in deciding the estimated useful lives of non-current assets)
  - relevant controls
  - the use of experts
  - the underlying assumptions
  - whether there ought to have been any change in the method used since the prior period
  - whether and how management has assessed the effect of estimation uncertainty.

If possible, the auditor should check the amount of an estimate against other known facts, to assess whether the estimated amount seems reasonable.

The auditor should also:

- review the outcome of accounting estimates included in the previous period's financial statements (to assess their reliability) and consider changes in the estimate from one year-end to the next
- evaluate the degree of estimation uncertainty associated with each current period estimate and, if the risk is high, whether this gives rise to significant risks.
Having assessed the risks of material misstatement the auditor must then determine:

- whether management has properly applied the requirements of the applicable financial reporting framework, and
- whether the methods used for making the estimates are appropriate and have been consistently applied (or whether any change in method since the previous period is appropriate).

In response to the assessed risks of material misstatement the auditor must then perform one or more of the following procedures.

- Determine whether events up to the date of the auditor’s report provide sufficient audit evidence in respect of the estimate. The auditor should review events after the reporting date, and if possible find evidence to confirm the validity of the estimates.
- Test how management made the estimate and the data on which it is based, considering the method used and assumptions made.
- Test the controls over management’s procedures for making estimates and carry out appropriate substantive procedures.
- Develop their own estimate or range of estimates and compare to management’s figure, evaluating any significant differences.

The auditor is also required to:

- consider the need for expert evidence
- obtain written representations from management, and
- document the basis for their conclusions and any indications of management bias.

The following examples of indicators of possible management bias in estimates are given in the ISA.

- Changes in an accounting estimate, or the method for making it, where this is a subjective assessment.
- Use of an entity’s own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
- Selection or construction of significant assumptions that yield an estimate which favours management objectives.
- Selection of an unduly optimistic or pessimistic estimate.

**Professional scepticism and the audit of accounting estimates**

The auditor’s professional scepticism becomes particularly important when addressing areas of the audit that are more complex, significant or highly judgmental. Subsequently, the need to maintain professional scepticism is paramount when auditing accounting estimates, in particular where the estimates relate to complex and highly judgmental areas such as financial instruments, warranty provisions or inventory and trade receivable related write-downs.
Example: Professional scepticism and the audit of accounting estimates

Saddique is a senior associate working on the audit of a medium-sized fashion retailer. Unfortunately the audit is running behind schedule due to staff illness and the reporting deadline is getting close.

The audit documentation shows that Saddique held a discussion with the financial controller (FC) to discuss the provision against obsolete inventory. Saddique concluded that the FC’s explanation that a 5% provision (compared to last year’s 15% provision) was reasonable. The client had planned a significant H1 marketing spend and was also confident of securing a “highly probable” sale of the majority of closing inventory to an exciting new customer in Russia. The sale was likely to achieve a mark-up on cost of 38%.

On reviewing the audit working papers, the audit manager commented that Saddique had not demonstrated sufficient professional scepticism in his audit of the obsolete inventory provision. The manager was particularly concerned in light of the significant uncertainty around the client’s ability to continue as a going concern.

Requirement
How could Saddique have applied greater scepticism in the audit of the obsolete inventory provision?

Answer
Saddique should have:
- assessed current market conditions, competitor activity and post year-end price lists to help build a view as to the saleability of closing inventory;
- reviewed after-date sales to establish the price at which any closing inventory was sold (and therefore whether it was sold above or below cost), plus establish how much closing inventory remains unsold (and potentially needs providing against);
- checked whether the new Russian customer had indeed purchased the bulk (or all) of the closing inventory (and at what price);
- sought evidence as to whether the planned marketing campaign happened / will happen and the impact it had / might have on closing inventory;
- reviewed the outcome of prior years’ inventory provision estimates to assess how accurate (or not) they were and how skilled and reliable management have been in making prior estimates; this would help Saddique form a view of the extent to which he feels he can rely on similar management estimates this year;
- discussed the process used by management to make their 5% provision estimate and critically challenged the assumptions therein; Saddique should have borne in mind other relevant factors such as market conditions, after-date sales, the going concern uncertainty and the status of the marketing campaign and Russian customer;
- Saddique should have fully documented the discussions with management including demonstrating how he challenged management’s assumptions, including why 5% was deemed appropriate rather than 15% as in prior years (or even higher).
7.3 ISA 501: Audit evidence – specific considerations for selected items (litigation and claims)

One section of ISA 501: Audit evidence – specific considerations for selected items addresses the audit of litigation and claims. ISA 501 states that the auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

c) Reviewing legal expense accounts

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other ISAs, seek direct communication with the entity’s external legal counsel. The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity’s external legal counsel to communicate directly with the auditor.

The review of ongoing litigation is particularly important and has been emphasised by the standards due to the fact that such litigations can impact the amounts and/or disclosures in the financial statements by a material amount and can have the tendency to change the overall opinion of the stakeholders about the financial statements. This is especially so in the case of entities in highly regulated industries such as pharmaceuticals, education or mining and in companies which are in the process of initial public offering or acquisition mode.

If law, regulation or the respective legal professional body prohibits the entity’s external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.

The auditor shall modify the opinion in the auditor’s report in accordance with ISA 705 if:

- management refuses to give the auditor permission to communicate or meet with the entity’s external legal counsel or the entity’s external legal counsel refuses to respond appropriately to the letter of inquiry or is prohibited from responding; and

- the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures.

7.4 IAASB Alert: Challenges in auditing fair value accounting estimates in the current market environment

The IAASB issued an alert in October 2008 to assist auditors by highlighting areas within the International Standards on Auditing (ISAs) that are particularly relevant in the audit of fair value accounting estimates in times of market uncertainty. It was prepared in light of difficulties in the credit markets and, therefore, focused on financial instruments.

The alert also refers to related issues concerning whether an entity has the ability to continue as a going concern.
The alert is relevant to audits of all entities that have investments in financial instruments, especially those in illiquid markets.

**Key matters highlighted in the alert**

- Challenges faced in accounting on the basis of fair value;
- Requirements and guidance in standards that are particularly relevant to fair values;
- Other considerations in audits of fair value accounting estimates;
- Initiatives of the International Accounting Standards Board; and
- Recent revisions to existing standards on auditing accounting estimates and fair value measurements and disclosures which, while not yet effective, may be helpful to auditors.
8 THE AUDIT OF SPECIFIC AREAS OF THE FINANCIAL STATEMENTS

Section overview

- Introduction
- Auditor’s checklist for specific IASs and IFRSs
- International auditing practice note 1000: Special considerations in auditing financial instruments
- Conclusion: audit papers, audit procedures and audit matters

8.1 Introduction

In your examination, you will be required to apply the general principles of obtaining audit evidence to specific areas of the financial statements that are regulated by one or more of the international accounting standards.

In order to deal with exam questions of this type you need to know the details of the relevant IFRS or IAS. You will then need to consider:

- Materiality: is the item material for the financial statements?
- Key requirements of the IFRS or IAS: what does the auditor need to test to ensure compliance?
- How to obtain suitable audit evidence to check compliance with the accounting standard.

The main areas that you may be required to consider in the exam are set out below, as a checklist of the main issues that the auditor should consider when gathering audit evidence. Note that the standards relating to group audit (IAS 27, IAS 28, IFRS 3, IFRS 10, IFRS 11 and IFRS 12) are explored further in a later chapter.

8.2 Auditor’s checklist for specific IASs and IFRSs

**IAS 1: Presentation of financial statements**

- Has the **going concern basis** been adopted? Is the going concern basis appropriate?
- If the directors of the client company have decided that the going concern basis is not appropriate, have the relevant disclosures been made?
- If there is uncertainty about the going concern status of the company, have the relevant disclosures been made?
- Has the **accruals concept** been complied with?
- Is there consistency in the presentation and classification of items in the financial statements, between the current and previous financial periods?
- Has each material class of items been separately presented in the financial statements?
- Has **offsetting** (of assets and liabilities, or income and expense) been applied only as permitted by an accounting standard?
Has an **appropriate format** been adopted for the statement of financial position, income statement/statement of comprehensive income and statement of changes in equity?

Are appropriate disclosure notes included?

**IAS 2: Inventories**

- Has inventory been consistently valued at the **lower of cost and net realisable value**, on an item-by-item basis?
- Has an **acceptable costing method** been used for inventory? (Remember that LIFO is not permitted by IAS 2.)
- Has inventory been **counted accurately**? (What is the evidence for this?)
- Has an appropriate method been used for the treatment of **overheads**?

**IAS 7: Statement of cash flows**

- Is the presentation of the statement of cash flows in accordance with the requirements of IAS 7?

**IAS 8: Accounting policies, changes in accounting estimates and errors**

- Have appropriate accounting policies been selected and consistently applied?
- Have any changes in accounting policy permitted under IAS 8 been correctly accounted for as prior period adjustments?
- Have fundamental errors in prior period financial statements been accounted for as prior period adjustments?
- Have changes in accounting estimates been reflected on a prospective basis?

**IAS 10: Events after the reporting period**

- Has the definition of events after the reporting period (as defined by IAS 10) been properly applied?
- Have all subsequent events having an impact on amounts and/or disclosures in the financial statements been identified?
- Is there a correct distinction between adjusting and non-adjusting events after the reporting period?
- Have adjustments been made correctly for **adjusting events**, in accordance with the appropriate IAS /IFRS?
- Have **non-adjusting events** been adequately disclosed?

**IAS 11: Construction contracts**

- Have revenue and profits been recognised in accordance with the principles of IAS 11?
- Has full provision been made for expected losses?
- Have the statement of financial position assets and liabilities been calculated and disclosed in accordance with IAS 11?
Chapter 8: Audit evidence

**IAS 12: Income taxes**
- Has the income tax liability been correctly calculated and disclosed?
- Has deferred tax been recognised in respect of all material temporary differences in accordance with IAS 12 guidance?
- Has an **appropriate rate of tax** been used in measuring the amount of the **deferred tax** liability (asset)?
- Are deferred tax assets recoverable?

**IAS 16: Property, plant and equipment**
- Has the **cost** of property, plant and equipment been determined in accordance with IAS 16?
- Has cost been correctly allocated to components of an asset in accordance with IAS 16?
- Has **post-acquisition expenditure** on property, plant and equipment been properly analysed between capital expenditure and revenue expenditure?
- Has **depreciation** been properly calculated and accounted for?
- Have **asset revaluations** been performed in accordance with IAS 16 and accounted for correctly?
- Have disposals and the resulting **gain or loss on disposal** been properly calculated and recorded?

**IAS 17: Leases**
- Have leases been properly classified between **finance leases and operating leases**, and has the appropriate accounting treatment been applied to each type of lease?
- Have leasing obligations (finance leases) been properly analysed into **current and non-current liabilities**?
- For finance leases, have the **depreciation and finance charges** been allocated to accounting periods in accordance with IAS 17?
- Have the appropriate disclosures been made?

**IAS 18: Revenue and IFRS 15: Revenue from contracts with customers**
- Have the appropriate principles of revenue recognition been applied to the recognition of revenue from the sale of goods, the provision of services and other items? (Note: The financial statement risk of non-compliance with IAS 18, and the over-statement of revenue by recognising it too early, was discussed in an earlier chapter.)

**IAS 19: Employee benefits**
- Have appropriate liabilities been recognised correctly when employees have provided service in exchange for employee benefits to be paid in the future?
- Has the expense of the entity consuming the economic benefit arising from service provided by employees in exchange for employee benefits been recognised correctly?
**IAS 20: Accounting for government grants and disclosure of government assistance**

- Have revenue-based grants been credited to the income statement/statement of comprehensive income at the same time as the related expense?
- Have capital-based grants been accounted for in accordance with IAS 20? The grant should either (1) be credited to the asset account, with depreciation then on the net cost of the asset, or (2) carried as a deferred credit which is then amortised to the income statement/statement of comprehensive income over the life of the asset.

**IAS 21: The effects of changes in foreign exchange rates**

- Have appropriate exchange rates been used in generating exchange differences and translating from functional to presentation currencies?
- Have exchange differences on settlement of monetary items been correctly calculated and classified within the income statement?
- Have exchange differences on foreign currency monetary items in the statement of financial position at year-end been correctly calculated and allocated within the income statement (or other comprehensive income if the asset/liability is a designated hedge)?
- Have exchange differences on non-monetary foreign currency assets/liabilities carried at fair value at year-end been correctly calculated and allocated within other comprehensive income?
- Have appropriate exchange rates been used?

**IAS 23: Borrowing costs**

- Have borrowing costs been recognised as an expense in the period in which they are incurred?
- If borrowing costs have been capitalised, are they directly attributable to the acquisition, construction or production of a qualifying asset?
- Have appropriate disclosures been made of the accounting policy, the amount of capitalised borrowing costs in the period and the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation?

**IAS 24: Related party disclosures**

- Have necessary disclosures been made to draw attention to the possibility that the company’s financial position or profit/loss has been affected by related parties and related party transactions?

**IAS 29: Financial reporting in hyperinflationary economies**

- Does the entities functional currency satisfy IAS 29’s definition of hyperinflationary?
- Have the financial statements been correctly restated into ‘measuring units’ at the reporting date including non-monetary assets/liabilities and income/expense items?
- Has the gain or loss on monetary items been calculated accurately and classified appropriately within the income statement?
For group audits does the parent company retain a sufficient level of control (for a subsidiary) or significant influence (for an associate) to satisfy the accounting treatment applied?

Does the hyperinflationary entity remain a going concern?

**IAS 32: Financial Instruments: Presentation and IFRS 7: Financial Instruments: Disclosures**

- Have financial instruments (liabilities) been properly classified as debt or equity based on their substance?
- Have compound instruments been properly analysed into their debt and equity elements?
- Have payments to the providers of capital been correctly classified as borrowing cost or dividend in accordance with the classification of the instrument to which they relate?
- Have appropriate disclosures been made of risk exposures, risk management and hedging policies?

**IAS 33: Earnings per share**

- Has the basic earnings per share been correctly calculated and disclosed for the current and prior reporting period?
- Has diluted earnings per share been properly calculated and disclosed where relevant?

**IAS 34: Interim financial reporting**

- Have the interim financial reports been prepared in accordance with local requirements as well as IAS 34?
- Do the contents comply with the minimum requirements of IAS 34?
- Are appropriate disclosures included in notes to the interim statements?

**IAS 36: Impairment of assets**

- Have the directors identified events that may indicate that an impairment review is necessary?
- Have recoverable amounts been calculated in accordance with IAS 36?
- Where appropriate, have cash-generating units been identified?
- If an impairment loss has been recognised, has the loss been allocated to assets and recorded correctly?

**IAS 37: Provisions, contingent liabilities and contingent assets**

- Have all necessary provisions been recorded?
- Have contingent liabilities/ contingent assets been disclosed as required by IAS 37?
- As discussed in more detail below, ISA 501 Audit evidence – specific considerations for selected items covers contingencies relating to litigation and legal claims. This typically represents the major part of audit work on contingencies.
IAS 38: Intangible assets
- Have purchased intangible assets been recognised and measured in accordance with IAS 38?
- Have the useful lives of intangible assets been estimated in a reasonable way?
- Is there evidence to support the non-depreciation of intangibles with an indefinite useful life?
- Have intangible assets been subject to annual impairment reviews?

IAS 39: Financial Instruments: Recognition and Measurement
- Have financial instruments been recognised and measured in accordance with IAS 39?

IAS 40: Investment Property
- Has the company adopted the cost model or the fair value model?
- If the cost model has been adopted, have the principles of IAS 16 been complied with?
- If the fair value model has been adopted, have annual valuations been performed and the gain or loss correctly accounted for?

IAS 41: Agriculture
- Have changes in fair value less point-of-sale costs in respect of biological assets been included in the income statement in the period in which they arose?
- Have government grants relating to biological assets been recognised only when they become receivable and measured as fair value less estimated point-of-sale costs?

IFRS 1: First-time Adoption of International Financial Reporting Standards
- Has the company followed the specific guidance in Pakistan issued in respect of the IFRS 1 guidance on exemptions and exceptions from full retrospective restatement on first time adoption?
- Has the company adopted a set of accounting policies that are appropriate and in compliance with IFRSs?
- Have all assets and liabilities recognised under IFRS been properly recognised and classified?
- Have all assets and liabilities not recognised under IFRS been removed from the financial statements?

IFRS 2: Share-based Payments
- Is the calculation of share-based payments correct? (Check the number of employees granted share options and the number of options per employee; the official date for the grant of the options; the length of the vesting period; the required performance conditions attached to the options.)
- Has the cost of the share-based payments been spread fairly over the vesting period?
Are the assumptions used to predict the level of staff turnover reasonable, based on available evidence? (If not, what assumptions would be reasonable?) The assumption about staff turnover affects the estimated cost of the share-based payments.

Is the estimate of the fair value of the equity instrument reasonable, and is it consistent with any valuation provided by an external expert (such as a chartered financial analyst)?

**IFRS 3: Business combinations**

- Does the “event” meet the definition of a “business combination” such that IFRS 3 applies, or is the “event” an acquisition of an asset/group of assets that does not constitute a business?
- The date from which the acquisition took place – when did the acquirer effectively obtain control?
- Fair value of any pre-held equity interest in the event of a “step acquisition”, when the acquiree is not an entity that is traded in a public market.
- Whether all contingent consideration has been identified and fair-valued at acquisition date?
- Whether contingent arrangements that “crystallize” during a reporting period are “measurement period adjustments” and therefore back-dated against goodwill?

**IFRS 4: Insurance contracts**

- Do the financial statements present fairly the substance of the insurance contract?
- Is the insurer exposed to both financial and insurance risk and hence satisfy the definition of an insurance contract?
- Has the liability adequacy test been appropriately performed?
- Has the required impairment test been applied for any reinsurance?
- Do the financial statements show insurance liabilities and reinsurance assets separately (gross) or have they been netted-off (and hence require restatement)?
- Have bundled contracts been unbundled correctly into the insurance and deposit components?

**IFRS 5: Non-current assets held for sale and discontinued operations**

- Has the definition of discontinued operations in IFRS 5 been properly applied?
- Have the results of discontinued operations been properly quantified and disclosed?
- Has the definition of assets held for sale contained in IFRS 5 been properly applied?
- Have assets held for sale been properly valued and disclosed?

**IFRS 6: Exploration for evaluation of mineral resources**

- Where a company has recognised assets as a result of exploration and evaluation expenditures, and facts and circumstances suggest that the
carrying value may exceed the recoverable amount, has an impairment test of those assets been carried out?

- Has any impairment loss been measured, presented and disclosed in accordance with IAS 36?
- Has the entity disclosed information that identifies and explains the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources?

**IFRS 7: Financial instruments: disclosures**

- Has the entity appropriately identified “classes” of financial instrument by reference to the type of instruments and type of information that is relevant, and then reconciled the totals to the category line items required by IAS 39?
- Whether any “risk disclosures” if made in a separate document, have been included in the scope of the audit, and suitably cross-referred to the financial statements?
- Whether the sensitivity disclosures of changes in the variables that are part of market-price risk have been correctly calculated and disclosed?

**IFRS 8: Operating segments**

- Have the criteria for reportable segments been properly applied?
- Has all the required information been disclosed?

**IFRS 9: Financial instruments**

- Have financial instruments been recognised and measured in accordance with IFRS 9?

**IFRS 10: Consolidated financial statements**

- Whether or not control exists?
- Whether there is adequate disclosure of the judgements entered into in determining the type of relationship with another entity.
- Whether the criteria for treating the parent as an investment entity have been met?
- Whether transactions involving an increase or decrease in a controlling shareholding that do not change the relationship have been correctly recorded in equity, and not through goodwill or as a profit on disposal?

**IFRS 11: Joint arrangements**

- Whether or not joint control as defined in IFRS 11 exists?
- The type of the joint arrangement (joint operations or joint venture) has been correctly identified, especially when structured through a separate vehicle?

**IFRS 12: Disclosure of Interests in other entities**

- Whether the additional requirements concerning “structured entities” have been correctly interpreted, especially in the context of financial institutions?
Chapter 8: Audit evidence

IFRS 13: Fair value measurement
- The correct identification of a principal market, or in its absence, the most advantageous market.
- Identifying whether or not an observed transaction is “orderly”, and therefore provides relevant evidence.
- Identifying the “highest and best use” for non-financial assets.

IFRS 14: Regulatory deferral accounts
- Whether or not an entity has activities that put it in scope of IFRS 14, and therefore which enable it to carry “regulatory deferral balances” that otherwise do not meet the definitions of assets and liabilities under the IASB Conceptual Framework?

IFRS 15: Revenue from contracts with customers
- Whether or not a contract with a customer exists?
- Whether modifications to an existing contract require to be treated as an entirely new contract, or as an amendment to an existing contract and possible “catch-up” adjustments?
- What are the performance obligations in the contract, and are there “distinct” goods or services?
- Whether a contract includes a significant financing effect, requiring the use of discounting?
- Whether or not a contract is performed “at an instant” or “over a period of time”?

8.3 International auditing practice note 1000: Special considerations in auditing financial instruments

In 2011 the IAASB issued International auditing practice note (IAPN) 1000 Special considerations in auditing financial instruments to assist with applying ISA 540 in the audit of financial instruments. The practice note provides assistance with areas such as:
- The use of models, including educational material, testing strategies and related audit considerations, and
- Further material on third-party pricing sources, particularly explanations of the different types of third-party pricing sources, and further elaboration of the audit considerations.

The practice note focuses on more complex financial instruments rather than the simplest of instruments such as cash, simple loans, trade receivables and accounts payable.

The structure of IAPN 1000 includes the following:
- Background information about financial instruments, such as:
  - Purpose and risks
  - Controls
  - Completeness, accuracy and existence
  - Valuation
  - Presentation and disclosure
Audit considerations relating to financial instruments, such as:

- Professional scepticism
- Planning
- Assessing and responding to the risks of material misstatement
- Valuation
- Presentation and disclosure
- Other relevant audit considerations such as written representations and communication with those charged with governance and others.

8.4 Conclusion: audit papers, audit procedures and audit matters

It is highly probable that a question in your examination will ask you to describe the audit procedures in relation to a specific issue in the financial statements or to comment on audit matters that should be considered in relation to a particular item. The question might also ask about the audit evidence you would expect to see on file in respect of these procedures and matters.

A question may therefore ask any of the following:

- **What audit procedures** should be carried out in respect of…? An audit procedure is an action; for example ‘discuss with management’ or ‘vouch to invoice’.

- **What audit evidence** would you expect to see in relation to…? Audit evidence will be an item or record; for example a copy of the relevant sales contract. Remember that discussions with managers about significant matters should be included in the documentation in the audit working papers, as audit evidence.

- **What matters** would you consider in respect of…? Relevant matters to consider will include (1) materiality (2) risk and (3) the requirements of any particular accounting or auditing standards.

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**Example: Audit procedures**

Your audit firm is carrying out the audit of ABC Company, which owns the well-known Halberd brand name for fashion clothes. The brand name was purchased three years ago, and is being amortised.

What audit procedures might be carried out in respect of the useful life of the Halberd brand name?

---

**Answer**

**Tutorial note**

You need to identify a suitable audit procedure. Vouching cost to original purchase documents would not be relevant to this question. Instead, it is important to consider how to audit the period over which the brand is being amortised.

**Ideas for a solution**

Relevant procedures would be as follows.
Compare the useful life attributed to the Halberd brand with the useful life of brands of other business entities in the industry.

Review the annual marketing spend on the brand.

Review planned future expenditure on the brand, to see if its value is likely to be maintained.

Review the results of management’s impairment test on the brand.

Example: Provisions and audit evidence

Bitton is a limited liability company. It manufactures and installs drilling equipment. Its charges for installing equipment were raised by 30% with effect from 1 January in the financial year just ended (to 31 December Year 9). The increase in installation charges was made to allow for the fact that from 1 January, Bitton gave a warranty to re-install any of its drilling equipment that did not perform to specification, due to a fault in the equipment or an error in the installation. The warranty is given for a two-year period.

The notes to the financial statements contain the following statements.

‘The company guarantees the installation of all its equipment since 1 January Year 9. No provision for the guarantees has been recognised since the amount of the obligation cannot be measured with sufficient reliability.’

Installation fees for the year to 31 December Year 9 amounted to Rs. 7.6 million of which Rs. 2.1 million related to the three months to 31 December Year 9.’

Required

As auditor of Bitton for the year to 31 December Year 9:

(a) state the matters that should be considered in respect of the warranties

(b) state the audit evidence that you would require in respect of these matters.

Answer

Matters to consider are as follows:

- The requirements of IAS 37 and whether a warranty provision was required based on the given facts
- The materiality of a best estimate of a warranty provision
- Whether the audit report would have to be modified if changes were not made

Possible audit evidence includes the following:

- The warranty terms offered to customers
- Management’s costings in respect of the warranties
- Schedules of installations (from which warranties arose) during the relevant period
- Letters of complaint from customers indicating the level of warranties used
- Costs of reinstallations from job cards.
Example: Development costs and audit evidence

Extracts from the draft financial statements of a company are as follows.

<table>
<thead>
<tr>
<th>Statement of financial position extract</th>
<th>Rs. 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development costs</td>
<td></td>
</tr>
<tr>
<td>At cost</td>
<td>3,400</td>
</tr>
<tr>
<td>Less: Accumulated amortisation</td>
<td>(1,850)</td>
</tr>
<tr>
<td></td>
<td>1,550</td>
</tr>
<tr>
<td>Total assets of the company</td>
<td>20,400</td>
</tr>
<tr>
<td>Development costs capitalised during the year</td>
<td>700</td>
</tr>
</tbody>
</table>

Income statement extracts

| Revenue                              | 5,600   |
| Research costs                       | 180     |
| Amortisation of development costs    | 900     |
| Profit before tax                    | 2,800   |

**Required**

What audit evidence should be obtained to check:

(a) that capitalised development costs are properly recognised
(b) the validity of the amortisation rate for development costs?

**Answer**

**Materiality**

The carrying value of the development costs is 7.6% of total assets and the item is therefore material.

Development costs capitalised during the year were Rs. 700,000. If these had been written off instead, profit would have been Rs. 2,100,000 or 25% lower than reported. This is also a material amount.

The total spending during the year on research and development costs was Rs. 880,000 (Rs. 180,000 + Rs. 700,000). This is 15.7% of sales revenue: this too is material.

The auditor therefore should obtain sufficient appropriate audit evidence to support the accounting treatment and the valuation of development costs (and R&D expenses).

**IAS 38 requirements**

IAS 38 specifies the conditions that must exist for development costs to be capitalised. Briefly, these are:

- Intention to complete the development and either use or sell the developed item
- Technical feasibility of completing the development and the ability of the entity to use the developed item or sell it
Chapter 8: Audit evidence

- Ability to create future economic benefits
- Availability of technical, financial and other resources to complete the development
- Ability to measure the costs attributable to the intangible asset.

The audit risk is that development costs have been capitalised when not all of the criteria for capitalisation have been met. The auditor should therefore obtain audit evidence to confirm that each criterion has been met. For example, in order to test the technical feasibility, the auditor should look at test results of the project to date.

To assess the amortisation rates used for development costs already capitalised, the auditor might look for evidence from market research about the likely demand for the item. In the case of development of a new product, the auditor can look at actual sales since the product launch and discuss with management whether these appear to support the estimated amortisation period for the development costs.

Example: Deferred tax asset and audit evidence

In its draft financial statements, a company has included a deferred tax asset of Rs. 5 million. This relates to unused tax losses that have accumulated during the past three years. Management are confident that that there will be sufficient future operating profits to claim the benefit of the tax losses in full in future years.

The auditor should assess whether it is appropriate to include a deferred tax asset in the financial statements, and so needs evidence about whether the tax losses will be recoverable.

- He should start by checking whether the amount is reliable. They should obtain a copy of the client’s tax computations and should agree the figures in the calculation to the accounting records.
- He should also review any correspondence about tax that may exist.
- He needs to make an assessment about whether the tax losses will be recoverable, by obtaining forecasts from the client of future profitability. The assumptions used in the forecast should be assessed for reasonableness in the context of the auditor’s understanding of the client’s business.
- If the forecasts of future profitability are reasonable, the auditor should assess how long it will be before the losses are recovered in full. This period should be checked against tax regulations, to confirm that there is no statutory limit on carrying forward tax losses.
9 TRANSACTION CYCLES

Section overview

- Introduction
- Revenue and receivables
- Purchases and payables
- Payroll
- Bank and cash
- Inventories
- Non-current assets

9.1 Introduction

For your examination, you may be expected to apply your auditing knowledge to the main transaction cycles of an entity. These are:

- the revenue (sales) and receivables cycle
- the purchases and payables cycle
- the payroll cycle.

You may also be required to show an understanding of controls and audit tests in relation to:

- bank and cash transactions
- inventory
- non-current assets.

This section of the chapter provides you with checklists, for each of these audit areas. The checklists set out:

- the control objectives
- the key internal controls
- tests of control that might be applied
- substantive tests that might be carried out (usually on a sample basis).

If you are not familiar with the items in the checklists, you should revise tests of control and substantive testing in your study material for basic audit and assurance.
### 9.2 Revenue and receivables

<table>
<thead>
<tr>
<th>Control objectives</th>
<th>Key controls</th>
<th>Tests of control</th>
<th>Substantive tests</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ There must be proper authorisation and recording of customer orders, goods returned and allowances (discounts) given.</td>
<td>▪ Segregation of duties (order acceptance/despatch/invoicing.)</td>
<td>▪ Sequence checks on all documents.</td>
<td>▪ Check the accuracy of the arithmetic in books of prime entry.</td>
</tr>
<tr>
<td>▪ Revenue must be recorded for all goods or services delivered.</td>
<td>▪ Check that a customer’s order is within the customer’s credit limit.</td>
<td>▪ Check on evidence of authorisation at each stage in the cycle.</td>
<td>▪ Check entries in books of prime entry back to the source documents.</td>
</tr>
<tr>
<td>▪ All documents and records must be recorded accurately.</td>
<td>▪ Authorisation of orders.</td>
<td>▪ Check for evidence that the arithmetic/calculations in all documents and records have been checked.</td>
<td>▪ Check the accuracy of postings to ledgers.</td>
</tr>
<tr>
<td>▪ A policy should be established for the collection of receivables.</td>
<td>▪ Use of pre-numbered sales order forms.</td>
<td>▪ Check that documents have been matched, where appropriate.</td>
<td>▪ Check invoices and credit notes for accuracy in the arithmetic and pricing.</td>
</tr>
<tr>
<td>▪ Segregation of duties (order acceptance/despatch/invoicing.)</td>
<td>▪ Despatch notes should be pre-numbered and matched with sales orders and invoices.</td>
<td>▪ Check that control account reconciliations have been performed and reviewed, with appropriate adjustments being made to the records.</td>
<td>▪ Check that inventory records have been correctly updated for despatches of goods to customers.</td>
</tr>
<tr>
<td>▪ Authorisation of despatches after checking.</td>
<td>▪ Invoices should be authorised for sending to customers, after checking them for accuracy and against sales orders and despatch notes.</td>
<td></td>
<td>▪ Review control account reconciliations.</td>
</tr>
<tr>
<td>▪ Invoices should be recorded promptly in the sales ledger. Batching of invoices for input and batch totals may be used as a control.</td>
<td>▪ Invoices should be recorded promptly in the sales ledger. Batching of invoices for input and batch totals may be used as a control.</td>
<td></td>
<td>▪ Test the sales cut-off.</td>
</tr>
<tr>
<td>▪ Sales returns and allowances (discounts) should be checked and authorised.</td>
<td>▪ Sales returns and allowances (discounts) should be checked and authorised.</td>
<td></td>
<td>▪ Apply analytical procedures, such as trend analysis for sales, and gross profit margin.</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Control objectives</th>
<th>Key controls</th>
<th>Tests of control</th>
<th>Substantive tests</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Credit notes must be recorded accurately.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>The control account for receivables in the main ledger should be reconciled regularly with account balances in the receivables ledger.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Statements should be sent regularly (monthly) to credit customers.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Debt collection procedures should be followed systematically, in accordance with debt collection policy.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Writing off any bad debts must be authorised.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### 9.3 Purchases and payables

<table>
<thead>
<tr>
<th>Control objectives</th>
<th>Key controls</th>
<th>Tests of control</th>
<th>Substantive tests</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goods and services are purchased:</td>
<td>■ Segregation of duties (ordering, receipt of goods, recording invoices, payment).</td>
<td>■ Sequence checks on all documents (purchase orders, goods received notes).</td>
<td>■ Check the accuracy of the arithmetic in books of prime entry.</td>
</tr>
<tr>
<td>■ with proper authority</td>
<td>■ Use of official pre-numbered documentation (purchase orders).</td>
<td>■ Check on evidence of authorisation at each stage in the purchasing cycle.</td>
<td>■ Check entries in books of prime entry back to the source documents.</td>
</tr>
<tr>
<td>■ under proper procedures</td>
<td>■ Appropriate authorisation procedures should be used for orders and payments.</td>
<td>■ Check for evidence that the arithmetic/calculations in all documents and records have been checked.</td>
<td>■ Check the accuracy of postings to ledgers.</td>
</tr>
<tr>
<td>■ for the business</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>■ from authorised suppliers</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>■ and are inspected for description, quantity and quality.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Before being recorded purchase invoices are:

- ■ authorised
- ■ checked for arithmetic accuracy and pricing
- ■ checked against supporting documentation (for example, purchase orders).

Completeness and accuracy of recording:

- ■ There is a policy for re-ordering regular items of inventory.
- ■ Goods received notes (GRNs) are used, and signed, as evidence that the quantity, quality and description of all goods received have been checked.
- ■ Matching of documents (purchase requisitions, purchase orders, GRNs and purchase invoices).
- ■ There is a policy for re-ordering regular items of inventory.
- ■ Goods received notes (GRNs) are used, and signed, as evidence that the quantity, quality and description of all goods received have been checked.  
  
  *Note that these tests of control are essentially the same as for the revenue/sales and receivables cycle.*

- ■ Check that documents have been matched where appropriate.
- ■ Check that control account reconciliations have been performed and reviewed, with appropriate adjustments being made to the records.
- ■ Check invoices and credit notes for accuracy in arithmetic and pricing.
- ■ Check that inventory records have been correctly updated for receipts of goods from suppliers.
  
  - Review control account reconciliations.
  - Test purchases cut-off.
  - Apply analytical procedures.
Control objectives | Key controls | Tests of control | Substantive tests
---|---|---|---

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Control objectives | Key controls | Tests of control | Substantive tests
---|---|---|---

9.4 Payroll

Control objectives | Key controls | Tests of control | Substantive tests
---|---|---|---

Procedures should exist for analysing purchase invoices and recording them in the correct expense or asset accounts.

Use of control accounts and batch totals to ensure completeness and accuracy of processing.

Accurate records should be kept of purchases returns, and these should be matched with credit notes from the supplier.

Review other audit areas and prior year working papers for evidence of possible unrecorded liabilities.

Gross pay is calculated at the correct rates.

Employees are paid only for work done.

Segregation of duties (establishing pay rates, calculating pay, recording pay).

Maintenance of up-to-date personnel records.

Authorisation of joiners and leavers, pay rates, overtime, voluntary deductions from pay.

Check:

- that payroll information is reconciled between periods and any changes between periods are explained
- entries in the wages control account, if used

Check:

- the accuracy of the arithmetic in payroll calculations and payroll records
- postings to ledger accounts
- that correct pay rates are used
<table>
<thead>
<tr>
<th>Control objectives</th>
<th>Key controls</th>
<th>Tests of control</th>
<th>Substantive tests</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross pay, net pay and deductions are recorded completely and accurately in the payroll, cash records and ledger accounts.</td>
<td>Regular management review of overall cost of payroll.</td>
<td>the accuracy and completeness of ledger account entries</td>
<td>that correct, authorised rates are used for statutory deductions (such as tax) and voluntary deductions</td>
</tr>
<tr>
<td>The correct employees are paid the correct amounts.</td>
<td>Establishment of standard procedures, timetables and systems for processing payroll.</td>
<td>the accuracy of the arithmetic in payroll records</td>
<td>that overtime, bonuses and similar payments have been properly authorised</td>
</tr>
<tr>
<td>The correct amount of deductions are paid to the tax authorities and other authorities.</td>
<td>Approval of payroll, once prepared.</td>
<td>that the payroll records agree with cash/bank records</td>
<td>that joiners are properly authorised</td>
</tr>
<tr>
<td></td>
<td>Use of a control account for payroll expenses/ liabilities.</td>
<td>Agree payroll amounts to bank records</td>
<td>that employees have not been paid for periods before they join or after they leave</td>
</tr>
<tr>
<td></td>
<td>Safe custody of cash, where employees are paid in cash.</td>
<td>Review payroll for unusual amounts.</td>
<td>the pay for hours worked or output produced should be checked against the authorised documentation</td>
</tr>
<tr>
<td></td>
<td>Verification of the identity of employees, when payment is in cash.</td>
<td>When employees are paid in cash:</td>
<td>that payments of deductions have been made to the appropriate authorities</td>
</tr>
<tr>
<td></td>
<td>Signature received for pay, when payment is in cash.</td>
<td>check that unclaimed wages are kept safe and reasons for not claiming wages are explained</td>
<td>the signed receipts for wages paid in cash.</td>
</tr>
<tr>
<td></td>
<td>Custody and investigation of unclaimed pay packets, when payment is in cash.</td>
<td>attend and observe a distribution of pay</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Use of a separate bank account for payroll.</td>
<td>compare names on payroll to names on pay packets</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>examine signed receipts for pay.</td>
<td></td>
</tr>
</tbody>
</table>
Control objectives | Key controls | Tests of control | Substantive tests
--- | --- | --- | ---
| | Authorisation of cheques/bank transfers, when employees are paid by these methods. | check that no employee receives more than one pay packet. | that the correct entries have been made in the wages control account. Also:
| | | | 
| | | | 
| | | | 

9.5 Bank and cash

Control objectives | Key controls | Tests of control | Substantive tests
--- | --- | --- | ---
Bank | | | |
<p>| | All money belonging to the company is received and is promptly and accurately recorded. | |
| | All payments are properly authorised and are promptly and accurately recorded. | |
| | Segregation of duties. | Review bank reconciliations for unusual items and evidence of management review of statements. | Send bank confirmation letter(s). |
| | Listing and prompt recording and banking of all receipts. | Review cash book for unusual entries. | Check or prepare bank reconciliation statement. |
| | Authorisation for all payments. | Check additions in cash book and entries in ledgers. | Assess audit significance of other information in the reply from the bank. |
| | Regular reconciliations are performed and reviewed. | Review payments for evidence of authorisation. | Review large or round-sum amounts just before and just after the reporting period. |
| | There are sufficient physical custody controls over cheques and cash. | | Carry out analytical procedures. |</p>
<table>
<thead>
<tr>
<th>Control objectives</th>
<th>Key controls</th>
<th>Tests of control</th>
<th>Substantive tests</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
<td></td>
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<tr>
<td>As for bank above.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Observe that procedures for opening mail and handling cash are being followed.
- Check amounts recorded as receipts against remittance advices from customers.
- Check the amounts in receipt books or on till rolls against paying-in slips (paying in cash to the bank), the cash book and bank statements.
- Check whether cash is banked daily.
- Check payments out of cash takings, if any.
- Check petty cash payments for authorisation.
- Check the documents that support any cash payments (for example, receipts).
- Attend/carry out cash counts.
- Check that postings are made correctly to ledger accounts.
- Analytical procedures.
### 9.6 Inventories

Many of the points listed above in relation to the purchases cycle (for example, in relation to the receipt of goods) and the sales cycle (for example, in relation to the despatch of goods) should also apply to the inventory system. For example, the requirement for authorisation procedures and segregation of duties are the same. The table below focuses on additional points.

<table>
<thead>
<tr>
<th>Control objectives</th>
<th>Key controls</th>
<th>Tests of control</th>
<th>Substantive tests</th>
</tr>
</thead>
<tbody>
<tr>
<td>■ Inventory in the inventory records should represent inventory that physically exists.</td>
<td>■ There should be regular inventory counts, with reconciliations of physical counts to inventory records. Differences should be explained.</td>
<td>■ Review and observe inventory counting procedures.</td>
<td>■ Attend inventory count: - observe procedures - record test counts - record cut-off information.</td>
</tr>
<tr>
<td>■ Inventory is valued at the lower of cost and net realisable value (NRV).</td>
<td>■ Reviews of inventory for items where NRV may be below cost.</td>
<td>■ Check that any necessary changes to inventory records are made.</td>
<td>■ Check inventory valuation, at lower of cost and NRV.</td>
</tr>
<tr>
<td>■ Inventory quantities are maintained at a level suitable to the business.</td>
<td>■ Accurate, up-to-date inventory records are maintained.</td>
<td>■ Confirm that NRV reviews are performed.</td>
<td>■ Check inventory cut-off.</td>
</tr>
<tr>
<td></td>
<td>■ Inventory cut-off procedures are in place.</td>
<td>■ Review inventory levels for adequacy.</td>
<td>■ Perform appropriate analytical review procedures.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>■ Confirm the existence of inventory held at outside locations.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>■ Check the treatment of inventory held on the client’s premises but owned by a third party.</td>
</tr>
<tr>
<td></td>
<td>■ Appropriate physical custody procedures should be in place.</td>
<td>■ Check that physical custody procedures are operational (applied in practice).</td>
<td></td>
</tr>
</tbody>
</table>
9.7 Non-current assets

Again, some of the controls and tests that are listed above (for example, the requirement that purchases/expenditure should be properly authorised) are also relevant here. The table below lists additional points.

<table>
<thead>
<tr>
<th>Control objectives</th>
<th>Key controls</th>
<th>Tests of control</th>
<th>Substantive tests</th>
</tr>
</thead>
<tbody>
<tr>
<td>Records of non-current assets should be complete and correct.</td>
<td>Use of authorised capital expenditure budgets and project evaluation techniques, if appropriate.</td>
<td>Check for the proper authorisation of additions and disposals.</td>
<td>Review the movement in non-current assets for the period.</td>
</tr>
<tr>
<td>There should be adequate controls for the safe custody of non-current assets.</td>
<td>Use of a non-current asset register, that is regularly checked and reconciled to the non-current asset accounts in the main ledger.</td>
<td>Check reconciliations of ledger balances with the non-current asset register.</td>
<td>Check additions, and the calculations of depreciation and gain or loss on disposals.</td>
</tr>
<tr>
<td>Depreciation, revaluations and disposals must be dealt with correctly.</td>
<td>Impairment reviews are performed as necessary.</td>
<td>Physically verify a sample of additions.</td>
<td>Physically verify a sample of additions.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Trace proceeds for disposals to cash records.</td>
<td>Review for unrecorded disposals.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Review evidence relating to any asset revaluations during the period.</td>
<td>Review evidence relating to any asset revaluations during the period.</td>
</tr>
</tbody>
</table>
10 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Explain the fundamental requirements of audit testing in the context of ISAs 500, 520, 530 and 230
- Describe the requirements of a number of other fieldwork-driven standards including ISAs 501, 540, 580, 610 and 620
- Summarise the audit approach relevant to a number of key IASs and IFRSs
- Explain how to audit the various transaction cycles such as revenue/receivables and purchases/payables
CHAPTER 9

Evaluation and review

Contents

1 The review stage of the audit
2 Opening balances and prior period comparatives: ISAs 510 and 710
3 Subsequent events: ISA 560
4 Going concern: ISA 570
5 Chapter review
INTRODUCTION

Learning outcomes
Performance of audit - general
A (a) 2 Initial engagements and opening balances
A (a) 12 Evaluation of misstatements identified during the audit
A (a) 18 Subsequent events
Performance of audit - specific
A (b) 1 Going concern
Audit conclusion and reporting
B 4 Reporting consideration on comparative information

Exam context
So far students have largely focused on the planning and fieldwork stages of the audit. This section introduces the student in some depth to the completion phase of the audit incorporating a number of new ISAs.

By the end of this chapter students will be able to:
- Describe the process and considerations for evaluating misstatements per ISA 450
- Audit opening balances and prior period comparatives in compliance with ISAs 510 and 710
- Explain how to audit subsequent events in accordance with ISA 560
- Summarise the concept of going concern and describe how to apply and comply with ISA 570
1 THE REVIEW STAGE OF THE AUDIT

Section overview
- The need for a review
- Evaluation of misstatements: ISA 450
- Other areas for evaluation and review
- Completion

1.1 The need for a review

Having carried out appropriate fieldwork (substantive procedures and tests of control), the auditor will reach a stage in the audit where they have a draft set of financial statements that are supported by appropriate and sufficient audit evidence.

ISA 220 Quality Control for an Audit of Financial Statements requires that the auditor carries out an overall review and an evaluation of the evidence they have gathered.

- The auditor should back up their detailed testing of controls, transactions and balances with a broader review of other information and events that may have an impact on the information presented in the financial statements.

- **Analytical procedures** are also used at this review stage, as a final check that the information contained in the draft financial statements ‘makes sense’.

The objective of the overall review is to provide the auditors with a reasonable basis for their audit report and opinion when considered in conjunction with conclusions drawn from the other audit evidence obtained. The overall review should be performed by a senior member of the audit team (often a partner) who has appropriate skills and experience.

1.2 Evaluation of misstatements: ISA 450

It is also at this stage of the audit that the auditor will make an overall evaluation of the level of errors they have found in the financial statements. Errors found in individual areas (such as receivables, or inventory) will be summarised and totalled.

The total amount of the errors will be compared with the **materiality thresholds** that were set at the planning stage. This will allow the auditor to reach a conclusion as to whether the financial statements are materially ‘correct’ (or not materially misstated) – one aspect of whether the financial statements show a true and fair view.

This area is covered by ISA 450 **Evaluation of misstatements identified during the audit**. The **objective** of the auditor in this area, per ISA 450, is to evaluate the effect of:

- identified misstatements on the audit, and
- any uncorrected misstatements on the financial statements.
A misstatement could be in relation to the amount, classification, presentation or disclosure of an item. Hence, all the below examples would classify as misstatements:

- Incorrect calculation of depreciation, mark-up or rent accrual by the company;
- Application of an accounting policy for revenue which contradicts the requirements of IAS 18 / IFRS 15;
- Misclassification of an item of expense (e.g. treatment as administrative expense rather than cost of sales);
- Misclassification of an item of assets or liabilities (e.g. current vs non-current distinction);
- Omission of a disclosure required by IFRS 5 of IFRS 7; and
- Presentation of the financial statements in an order other than what is prescribed or allowed by IAS 1.

ISA 450 requires the auditor to carry out the following procedures:

- Accumulate all misstatements found during the audit, unless they are clearly trivial.
- If the total of misstatements identified during the audit approach (or could approach) materiality, decide if the overall audit strategy and audit plan need to be revised.
- Communicate all misstatements found during the audit to an appropriate level of management and request that the misstatements be corrected.
- If management refuse to correct the misstatements obtain the reasons for this and take those reasons into account when evaluating whether the financial statements as a whole are free from material misstatement.
- Prior to evaluating the effect of uncorrected misstatements re-assess materiality per ISA 320.
- Decide whether uncorrected misstatements are material, individually, or when added together. In making this assessment the auditor should take into account the size, nature and circumstances of the misstatements and the effect of any uncorrected misstatements from prior periods.
- Communicate to those charged with governance the effect that uncorrected misstatements may have on the audit report.
- Request a written representation from management as to whether they believe the effect of uncorrected misstatements are immaterial, individually, or in total (see example of the letter of representation in the previous chapter).

Document:

- the amount below which misstatements would be regarded as clearly trivial
- all misstatements accumulated during the audit and whether they have been corrected
- the conclusion as to whether uncorrected misstatements are material, individually, or in total.
1.3 Other areas for evaluation and review

However, there are also a number of other specific areas which form part of the overall evaluation and review process, including the auditor’s work on:

- opening balances and comparative figures
- other information published with the audited financial statements (covered in a later chapter)
- subsequent events
- going concern basis.

1.4 Completion

Most (if not all) audit firms require ‘completion checklists’ to be signed off. These serve as evidence that all necessary audit procedures, reviews, discussions and communications required prior to the issuing of the audit report have been performed.

During the final phase of the audit it is common for the engagement partner (and any other senior audit team members as appropriate) to hold a ‘clearance meeting’ with client management (or those charged with governance).

The clearance meeting enables the auditor and client to discuss the financial statements and proposed audit report as well as other items such as ethical matters, written representations and deficiencies in internal control.
2 OPENING BALANCES AND PRIOR PERIOD COMPARATIVES: ISAS 510 AND 710

Section overview

- Opening balances and comparatives
- ISA 510: Initial audit engagements – opening balances
- ISA 710: Comparative information – corresponding figures and comparative financial statements

2.1 Opening balances and comparatives

The auditor’s work on this area is regulated by ISA 510 Initial audit engagements – opening balances and ISA 710 Comparative information – corresponding figures and comparative financial statements.

In most countries, the financial statements of companies must include comparative figures for the previous year. To reach the conclusion that the financial statements present a true and fair view, the auditor therefore needs to be confident that:

- opening balances brought forward in the accounting records agree with the audited figures reported in the prior year financial statements
- accounting policies have been applied consistently over the current financial year and prior years
- there is consistency of classification and disclosure between the current financial year and prior years.

Where the current auditor performed the audit in the previous year and issued an ‘unmodified’ opinion, it should be a straightforward exercise for the auditor to confirm that points listed above have all been complied with.

A different situation arises when an audit firm is carrying out an audit of a client for the first time.

For example, an auditor may be appointed to carry out their first audit of the financial statements for the year to 31st December 20X4. To do this, the auditor cannot ignore the opening statement of financial position, as at 31st December 20X3.

- The figures in the closing statement of financial position for the previous period will be presented as prior period comparative figures in the 20X4 financial statements. The new auditor is therefore giving an audit opinion on published financial statements that include the previous year’s closing balances.
- Errors in the opening balances may affect the figures for the current financial period. For example, if opening inventory is misstated and is overvalued, the cost of sales in the current period may also be misstated (too high).
2.2 ISA 510: Initial audit engagements – opening balances

ISA 510 provides guidance on the auditor’s responsibilities in relation to opening balances where:

- the financial statements for the prior period were not audited, or
- the financial statements for the prior period were audited by another auditor (referred to as the predecessor auditor).

The objective of the auditor when considering such an initial audit engagement is to obtain sufficient appropriate audit evidence about whether:

- the opening balances contain misstatements that materially affect the current period’s financial statements, and
- appropriate accounting policies reflected in the opening balances have been consistently applied in the current period (or a change of accounting policy has been properly accounted for and disclosed).

The following audit procedures are required:

- Read the most recent financial statements and audit report, if any, for information relevant to opening balances.
- Check that the prior period’s closing balances have been correctly brought forward.
- Check that opening balances reflect appropriate accounting policies.
- One or more of the following procedures:
  - Where the prior period financial statements were audited, review the predecessor auditor’s working papers to obtain evidence regarding the opening balances.
  - Consider whether audit procedures carried out in the current period provide evidence on some of the opening balances. For example, cash received from customers in the current period gives evidence of the existence of a receivable at the opening date.
  - Carry out specific audit procedures to obtain evidence regarding opening balances. For example, reconstruct opening inventory using a combination of sources such as goods received notes, goods despatched notes, bank reconciliations, customer and supplier correspondence.

- If evidence is found that opening balances could contain material misstatements affecting the current period’s financial statements, perform appropriate additional procedures to assess the effect, and
- if such misstatements do exist, communicate this to those charged with governance in accordance with ISA 450.
- Check that the accounting policies reflected in the opening balances have been consistently applied in the current period (or a change of accounting policy has been properly accounted for and disclosed).
2.3 ISA 710: Comparative information – corresponding figures and comparative financial statements

ISA 710 Comparative information – corresponding figures and comparative financial statements also relating to a similar area of the audit work. It deals with audit work on corresponding amounts and other comparative information for the preceding financial reporting period. The considerations in ISA 710 apply to all external audit engagements, whereas ISA 510 focuses particularly on new audit engagements and opening balances (or comparative statement of financial position figures).

Definitions

ISA 710 provides the following definitions:

**Definition: Comparative Information**

The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

Comparative information can take one of two forms:

- Corresponding figures
- Comparative financial statements

**Definition: Corresponding figures**

Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures”). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

**Definition: Comparative financial statements**

Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

In practice, corresponding figures and comparative financial statements are both presentations of prior period information (comparative information). However, the differentiation arises from how they are presented and the audit opinion thereon:

- **Corresponding figures** typically appear next to the current period figures for comparison purposes (or in a separate column on the face of the income statement and statement of financial position). Just one audit opinion is given on the current period financial statements as the corresponding figures form an integral part of the current period financial statements.
Comparative financial statements are presented as a complete set (or sets) of comparable financial statements. In the case of comparative financial statements an audit opinion is given on each period for which financial statements are prepared.

The most common form is the use of corresponding figures and the provision of a single audit opinion referring to just the one set of financial statements.

Audit procedures

Audit procedures carried out on comparative figures are significantly less than those carried out on the current year figures. They are normally limited to ensuring that comparative figures have been:

- correctly reported as required by the applicable financial reporting framework, and
- appropriately classified.

ISA 710 therefore requires the auditor to evaluate whether:

- the comparative information agrees with the previous period, or, where appropriate has been restated, and
- accounting policies have been consistently applied in the two periods, or, if there have been changes in accounting policies, whether those changes have been properly dealt with.

In addition, they are required to:

- perform appropriate additional procedures if they become aware of a possible material misstatement in the comparative information whilst performing the current period audit
- obtain written representations which cover all periods referred to in their opinion.

The task set by ISA 710 should not present any problems where the auditor:

- also audited the client’s financial statements in the previous financial period, and
- issued an audit report on those financial statements stating that they showed a true and fair view.

If they did not audit the prior period financial statements, then they should also follow the guidance set out in ISA 510 (see above).

The audit opinion should not normally refer to the corresponding figures, unless particular circumstances apply. These circumstances are considered in a later chapter.
3 SUBSEQUENT EVENTS: ISA 560

Section overview

- IAS 10 and ISA 560
- Audit work to check compliance with IAS 10
- Events occurring after the reporting period and up to the date of the audit report
- Facts discovered after the date of the audit report and before the financial statements are issued
- Facts discovered after the financial statements have been issued

3.1 IAS 10 and ISA 560

It is not possible to prepare financial statements that present a true and fair view by considering only those events and transactions that take place before the date at which the statement of financial position is prepared. Material events that occur after the reporting period should also be considered when preparing the financial statements for the year.

Purpose of IAS 10

IAS 10 Events after the reporting period has two main objectives:

- to specify when an entity should adjust its financial statements for events that occur after the reporting period, but before the financial statements are authorised for issue, and
- to specify the disclosures that should be given about events that have occurred after the reporting period but before the financial statements were authorised for issue.

Events after the reporting period are defined in IAS 10 as ‘those events, favourable and unfavourable that occur between the end of the reporting period and the date when the financial statements are authorised for issue.’ There are two types of events after the reporting period:

- Adjusting events. These are events that provide evidence of conditions that already existed at the end of the reporting period.
- Non-adjusting events. These are events that have occurred due to conditions arising after the reporting period.

Accounting for adjusting events after the reporting period

IAS 10 states that if an entity obtains information about an adjusting event after the reporting period, it should update the financial statements to allow for this new information.

‘An entity shall adjust the amounts recognised in its financial statements to reflect adjusting events after the reporting period.’

IAS 10 gives the following examples of adjusting events:

- The settlement after the reporting period of a court case, confirming that the entity had a present obligation as at the end of the reporting period as a consequence of the case.
- The receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period.
The determination after the reporting period of the purchase cost of an asset, where the asset had already been purchased at the end of the reporting period, but the purchase price had not been finally agreed or decided.

The discovery of fraud or errors showing that the financial statements are incorrect

Disclosures for non-adjusting events after the reporting period

Non-adjusting events after the reporting period are treated differently. A non-adjusting event relates to conditions that did not exist at the end of the reporting period; therefore the financial statements must not be updated to include the effects of the event. IAS 10 states quite firmly: 'An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period'.

However, IAS 10 goes on to say that if a non-adjusting event is material, a failure by the entity to provide a disclosure about it could influence the economic decisions taken by users of the financial statements. For material non-adjusting events IAS 10 therefore requires disclosure of:

- the nature of the event, and
- an estimate of its financial effect or a statement that such an estimate cannot be made.

This information should be disclosed in a note to the financial statements. IAS 10 gives the following examples of non-adjusting events:

- A fall in value of an asset after the reporting period, such as a large fall in the market value of some investments owned by the entity, between the end of the reporting period and the date the financial statements are authorised for issue.
- The acquisition or disposal of a major subsidiary.
- The formal announcement of a plan to discontinue a major operation.
-Announcing or commencing the implementation of a major restructuring.
- The destruction of a major plant by a fire after the reporting period.

The role of the auditor: ISA 560

The work of the external auditor in this area is covered by ISA 560 Subsequent events. The objectives of the auditor, per ISA 560, are to:

- obtain sufficient, appropriate evidence about whether events occurring between the date of the financial statements and the date of the audit report are appropriately reflected in those financial statements, and
- respond appropriately to facts that became known to them after the date of the audit report that, had they been known to them at that date, may have caused them to amend their report.

This means that audit procedures must be planned and performed so as to consider all significant transactions occurring after the reporting period. This means that the audit work does not stop with events only up to the end of the reporting period. There are two key dates after the reporting period: the date of the audit report and the date that the financial statements are issued.
Before the issue of the audit report, the auditor should **actively look for** significant subsequent events.

After the issue of the audit report (and up to the time that the financial statements are issued), the auditor has to consider the impact of any significant subsequent events **that come to their attention**. However, they do not have to look for these events actively.

### 3.2 Audit work to check compliance with IAS 10

Audit work to check compliance with IAS 10 can be divided into three phases:

- from the end of the reporting period to the date of the audit report
- from the date of audit report to the date that the financial statements are issued
- after the financial statements have been issued.

### 3.3 Events occurring after the reporting period and up to the date of the audit report

Between the end of the reporting period and the date of the audit report, the auditor is required to obtain sufficient appropriate evidence that all events that require adjustment of or disclosure in the financial statements:

- have been identified, and
- are suitably reported in the financial statements.

**Normal audit verification work**

The auditor may find sufficient evidence of subsequent events in the course of normal audit verification work. Where this is the case they are not required to perform additional audit procedures. Such normal audit verification work will include looking at sales, invoices and cash transactions after the year-end in order to verify items in the statement of financial position at the year end. For example:

- The audit of receivables will consider whether receivables at the end of the reporting period are collectable. Cash receipts after the year-end may indicate a significant non-payment, suggesting the need to write off a debt as ‘bad’.

- The audit of inventory procedures includes a review of the net realisable value of inventory. Sales of inventory after the year-end may indicate that some inventory in the statement of financial position is over-valued (because subsequent events have shown that its NRV was less than cost).

- A search for unrecorded liabilities may discover the existence of some unrecorded liabilities, from invoices received after the reporting period but relating to the period covered by the financial statements.

- A review of the entity’s cash position at the end of the reporting period may find that a cheque from a customer, recorded as part of the bank balances, was dishonoured after the reporting period.
Procedures aimed specifically at identifying subsequent events

The auditor should also actively look for ‘subsequent events’, up to the time that they prepare the audit report. Taking into account their risk assessment of this area, they should:

- obtain an understanding of management’s procedures for identifying subsequent events
- inquire of management as to whether any subsequent events have occurred which might affect the financial statements
- read the entity’s latest subsequent financial statements
- read minutes of shareholders’ meetings, meetings of the board of directors and senior management meetings held after the date of the financial statements and inquire about matters discussed at any such meetings where minutes are not yet available
- obtain written representations in respect of subsequent events.

3.4 Facts discovered after the date of the audit report and before the financial statements are issued

Even after the date on which the audit report is signed, the auditor retains some degree of responsibility for events of which they become aware, up to the time that the financial statements are issued. They are not required, during this period, to actively look for subsequent events. Their level of responsibility is therefore much reduced compared with the period before the signing of the audit report.

If the auditor becomes aware of a fact that, had it been known to them at the date of the report, may have caused them to amend their report, then they must:

- discuss the matter with management,
- determine whether the financial statements need amending, and
- inquire how management intend to address the matter in the financial statements.

If the financial statements are amended, the auditor is required to:

- carry out the necessary audit procedures on the amendment(s), and
- extend their review of subsequent events up to the date of the new audit report.

(In some jurisdictions management are not prevented from restricting their amendments to the effects of the subsequent event. In such cases ISA 560 permits the auditor to restrict their extended review of subsequent events to that amendment only. In such a case the auditor must draw attention to this restriction in an emphasis of matter paragraph or other matter paragraph (covered in a later chapter)).

If management do not amend the financial statements for the subsequent event, but the auditor feels that an amendment should be made, the auditor should take the following action:

- If the audit report has not yet been provided to the entity, modify their opinion as appropriate.
If the audit report has been provided to the entity:
- request management not to issue the financial statements before the necessary amendments have been made
- if they do so, take appropriate action to prevent reliance on the audit report, after taking legal advice.

### 3.5 Facts discovered after the financial statements have been issued

As above, the auditor has no obligation to perform audit procedures or make inquiries regarding the financial statements after they have been issued. However, if they become aware of a fact that, **had it been known to them at the date of their audit report, may have caused them to amend their report** then they should:
- discuss the matter with management
- determine how the financial statements need amending, and
- inquire how management intend to address the matter in the financial statements.

If the financial statements are amended, the auditor is required to:
- carry out the necessary audit procedures on the amendment
- extend their review of subsequent events up to the date of the new audit report (as above)
- review the steps taken by management to inform anyone who received the original financial statements and audit report of the situation
- issue a new audit report, containing an emphasis of matter paragraph or other matter paragraph (covered in a later chapter). This should refer to a note in the revised financial statements that explains in more detail the reason for the re-issue of the financial statements.

In the real examination, you are likely to be asked to apply your knowledge to a given scenario.

#### Example: Subsequent events

You are the auditor in charge of the audit of Hindsight, which has a 30 June year end. The subsequent events review for the year ended 30 June Year 5 revealed that, on 1 August Year 5, a receiver was appointed at a major customer. At 30 June Year 5 that customer owed Rs. 200,000 and goods costing Rs. 300,000 made to that customer’s specification were held in inventory. Both these amounts are material.

**Required**

List the matters to which you would direct your attention in respect of the above in relation to the audit for the year ended 30 June Year 5, if the audit report on the financial statements has not yet been written.

**Solution**

- Check that the directors are willing to adjust the financial statements for this adjusting event after the reporting period.
- Establish whether any cash has been received from this customer since the year end.
Review any correspondence from the receiver to establish to what extent the outstanding debt will be recovered.

Consider whether the goods held in inventory are now valued at the lower of cost and NRV, given that these goods were made to the customer's specification. This may depend on whether or not those goods can be sold to a different customer.

In the light of the above, consider whether any write downs proposed by the directors to receivables and/or inventory are reasonable.

If they are not, or if the directors refuse to adjust the financial statements, consider the impact on the audit report.

Note

If the event occurs after the date of the audit report but before the financial statements are issued, the auditor should discuss the matter with the directors of the client entity and ask what they propose to do.

If the directors intend to amend the financial statements to include or report the event, the auditor should re-write the audit report accordingly and give it a new date.

If the directors say that they do not intend to amend the financial statements, the auditor must consider the most appropriate course of action. If it is too late to re-write the audit report the auditor should consider communicating with the shareholders in another way; for example by asking to speak at the annual general meeting of the entity (which is the auditor's right).

In the longer term, the auditor should also consider resigning from the audit, but this would not be appropriate as an immediate response to the problem. The immediate requirement is to convey the auditor's opinion to the shareholders.
4 GOING CONCERN: ISA 570

Section overview

- Introduction
- Going concern: duties of the directors
- Going concern: duties of the auditor (ISA 570)
- IAASB Alert: Audit Considerations in Respect of Going Concern in the Current Economic Environment

4.1 Introduction

The going concern assumption means that the income statement/statement of comprehensive income and statement of financial position are prepared on the assumption that the entity will continue in operational existence for the foreseeable future.

If the entity is not a going concern, there will be significant implications for the financial statements. For example:

- the distinction between 'current' and 'non-current' for both assets and liabilities ceases to have any meaning: all assets and liabilities become 'current'
- all assets must be carried in the statement of financial position at their net realisable value
- there may be additional liabilities
- revenue from ongoing contracts or projects may no longer remain recoverable, and
- certain expense accruals may have to be made.

The auditor needs to be satisfied that the going concern assumption is appropriate to the financial statements under audit. This will involve an investigation of the financial and operating position of the client before the end of the reporting period. If this review indicates that the going concern assumption may not be appropriate, further investigation will be needed.

4.2 Going concern: duties of the directors

In preparing the financial statements, the directors must satisfy themselves (in accordance with IAS 1) that the going concern basis is appropriate. In some countries, there is a requirement for large companies (listed companies) to disclose the fact that, in the opinion of the directors, the company is a going concern.

It is therefore the responsibility of management to make the going concern assessment.

4.3 Going concern: duties of the auditor (ISA 570)

The work of the external auditor on the going concern status of an entity is covered by ISA 570 Going concern. Key points from ISA 570 are set out below.
The **objectives** of the auditor in this area, according to ISA 570, are to:

- obtain sufficient appropriate evidence about the appropriateness of management’s use of the going concern assumption in the preparation and presentation of the financial statements
- conclude whether a material uncertainty exists that may cast significant doubt on the entity’s ability to continue as a going concern, and
- determine the implications for the audit report (covered in a later chapter).

This is a subjective area where judgement is usually required to assess the uncertainties surrounding the assumptions that were made by management in reaching their conclusion about the going concern status of the entity.

**ISA 570 requires** that the auditor must perform **risk assessment procedures** to consider whether there are events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern.

If management has already performed such an assessment, the auditor must:

- discuss this assessment with management
- determine whether the assessment identified any relevant events or conditions, and, if so
- determine management’s plans to address them.

If management has not yet performed such an assessment, the auditor must:

- discuss with management the basis for the intended use of the going concern assumption, and
- inquire of them whether events or conditions exist that may cast significant doubt on the entity’s ability to continue as a going concern.

In evaluating management’s assessment the auditor must consider the same time period. If management looked less than 12 months into the future, the auditor should ask management to make a re-assessment looking at least 12 months into the future. The auditor must also inquire if management is aware of any relevant events or conditions beyond this time period.

**Factors that raise questions about the going concern assumption**

The auditor should remain alert throughout the audit process for factors or events that may indicate that the going concern status could be questionable/doubtful. ISA 570 gives a number of examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption:

**Financial**

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

**Operating**
- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labour difficulties (e.g. riot, strike or conflict).
- Shortages of important supplies.
- Emergence of a highly successful competitor.

**Other**
- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

**Going concern assumption: audit procedures**
Where events or conditions have been identified that may cast significant doubt on the entity’s ability to continue as a going concern the auditor must obtain sufficient appropriate evidence to determine whether in fact a material going concern uncertainty does exist. They do this by performing additional audit procedures.

- **Discussion with management.** Management should be asked to explain the reasons why they consider the going concern assumption to be valid. They should also be asked about their future plans for the business. If the entity is expecting to make a loss next year, the possible implications of this for the going concern assumption should be discussed extensively.

- **Obtain a cash flow forecast.** A cash flow forecast should be obtained from the entity and this should also be discussed with management. The assumptions in the forecast should be checked and, if appropriate, challenged. If there is a forecast of a cash shortage, the auditor should discuss with management their plans for obtaining the additional financing that will be required.

- **Review the sales order book.** If this indicates a decline in sales orders, the issue should be discussed with management.

- **Review ageing receivables.** Check a list of ageing receivables and assess the average time to pay. If customers are taking longer to pay, this may have adverse implications for operational cash flow.
Consider whether planned **capital expenditure** by the entity may be insufficient to support the business as a going concern in the future.

If a **key senior employee** has left the business entity in the recent past, the possible implications (for example, the possibility of losing key customers with the loss of the key employee) should be discussed.

**Litigation.** If the company is involved in continuing litigation, and faces the possibility of having to pay a large amount of money to settle the dispute, the implications should be discussed.

**Information from the client entity’s bank.** If the client entity is expecting to rely on continuing financial support from its bank (for example, a continuation of its bank overdraft facility) the bank should be asked to confirm that the finance will remain available.

After discussing the issues with management, the auditor should obtain a **letter of representation from management** confirming their opinion that the entity is a going concern.

The financial statements are the responsibility of management, and if the auditor considers that the going concern assumption is invalid whereas management consider it to be valid, the options available to the auditor are to:

- discuss the matter with management, having carried out audit procedures to obtain more evidence
- try to persuade management to change their mind and prepare the financial statements on a different basis (a break up basis), and
- if management does not agree to change its view, consider making a qualified or adverse audit report. (Qualified and adverse opinions are discussed more fully in a later chapter).

Unless all those charged with governance are also involved in managing the entity, the auditor must **communicate to those charged with governance** any events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern. Such communication must include the following:

- Whether the events or conditions constitute a material uncertainty.
- Whether the use of the going concern assumption is appropriate.
- Whether the related disclosures in the financial statements are adequate.

If there is a **significant delay in the approval of the financial statements**, which the auditor believes is due to events or conditions related to the going concern assessment, they must:

- perform the additional audit procedures listed above
- consider the effect of this delay on their conclusions.
The audit work relating to the going concern status is summarised below.

<table>
<thead>
<tr>
<th>Audit stage</th>
<th>Audit procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Planning and assessment</td>
<td>▪ Consider whether circumstances exist which cast doubt on the going concern status.</td>
</tr>
<tr>
<td></td>
<td>▪ If management have already carried out their assessment, review and evaluate that assessment.</td>
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<tr>
<td></td>
<td>▪ Review management’s plans to deal with any problems identified.</td>
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<tr>
<td></td>
<td>▪ If the auditor has identified problems not identified by management, ask management to prepare appropriate plans which the auditor should then review.</td>
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<tr>
<td></td>
<td>▪ Seek written representation regarding the plans/going concern status.</td>
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<tr>
<td></td>
<td>▪ Assess whether there are any material uncertainties relating to the going concern status of the entity.</td>
</tr>
<tr>
<td>Detailed audit procedures to assess the going concern status</td>
<td>These might include the following:</td>
</tr>
<tr>
<td></td>
<td>▪ Reviewing cash flow, profit and funding forecasts, normally for at least one year from the end of the reporting period.</td>
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<tr>
<td></td>
<td>▪ Analysing interim or management accounts.</td>
</tr>
<tr>
<td></td>
<td>▪ Reviewing loan agreements and other relationships with providers of finance.</td>
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<tr>
<td></td>
<td>▪ Reviewing minutes of board meetings.</td>
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<tr>
<td></td>
<td>▪ Reviewing current and future order levels and relationships with customers.</td>
</tr>
<tr>
<td></td>
<td>▪ Reviewing operating plans and the availability of future resources.</td>
</tr>
</tbody>
</table>

The impact of the going concern status on the audit report is more fully dealt with in a later chapter.

4.4 IAASB Alert: Audit Considerations in Respect of Going Concern in the Current Economic Environment

The IAASB issued an alert in January 2009 to raise auditors’ awareness about matters relevant to the consideration of the use of the going concern assumption in the preparation of the financial statements in the current environment. In particular, management, those charged with governance and auditors alike will be faced with the challenge of evaluating the effect of the credit crisis and economic downturn on an entity’s ability to continue as a going concern and whether these effects on the entity ought to be described, or otherwise reflected, in the financial statements.
Key matters highlighted in the alert

- The going concern assumption is a fundamental principle in the preparation of financial statements.
- The assessment of an entity’s ability to continue as a going concern is the responsibility of the entity’s management.
- The appropriateness of the use of the going concern assumption is a matter for the auditor to consider on every audit engagement.
- International Standard on Auditing (ISA) 570, “Going Concern”, establishes the relevant requirements and guidance with regard to the auditor’s consideration of the appropriateness of management’s use of the going concern assumption and auditor reporting.
- The credit crisis and economic downturn have led to a lack of available credit to entities of all sizes, which may affect an entity’s ability to continue as a going concern; this and other factors may be relevant in the auditor’s evaluation of forecasts prepared by management to support its going concern assessment.
- The extent of disclosures in the financial statements is driven by management’s assessment of an entity’s ability to continue as a going concern, coupled with the disclosure requirements of the applicable financial reporting framework.
- Consideration of the need for an emphasis of matter paragraph in the auditor’s report will be a difficult matter of judgment to be made in the context of the entity’s circumstances; the mere existence of the credit crisis, though referred to in the financial statements, does not of itself create the need for an emphasis of matter paragraph.
5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:
- Describe the process and considerations for evaluating misstatements per ISA 450
- Audit opening balances and prior period comparatives in compliance with ISAs 510 and 710
- Explain how to audit subsequent events in accordance with ISA 560
- Summarise the concept of going concern and describe how to apply and comply with ISA 570
CHAPTER 10

Group audits

Contents

1 Introduction to group audits
2 Group audits: preliminaries
3 Working with component auditors
4 Auditing the consolidation process
5 Documentation and communication with management and those charged with governance
6 Chapter review
INTRODUCTION

Learning outcomes

Performance of audit - specific

A (b) 5 Special consideration – Audit of group financial statements (including work of component auditors)

Exam context

Group audit can be complex and confusing. Regulators often identify group audit in their quality inspections as an area that needs improving. With this in mind a whole chapter is dedicated to group audit in compliance with the revised ISA 600.

By the end of this chapter students will be able to:

- Summarise the key elements of group audit
- Describe how component auditors are used and the various communications that they will participate in
- Explain the responsibilities and tasks involved in performing a group audit in compliance with ISA 600 including planning, performing and reporting.
1 INTRODUCTION TO GROUP AUDITS

Section overview

- Introduction
- Group audits and the audit of individual group companies
- Possible problems with group audits
- Terminology in group audits

1.1 Introduction

A group audit is the audit of a group’s consolidated financial statements. For this topic, you need to be aware of the requirements of the following accounting standards:

- IFRS 3 Business combinations
- IFRS 10 Consolidated financial statements
- IFRS 11 Joint arrangements
- IFRS 12 Disclosure of interests in other entities
- IAS 27 (revised) Separate financial statements
- IAS 28 Investments in associates

In addition, IAS 24 Related party disclosures is also of particular relevance because companies within a group are related parties.

1.2 Group audits and the audit of individual group companies

Much of the basic audit work for groups of companies consists of auditing the financial statements of the individual companies in the group. The parent company and subsidiaries are referred to (for audit purposes) as the ‘components’ of the group.

The audit work on the financial statements of the components of a group will follow normal auditing principles and practice.

This chapter is concerned with the additional audit considerations that arise in connection with the preparation of the group financial statements.

1.3 Possible problems with group audits

The organisation and planning of a group audit is usually more complex than the planning of the audit of a single company, for the following reasons:

- Groups may include a large number of companies. Some group companies may be foreign subsidiaries that report in their own currency and perhaps use their national accounting practices to prepare their financial statements, rather than international financial reporting standards.
- Some companies in the group may have a different year-end accounting date from other companies.
- It will be necessary to make or audit the adjustments that are made to the financial statements of individual group companies, for consolidation purposes.
Audit, Assurance and Related Services

- Some group companies may be audited by an audit firm that is not the auditor of the parent company.
- Direction, supervision, review and communication protocols need to be set bearing in mind the local laws and regulation applicable to each component separately (this implies that data protection laws for example, may prohibit sharing of certain information with group auditors).

### 1.4 Terminology in group audits

Some special terms from ISA 600 (see below) are used for group audits.

<table>
<thead>
<tr>
<th>Definition: Group engagement team</th>
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<tbody>
<tr>
<td>The group engagement team is the audit team responsible for the audit of the group financial statements (and will usually also be the audit team responsible for the audit of the parent company). ISA 600 in fact refers to the 'group audit', the 'group engagement partner' and the 'group engagement team' whilst a number of other ISAs use the term 'group auditor' as a synonym for group engagement team.</td>
</tr>
<tr>
<td>The group engagement team will:</td>
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<tr>
<td>- establish the overall group audit strategy</td>
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<tr>
<td>- communicate with component auditors (see below)</td>
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<tr>
<td>- perform work on the consolidation process, and</td>
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<tr>
<td>- evaluate the conclusions drawn from the audit evidence obtained in order to form an opinion on the group financial statements.</td>
</tr>
<tr>
<td>Each of the above stages is considered in more detail in this chapter.</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Definition: Component auditor</th>
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<tbody>
<tr>
<td>A component auditor is an auditor who, at the request of the group auditor, performs work on the financial information of a component. For example, the audit of an individual subsidiary, associate or joint venture may be performed by Audit firm A, when the group auditor is Audit firm B. Audit firm A is a 'component auditor'.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Definition: Component</th>
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<tbody>
<tr>
<td>A component is an entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Definition: Group</th>
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</thead>
<tbody>
<tr>
<td>All the components whose financial information is included in the group financial statements. A group always has more than one component.</td>
</tr>
</tbody>
</table>
### Definition: Group audit
The audit of group financial statements.

### Definition: Component materiality
The materiality for a component determined by the group engagement team.

### Definition: Group-wide controls
Controls designed, implemented and maintained by group management over group financial reporting.

The following definitions are reminders from IAS and IFRS of the accounting terms particularly relevant to group audit:

### Definition: Key accounting terms relevant to group audit

#### Business combination
A transaction or other event in which an acquirer obtains control of one or more businesses.

- **Parent**
  An entity that has one or more entities (IFRS 10).

- **Subsidiary**
  An entity that is controlled by another entity (IFRS 10).

- **Control**
  An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee (IFRS 10).

- **Power**
  Existing rights that give the current ability to direct the relevant activities of the investee.

- **Associate**
  An entity over which the investor has significant influence.

- **Significant Influence**
  The power to participate in financial and operating policy decisions of the investee, but is not control or joint control over those policies.

- **Joint arrangement**
  An arrangement of which two or more parties have joint control.

- **Joint control**
  The contractually agreed sharing of control over an arrangement, which exists only when the decisions about the relevant activities require the unanimous consent of the parties sharing control.

- **Joint venture**
  A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.
2 GROUP AUDITS: PRELIMINARIES

Section overview

- The relationship between the group auditor and component auditors
- Accepting an appointment as group auditor
- Understanding the group, its components and component auditors
- Materiality
- Planning and controlling a group audit

2.1 The relationship between the group auditor and component auditors

ISA 600 regulates situations where group financial statements include financial information of components that are audited by other audit firms. The group auditor is required to determine how the work of the component auditors will affect the audit of the group financial statements.

The group engagement partner is responsible for:

- the direction, supervision and performance of the group audit, and
- issuing an appropriate group audit report.

The group auditor is solely responsible for the audit report on the group financial statements (although ISA 600 does not in fact use this term). The group audit report does not therefore refer to any component auditors, unless such a reference is required by local law. If it is required, the group audit report must indicate that such a reference does not reduce the group auditor’s responsibility for the opinion on the group financial statements.

Because of this sole responsibility, ISA 600 contains very specific guidance on:

- the direction that the group auditor should give to the group audit.
- the group auditor’s involvement in the work of component auditors, and
- the extent of review which the group auditor can carry out of the component auditor’s work.

2.2 Accepting an appointment as group auditor

It is normal practice for the auditor of the parent company to act as the group auditor. However, this is ‘technically’ a separate appointment. As in the case of all appointments, the audit firm should consider whether it is in a position to accept the appointment as group auditor.

Before accepting appointment as group auditor, the audit firm should ensure that all the procedures relating to acceptance of an engagement per ISA 220 are met and that they have a ‘reasonable expectation’ of obtaining sufficient appropriate audit evidence about the consolidation process and the financial information of components to reduce audit risk to an acceptable level.

The firm does this by obtaining an understanding of the group and its components and their environment sufficient to determine:

- which components are significant to the group
- which significant components are audited by others, and
whether as group auditor, the firm will be able to be sufficiently involved in the audit of significant components to obtain sufficient appropriate evidence about them.

If the group auditor is not able to be involved in the audit of a significant component, then it is unlikely that the group auditor can obtain sufficient appropriate evidence in respect of that component and it should not accept (or should resign from) the engagement. If the auditor is prevented from resigning from the engagement by the law, they should issue a disclaimer of opinion on the group financial statements.

**Definition: Significant components**

Significant components are those that:

- are of individual significance to the group (i.e. individually material in a group context), or
- have been identified as likely to include significant risks of material misstatement of the group financial statements.

### 2.3 Understanding the group, its components and the component auditors

In accordance with ISA 315, the group auditor must identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment. This will mean:

- enhancing the understanding of the group, its components and their environments, obtained at the acceptance or continuation stage, and
- obtaining an understanding of the consolidation process, including the instructions issued by management to its components.

This will enable the group auditor to confirm or revise its initial assessment of components which are likely to be significant.

When the group auditor plans to request a component auditor to perform work on the financial information of a component, they must assess the following issues:

- Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit (in particular that they are independent).
- The component auditor’s professional competence.
- Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence.
- Whether the component auditor operates in a regulatory environment that actively oversees auditors.

The group auditor cannot simply rely on the work performed by the component auditor without assessing the likely quality of that work.

If the component auditor is not independent or there are serious concerns about any of the other matters above, the group auditor will need to obtain evidence relating to the financial information of the component without requesting the component auditor to perform any work.
2.4 Materiality

The group auditor will need to set:

- group materiality for the group financial statements as a whole, and
- component materiality for those components where component auditors will perform an audit or a review for the purposes of the group audit.

Component materiality will usually be lower than group materiality. If a component has been audited in its own right (e.g. because of local laws or regulations) and the group auditor decides to use that audit to provide audit evidence for the group audit, the materiality threshold used on that audit will need to be assessed. If the threshold was too high then additional work may be needed where component materiality is lower than the overall materiality level used in the local statutory audit for the individual component.

Different risk profiles for different components would mean separate materiality levels would be set for each component; these could be higher or lower than the materiality set for the components' individual audit. Thus, the aggregate of components' materiality would not likely equal the materiality for the consolidated financial statements. The group auditor is particularly concerned with items that affect the consolidated financial statements, hence there could be items of significance to a component that may not affect the consolidated financial statements at all, or in an immaterial manner.

2.5 Planning and controlling a group audit

The principles and guidelines for planning and controlling a group audit are similar to those for the audit of an individual company. However, additional considerations arise, in regard to the complexities of a group audit.

These additional considerations will require the group auditor to do the following:

- Familiarise themself with the client’s procedures for preparing group financial statements (for example, the client may use standard consolidation schedules).
- Ascertain the client’s timetable for the preparation of the group financial statements.
- Establish an audit strategy and audit plan for the entire group audit, including the audit of components. This should include:
  - staffing requirements for the group audit
  - a timetable for the audit of the company financial statements and the group financial statements
  - an action plan for possible problem areas (for example, foreign subsidiaries)
  - arrangements for communication and co-operation with component auditors.
3 WORKING WITH COMPONENT AUDITORS

Section overview

- Determining the type of work to be performed on components
- Communication with component auditors
- Involvement of the group auditor in work performed by component auditors
- Joint auditors

3.1 Determining the type of work to be performed on components

Where a component is of **individual financial significance** to the group, the group auditor or a component auditor must perform an audit using component materiality.

Where a component is **significant because of likely significant risk of material misstatement**, the group auditor or a component auditor must perform one or more of the following.

- An audit using component materiality.
- An audit of one or more account balances, classes of transactions or disclosures (depending on where the risk of material misstatement lies).
- Specified audit procedures to address the risk of material misstatement.

For **non-significant components** the group auditor should perform analytical procedures at a group level. However, the performance of such procedure may indicate a previously-unidentified significant risk. In this case, the component classification may have to change to significant component and the procedures stated above would have to be performed.

If the group auditor does not consider that sufficient appropriate audit evidence will be obtained from the sum of the above work then additional work should be performed on non-significant components (similar to that for significant components). The selection of such components should be varied from year to year.

3.2 Communication with component auditors

If there is not effective communication between the group auditor and the component auditor, there is a risk that the group auditor may not obtain sufficient appropriate audit evidence on which to base the group audit opinion.

It is therefore vital that there is **clear and timely two-way communication** between the group auditor and the component auditor. The group auditor’s requirements are usually communicated in a **letter of instruction**. The component auditor’s communication with the group auditor will usually be in the form of a **memorandum** or **report of work performed**.

However, such communication may not necessarily be in writing. For example, the group engagement team may visit the component auditor to discuss identified significant risks or review relevant parts of the component auditor’s audit documentation. In such cases, matters must be properly documented in accordance with ISA 230.

In co-operating with the group auditor, the component auditor will provide the group engagement team with access to relevant audit documentation provided this is not prohibited by law or regulation.
**Letter of Instruction**

The group auditor’s **letter of instruction** to the component auditor should set out:

- the work required
- the use to be made of that work, and
- the form and content of the component auditor’s communication with the group engagement team.

It should also include:

- a request for co-operation
- ethical requirements, including independence
- component materiality
- identified significant risks
- a list of known related parties
- protocols and approval process for providing non-audit services to the component that could have an effect on the independence at group level.

**Evaluating the work of the component auditor**

The group auditor is required to evaluate the work performed by component auditors. This is typically achieved by reviewing a report or questionnaire completed by the component auditors and engaging in appropriate discussion with the component auditors.

The group auditor must:

- Discuss significant matters arising from their evaluation with the component auditor, component management or group management, as appropriate; and
- Determine whether it is necessary to review other relevant parts of the component auditor’s audit documentation.

If the group engagement team concludes that the work of the component auditor is insufficient, the group engagement team shall determine what additional procedures are to be performed, and whether they are to be performed by the component auditor or by the group engagement team.

The component auditor’s **report of work performed** should include:

- a statement of compliance with ethical and group auditor requirements
- identification of the financial information on which the component auditor is reporting
- any instances of non-compliance with laws and/or regulations which could lead to a material misstatement of the group financial statements
- a list of uncorrected misstatements of the financial information of the component
- indicators of possible management bias
- any identified material weaknesses in internal control
- any other significant matters the component auditor expects to communicate to those charged with governance of the component
- any other matters that may be relevant to the group audit
- the component auditor’s overall findings, conclusions or opinion.
3.3 Involvement of the group auditor in the work performed by component auditors

It is the group auditor’s responsibility to decide what work is to be performed on the financial information of the component by the component auditor.

The group auditor then has to decide the extent of their involvement in that work. For significant components they must, as a minimum:

- discuss with component management or the component auditor the business activities of the component that are significant to the group
- discuss with the component auditor the risk of material misstatement of the financial information of the component, and
- review the component auditor’s documentation of identified significant risks of material misstatement of the group financial statements.

Where significant risks of material misstatement of the group financial statements have been identified at a component the group auditor should:

- evaluate the further audit procedures to be performed to address such risks, and
- consider whether it is necessary to be involved in those procedures.

Such involvement might include:

- meeting with component management/auditors to obtain an understanding of the component
- reviewing the component auditor’s overall audit strategy and plan
- performing risk assessment procedures at the component
- designing and/or performing further audit procedures
- participating in closing/other key meetings between component auditors/management
- reviewing other relevant parts of the component auditor’s documentation.

For other components, the extent of the group auditor’s involvement will depend on their understanding of that component auditor. If they have concerns about that particular component auditor’s competence, or a lack of local regulation, they may decide that they need to be involved in that component auditor’s risk assessment.

In all cases the group auditor is required to evaluate the report of the work performed by the other auditor. If, after such evaluation and after discussion with the component auditor/management, the group auditor concludes that the work is insufficient they should:

- determine what additional procedures are needed;
- establish whether such procedures should be performed by the component auditor or themselves, and
- understand the possible impact on the audit report on the group financial statements (if any).

3.4 Joint auditors

A joint audit involves two (or more) audit firms being appointed to audit the financial statements of an entity.

Joint audits may occur in other situations, but they are most commonly found in group audits. In particular when a group acquires a new subsidiary, it is not
unusual to appoint the group’s auditors jointly with the subsidiary’s existing auditors, at least for a period of time after the acquisition.

The joint audit provides a joint opinion on the financial statements of the subsidiary.

**Advantages of joint audits**

The reasons why joint auditors might be appointed include the following issues:

- The client company may be so large that it requires the services of more than one firm of auditors.
- After the acquisition of a large subsidiary, using joint auditors may help the transition process while the group auditors become familiar with the new subsidiary. The ‘old’ auditors should be familiar with the business of the subsidiary and should pass their knowledge over to the parent company auditors. For the parent company auditors, this should accelerate the process of getting to know the business of the new subsidiary.
- Joint auditors may provide a higher level of technical expertise than either audit firm could provide individually.
- Improved geographical coverage may be obtained for the audit, where each of the joint auditors on its own does not have offices that cover all the geographical locations of the component companies in the group.
- It has been suggested that two medium-sized accountancy firms might ‘join forces’ and tender for the audit of a company for which the auditors would normally be one of the ‘Big 4’ accountancy firms. This is possibly a way in which medium-sized firms might try to ‘break the monopoly’ of the Big 4 on large company audits.

**Disadvantages of joint audits**

Possible disadvantages of joint audits include the following:

- The extra cost to the client. It is likely to cost more to use two accountancy firms than to use one.
- Possible inconsistencies between the two joint auditors in the audit methods that they use. If so, there may be problems in reaching agreement on whose audit method to use.
- The possible difficulty the two firms may have in agreeing the division of work.
- Additional problems that will arise in monitoring and controlling the audit work of two different firms.
- The two firms may find it difficult to work well together, and each firm may try to become the leading firm in the joint audit.
- If there is a claim against the auditors for negligence in the conduct of the audit, there may be some difficulty in identifying which of the joint auditors is potentially liable.

The key to a successful joint audit is good communication between the firms, including **joint planning meetings** and **regular discussions** between the firms at all key stages of the audit process. The meetings and discussions should be **fully documented**.
4  AUDITING THE CONSOLIDATION PROCESS

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<td>■ The main audit procedures relating to consolidation</td>
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<td>■ Subsequent events</td>
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</table>

4.1  Role of the group auditor with regard to consolidation

As discussed above, ISA 600 requires the group auditor to obtain an understanding of the consolidation process, including the instructions issued by management to its components. This will allow an assessment of the risks involved in the consolidation process.

The group auditor will want to confirm that the following actions have been taken correctly by the client group:

- There has been a full and accurate transfer of information from the individual financial statements of the components of the group to the final consolidated financial statements.
- Appropriate consolidation adjustments have been made.

However, the amount and type of detailed audit procedures to be carried out will depend on the group auditor’s assessment of risk in this area.

4.2  The main audit procedures relating to consolidation

The table below sets out the main audit procedures that could be performed in relation to the consolidation process i.e. preparing the consolidated financial statements from the financial statements of the individual components in the group.

<table>
<thead>
<tr>
<th>Topic</th>
<th>Audit procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clerical accuracy</td>
<td>■ Confirm that figures have been transferred accurately from the financial statements of the components (individual companies in the group) to the consolidation schedules.</td>
</tr>
<tr>
<td></td>
<td>■ Check the arithmetical accuracy of all consolidation calculations, such as the consolidation total balances and total transaction values.</td>
</tr>
<tr>
<td>Status of investments</td>
<td>■ Confirm that the parent company has correctly classified investments as a subsidiary, associate, joint venture or simple investment, in accordance with standard accounting practice.</td>
</tr>
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<td></td>
<td>■ Confirm that the appropriate accounting treatment has been adopted for each of these classifications of investment in the group accounts.</td>
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<tr>
<td>Topic</td>
<td>Audit procedures</td>
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<tr>
<td><strong>Changes in the group</strong></td>
<td>- For acquisitions: confirm fair values, the calculation of purchased goodwill and accounting treatment in accordance with IFRS 3 and any other relevant standards.</td>
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<tr>
<td></td>
<td>- Where there has been an acquisition during the year involving deferred consideration as part-payment, check that the amount of the deferred consideration has been included in the cost of the acquisition at discounted present value, using a current pre-tax cost of capital as the discount rate. (Note: The cost of the acquisition affects the amount of the purchased goodwill.)</td>
</tr>
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<td></td>
<td>- Where there has been an acquisition during the year involving a possible contingent consideration as part-payment, check the reasonableness of the assumption that the recent value of the contingent consideration should be included in the cost of the acquisition.</td>
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<td></td>
<td>- For disposals: confirm the sale proceeds, and the calculation of the gain or loss on sale.</td>
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<td></td>
<td>- Check that the correct accounting treatments of items are applied in the consolidated income statement/statement of comprehensive income and the consolidated. For example, when a subsidiary has been acquired during the year, check that the calculation of pre-acquisition and post-acquisition profit is correct.</td>
</tr>
<tr>
<td><strong>Consolidation adjustments</strong></td>
<td>- Reconcile the inter-company transactions and balances (or review the reconciliation of the inter-company transactions and balances that has been made by the client’s staff).</td>
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<td></td>
<td>- Confirm the inter-company balances.</td>
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<td></td>
<td>- Check calculations of the adjustments for unrealised profit.</td>
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<td></td>
<td>- Check the calculations and disclosure of non-controlling interests.</td>
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<td></td>
<td>- Check the accounting treatment of inter-company dividends and other dividends.</td>
</tr>
<tr>
<td><strong>Loss-making investments</strong></td>
<td>- Consider whether any goodwill on acquisition has suffered an impairment.</td>
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<td></td>
<td>- Consider whether a write down of the investment in the books of the parent company is needed.</td>
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<td></td>
<td>- If a subsidiary makes losses consistently, its going concern status may be in question.</td>
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<tr>
<td></td>
<td>- However, the group may take a formal decision to provide financial support to the subsidiary. This decision, in effect, would protect the going concern status of the subsidiary, even if it is making losses. In such a situation, the group auditor will normally request a ‘comfort letter’ (or ‘support letter’) to this effect from the directors of the parent company.</td>
</tr>
</tbody>
</table>
### Topic: Audit procedures

#### Related parties
- Ensure the provisions of IAS 24 are complied with.
- (Most components of the group will be 'related' to most other components.)
- Sometimes, one component or the parent may have provided financial support to, or letters of guarantee on behalf of, other components to bank or financial institutions. These need to be considered for disclosure.

#### Reporting
- Reach a conclusion about whether the group financial statements present a true and fair view. (The principles relating to group audit reports are dealt with in a later chapter.)

*(Note: Consolidation adjustments are adjustments that are made after the financial statements of the individual group companies have been prepared. The adjustments are needed to consolidate the financial statements of the individual companies into a single set of group financial statements. Consolidation adjustments may therefore include adjustments to the financial statements of individual group companies, to achieve consistency of accounting policies. There are also adjustments for inter-group balances and closing inventory from intra-group sales, for goodwill impairment, and so on.)*

### 4.3 Subsequent events
The subsequent events review will need to include procedures to identify events at components that occur between the dates of the components’ financial information and the date of the group audit report. These procedures could be carried out by the group auditor or by component auditors.
5 DOCUMENTATION AND COMMUNICATION WITH MANAGEMENT AND THOSE CHARGED WITH GOVERNANCE

Section overview

- Documentation
- Communication with group management
- Communication with those charged with governance of the group

5.1 Documentation

In addition to meeting the requirements of ISA 230 Audit documentation the group auditor must also document the following matters.

- An analysis of components, identifying significant components.
- The type of work performed on the financial information of components.
- The extent of the group auditor’s involvement in the work performed by component auditors on significant components.
- Written communications between the group auditor and component auditors concerning the group auditor’s requirements.

5.2 Communication with group management

The group auditor should make group management aware, on a timely basis, of the following matters.

- Material weaknesses in the design or operating efficiency of group-wide controls.
- Material weaknesses which are significant to the group that the group auditor has identified at components.
- Material weaknesses which are significant to the group that component auditors have identified at components and have brought to the attention of the group auditor.
- Any fraud or suspected fraud identified by the group or component auditors.

The distinction between management and “those charged with governance” (see below), who could in fact be the same, is covered in a later chapter.

5.3 Communication with those charged with governance of the group

In addition to the matters required to be communicated within ISA 260 Communication with those charged with governance, ISA 600 requires the group auditor to communicate the following matters to those charged with the governance of the group:

- The type of work to be performed on the financial information of components.
- The group auditor’s planned involvement in the work to be performed by component auditors.
- Any concerns over the quality of any component auditor’s work.
- Any limitations on the group audit (e.g. a lack of access to information).
Any fraud or suspected fraud involving group management, component management, or employees with significant roles in group-wide controls where the fraud resulted in a material misstatement of the group financial statements.
Before moving on to the next chapter check that you can:

- Summarise the key elements of group audit
- Describe how component auditors are used and the various communications that they will participate in
- Explain the responsibilities and tasks involved in performing a group audit in compliance with ISA 600 including planning, performing and reporting.
Audit-related services

Contents

1 Introduction
2 Review engagements
3 Agreed-upon procedures
4 Compilation engagements
5 Chapter review
INTRODUCTION

Learning outcomes

Other assurance engagements and related services (including reporting on relevant services) – Other assurance engagements

D (a) 1 Review engagements

Other assurance engagements and related services (including reporting on relevant services) – Related services

D (b) 1 Agreed-upon procedures
D (b) 2 Compiling financial statements

Exam context

With the global trend towards increased audit exemption leading to fewer mandatory audits being performed there is an ever increasing market opportunity to offer non-audit services. This is the first of two chapters that focus on such non-audit engagements.

In this chapter students will learn how to perform review engagements in accordance with ISREs 2400 and 2410. Students will also learn how to perform related services engagements such as agreed-upon procedures and compilation engagements in accordance with ISRS 4400 and 4410.

By the end of this chapter students will be able to:

- Describe the objectives and conduct of review engagements in accordance with ISRE 2400 and 2410
- Describe the objectives and conduct of related services engagements in accordance with ISRS 4400 and 4410
INTRODUCTION

Section overview

- Overview of assurance and audit-related services

1.1 Overview of assurance and audit-related services

You have already seen how practitioners are engaged to perform statutory audit in accordance with ISAs providing a reasonable level of assurance to the shareholders.

Practitioners are also engaged to perform other ‘audit-related’ services, some of which provide the client with assurance and others which do not.

The next two chapters address audit-related engagements other than statutory audit (which is covered elsewhere in this manual). The below table provides an overview of the standards and various types of assurance and audit-related services that are offered.

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<td>- ISAE 3420: Assurance on the compilation of pro forma financial information included in a prospectus</td>
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<td>2. Engagements that do NOT provide assurance</td>
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<td>Audit-related services</td>
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<tr>
<td>- Audit-related services</td>
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</table>
2 REVIEW ENGAGEMENTS

Section overview

- The distinction between audit and audit-related services
- International Standard on Review Engagements (ISRE) 2400
- Reporting at the end of a review engagement
- International Standard on Review Engagements (ISRE) 2410
- Procedures for the review of interim financial information
- Reporting on the review of interim financial information

2.1 The distinction between audit and audit-related services

An audit is a form of assurance engagement. The objective of an audit is to enable the auditor to form an opinion as to whether the financial statements of an entity give a ‘true and fair view’.

An audit is designed to provide a high level of assurance to the users of the financial statements.

In contrast, audit-related services do not provide the same high level of assurance, and in some cases do not provide any assurance. Audit-related services include engagements such as:

- **Reviews of data.** Reviews of data are checks carried out on information prepared by another person. They provide a limited level of assurance that the information under review is free of material misstatement.

- **Assurance engagements.** Assurance engagements (sometimes called ‘assurance reviews’) are similar to audit in that the practitioner is engaged to assess subject matter against agreed criteria. Assurance engagements typically provide a limited level of assurance that the information under review is free of material misstatement.

- **Agreed-upon procedures.** This is an engagement where the party hiring the practitioner specifies the procedures that the practitioner should follow when performing the assignment.

- **Compilations.** The practitioner is engaged to prepare information, rather than to audit information prepared by someone else. For example, an accountancy firm may be engaged to prepare a tax computation for a client.

2.2 International Standard on Review Engagements (ISRE) 2400

**Objectives of ISRE 2400**

When a company is not required to commission a statutory audit and subsequently chooses not to commission a voluntary audit in compliance with ISAs it may still wish to engage a practitioner to perform a review of the historical financial statements.

ISRE 2400 *Engagements to review financial information* sets out that the objective of a review of financial statements is to:

‘Obtain limited assurance, primarily by performing inquiry and analytical procedures, about whether the financial statements as a whole are free from material misstatement, thereby enabling the practitioner to express a conclusion on whether anything has come to the practitioner’s attention that causes the
practitioner to believe the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework.’

Note that a review:
- requires less evidence than an audit, and
- has an opinion that is expressed in negative terms: (it gives ‘negative assurance’).

Because a review engagement provides a lesser form of assurance than an audit, the work for the review will usually be limited to analytical review and other review procedures. Detailed verification work (for example, substantive tests) will not usually be carried out. This will usually mean that fewer accountancy staff, but more experienced staff, will be required for a review engagement than for an audit.

So in summary, a review performed in accordance with ISRE 2400 applies to the financial statements for a full accounting period and is conducted by a practitioner in the absence of a statutory auditor.

**Principles to apply to review engagements**

ISRE 2400 sets out the following general principles that should be applied to a review engagement. The practitioner should:
- comply with relevant codes of ethics
- plan and perform the work with an attitude of professional scepticism, recognising that material misstatements may exist in the information that is subject to review
- obtain sufficient and appropriate evidence, primarily through inquiry and analytical procedures.

The actual terms of a review engagement should be agreed with the client, and set out in an engagement letter.

**Procedures for a review of financial statements**

Procedures for the review of financial statements will usually include the following:
- The practitioner should obtain an understanding of the entity’s business and the industry in which it operates.
- The practitioner shall determine materiality for the financial statements as a whole, and apply this materiality in designing the procedures and in evaluating the results obtained from those procedures.
- The practitioner should make inquiries into:
  - the entity’s accounting policies, practices and procedures, including the preparation of financial statements
  - material assertions in the financial statements that are subject to the review
  - decisions taken at board meetings and other meetings of the entity that may affect the financial statements
  - the completeness of the accounting records that were used to prepare the financial statements.
The practitioner will use analytical procedures. These should be designed to identify unusual relationships between items in the financial statements, and individual items that appear unusual. Analytical procedures would include:

- comparing the financial statements under review with financial statements for prior periods
- comparing the financial statements with the anticipated results and financial position of the entity
- a study of the relationships between elements in the financial statements that should be expected to conform to a predictable pattern (based on the entity’s past experience or normal ratios/relationships for the industry as a whole).

Procedures may need performing to address specific risks such as:

- Going concern
- Fraud and non-compliance with laws or regulations
- Related parties

The practitioner must obtain evidence that the financial statements agree to the accounting records.

Other procedures that will usually be carried out in a review of financial statements include:

- discussions with the company’s auditors (if the audit firm is not the firm of accountants that is performing the review engagement)
- obtaining representations from management
- considering the appropriateness of the accounting policies employed by the entity
- making inquiries into subsequent events (after the date of the statement of financial position)
- making a review of the statements as a whole.

If the practitioner finds information indicating that misstatements might exist in the financial statements, the scope of the work should be extended.

2.3 Reporting at the end of a review engagement

The outcome of a review engagement will be a report from the practitioner. The report will be in one of two main forms, depending on whether:

- no matters have come to the attention of the practitioner, which indicate that a true and fair view is not presented
- some matters have come to the attention of the practitioner, indicating that a true and fair view might not be presented.

No matters have come to the attention of the auditor

In this situation the auditor will issue a report giving a clear expression of negative assurance. An example of such a report, based on ISRE 2400, is given below.
INDEPENDENT PRACTITIONER’S REVIEW REPORT

[Appropriate Addresssee]

Report on the Financial Statements

We have reviewed the accompanying financial statements of ABC Company, which comprise the statement of financial position as at December 31, 20X4, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management’s Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the International Financial Reporting Standard for Small and Medium-sized Entities, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Practitioner’s Responsibility

Our responsibility is to express a conclusion on the accompanying financial statements. We conducted our review in accordance with International Standard on Review Engagements (ISRE) 2400 (Revised), Engagements to Review Historical Financial Statements. ISRE 2400 (Revised) requires us to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects in accordance with the applicable financial reporting framework. This Standard also requires us to comply with relevant ethical requirements.

A review of financial statements in accordance with ISRE 2400 (Revised) is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with International Standards on Auditing. Accordingly, we do not express an audit opinion on these financial statements.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that these financial statements do not present fairly, in all material respects, (or do not give a true and fair view of) the financial position of ABC Company as at December 31, 20X4, and (of) its financial performance and cash flows for the year then ended, in accordance with the International Financial Reporting Standard for Small and Medium-sized Entities.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the practitioner’s report will vary depending on the nature of the practitioner’s other reporting responsibilities.]

[Practitioner’s signature]

[Date of the practitioner’s report]

[Practitioner’s address]

Note the negative assurance that is given in the report – nothing has come to the attention of the practitioner to indicate that a material misstatement exists.
Where such matters have come to the practitioner's attention

When matters have come to the practitioner’s attention, suggesting that a material misstatement exists, the reporting requirements are similar to those in ISA 705 for qualified external audit reports. The auditor will need to:

- describe the matters involved
- assess the impact of the matter, as either material or pervasive/fundamental
- distinguish between ‘financial statements are misstated’ and ‘inability to obtain sufficient appropriate audit evidence’ when presenting the opinion in the report.

The following example of a report dealing with a material misstatement is based on ISRE 2400:

### INDEPENDENT PRACTITIONER’S REVIEW REPORT

[Appropriate Addressee]

**Report on the Financial Statements**

*(Previous paragraphs as for the standard unqualified report).*

**Basis for Qualified Conclusion**

The company's inventories are carried in the statement of financial position at xxx. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from the requirements of the Financial Reporting Framework (XYZ Law) of Jurisdiction X. The company’s records indicate that, had management stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders’ equity would have been reduced by xxx, xxx and xxx, respectively.

**Qualified Conclusion**

Based on our review, except for the effects of the matter described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the financial statements of ABC Company are not prepared, in all material respects, in accordance with the Financial Reporting Framework (XYZ Law) of Jurisdiction X.

**Report on Other Legal and Regulatory Requirements**

[Form and content of this section of the practitioner’s report will vary depending on the nature of the practitioner’s other reporting responsibilities.]

*[Practitioner’s signature]*

*[Date of the practitioner’s report]*

*[Practitioner’s address]*
2.4 International Standard on Review Engagements (ISRE) 2410

ISRE 2410 Review of interim financial information performed by the independent auditor of the entity deals with a more specific topic than ISRE 2400. It deals with the review carried out by a company’s external auditors of the interim financial statements (mid-year financial statements), where companies are required to produce interim statements. The interim financial statements are not subject to a full audit; however, they are subject to a review.

On the whole general auditing principles apply to this type of review, as set out below.

The auditing firm that reviews interim Financial Information (IFI) is normally the external auditor for the end-of-year accounts (as required by ISRE 2410). The audit firm should:

- comply with the same ethical requirements as it does for the main audit
- implement appropriate quality control procedures
- plan and perform the review with an attitude of professional scepticism
- agree the terms of engagement with the client in an engagement letter
- prepare documentation sufficient to support the auditor’s review conclusions and to provide evidence that the review was conducted in accordance with ISRE 2410.

2.5 Procedures for the review of interim financial information

Procedures for the review of Interim Financial Information (IFI) should include the following:

- The auditor should obtain an understanding of the entity and its environment, including its internal controls, in order to:
  - assess the risk of misstatement in the financial statements
  - select appropriate ‘audit’ procedures for the review.

- The auditor should make inquiries and perform analytical procedures sufficient to reach a conclusion for the review. This conclusion should be about whether anything has come to the auditor’s attention to indicate that the IFI has not been prepared, in all material respects, in accordance with the applicable financial reporting framework. (As with ISRE 2400, the auditor’s opinion is expressed in negative terms.)

- If any such matters come to the auditor’s attention, the auditor should make additional inquiries or perform other procedures in order to obtain more information.

- The auditor should check that the IFI agrees or reconciles to the underlying accounting records.

- The auditor should discover whether management has:
  - taken subsequent events into account, and
  - made an assessment of the entity’s ability to continue as a going concern.

- The auditor should evaluate any uncorrected misstatements in the IFI, both individually and in aggregate. (This is the same as for the annual audit.)
The auditor should obtain written representations from management that:

- they acknowledge their responsibility for internal controls
- the IFI has been prepared and presented in accordance with the applicable financial reporting framework
- they believe the effect of any uncorrected misstatements are immaterial, both individually and in aggregate
- there has been full disclosure of all significant facts, risk assessment, possible or actual non-compliance with laws and regulations, and subsequent events.

The auditor should ensure that any other information issued with the IFI is materially consistent with the IFI.

### 2.6 Reporting on the review of interim financial information

The auditor should issue a written report on the review of the IFI. This report should consist of the following elements:

- **Title:** Review of the IFI
- **Addressee.**
- **Identification of the IFI** that has been reviewed. This should include the title of each of the financial statements in the set of financial statements subject to review, and the end-of-period date and the period covered by the IFI.
- **A statement that management is responsible for preparing the IFI in accordance with the applicable financial reporting framework, and for its fair presentation.**
- **When the IFI consists of a complete set of general-purpose financial statements that should be prepared in accordance with a financial reporting framework, and the statements are designed to achieve fair presentation,** the review report should include an auditor’s conclusion. This conclusion should state whether anything has come to the auditor’s attention that causes them to believe that the IFI does not give a true and fair view in accordance with the applicable financial reporting framework.
- A statement that the auditor is responsible for expressing a conclusion on the IFI, based on the review that the auditor has carried out.
- A statement that the review of the IFI was conducted in accordance with ISRE 2410 and a statement that this review consisted of making inquiries and applying analytical procedures and other review procedures.
- A statement that a review is substantially less in scope than an audit conducted in accordance with ISAs. Consequently the review does not enable the auditor to obtain assurance that they would become aware of all significant matters that might be identified in an audit. Accordingly, no audit opinion is expressed (and the auditor expresses a negative opinion rather than a positive opinion).
- **Conclusion**
- **Signature of the auditor.**
- **Date of the report**
- **Address (normally the location in the country or jurisdiction where the accountancy firm practices)**
Example:
Shown below is an example of an unmodified report, based on ISRE 2410. The report relates to IFI comprising a complete set of general purpose financial statements prepared in accordance with IFRSs. (In other words, the report relates to a review of IFI that uses a financial reporting framework designed to achieve fair presentation.) Note that ISRE 2410 has not yet been updated for the changes in terminology introduced by the revision of IAS 1 *Presentation of financial statements*.

REPORT ON REVIEW OF INTERIM FINANCIAL INFORMATION
(Appropriate addressee)

Introduction
We have reviewed the accompanying balance sheet of ABC Entity as of March 31, 20XX and the related statements of income, changes in equity and cash flows for the three-month period then ended, and a summary of significant accounting policies and other explanatory notes. Management is responsible for the preparation and fair presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of review
We conducted our review in accordance with International Standard on Review Engagements 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion
Based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of (or “does not present fairly, in all material respects,”) the financial position of the entity as at March 31, 20XX, and of its financial performance and its cash flows for the three month period then ended in accordance with [applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards].

[Practitioner’s signature]
[Date of the practitioner’s report]
[Practitioner’s address]

A **qualified or adverse opinion** should be given where the auditor/accountant believes that the IFI has not been prepared in accordance with the applicable financial reporting framework.
If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should:

- communicate to the appropriate level of management, and to those charged with governance, the difficulty the auditor has in reaching an opinion, and
- consider whether they can issue a report.

If there are uncertainties surrounding going concern, then the auditor should modify their report in a manner consistent with ISA 570 Going concern.

**Modified report**

The following example shows a modified report dealing with a material misstatement based on ISRE 2410:

<table>
<thead>
<tr>
<th>REPORT ON REVIEW OF INTERIM FINANCIAL INFORMATION</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>(Appropriate addressee)</em></td>
</tr>
<tr>
<td><em>(Previous paragraphs as for the standard unqualified report)</em>.</td>
</tr>
</tbody>
</table>

**Basis for Qualified Conclusion**

Based on information provided to us by management, ABC Entity has excluded from property and long-term debt certain lease obligations that we believe should be capitalised to conform with [indicate applicable financial reporting framework]. This information indicates that if these lease obligations were capitalised at March 31, 20X1, property would be increased by Rs.______, long-term debt by Rs.______, and net income and earnings per share would be increased (decreased) by Rs.______, Rs.______, Rs.______, and Rs.______, respectively for the three-month period then ended.

**Qualified Conclusion**

Based on our review, with the exception of the matter described in the preceding paragraph, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of (or “does not present fairly, in all material respects,”) the financial position of the entity as at March 31, 20X1, and of its financial performance and its cash flows for the three month period then ended in accordance with [indicate applicable financial reporting framework, including the reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards].

[Practitioner’s signature]

[Date of the practitioner’s report]

[Practitioner’s address]
3 AGREE-D UPON PROCEDURES

Section overview

- The nature of agreed-upon procedures
- International Standard on Related Services (ISRS) 4400
- Reporting on the agreed-upon procedures

3.1 The nature of agreed-upon procedures

In an agreed-upon procedures engagement, the client that engages also decides the procedures that the accountant will follow.

This is very different from an audit engagement, where the auditor decides the procedures to be followed in order to reach an audit opinion.

- The accountant provides a report on factual findings from the procedures performed. No assurance is provided.
- It is left to the user to assess the procedures and findings and to draw their own conclusions.

The report issued at the end of an agreed-upon procedure should be made available only to those who have agreed the procedures with the auditor/accountant. This is because other people who are unaware of the agreed-upon procedures may misinterpret the meaning of the report.

3.2 International Standard on Related Services (ISRS) 4400

The conduct of agreed-upon procedures is regulated by ISRS 4400. Engagements to perform agreed-upon procedures regarding financial information.

Key points in ISRS 4400 are as follows:

- The terms of engagement for agreed-upon procedures should be set out in an engagement letter. The engagement letter should include:
  - the nature and purpose of the engagement, including a specific clarification that it is not an audit and it is not a review
  - the procedures to be carried out by the accountant, and the information to which the accountant is required to apply these agreed-upon procedures
  - the form of the report to be issued at the end of the engagement, and agreed limitations on the distribution of the report.

- The processes undertaken by the accountant to perform agreed-upon procedures may be similar to those involved in an audit:
  - planning and documentation will be required
  - evidence must be collected
  - conclusions must be reached
  - a report must be prepared.
However, since there is no assurance attached to the assignment, it is likely that the volume of work undertaken by the accountant will be significantly less than for an audit of similar financial information.

### 3.3 Reporting on the agreed-upon procedures

The report of factual findings should contain:

- Title;
- Addressee (ordinarily the client who engaged the auditor to perform the agreed-upon procedures);
- Identification of specific financial or non-financial information to which the agreed-upon procedures have been applied;
- A statement that the procedures performed were those agreed upon with the recipient;
- A statement that the engagement was performed in accordance with the International Standard on Related Services applicable to agreed-upon procedures engagements, or with relevant national standards or practices;
- When relevant a statement that the auditor is not independent of the entity;
- Identification of the purpose for which the agreed-upon procedures were performed;
- A listing of the specific procedures performed;
- A description of the auditor’s factual findings including sufficient details of errors and exceptions found;
- Statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed;
- A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported;
- A statement that the report is restricted to those parties that have agreed to the procedures to be performed;
- A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity’s financial statements taken as a whole;
- Date of the report;
- Auditor's address; and
- Auditor’s signature.
Example: Report at the end of an engagement with agreed-upon procedures
An example of an appropriate report in connection with accounts payable is set out below.

To: The Board of Directors, C B R Manufacturing Company

REPORT OF FACTUAL FINDINGS

We have performed the procedures agreed with you and enumerated below with respect to the accounts payable of C B R Manufacturing Company as at (date), set forth in the accompanying schedules (not shown in this example). Our engagement was undertaken in accordance with the International Standard on Related Services (or refer to relevant national standards or practices) applicable to agreed-upon procedures engagements. The procedures were performed solely to assist you in evaluating the validity of the accounts payable and are summarised as follows.

[Insert a list of agreed upon procedures] – for example:

1. We obtained and checked the addition of the trial balance of accounts payable as at (date) prepared by ABC Company, and we compared the total to the balance in the related general ledger account.
2. We compared the attached list (not shown in this example) of major suppliers and the amounts owing at (date) to the related names and amounts in the trial balance.
3. We obtained suppliers’ statements or requested suppliers to confirm balances owing at (date).
4. We compared such statements or confirmations to the amounts referred to in 2.

For amounts which did not agree, we obtained reconciliations from ABC Company. For reconciliations obtained, we identified and listed outstanding invoices, credit notes and outstanding checks, each of which was greater than xxx. We located and examined such invoices and credit notes subsequently received and checks subsequently paid and we ascertained that they should in fact have been listed as outstanding on the reconciliations.

We report our findings below:

[Insert findings resulting from each of the procedures, with details of exceptions’ as relevant] – for example:

(a) With respect to item 1 we found the addition to be correct and the total amount to be in agreement.
(b) With respect to item 2 we found the amounts compared to be in agreement.
(c) With respect to item 3 we found there were suppliers’ statements for all such suppliers.
(d) With respect to item 4 we found the amounts agreed, or with respect to amounts which did not agree, we found ABC Company had prepared reconciliations and that the credit notes, invoices and outstanding checks over xxx were appropriately listed as reconciling items with the following exceptions:

(Detail the exceptions)
Because the above procedures do not constitute either an audit or a review made in accordance with International Standards on Auditing or International Standards on Review Engagements (or relevant national standards or practices), we do not express any assurance on the accounts payable as of (date).

Had we performed additional procedures or had we performed an audit or review of the financial statements in accordance with International Standards on Auditing or International Standards on Review Engagements (or relevant national standards or practices), other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report and for your information and is not to be used for any other purpose or to be distributed to any other parties. This report relates only to the accounts and items specified above and does not extend to any financial statements of ABC Company, taken as a whole.

AUDITOR
Date
Address
4 COMPILATION ENGAGEMENTS

Section overview

- Nature of a compilation engagement
- International Standard on Related Services (ISRS) 4410
- Reporting on compilation engagements

4.1 Nature of a compilation engagement

In a compilation engagement, the accountant is engaged to prepare financial statements or other information, and not to audit or review the financial statements or other information that has been prepared by someone else. They will therefore use accounting expertise rather than auditing expertise.

An example is the preparation of financial statements for a sole trader or a club or association.

- The accountancy firm is engaged for its accounting expertise, not its auditing expertise.
- No assurance is provided by the accountant who carries out the work.
- The work normally involves the collection and summarising of information.
- A ‘compilation report’ may be issued at the end of the assignment, but some compilation assignments (such as doing a tax calculation for the client) do not require a report.

4.2 International Standard on Related Services (ISRS) 4410

ISRS 4410 (revised) Compilation Engagements regulates the conduct of compilation engagements. The standard was revised in March 2012 following growth in demand from SMEs for services other than audit. Demand has been particularly strong in jurisdictions where audit exemptions have either been introduced or extended.

No assurance is given by the accountant about the information that has been compiled. However the client gains some assurance from the requirement that the accountant for a compilation assignment must comply with professional codes of conduct. The accountant is therefore obliged to exercise due care and technical competence in carrying out the work.

The key points of ISRS 4410 are as follows:

- An engagement letter is required, confirming:
  - that the work to be carried out is not an audit and is not a review
  - that the engagement cannot be relied upon to disclose error, fraud or other irregularities
  - the information on which the assignment will be based (for example, its accuracy and completeness) is the responsibility of the client’s management
  - the intended use and distribution of the information that will be provided at the end of the engagement.
  - the applicable financial reporting framework
• the objective and scope of the engagement
• responsibilities of the practitioner, including the requirement to comply with relevant ethical requirements
• the expected form and content of the practitioner’s report

Planning and documentation will be required for the engagement.

The accountant needs to have adequate knowledge of the client’s business and its operations. This knowledge must also cover the accounting system, accounting records and applicable financial reporting framework.

If the accountant becomes aware that the information provided is unsatisfactory (incomplete, inaccurate or otherwise unsatisfactory), they should ask management to correct or improve the information. If management refuses to do this, the accountant should withdraw from the engagement, and inform the entity accordingly.

The practitioner must obtain an acknowledgement from management or those charged with governance that they take responsibility for the final version of the information.

4.3 Reporting on compilation engagements

ISRS 4410 (revised) Compilation Engagements requires that a written report on the compilation engagement should be provided. Note that the practitioner does not include an opinion within the report because no assurance is provided by a compilation engagement.

The report should contain the following:

- Title
- Addressee
- A statement that the practitioner has compiled the financial information based on information provided by management
- A description of the responsibilities of management, or those charged with governance in relation to the compilation engagement, and in relation to the financial statements
- Identification of the applicable financial reporting framework and, if a special purpose financial reporting framework is used, a description or reference to the description of that special purpose financial reporting framework in the financial information;
- Identification of the financial information, including the title of each element of the financial information if it comprises more than one element, and the date of the financial information or the period to which it relates;
- A description of the practitioner’s responsibilities in compiling the financial information, including that the engagement was performed in accordance with ISRS 4410 (revised) and that the practitioner has complied with relevant ethical requirements
- A description of what a compilation engagement entails
- Explanation that as the compilation engagement is not an assurance engagement, the practitioner is not required to verify the accuracy or completeness of the information provided by management for the compilation
Explanation that the practitioner does not express an audit opinion or a review conclusion on whether the financial information is prepared in accordance with the applicable financial reporting framework

If the financial information is prepared using a special purpose framework an explanatory paragraph that describes the purpose of the financial information and the intended users and draws the readers’ attention to the fact that the information may not be suitable for other purposes

Date of the report

Practitioner’s address

Practitioner’s signature.

Example: Compilation report

An example of a compilation report is provided in the appendix to ISRS 4410 (revised) as set out below:

PRACTITIONER’S COMPILATION REPORT

[To Management of ABC Company]

We have compiled the accompanying financial statements of ABC Company based on information you have provided. These financial statements comprise the statement of financial position of ABC Company as at December 31, 20X4, the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

We performed this compilation engagement in accordance with International Standard on Related Services 4410 (Revised), Compilation Engagements.

We have applied our expertise in accounting and financial reporting to assist you in the preparation and presentation of these financial statements in accordance with International Financial Reporting Standards for Small- and Medium-sized Entities (IFRS for SMEs). We have complied with relevant ethical requirements, including principles of integrity, objectivity, professional competence and due care.

These financial statements and the accuracy and completeness of the information used to compile them are your responsibility.

Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information you provided to us to compile these financial statements. Accordingly, we do not express an audit opinion or a review conclusion on whether these financial statements are prepared in accordance with IFRS for SMEs.

[Practitioner’s signature]

[Date of practitioner’s report]

[Practitioner’s address]
## 5  CHAPTER REVIEW

### Chapter review

Before moving on to the next chapter check that you can:

- Describe the objectives and conduct of review engagements in accordance with ISRE 2400 and 2410
- Describe the objectives and conduct of related services engagements in accordance with ISRS 4400 and 4410
Certified Finance and Accounting Professional
Audit, Assurance and Related Services

CHAPTER 12

Assurance services

Contents

1 Introduction and available guidance
2 The objective and nature of assurance engagements
3 Examples of assurance engagements
4 Prospective financial information
5 Pro forma financial information included in a prospectus
6 Due diligence engagements
7 Chapter review
INTRODUCTION

Learning outcomes

Other assurance engagements and related services (including reporting on relevant services) – Other assurance engagements

D (a) 2  Assurance engagements other than audits or review of historical financial information

D (a) 3  Examination of prospective financial statements

Other assurance engagements and related services (including reporting on relevant services) – Related services

D (b) 3  Assurance engagements to report on the compilation of Pro Forma Financial Information included in Prospectus

Exam context

This is the second of two chapters looking at non-audit services. In this chapter you will learn about assurance engagements performed in compliance with ISAEs 3000, 3400 and 3420.

By the end of this chapter students will be able to:

- Discuss the need for, objective and nature of assurance engagements
- Describe the steps involved in performing an assurance engagement in compliance with ISAE 3000
- Explain the steps involved in performing an examination of prospective financial information in compliance with ISAE 3400
- Explain the steps involved in performing an engagement to report on the compilation of proforma financial information included in a prospectus in compliance with ISAE 3420
1 INTRODUCTION AND AVAILABLE GUIDANCE

Section overview

- The need for assurance services
- Available guidance on assurance engagements
- The International Framework for Assurance Engagements
- Attestation engagements and direct engagements
- International Standard on Assurance Engagements (ISAE) 3000

1.1 The need for assurance services

Traditionally, the ‘assurance’ role of the professional accountant has mainly been concerned with provision of audit services within a statutory framework – the audit of published annual financial statements. An audit provides a high level (but not absolute level) of assurance. The requirement for an audit of the annual financial statements therefore has the objective of adding ‘assurance’ (or ‘credibility’) to the financial statements under audit.

However, the management of companies and other organisations are required or expected to report to stakeholders on a wide range of information, both financial and non-financial, that is not subject to statutory audit. This might include such matters as:

- corporate governance issues, including risk assessment and internal control systems
- e-commerce and the operation of e-commerce activities
- information systems and systems reliability
- performance measurement (both financial and non-financial)
- environmental, social and sustainability concerns
- value for money (VFM)
- compliance with grant or contract conditions.

Although information about these matters may not be subject to a statutory audit, it is often considered important that the information should have credibility. Credibility may be obtained from an assurance report provided by a professionally-qualified accountant.

This chapter deals with:

- the framework for the regulation of assurance reports
- the objectives and key features of an assurance engagement
- specific features of certain specific types of assurance engagement.

1.2 Available guidance on assurance engagements

Guidance on the conduct of assurance engagements is provided by International Standards on Assurance Engagements (ISAEs) in the context of the International Framework for Assurance Engagements.

- International Standard on Assurance Engagements (ISAE) 3000 describes the general approach to assurance engagements.
Further ISAEs provide guidance on applying ISAE 3000 to specific areas, including:

- ISAE 3402 Assurance reports on controls at a service organization
- ISAE 3410 Assurance engagements on greenhouse gas statements
- ISAE 3420 Assurance engagements to report on the compilation of pro forma financial information included in a prospectus.

1.3 The International Framework for Assurance Engagements

The International Framework for Assurance Engagements is a series of pronouncements that came into effect on 1 January 2005.

The Framework makes a distinction between:

- audits and reviews of historical financial information (regulated by ISAs and ISREs), and
- assurance engagements other than audits and reviews of historical financial information. These engagements are regulated by International Standards on Assurance Engagements (ISAEs).

The Framework also makes a distinction between:

- assurance assignments that give a reasonable level of assurance, and
- assurance assignments that give a limited level of assurance.

In assurance engagements it is not possible to give an absolute level of assurance as a result of:

- the lack of precision often associated with the subject matter
- the nature of the evidence available
- the timescale involved.

Reasonable level of assurance

Where a reasonable level of assurance is given, the risk attached to the assignment is at a sufficiently low level to enable the practitioner to give positive assurance.

Reasonable assurance can only be given in the following circumstances:

- the subject matter of the assurance service engagement is the responsibility of another party, and
- the subject matter is identifiable and can be subjected to evidence-gathering techniques.

In other words, a reasonable level of assurance can be given only if the accountant is carrying out an assignment that looks at information that has not been prepared by the accountant (or relates to some other subject matter that is not the responsibility of the accountant). In addition, the accountant must be able to obtain sufficient evidence for giving a positive opinion.

Limited level of assurance

Where only a limited level of assurance is given:

- the risk is higher than that for an engagement where the accountant is able to give a reasonable assurance, but
the risk is sufficiently low to allow for a ‘negative’ expression of the accountant’s conclusions (a negative opinion, as in a review report).

1.4 Attestation engagements and direct engagements

Assurance engagements fall into one of two categories:

- an attestation engagement, and
- a direct reporting engagement.

Attestation engagement

To attest to something means to affirm it or vouch for it. In an attestation engagement, a practitioner is engaged to attest to something. For example, a practitioner might be engaged to attest to the fact that certain procedures within an entity have been performed in a prescribed way. The practitioner will not comment on the quality of the procedures, but will simply attest to the fact that they have been performed.

ISAE 3000 defines an attestation engagement as:

“An assurance engagement in which a party other than the practitioner measures or evaluates the underlying subject matter against the criteria. A party other than the practitioner also often presents the resulting subject matter information in a report or statement. In some cases, however, the subject matter information may be presented by the practitioner in the assurance report. In an attestation engagement, the practitioner’s conclusion addresses whether the subject matter information is free from material misstatement.”

Direct reporting engagement

In a direct reporting engagement, a practitioner is engaged to provide a special report on some aspect of the client’s affairs.

- The report will provide an expression of conclusion (usually providing negative assurance) that is made in accordance with the agreed terms of the engagement.
- The report is prepared after the practitioner has carried out an independent examination of financial information or other information that has been prepared for use by another party.

ISAE 3000 defines a direct reporting engagement as:

“An assurance engagement in which the practitioner measures or evaluates the underlying subject matter against the applicable criteria and the practitioner presents the resulting subject matter information as part of, or accompanying, the assurance report. In a direct engagement, the practitioner’s conclusion addresses the reported outcome of the measurement or evaluation of the underlying subject matter against the criteria.”

So in summary, the practitioner provides assurance in both types of engagement. However, with the direct reporting engagement the practitioner also prepares the assessment of the subject matter on which assurance is also provided. With an attestation engagement it is the client (or some other party other than the practitioner) that prepares the assessment on the subject matter which the practitioner subsequently reviews.
1.5 International Standard on Assurance Engagements (ISAE) 3000

ISAE 3000 Assurance engagements other than audits and reviews of historical financial information sets out basic principles, key procedures and guidance for professional accountants (referred to as ‘practitioners’) when carrying out assurance engagements.

ISAE 3000 was revised and redrafted in 2013 to offer greater assistance and clearer guidance for performing assurance engagements. The revision reflects the increasing demand for assurance engagements other than audits or reviews of historical financial information, particularly in light of the relaxing of mandatory audit thresholds in some countries.

Key general points from ISAE 3000 are set out below.

- **Ethical requirements.** The IFAC ethical code should be followed.
- **Quality control.** Appropriate procedures for quality control of the accountant’s work should be applied to each engagement.
- The engagement should be planned and performed with a degree of **professional scepticism**, recognising that the subject matter of the engagement may be materially misstated.
- Before completion of an assurance engagement, the client may ask for the nature of the engagement to be changed to a ‘non-assurance’ engagement, or for the level of assurance to be reduced. If this happens, the practitioner should consider whether the request is appropriate, and should not agree to the change unless there is a good reason.

The main principles of ISAE 3000 (revised) are explored further in the next section. ISAE 3000 (revised) applies to attestation and direct reporting engagements as well as both reasonable and limited assurance engagements.
2 THE OBJECTIVE AND NATURE OF ASSURANCE ENGAGEMENTS

Section overview

- Objective of an assurance engagement
- The elements of an assurance relationship and an assurance engagement
- Suitable criteria for assessment
- Acceptance and continuance procedures
- Planning and performing the assurance engagement
- Reporting on an assurance engagement

2.1 Objective of an assurance engagement

The objective of an assurance engagement is:

(a) To obtain either reasonable assurance or limited assurance, as appropriate, about whether the subject matter information is free from material misstatement; and

(b) To express a conclusion regarding the outcome of the measurement or evaluation of the underlying subject matter through a written report that conveys either a reasonable assurance or a limited assurance conclusion and describes the basis for the conclusion.

(Note: the accountant who carries out an assurance engagement is called a 'practitioner'.)

2.2 The elements of an assurance relationship and an assurance engagement

An assurance relationship is a three-party relationship between:

- the practitioner (the accountant)
- the party responsible for the subject matter of the engagement
- the intended user of the subject matter of the engagement.

There will be:

- a defined subject matter
- suitable criteria for assessment
- a formal engagement process: typically there is an engagement for the work and the accountant gathers evidence and evaluates it

At the end of the engagement, the accountant prepares a report containing a conclusion based on the evidence that has been gathered and evaluated.

2.3 Suitable criteria for assessment

Suitable criteria are the standards against which the subject matter of the assignment is assessed. This can be a difficult aspect of some assurance assignments.

- Establishing suitable criteria is relatively straightforward where regulations are involved (for example, the law or accounting standards).
The process is more difficult in more subjective assurance engagements, in areas such as customer care or labour relations.

**Example:**
A firm of accountants takes on an engagement to report on the standards of care provided by a state-owned hospital.

What criteria are used to measure the standards of patient care in the hospital?

Suitable criteria might include the mortality rates of patients treated in the hospital. (This might be expressed as the number of patients who die within a specified period of time after treatment.) However, mortality rates are also affected by factors such as the age of patients and the seriousness of their illnesses.

It is, therefore, not certain that mortality rates would be a suitable criterion for assessing the performance of the hospital.

### 2.4 Acceptance and continuance procedures

The practitioner should:

- Ensure that the pre-conditions for an assurance engagement are in place. i.e.:
  - The roles and responsibilities of the appropriate parties are suitable in the circumstances
  - The underlying subject matter is appropriate
  - The criteria that the practitioner expects to be applied in the preparation of the subject matter information are suitable for the engagement circumstances
  - The criteria that the practitioner expects to be applied in the preparation of the subject matter information will be available to the intended users
  - The practitioner expects to be able to obtain the evidence needed to support the practitioner’s conclusion
  - The practitioner’s conclusion, in the form appropriate to either a reasonable assurance engagement or a limited assurance engagement, is to be contained in a written report
  - A rational purpose including, in the case of a limited assurance engagement, that the practitioner expects to be able to obtain a meaningful level of assurance.

- Comply with relevant codes of ethics
- Comply with ISQC 1 (or other professional requirements in law or regulation that are at least as demanding as ISQC 1)
- Ensure the firm has sufficient competence in the underlying subject matter
- Agree the terms of a review engagement with the client setting them out in writing in an engagement letter.
### 2.5 Planning and performing the assurance engagement

- The practitioner should plan the engagement so that it will be performed in an effective manner. This will involve:
  - establishing the scope, timing and direction of the engagement;
  - setting the nature, timing and extent of procedures;
  - considering if the criteria are suitable.

- The engagement should be planned and performed with a degree of **professional scepticism**, recognising that the subject matter of the engagement may be materially misstated.

- The practitioner should obtain an **understanding** of the entity’s business and the industry in which it operates.

- The practitioner shall determine **materiality** and apply this materiality in designing the procedures and in evaluating the results obtained from those procedures.

- The practitioner would normally use, as a minimum, analytical procedures and inquiry.

- Depending on the nature of the engagement and the level of assurance being provided, the practitioner may also use any or all of:
  - Observation
  - Inspection
  - Reperformance
  - Recalculation
  - Confirmation

- The practitioner may consider the use of a practitioner’s expert in the engagement.

- Other procedures that will usually be carried out in an assurance engagement include:
  - obtaining written representations from management:
    - that it has provided the practitioner with all information of which the appropriate party(ies) is aware that is relevant to the engagement, and
    - confirming the measurement or evaluation of the underlying subject matter against the applicable criteria, including that all relevant matters are reflected in the subject matter information
  - making inquiries into subsequent events (when relevant to the engagement)

- Similar to ISA 720, when documents containing the subject matter information and the assurance report thereon include other information, the practitioner shall read that other information to identify material inconsistencies.
Further actions that may be appropriate if the practitioner identifies a material inconsistency or becomes aware of a material misstatement of fact include:

- Requesting the appropriate party(ies) to consult with a qualified third party, such as the appropriate party(ies)’s legal counsel.
- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (for example, a regulator).
- Withholding the assurance report.
- Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.
- Describing the material inconsistency in the assurance report.

2.6 Reporting on an assurance engagement

Whilst audit reports include an audit opinion, assurance reports include an assurance conclusion.

The report prepared by accountants at the end of an assurance engagement will include the following elements:

- A title, indicating that the report is an independent assurance report.
- An addressee (the person or body to which the report is addressed).
- An identification or description of the level of assurance obtained by the practitioner.
- Subject matter of the report, including any relevant information relating to the subject matter reviewed, such as the time period for which the information was gathered.
- Suitable criteria that have been selected for assessment.
- Identification of the responsible party.
- Where appropriate, a statement that the use of the report must be restricted to certain specified users, or that the use of the report should be restricted to a specific purpose for which it was prepared.
- A statement that the engagement was carried out in accordance with ISAEs.
- A statement of compliance with ISQC 1 (or other professional requirements) and the IESBA Code of ethics.
- A summary of the work performed.
- The practitioner’s conclusion.
- The date, signature (name) and address of the practitioner.

As with a statutory audit report, qualifications may be required in the conclusion provided by an assurance report, where the matter involved may be material. These possible qualifications are set out in the table below.
Chapter 12: Assurance services

<table>
<thead>
<tr>
<th>Situation</th>
<th>Impact on the conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inability to obtain sufficient appropriate audit evidence.</td>
<td>A qualified conclusion or disclaimer of opinion.</td>
</tr>
<tr>
<td>The assertion made by the responsible party is not fairly stated.</td>
<td>A qualified or adverse conclusion.</td>
</tr>
<tr>
<td>The subject matter has been materially misstated.</td>
<td>A qualified or adverse conclusion.</td>
</tr>
<tr>
<td>The criteria are unsuitable or the subject matter is not appropriate to an assurance engagement.</td>
<td>- A qualified or adverse conclusion, if users are likely to be misled.</td>
</tr>
<tr>
<td></td>
<td>- Otherwise, a qualified conclusion or disclaimer.</td>
</tr>
</tbody>
</table>

The level of materiality that is attached to the matters giving rise to the qualification in the report is important. This will determine whether the report should be qualified, or whether the accountant should give a disclaimer of opinion or an adverse opinion.
3 EXamples of assurance engagements

section overview

- Engagements relating to risk assessment
- Engagements relating to performance measurement
- Engagements relating to value for money (VFM)
- Engagements relating to systems reliability
- Engagements relating to e-commerce

Some key types of assurance engagement that may be the subject of an examination question are engagements relating to:

- risk assessment
- performance measurement
- value for money (VFM)
- systems reliability, and
- e-commerce matters

3.1 Engagements relating to risk assessment

The concept of business risk assessment was introduced earlier, in the context of auditors using business risk assessments as part of audit approach.

Obviously businesses have systems in place to identify and monitor business risks themselves. Management will distinguish between strategic, operating and information risks. They will analyse risks, considering potential impact on the business and probability of the risk occurring.

When risks have been identified and analysed in this way, management has to come up with strategies to manage risks. There are various strategies.

- If risks are low impact, low probability, then they may well be accepted.
- Higher impact risks must be dealt with, perhaps by taking out insurance against the eventuality (transferring the risk) or by putting in place internal controls to prevent the risk arising (managing the risk).
- If a risk is high impact, high probability it might have to be avoided, for instance, by not taking up the new business opportunity.
- The risks associated with e-commerce particularly are looked at below.

Large companies now typically focus on enterprise-wide risk management rather than dealing with risk individually on a department by department basis (as has traditionally been the case). Companies will employ a head of risk management to oversee a consistent firm-wide risk management strategy.

Assurance on risk assessment

Monitoring risk assessment processes is often a task carried out by internal audit but which could equally be carried out by external parties (such as the audit firm) as an assurance engagement.
3.2 Engagements relating to performance measurement

The nature of performance measurement

All entities should have systems for measuring and monitoring the performance of different aspects of the entity’s operations and activities. Performance measurement reports indicate to management whether the objectives of the entity are being achieved.

Performance is measured and compared with a ‘benchmark’, such as a target or budget, or by comparing actual results with results for the previous years, or results achieved by competitors. Examples of performance measurements include sales (and whether sales targets have been achieved), profit (and whether profit targets have been achieved), cost variances and other budget variances, product quality, customer satisfaction, employee efficiency, capacity utilisation, and so on.

There have been significant developments in performance reporting in recent years.

- Many entities publish some or all of their performance measures.
- A wide range of performance measures may be used, including performance relating to non-financial information (such as product quality or customer satisfaction) as well as financial measures. Non-financial measures might be particularly relevant for not-for-profit organisations.
- In some countries, the government sets performance targets for government departments and publicly-owned entities. (For example in the UK, the government publishes performance tables for schools and hospitals.)

Assurance engagements and performance

A client may ask a practitioner to provide assurance about the way in which performance measurements are calculated and presented. The practitioners will need to consider whether the performance measurement system operates as prescribed and intended.

To perform such an engagement, the practitioner will need to:

- understand the performance measurement system in use
- assess and evaluate it, and
- test the effectiveness of its operation.

3.3 Engagements relating to value for money (VFM)

‘Value for money’ means using resources in the best way in order to achieve intended objectives. There are three aspects to achieving value for money, often known as the ‘3Es’.

- **Economy**. This means spending money carefully, and not paying more than necessary for resources - materials, labour and other expenses.
- **Efficiency**. Efficiency means using resources in such a way that they produce the greatest possible amount of ‘output’. It means getting more from the use of available resources. For example, efficiency in the use of an employee means getting a high rate of output for every hour or day worked.
Effectiveness. Effectiveness means using resources in such a way as to achieve the desired objectives. Efficiency is of little value unless the output from the system is what the entity wishes to achieve.

Entities may use their own internal audit department to carry out value for money (VFM) audits.

Alternatively, an external firm of practitioners may be engaged to carry out a similar task.

Objective of a VFM engagement

The purpose of a VFM engagement is to investigate a particular aspect of an entity’s operations, and reach a conclusion about whether the entity is obtaining value for money.

<table>
<thead>
<tr>
<th>Meaning</th>
<th>Measurement</th>
</tr>
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<tbody>
<tr>
<td>Economy</td>
<td>‘Doing it cheaply’</td>
</tr>
<tr>
<td>Efficient</td>
<td>‘Doing it well’</td>
</tr>
<tr>
<td>Effectiveness</td>
<td>‘Doing the right thing’</td>
</tr>
</tbody>
</table>

The practitioner’s approach to a VFM engagement

The approach to performing a VFM engagement is summarised below.

- For the particular aspect of operations that is the subject of the investigation or ‘audit’, the practitioner should identify and develop methods of measuring the 3Es – measurements of economy, efficiency and effectiveness.

- It is often necessary to assess the 3Es by making comparisons. The practitioner should therefore establish an appropriate basis for making comparisons (such as economy, efficiency and achievements in previous periods, comparisons with other entities, comparisons with targets, and possibly comparisons with national averages).

- Having gathered and analysed measurements of the 3Es, the practitioner should reach a conclusion. Are the 3Es being achieved for the operations that have been the subject of the investigation?

- If appropriate, the practitioner should identify areas of weakness and make appropriate recommendations to the client about improvements that should be made.

3.4 Engagements relating to systems reliability

Even if an entity is not specifically involved in e-commerce activities, it is likely that a large part of its internal information processing will be computer-based. Major systems failure would therefore make it difficult for many entities to operate effectively, especially if they use on-line systems (network systems) for their transaction processing.

Management and other stakeholders may therefore engage a practitioner to give assurance on the effective and secure operation of their computer systems.
The general approach that the accountant should take for these assurance engagements is similar to the approach to be taken for e-commerce activities which we shall look at below. However, the accountant’s work will focus more on identifying, evaluating and testing controls within the company’s information systems. (The web site aspects that are important for e-commerce engagements are less significant for engagements relating to systems reliability.)

- Computer-assisted audit techniques (CAATs) such as audit software and test data are likely to be used by the accountant to carry out the work. CAATs were described in an earlier chapter.

### 3.5 Engagements relating to e-commerce

Entities may use information technology to conduct business transactions, using:

- e-commerce, or
- electronic data interchange (EDI). EDI is the process of transferring documents between the computer systems of different entities. An extension of EDI, known as SET (secure electronic transmission) is used to process money transfers electronically for credit cards and debit cards.

E-commerce is a general term that refers to trading electronically, at distances between the buyer and seller. Business transactions take place electronically, rather than face-to-face, or in a paper-based system. Rapid developments in information technology in recent years have led to substantial growth in the volume of e-commerce. Most e-commerce activity is carried out over the Internet, with customers buying goods or services through the web sites of sellers.

An important aspect of e-commerce is that users of an e-commerce system need to have trust in the integrity of the system. This means that a customer buying from a remote seller must be confident that the seller is ‘genuine’ and will deliver the goods that the buyer purchases. Similarly, the seller needs to be confident that the buyer has properly identified themself and can be trusted to pay.

Both the buyer and the seller need to be confident that the details of their transaction will not be ‘intercepted’ by a third party, because they want the details of the transaction to be kept confidential. For example the name and credit card number of the buyer has to be kept confidential, and there must be no risk of an unauthorised person intercepting and then making use of the buyer’s credit card details.

#### Risk and risk management with e-commerce

Risks arise from the use of e-commerce systems, such as:

- a loss of transaction integrity
- increased security risks with ‘remote’ trading than with face-to-face trading or paper-based trading transactions
- the use of inappropriate accounting policies (for example, in respect of the capitalisation of website development costs)
- legal and regulatory risks: this is the risk, for example, that e-commerce activities may be breaking the law in some countries.

In addition, the internal controls for an e-commerce system may be efficient, but **there may not be an adequate audit trail** for checking transactions and confirming that the controls are efficient.
Management responsibility for e-commerce risks

As in all risk situations, management should evaluate the risks to which the entity is exposed and take appropriate action to manage those risks. The general approach that should be taken is summarised below.

- Management should carry out risk assessment exercises on a regular basis.
- Management should create an appropriate control environment, including an information systems security policy.
- The entity should make appropriate use of an internal audit function, to obtain assurance that the e-commerce system is functioning properly.
- There should be adequate audit trails for e-commerce transactions.
- The entity should keep up-to-date back-up copies of data files.
- For some systems, it may be appropriate to use encryption for data: encryption involves the electronic conversion of data into a secure coded language for transmission, so that it will be incomprehensible to anyone who intercepts it in transmission.
- The system user should comply with generally-recognised standards and register with the Web Trust or a similar organisation.

Note: The Web Trust is an organisation established to provide confidence to customers using e-commerce. The Web Trust gives a seal of approval to web sites, and customers who use a web site that has the Trust’s seal of approval can have confidence that their transactions are secure. Specially-licensed accountants grant the seal (which has to be renewed every three months), on behalf of the Trust. The accountants confirm that the controls operated by the site comply with the regulations of the Trust.

The e-commerce ‘audit’

A firm of accountants may be engaged by a client to provide assurance about the integrity of transactions on the client’s web site, and that the client’s e-commerce system is suitably protected from risk.

Performing an assurance engagement on electronic processing systems provides additional challenges for auditors. These include:

- the need for specialist knowledge about e-commerce systems
- problems that may arise when some aspects of the e-commerce system (such as the electronic payments system) are outsourced by the client to another entity
- the role of the client’s internal auditors in monitoring the integrity of the e-commerce system
- the need for specialist controls (general and application controls) for the system
- possible problems of independence and conflicts of interest, if the audit firm was involved in designing or setting up the e-commerce system that is now subject to ‘audit’.
The audit approach to an e-commerce system should include the following elements:

- First of all, the audit firm should decide whether the engagement should be accepted (as in any professional engagement).
- The firm should then plan the engagement: an important aspect of planning may be to make available audit staff with appropriate expertise in e-commerce systems.
- The firm should obtain a detailed knowledge of the client’s business.
- It should consider liaison with the internal auditors of the client, if there have been internal audit investigations into the client’s e-commerce transactions or system.
- The firm should identify and evaluate the risks in the system.
- It should ascertain and evaluate the control environment and the specific internal controls that are in operation.
- It may also be appropriate to perform a going concern review, particularly in the case of entities that rely mainly on e-commerce activities for their income.
4 PROSPECTIVE FINANCIAL INFORMATION

Section overview

- The nature of prospective financial information (PFI)
- ISAE 3400: The examination of prospective financial information
- Reporting on PFI

4.1 The nature of prospective financial information (PFI)

Traditionally, the role of the auditor has focused on providing assurance on ‘historical’ events, for example on financial statements relating to a period of time in the past.

When an auditor examines historical data, there is usually factual evidence to support the reported figures. This evidence will often come from events that have taken place since the financial statements were produced. For example, receivables may subsequently have been paid, inventories may subsequently have been sold, providing evidence that trade receivables were correctly valued in the statement of financial position, and that inventory was also correctly valued. This evidence is critical to the audit process.

As business and economic environments have changed, demand has grown for professional accountants to provide assurance on information relating to the future. Such information is known as prospective financial information (PFI).

PFI is widely used both within an entity (internally) and externally.

- **Internally**, forecasts and projections are widely used as a form of management information. Examples include forecasts and projections relating to:
  - revenue
  - capital expenditure
  - revenue expenditure
  - profits
  - cash flows
  - working capital
  - going concern assumption of the entity
  - deferred tax asset recoup (to assess whether future taxable profits exist)

- **External** uses include:
  - profit forecasts, for providing to the stock market
  - forecasts of cash flows, to support an application for a loan from a bank
  - profit forecasts to support or defend take-over bids.

The auditing profession has traditionally been cautious about expressing a firm opinion on financial information relating to a future period.
However, when an audit firm undertakes this type of work, the work (on PFI) is closely regulated. For example, accountants are required to use very careful wording in their reports on PFI.

**Definitions**

**Prospective financial information** (PFI). PFI is financial information based on assumptions:
- about events that may occur in the future, and
- possible actions by an entity.

**Forecast**: A forecast is PFI prepared on the basis of assumptions about:
- future events that management expect to take place, and
- the actions that management expect to take.

The assumptions that are used by management to prepare a forecast are called ‘**best estimate assumptions**’.

**Projection**: A projection is PFI prepared on the basis of:
- **hypothetical assumptions** about future events and management actions that are not necessarily expected to take place, or
- a mix of best estimate and hypothetical assumptions.

A forecast is therefore a best estimate of what is expected to happen, and a projection is an estimate of what is likely to happen if certain conditions or events were to happen. Both are distinguished from a ‘target’, which is what management want to happen.

**4.2 ISAE 3400: The examination of prospective financial information**

ISAE 3400 *The examination of prospective financial information* is the main source of regulation in this area. It provides guidance on:
- the examination of PFI, and
- reporting on PFI.

It focuses mainly on **numerical information** and numerical forecasts or predictions.

**Accepting a PFI assurance engagement**

Many of the points relevant to deciding whether to accept any audit or assurance engagement will apply to accepting a PFI assurance engagement. Issues to consider will include, for example:
- the availability of resources and staff with the necessary expertise;
- the timescale for the completion of the engagement, and
- agreeing a fee for the work with the client.

The accountant should also establish with the client the form that the assurance report should take. It is particularly important that the client should understand that in a review of forward-looking information, only negative assurance can be provided.

The client should also be informed that the practitioner will comply with the requirements of ISAE 3400 when reviewing the prospective financial information.
An engagement letter should be agreed and signed by both parties before the work is actually started.

**Procedures in a PFI assurance engagement**

There are several specific points that might apply to PFI engagements:

- understanding the nature of the information to be examined
- establishing the intended use of the information (and the intended recipients of the final report)
- establishing whether the information will be for general distribution or limited distribution to a small number of users
- the nature of the assumptions that have been made by management (whether they are best estimate assumptions for a forecast, or hypothetical assumptions for the purpose of making a projection)
- the time period covered by this information.

When deciding the nature, timing and extent of the procedures required to complete a PFI assurance engagement, the auditor should consider the following issues:

- The likelihood of material misstatement in the forecast or projection.
- The knowledge that the auditor has obtained during any previous similar engagements.
- The competence of the client’s management with regard to the preparation of PFI.
- The extent to which the PFI is affected by management’s judgement (in other words, to what extent does the PFI depend on judgement about best estimates or hypotheses).
- The adequacy and reliability of the underlying data and assumptions that have been used as the basis for preparing the prospective financial information.

The general approach to the assurance work should be similar to the approach for audit work or other assurance work, but with some modifications to allow for the specific nature of the work. Furthermore, given the reduced level of authoritative evidence available (given prospective information relates to the future) procedures are normally limited to:

- Analytical review
- Verification of projections, estimates and forecasts

Specific procedures will include the following:

- Where the practitioner has no previous knowledge of the entity, it should obtain sufficient knowledge of the entity and its environment.
- If best estimate assumptions have been used in preparing the PFI (a forecast), the auditor should seek evidence to support these estimates.
- If hypothetical assumptions have been used (to prepare a projection), the auditor should assess whether they are realistic and sensible, and whether the full implications of the hypothetical assumptions have been properly reflected in the PFI.
The practitioner should assess whether the PFI contains all the relevant material items and that nothing of significance has been omitted.

If part of the ‘future period’ in the forecast or projection has already passed, the auditor should review the actual results for that part of the period, and compare actual results with the forecast or projection. The differences will help the auditor to assess the reliability of the forecast or accuracy of the projection.

The practitioner should also check the arithmetical accuracy and consistency of the projected financial information that has been prepared.

The practitioner should obtain representations from management on:
- management’s acceptance of responsibility for the information
- the intended use of the information
- the completeness of the assumptions that were made to prepare the PFI.

Example 1: Profit forecast

Procedures relating to a profit forecast that the entity will use in support of a bank loan application might be as follows:

- Understand the basis of the forecast (by asking the person who prepared it). Then test the calculation of the forecast according to its method (for example, if it has been extrapolated from previous results, re-perform the arithmetic of the extrapolation).
- Consider whether the assumptions in the forecast are consistent with each other (for example, will sales grow at that rate without additional marketing costs?).
- Consider whether the forecast is reasonable in the light of known facts such as:
  - Current economic circumstances
  - Past trading history
- Discuss the key variables and sensitivities with management. Often, key assumptions will be estimates of sales demand and sales price, and the gross profit ratio. The auditor should establish the basis on which these estimates have been made.
- Review internal consistency of forecast (for example, has the same interest rate been used throughout the forecast, has the same growth rate been applied to sales and purchases?)
- Compare assumptions and bases for forecasting with information used internally (for example, by the marketing department)
- Compare figures with other forecasts to ensure consistency (for example, depreciation should appear in both profit forecast and capital expenditure forecast)
- Compare figures with any available evidence – for example, costs may be compared to quotations for work to be done. Assess costs for reasonableness. For example if the profit forecast includes estimates of advertising and marketing costs, do these seem reasonable in comparison with the value of sales turnover and other operating costs?
Consider whether all items of cost have been included. For example if the profit forecast involves the launch of a new product, have all the initial running costs been included, such as initial marketing costs and set-up costs for operations.

Consider whether the forecast of the amount of finance required allows for working capital.

Check that the forecast of profit and cash flows includes the cost of borrowed finance.

Check that forecasts of costs and revenues allow for estimated inflation.

It would also be appropriate to carry out some sensitivity analysis of the forecasts of revenues, costs and profits, to establish the extent to which estimates in the forecast would need to differ before the forecast profit turns into a forecast of loss.

**Tutorial note:** If you are asked in your examination to list procedures in relation to a particular forecast, you should think what that forecast will contain and what it will not contain. For example, a cash flow forecast will not include amounts for depreciation.

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**Example 2: Youth hostel**

Salma plans to purchase a dilapidated residential property and convert it into a youth hostel. The property has been empty for a number of years and is in a poor state of repair. Significant structural alterations (building work) and refurbishment are required.

Salma has prepared a capital expenditure forecast and asked you to check it prior to submission to the bank in order to secure finance for the project.

**Required**

Describe the procedures you would carry out on the capital expenditure forecast.

**Solution**

- Read solicitors’ correspondence and realtor’s details and compare them with the capital expenditure forecast. Ensure that all expenses (e.g. surveyors’ fees, legal costs, purchase taxes and sale price) are included.
- Compare the forecast building and decoration costs to quotations provided by suppliers.
- Confirm new furnishing cost estimates to supplier quotations or price lists.
- Confirm the forecast cost of specialist equipment needed to furnish a youth hostel (e.g. kitchen and fire equipment) to suppliers’ websites, price lists or quotations (including any discounts available).
- Check discounts incorporated in the forecasts would be applied to this project by verifying their application to the youth hostel project with suppliers.
- Consider whether all relevant costs are included given experience of similar ventures.
4.3 Reporting on PFI

Given the subjective nature of prospective financial information it is impossible for a practitioner to provide the same reasonable level of assurance as provided in an audit. Practitioners therefore normally provide limited assurance in a prospective financial information assignment.

The limited assurance would be expressed negatively as to whether the assumptions provide a reasonable basis for the prospective financial information. The practitioner should also caveat the achievability of the forecasts.

A report from the audit/accountancy firm on PFI should contain the following elements:

- Title
- Addressee
- Identification of the PFI (for example by page references to pages in same document as the report, where the PFI can be found).
- A reference to the ISAE.
- A statement that management is responsible for the PFI, including the assumptions on which it is based.
- A reference to the purpose of the PFI and/or the restricted distribution of the report (and the PFI) to a limited number of users.
- A statement of negative assurance as to whether the assumptions that management have made provide a reasonable basis for the PFI.
- An opinion as to whether the PFI is properly prepared on the basis of these assumptions, and whether the PFI is presented in accordance with the relevant financial reporting framework.
- The report should also contain warnings (caveats) that the PFI is a forecast or projection, and the results indicated by the PFI might not be achieved.
- Date, address and signature of the accountant/auditor.

When the practitioner believes that the presentation and disclosure of the prospective financial information is not adequate, the practitioner should express a qualified or adverse opinion in the report on the prospective financial information, or withdraw from the engagement as appropriate.
### Example: Unmodified report on a forecast

The following is an example of an extract from an unmodified report on a forecast.

**REPORT ON A FINANCIAL FORECAST**

**To the Board of Directors of Entity AZ**

We have examined the forecast [Include name of the entity, the period covered by the forecast and provide suitable identification, such as by reference to page numbers or by identifying the individual statements] in accordance with the International Standard on Assurance Engagement 3400.

**Management is responsible for the forecast** including the assumptions set out in Note X on which it is based.

Based on our examination of the evidence supporting the assumptions, **nothing has come to our attention** which causes us to believe that these assumptions do not provide a reasonable basis for the forecast. Further, in our opinion **the forecast is properly prepared on the basis of the assumptions and is presented in accordance with** [indicate the relevant reporting framework].

**Actual results are likely to be different** from the forecast since anticipated events frequently do not occur as expected and the variation may be material.

**PRACTITIONER**

**Address**

**Date**
Example: unmodified report on a projection

REPORT ON A FINANCIAL PROJECTION

To the Board of Directors of Entity AZ

We have examined the projection [Include name of the entity, the period covered by the projection and provide suitable identification, such as by reference to page numbers or by identifying the individual statements] in accordance with the International Standard on Assurance Engagements 3400.

Management is responsible for the projection including the assumptions set out in Note X on which it is based.

This projection has been prepared for (describe purpose). As the entity is in a start-up phase the projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management’s actions that are not necessarily expected to occur. Consequently, readers are cautioned that this projection may not be appropriate for purposes other than that described above.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the projection, assuming that (state or refer to the hypothetical assumptions). Further, in our opinion the projection is properly prepared on the basis of the assumptions and is presented in accordance with [Indicate the relevant financial reporting framework].

Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to be different from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

PRACTITIONER
Address
Date

The auditor may not be in a position to issue an unqualified report. In these circumstances, and after due consideration, the auditor may issue:

- a qualified report, or
- an adverse report, or
- they may decide to withdraw from the engagement.
PRO FORMA FINANCIAL INFORMATION INCLUDED IN A PROSPECTUS

Section overview

- Reporting on the compilation of pro forma financial information
- ISAE 3420 Assurance engagements to report on the compilation of pro forma financial information included in a prospectus
- Illustrative assurance report (ISAE 3420)

5.1 Reporting on the compilation of pro forma financial information

Increasing globalisation of capital markets has made it important for the financial information used in capital market transactions to be understandable across borders and for assurance to be provided to enhance users' confidence in how such information is produced.

Given this trend the IAASB issued ISAE 3420 Assurance engagements to report on the compilation of pro forma financial information included in a prospectus in December 2011.

5.2 ISAE 3420 Assurance engagements to report on the compilation of pro forma financial information included in a prospectus

The nature of an ISAE 3420 engagement includes the following:

- The practitioner provides reasonable assurance on the responsible party's (i.e. the client's) compilation of pro forma financial information included in a prospectus.
- The practitioner has no responsibility to compile the pro forma financial information for the entity; such responsibility rests with the responsible party (the client).
- Applying ISAE 3420 involves evaluating the overall presentation of the pro forma financial information.
- The engagement, however, does not involve the practitioner updating or reissuing any reports or opinions on any historical financial information used in compiling the pro forma financial information, or performing an audit or review of the financial information used in compiling the pro forma financial information.
- The objectives of the practitioner in an ISAE 3420 engagement are:
  - to obtain reasonable assurance about whether the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria; and
  - to report in accordance with the practitioner's findings.
### 5.3 Illustrative assurance report (ISAE 3420)

**INDEPENDENT PRACTITIONER’S ASSURANCE REPORT ON THE COMPILATION OF PRO FORMA FINANCIAL INFORMATION INCLUDED IN A PROSPECTUS**

[Appropriate Addressee(s)]

**Report on the Compilation of Pro Forma Financial Information Included in a Prospectus**

We have completed our assurance engagement to report on the compilation of pro forma financial information of ABC Company by [the responsible party]. The pro forma financial information consists of [the pro forma net asset statement as at [date]], [the pro forma income statement for the period ended [date]], [the pro forma cash flow statement for the period ended [date]], and related notes [as set out on pages xx–xx of the prospectus issued by the company]. The applicable criteria on the basis of which [the responsible party] has compiled the pro forma financial information are [specified in [Securities Regulation XX] and described in [Note X]]/[described in [Note X]].

The pro forma financial information has been compiled by [the responsible party] to illustrate the impact of the [event or transaction] [set out in Note X] on the [company’s financial position as at specify date] [and] [the company’s/its financial performance [and cash flows] for the period ended specify date] as if the [event or transaction] had taken place at [specify date] [and specify date respectively]. As part of this process, information about the company’s [financial position], [financial performance] [and cash flows] has been extracted by [the responsible party] from the company’s financial statements [for the period ended [date]], on which [[an audit]/[a review report]/[no audit or review report] has been published.

**[The Responsible Party’s] Responsibility for the Pro Forma Financial Information**

[The responsible party] is responsible for compiling the pro forma financial information on the basis of the [applicable criteria].

**Practitioner’s Responsibilities**

Our responsibility is to express an opinion [, as required by [Securities Regulation XX],] about whether the pro forma financial information has been compiled, in all material respects, by [the responsible party] on the basis of the [applicable criteria].

We conducted our engagement in accordance with International Standard on Assurance Engagements (ISAE) 3420, Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus, issued by the International Auditing and Assurance Standards Board. This standard requires that the practitioner comply with ethical requirements and plan and perform procedures to obtain reasonable assurance about whether [the responsible party] has compiled, in all material respects, the pro forma financial information on the basis of the [applicable criteria].

For purposes of this engagement, we are not responsible for updating or reissuing any reports or opinions on any historical financial information used in compiling the pro forma financial information, nor have we, in the course of this engagement, performed an audit or review of the financial information used in compiling the pro forma financial information.
The purpose of pro forma financial information included in a prospectus is solely to illustrate the impact of a significant event or transaction on unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration. Accordingly, we do not provide any assurance that the actual outcome of the event or transaction at [specify date] would have been as presented.

A reasonable assurance engagement to report on whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria involves performing procedures to assess whether the applicable criteria used by [the responsible party] in the compilation of the pro forma financial information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction, and to obtain sufficient appropriate evidence about whether:

- The related pro forma adjustments give appropriate effect to those criteria; and
- The pro forma financial information reflects the proper application of those adjustments to the unadjusted financial information.

The procedures selected depend on the practitioner’s judgment, having regard to the practitioner’s understanding of the nature of the company, the event or transaction in respect of which the pro forma financial information has been compiled, and other relevant engagement circumstances.

The engagement also involves evaluating the overall presentation of the pro forma financial information.

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

**Opinion**

In our opinion, [the pro forma financial information has been compiled, in all material respects, on the basis of the [applicable criteria]]/[the pro forma financial information has been properly compiled on the basis stated].

**Report on Other Legal or Regulatory Requirements**

[Relevant law or regulation may require the practitioner to express an opinion on other matters. The form and content of this section of the practitioner’s report will vary with the nature of such other reporting responsibilities.]

**PRACTITIONER**

Date

Address
6  DUE DILIGENCE ENGAGEMENTS

Section overview

- Due diligence engagements

6.1  Due diligence engagements

One of the most common forms of audit-related review services is ‘due diligence’ work. This term refers to any engagement where the practitioner is engaged to make inquiries into the accounts, organisation or activities of an entity.

Due diligence is not governed by a specific standard and therefore can be interpreted in a number of ways. In practice a due diligence engagement would be conducted in accordance with whichever standard best fits the particular engagement being conducted e.g.

- As a review engagements in accordance with ISRE 2400
- As an assurance engagement in accordance with ISAE 3000
- As a related services engagement (e.g. agreed-upon procedures) in accordance with ISRS 4400.

Due diligence work is most commonly referred to in the context of mergers and takeovers. The work involves obtaining information about the target company, prior to the takeover (or merger). The objective should be to find out everything that may be relevant about the target company’s operations, financial performance, financial position and future prospects. In addition, information should also be gathered about the business environment in which the target company operates.

The practitioner will also interview the senior management of the target company as well as other key employees and possibly external third parties. Due diligence work does not involve tests of controls (unless the client specifically asks for this), nor does it involve substantive testing. Due diligence work is not a form of audit work.

The main objective of due diligence is therefore often to provide information that will allow the client to:

- decide whether a takeover or merger is actually desirable, and
- if so, whether the proposed cost of the acquisition is reasonable.

An adverse or critical due diligence report may therefore result in:

- abandoning a proposed takeover or merger, or
- reducing the offer price for the acquisition.

Items to investigate in a due diligence exercise

Financial performance and financial position. The practitioner will look at the available historical financial information about the target company, such as its financial statements for the past few years. Ratio analysis will often be used to make an assessment. The practitioner will also look at the target company’s management accounts, budgets and profit/cash flow forecasts, and at any current business plan.
Operational issues. The practitioner should also look for any operational issues in the target company that may raise questions about its value. For example, the target company might have important contracts with major customers, and the practitioner should try to find out when these contracts reach their termination date and what the probability that the contracts will be renewed is. Other operational problems may be discovered, such as a high rate of labour turnover, or high costs incurred in meeting warranties or guarantees to customers.

Management representations. Management of the takeover target may have provided representations to the potential buyer. For example, they might have given a written assurance that the target company is not subject to any tax investigation or potential litigation. Due diligence work should seek to establish that these representations appear to be correct.

Identification of assets. A takeover usually results in purchased goodwill in the consolidated accounts. However, the takeover target may have several intangible assets that do not appear in its statement of financial position (because they were internally-generated assets) but which should be recognised for the purpose of consolidation. Examples are internally-generated patent rights, customer lists and databases and brand names. These should be identified and valued, for inclusion in the consolidated statement of financial position after the acquisition. It is also useful for the management of the potential buyer to be aware of the nature and estimated value of the intangible assets that they would be acquiring.

Benefits and costs of a takeover. Due diligence may also include an attempt to estimate the future benefits of the takeover, such as cost savings from synergies such as economies of scale. Any ‘one off’ expenses such as redundancy costs and reorganisation costs will have to be estimated.

Benefits of using an audit firm for due diligence

There is no reason why an accountancy firm should not be engaged to carry out due diligence. Management could do some or all the work themselves. However, using an accountancy firm to do the work has two potential benefits:

- Hiring an accountancy firm to do the work saves management time for the potential buyer. In addition, the practitioners assigned to the due diligence work should have suitable experience in this type of work. For large takeover, the amount of time and resources required to carry out proper due diligence can be substantial.

- Using a professional firm to do due diligence may help to reassure shareholders in the potential buyer (or investors who will be asked to provide loan finance for the takeover) that the acquisition has been properly evaluated.

Examples of due diligence engagements

Practical examples include:

- Financial due diligence
- Personnel due diligence
- Environmental due diligence
- Regulatory due diligence
- Operational and IT due diligence.
CHAPTER REVIEW

Before moving on to the next chapter check that you can:

- Discuss the need for, objective and nature of assurance engagements
- Describe the steps involved in performing an assurance engagement in compliance with ISAE 3000
- Explain the steps involved in performing an examination of prospective financial information in compliance with ISAE 3400
- Explain the steps involved in performing an engagement to report on the compilation of proforma financial information included in a prospectus in compliance with ISAE 3420
CHAPTER 13

Internal audit and outsourcing

Contents

1 The nature and development of internal auditing
2 Types of internal audit
3 Outsourcing
4 Chapter review
INTRODUCTION

Learning outcomes

Performance of audit - specific
A (b) 3 Entities using service organizations

Audit conclusions and reporting
B 6 Assurance Reports on Controls at a Service Organization

Exam context

This short chapter deals with two discrete topics – internal audit, and outsourcing. You will learn about the type of work that an internal audit department typically performs and the reports they typically produce. The chapter also articulates the difference between internal and external audit.

This chapter also looks at outsourcing – what it is and how it works - as well as its advantages and disadvantages. You will see how a client’s outsourced operations impact the audit and the subsequent audit approach that should be adopted in accordance with ISA 402.

By the end of this chapter students will be able to:

■ Describe the function of internal audit and differentiate between internal and external audit
■ Explain the difference between financial, operational and compliance audits
■ Discuss which functions may be outsourced and the relative advantages and disadvantages of outsourcing
■ Explain the audit considerations per ISA 402 relating to entities using service organisations and the nature of type 1 and type 2 reports as included in ISAE 3402
1 THE NATURE AND DEVELOPMENT OF INTERNAL AUDITING

Section overview

- Definition of internal audit
- Reasons for the development of internal auditing
- Typical functions of internal audit
- Comparison of external and internal audit

1.1 Definition of Internal audit

The role of the internal audit function has been defined as:
‘….an appraisal system established by management for the review of the accounting and internal control systems as a service to the entity.’

There are several parts to this definition:
- Internal auditing is an appraisal system.
- It is established by management as a service to the entity.
- It involves the review of accounting systems.
- It also involves the review of internal control systems, which are systems for financial controls, operational controls and compliance controls.

Internal auditing is a separate and distinct branch of the accounting profession. The role of internal auditing has become more significant in larger entities and is now seen as an important management tool.

1.2 Reasons for the development of internal auditing

The main reasons for the importance of the internal audit function are as follows:
- Internal audit helps management to monitor the controls within their entity. As entities increase in size and complexity, and become global in nature, the task of monitoring controls becomes more difficult. An internal audit function helps management to monitor these controls.
- Similarly, as markets become increasingly competitive, it is important that entities should be very competitive themselves. This means using resources efficiently and effectively. An internal audit function can be used to monitor the efficiency of operations.
- In many countries there is a large amount of statutory and accounting regulation, including corporate governance regulation. An internal audit function can be used by management to check on compliance with laws and regulations.
- Many entities use complex IT systems. Specialist internal auditors can help management to review the effectiveness of controls within IT systems (by means of IT audits).
- The increasing cost of the external auditor’s services means that it may be cheaper to use internal auditors to perform audit tasks whenever possible. (The reliance of external auditors on work done by internal auditors is considered later. However, an internal audit department may be used for work not related to the external audit that might otherwise be given to an external firm of accountants as non-audit work.)
There is no legal requirement for an entity to establish an internal audit function. The fact that many organisations do so indicates that there are significant benefits to be gained.

For companies that operate over multiple sites, internal audit may be an essential tool for effective management. Senior management can use an internal audit department to carry out ‘external’ checks on its operational departments. Random visits or surprise visits by internal auditors may be used to confirm that all locations are applying internal controls properly, and are complying with relevant laws and regulations. The largest locations, or locations where there is a high risk of control failure, may be visited more frequently by the internal auditors.

1.3 Typical functions of internal audit

The scope and objectives of internal audit vary widely, and depend on:

- the size and structure of the entity, and
- the requirements of its management.

However, internal audit activities usually include one or more of the following:

- **Monitoring of internal control.** Senior management need to reassure themselves that internal controls are functioning effectively. In a large organisation, they do not have the time to carry out this task personally, for example through observation. Monitoring controls, and making sure that the controls are working properly, needs attention on a continuous basis. An internal audit department is usually given the specific responsibility by management for reviewing controls, monitoring their operation and recommending improvements.

- **Examination of financial and operating information.** An internal audit department might be given the responsibility for a detailed examination of financial and operating information, and in particular, its reliability and usefulness. Internal auditors may investigate how information is identified, measured, classified and reported, and recommend improvements where appropriate. The audit work may involve investigations into specific items of information, including the detailed testing of transactions, balances and procedures.

- **Review of the economy, efficiency and effectiveness of operations,** including non-financial controls of an entity. Audits of economy, efficiency and effectiveness can be carried out on any aspect of operations, and are usually called value for money (VFM) audits.

- **Review of compliance.** Senior management may ask the internal auditors to check that operational departments are complying properly with certain laws, regulations and other external requirements, or with management policies and directives and other internal requirements. These investigations are often called ‘compliance audits’.
1.4 Comparison of external and internal audit

Internal and external auditors will often carry out their work using similar procedures. However, there are a number of fundamental differences between the two audit roles. These are summarised in the following table:

<table>
<thead>
<tr>
<th>Factor</th>
<th>External audit</th>
<th>Internal audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Role</td>
<td>To express an opinion on the truth and fairness of the annual financial statements</td>
<td>To examine systems and controls and assess risks in order to make recommendations to management for improvement.</td>
</tr>
<tr>
<td>Qualification to act</td>
<td>Set out by statute.</td>
<td>No statutory requirements – management select a suitably competent person.</td>
</tr>
<tr>
<td>Appointed by</td>
<td>The shareholders</td>
<td>Management</td>
</tr>
<tr>
<td>Duties set out by</td>
<td>Statute</td>
<td>Management</td>
</tr>
<tr>
<td>Report to</td>
<td>The shareholders</td>
<td>Management</td>
</tr>
</tbody>
</table>
2 TYPES OF INTERNAL AUDIT

Section overview

- Introduction
- Financial audits
- Operational audits
- Compliance audits

2.1 Introduction

Internal auditors may be involved in ‘financial’ audits, focusing on the audit of items in the income statement/statement of comprehensive income and statement of financial position. When the internal auditors perform this type of work, they may duplicate work that the external auditors might otherwise be expected to do. The external auditors might therefore be able to rely on the work of the internal auditors in reaching their audit conclusion. This was considered in Chapter 8.

However, the internal audit function often has a much wider role than simply performing financial audits, and in many entities (particularly large entities) the internal auditors are involved in other aspects of auditing, such as:

- **energy audits**: these are checks on how the entity is making use of energy and whether its operations are energy-efficient
- **social audits**: these are checks on the impact of the entity on the society in which it operates
- **environmental audits**: these are checks on the effect the entity is having on its natural environment, and considers issues such as the use of sustainable materials, re-cycling, reducing pollution, and so on
- **human resource audits**: these are audits into the work force of an entity, to check whether the entity has adequate systems for the recruitment, training and development of employees to meet its current and future needs.

2.2 Financial audits

Performing financial audits is the traditional role of the internal auditor. Internal auditors may be asked by management to review accounting records and other records to substantiate figures appearing in financial statements and management accounts.

This work overlaps with the work of the external auditor. Consequently, this aspect of internal audit work is now seen as a relatively minor part of the total work of an internal audit department.

However, it is important to remember that by performing financial audits, the internal auditor is able to look at the internal controls that are in place to minimise risks, to identify weaknesses and to recommend improvements in the internal control system.
2.3 Operational audits

Operational audits examine the entity’s internal control procedures and whether or not the control systems that have been established by management are operating effectively. As a result of the audit, the internal audit department will make recommendations to management for improvements to the system or the way in which it is operated.

The value for money (or VFM) audit was described in an earlier chapter as an assurance service that might be performed for a client by an external accountancy firm. VFM audits may also be carried out by the internal audit department.

Finding the best possible combination of the 3Es is seen as a strategy for maximising profit performance. It is not usually possible to achieve objectives (effectiveness) by using the cheapest resources (economy) in the most productive way possible (efficiency). Sometimes, greater efficiency can only be achieved by spending more, so a balance must be found between economy and efficiency. Sometimes, the benefits of greater effectiveness are not justified by the extra cost, so a balance must be found between economy and effectiveness.

One of the purposes of a VFM audit should be to check whether the most appropriate balance between economy, efficiency and effectiveness is being achieved.

2.4 Compliance audits

Entities are subject to a large number of laws and regulations, and they may be exposed to the risk of regulatory action by the authorities if they fail to comply with the regulations. The nature of important regulations varies from one industry to another. Controls over health and hygiene are important for the food manufacturing industry, for example. Controls over pollution are important for companies involved in oil and gas exploration. Controls over money laundering are important for financial services; and controls over safety are important for companies in the public transport industry.

Internal audit can be used by management as a tool to confirm that significant laws and regulations are being complied with by the company (or other reporting entity).
3 OUTSOURCING

Section overview

- Financial operations that might be outsourced
- Advantages and disadvantages of outsourcing
- Outsourcing the internal audit functions
- Outsourcing other finance or accounting functions
- ISA 402: Audit considerations relating to an entity using a service organisation
- ISAE 3402: Assurance reports on controls at a service organization

3.1 Financial operations that might be outsourced

Definition: Outsourcing

‘Outsourcing’ by a company means arranging for an external entity to perform a task that would otherwise be performed by the company’s own staff. It usually refers to routine and repetitive procedures and operations.

Outsourcing of work to ‘external suppliers’ and service organisations is a common practice. Examples of work that may be outsourced include:

- payroll operations
- internal auditing
- financial and management accounting activities (for example data processing or pensions)
- IT services
- work relating to taxation compliance and tax consultancy
- due diligence procedures for acquisitions and mergers
- non-financial services, such as catering, cleaning, motor vehicle fleet management, and staff recruitment and selection.

Entire functions may be outsourced. For example, an entity may outsource all the financial accounting functions, from book-keeping through to the preparation of final financial statements.

Alternatively, only parts of functions may be outsourced, with the remainder of the function being retained ‘in house’. For example, an entity may outsource its payroll function, but perform the rest of the accounting and finance function itself.

A problem for the auditors (internal and external) is that when work is outsourced, they need to satisfy themselves that the external agencies are performing their work properly. It may be necessary to check that the information provided by the external agency is correct (and not subject to misstatement) and that the internal controls applied by these external agencies are effective.
3.2 Advantages and disadvantages of outsourcing

Advantages
There are several reasons why entities outsource their operations.

Financial efficiencies and cost savings
- It may be cheaper to outsource work to an external service provider than to do the work in-house.
- The organisation may be able to save on capital costs and investment as it switches to an external service fee basis rather than a fully-funded in-house model.

Strategy
- An external service provider may have skills and expertise for doing the work, that the entity itself does not have ‘in house’.
- Access to the most up-to-date techniques and technology might not be readily available within the entity, but the external agency may have them.
- The outsourcing organisation may be able to offer guarantees, insurance and/or back-ups that would otherwise be unavailable or unsustainable when providing the service in-house.

Effecting change
- The management of the entity are able to focus their time and effort on ‘core activities’, and do not have to spend as much time monitoring the out-sourced activities.

Disadvantages
There are also disadvantages with outsourcing.

- The management of the entity needs to make sure that the service provider understands the requirements of the entity in respect of the service that it is providing. If the work is not properly specified, the service provider may fail to do everything that the entity requires it to do.
- The initial cost (time and money) of transferring the function externally may be high.
- The entity relies on the service provider to do its work on time and have it ready at the time that the entity requires it. This is particularly important, for example, when payroll operations are outsourced.
- There may be problems with negotiating an appropriate fee for the work with the service provider.
- Management need to ensure that the service provider gives the organisation an appropriate level of priority and ‘customer care’. This means that management must carry out regular reviews of the service level and service quality provided.
- There is a loss of control of the outsourced process. This can be a particular issue if the company subsequently decides to bring the outsourced services back ‘in-house’. By outsourcing, the entity becomes reliant on the service organisation for the provision of the service.
One method of mitigating the sense of loss of control can be to ‘insource’ rather than ‘outsource’ so that the actual operations continue to be performed on the client’s premises.

**Definition: Insourcing**

‘Insourcing’ is when a company brings in experts and specialists from outside the company to run facilities in-house. An example might be using external IT specialists to run the internal computer systems. A second example might be to in-source an internal audit function with staff seconded from an audit firm.

In any case, the outsourcing arrangement needs to be effectively managed and controlled by the organisation.

### 3.3 Outsourcing the Internal audit functions

Some entities outsource the work of the internal audit function. When this happens, the service provider is often the accountancy firm that provides the entity with its external audit services.

Several factors need to be considered when an entity outsources its internal audit function.

- The audit firm must have a greater level of independence than the entity’s own internal audit staff. If the external audit firm is not properly independent from the executive management of the entity, it should not be given any internal audit work.
- The audit firm may have access to more highly trained, specialist employees. This can create immediate accessibility to a fully operational and trained internal audit department.
- The audit firm will have greater numbers of employees available for any urgent internal audit assignments. This provides the client with greater flexibility in capacity without having to maintain a large internal audit headcount of its own.
- Professional codes of conduct and standards of behaviour will regulate the audit firm. This **might not** be the case with an in-house internal audit department.
- The audit firm may be sued for breach of contract or for negligent work and should have professional indemnity insurance to meet claims for losses due to negligent work.

However, there are a number of disadvantages with outsourcing the internal audit function to the external accounting firm.

- Professional firms are not under the control of the entity in the same way as their ‘in house’ internal audit employees.
- Fees for internal audit work can be high.
- Professional firms may not have the same level of detailed knowledge of the entity and its operations that ‘in house’ internal auditors (working in the organisation on a daily basis) should have.
- There may be threats to the independence of the external audit where the firm acts as both internal auditors and external auditors. This could compromise compliance with the fundamental ethical principles when it comes to performing the external audit.
3.4 Outsourcing other finance or accounting functions

A list of examples of other functions that could be outsourced was given at the start of this section. In the exam, you may be required to comment on the specific advantages and disadvantages of outsourcing any of these.

An important aspect of outsourcing accounting functions may be that the external supplier controls the accounting records from which figures for the financial statements are obtained. For example, if payroll work is outsourced, the data for employee costs and any liabilities for payroll (such as tax liabilities) may be held by the service provider, not by the audit client.

The audit client may hold none of this information directly, which could pose an issue for the external auditor who is engaged by the audit client but has no contractual relationship with the service organisation. This then becomes an issue when the external auditor needs to obtain audit evidence from the service organisation.

Clearly it is important that if the service organisation controls any accounting information for the audit client, the contractual arrangement between the audit client and the service organisation should include an obligation for the service organisation to provide the auditor with access to the information required for external audit purposes.

Issues for the auditor to consider in this type of situation are as follows:

- **Materiality.** The auditor should decide whether the outsourced operation is material in terms of the financial statements. If payroll work is outsourced, this is likely to be a material item and the auditor will have to consider how to obtain sufficient appropriate evidence about payroll costs.

- **Accessibility to the records.** This point was considered earlier. It is important that access to the relevant records is available for the auditor, and the auditor should discuss with the service organisation the arrangements for obtaining the information required.

- **Control risk.** The auditor will need to make an assessment of control risk in the outsourced operation. A systems audit will be possible only if the auditor is satisfied with the control system in the service organisation. Otherwise substantive auditing procedures will be needed.

- **Compliance.** Where the outsourced work is subject to regulatory requirements, the auditor will need to consider how to gather evidence about compliance with the regulations. An example is the need to check compliance with tax regulations for deductions from tax, in the case of outsourced payroll activities.

- **Transfer of information.** It may also be necessary to check the procedures for the transfer of information between the service organisation and the audit client, to establish how information is transferred, how often it is transferred and whether the method of transfer is reliable.

If you are asked in an exam question to comment on outsourcing any function, remember to think specifically about the relevant function you are being asked about, and think through factors such as:

- the logistics/practical issues of the outsourced operation
- the confidentiality associated with the source information (for example, in respect of payroll, pension details are considered highly confidential by staff)
the speed of technological advancement in the area
the responsibility for the function: for example, directors will still be legally responsible to ensure that proper accounting records are kept, even if they outsource them.

3.5 ISA 402: Audit considerations relating to an entity using a service organisation

ISA 402 provides guidance to external auditors where clients outsource some of their operations to service organisations. The services provided by a service organisation are relevant to the audit when those services, and the controls over them, are part of the entity’s information system. Such controls are most likely to relate to financial reporting but other controls could also be relevant to the audit – such as controls over the safeguarding of assets.

When the client uses the services of a service organisation, the objectives of the auditor, per ISA 402, are:
- to obtain an understanding of the nature and significance of those services and their effect on their client’s internal controls, sufficient to identify and assess the risks of material misstatement, and
- to design and perform audit procedures in response to the assessed risks.

Obtaining an understanding of the services provided

In obtaining an understanding of the services provided the auditor is required to apply ISA 315, which was discussed in a previous chapter. The auditor is required to:
- understand how their client uses the services provided, and
- evaluate the controls at their client which relate to the services provided.

For example, a client may have outsourced its payroll transactions, and have established controls over the submission and receipt of payroll information that would prevent or detect material misstatements. Testing these controls may enable the auditor to conclude that payroll is not materially misstated, regardless of the controls in place at the service organisation.

If the auditor is unable to obtain a sufficient understanding from the client then they should use one or more of the following procedures:
- Obtain a Type 1 or Type 2 report (see below).
- Contact the service organisation, via the client, to obtain specific information.
- Visit the service organisation and perform appropriate procedures to give the necessary information.
- Use another auditor to perform such procedures.

Type 1 and Type 2 reports

Type 1 and type 2 reports refer to:
- ‘Service auditor’ – this is the auditor of the service organisation (who prepares the type 1 or type 2 report);
- ‘User auditor’ – this is the auditor whose client uses a service organisation.
A **Type 1 report** comprises:

- A description of the service organisation’s system, control objectives and controls as at a specified date (prepared by the management of the service organisation), and
- A “reasonable assurance” report on the above description and the suitability of the controls to achieve the specified control objectives (prepared by an auditor instructed by the service organisation).

A **Type 2 report** is a more detailed report, covering not only the theoretical controls in place, but also whether, in practice, the controls have achieved their objectives. The description may now cover a specified period, and may also report on the operating effectiveness of the controls over that period. The report will now also give:

- the “service auditor’s” opinion on the operating effectiveness of the controls, and
- a description and the results of their tests of controls.

In response to the recent trend of an increase in the use of service organisations a new International Standard on Assurance Engagements (ISAE) 3402 *Assurance reports on controls at a service organisation* has been issued. This is effective for periods ending on or after June 15 2011 – see below.

In common with earlier theory in this chapter, before relying on a Type 1 or Type 2 report the “user auditor” must be satisfied as to:

- the service auditor’s professional competence and independence from the service organisation, and
- the standards under which the report was issued.

**Responding to the assessed risks of material misstatement**

In responding to the assessed risks, the auditor is required to apply ISA 330, which was discussed in a previous chapter. The auditor is required to:

- determine whether sufficient appropriate audit evidence is available from records held at the client, and, if not
- perform further audit procedures to obtain such evidence or use another auditor to perform those procedures at the service organisation on their behalf.

If the auditor wishes to perform tests of controls they should use one or more of the following procedures:

- Obtain a Type 2 report.
- Perform appropriate tests of controls at the service organisation.
- Use another auditor to perform such procedures on their behalf.

**Other requirements**

The auditor should inquire of management as to whether the service organisation has reported any fraud, non-compliance or uncorrected misstatements to them.

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation they should express a modified opinion in their audit report. (The different types of audit opinions are discussed in a later chapter.)
The auditor should not refer in their report to the work of a service auditor unless that is required by law or regulation. Even then, if the auditor refers to the expert’s work in their report because it is relevant to an understanding of a modified opinion, then they must make it clear that such a reference does not reduce their responsibility for that opinion in any way.

3.6 ISAE 3402: Assurance reports on controls at a service organization

ISAE 3402 deals with assurance engagements undertaken by a professional accountant in public practice to provide a report for use by user entities (i.e. the audit client) and their auditors on the controls at a service organization that provides a service to user entities that is likely to be relevant to user entities' internal control as it relates to financial reporting.

ISAE 3402 complements ISA 402 in that reports prepared in accordance with ISAE 3402 are capable of providing appropriate evidence under ISA 402.

ISAE 3402 states that the objectives of the service auditor are:

- To obtain reasonable assurance about whether, in all material respects, based on suitable criteria:
  - (i) The service organization's description of its system fairly presents the system as designed and implemented throughout the specified period (or in the case of a type 1 report, as at a specified date);
  - (ii) The controls related to the control objectives stated in the service organization's description of its system were suitably designed throughout the specified period (or in the case of a type 1 report, as at a specified date);
  - (iii) Where included in the scope of the engagement, the controls operated effectively to provide reasonable assurance that the control objectives stated in the service organization's description of its system were achieved throughout the specified period.

- To report on the matters in (i) above in accordance with the service auditor's findings.

**Illustrative opinion for a Type 1 report**

**Opinion**

*Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion are those described at page [aa]. In our opinion, in all material respects:*

(a) The description fairly presents the [the type or name of] system as designed and implemented as at [date]; and

(b) The controls related to the control objectives stated in the description were suitably designed as at [date].

**Illustrative opinion for a Type 2 report**

**Opinion**

*Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion are those described at page [aa]. In our opinion, in all material respects:*

(a) The description fairly presents the [the type or name of] system as designed and implemented throughout the period from [date] to [date];
(b) The controls related to the control objectives stated in the description were suitably designed throughout the period from [date] to [date]; and

(c) The controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period from [date] to [date].

Description of Tests of Controls

The specific controls tested and the nature, timing and results of those tests are listed on pages [yy–zz].
4 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Describe the function of internal audit and differentiate between internal and external audit
- Explain the difference between financial, operational and compliance audits
- Discuss which functions may be outsourced and the relative advantages and disadvantages of outsourcing
- Explain the audit considerations per ISA 402 relating to entities using service organisations and the nature of type 1 and type 2 reports as included in ISAE 3402
CHAPTER 14

Reporting

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INTRODUCTION

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A (a) 17 Communication with the management and those charged with governance (including communication of deficiencies in internal controls)

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C 1 Audit of special purpose financial statements prepared in accordance with special purpose framework
C 2 Audit of single financial statements and specific elements, accounts or items
C 3 Engagement to report on summary financial statements
C 5 Understanding of provisions related to audit and accounts under the Banking Companies Ordinance 1962
C 6 Understanding of provisions related to audit and accounts under the Insurance Companies Ordinance 2000

Exam context

This chapter is fundamental to students’ advanced audit and assurance studies as it relates to the output for which a client pays a fee – i.e. the audit or assurance report.

Following a revision of the basic structure of an independent auditor’s report as encountered in your earlier studies you will then learn about the various modifications that may be required in the audit report. You will encounter the various ISAs relevant to this final phase of the audit such as ISAs 510 and 710 on opening balances and prior year comparatives respectively and of course the early ISA 700-series specifically on audit reports.

You also need to be familiar with the nature and content of communication with the client and in particular with those charged with governance.

For completion the final section briefly addresses special purpose audit reports.

By the end of this chapter students will be able to:

- Audit opening balances and comparatives
- Explain the impact of going concern on the audit report as required by ISA 570
- Describe in detail the contents of an audit report
- Identify when the basic audit report should be modified, and if so, how
- Explain the auditors’ duties with respect to other information in documents containing audited financial statements as per ISA 720
- Discuss which matters should be communicated with those charged with governance, and describe the communication process
- Describe the form, content and use of specialised audit reports
1 THE AUDIT REPORT AND THE MEANING OF A ‘TRUE AND FAIR VIEW’

Section overview

- The audit report
- The meaning of a ‘true and fair view’

1.1 The audit report

The auditor’s report on the financial statements is the only direct communication between the auditor and the owners of the company (to whom the auditor normally reports). Therefore it needs to be clear, meaningful and understandable.

In the past, the auditor’s report was criticised for being too brief to allow the general reader to understand the nature of an audit and the meaning of the auditor’s report. This was seen to be a major cause of the ‘expectation gap’ – the problem that users of financial statements expect more from the audit than statutory and other regulations require.

The expectation gap

The term ‘expectation gap’ refers to the fact that the public perception of the role and responsibilities of the external auditor is different from their statutory role and responsibilities. The expectations of the public are often set at a level higher than that at which the external auditor actually operates.

Some examples of the misunderstandings inherent in the public’s expectations are as follows:

- The public believes that the audit opinion in the audit report amounts to a ‘certificate’ that the financial statements are correct and can be relied upon for all decision-making purposes, including decisions about takeovers.
- The public also believes that the auditor has a duty to prevent and detect fraud and that this is a purpose of the audit.
- The public assumes that in carrying out their audit work, the auditor tests 100% of the transactions undertaken during the accounting period.

One consequence of these misunderstandings has been an increasing tendency in some countries to undertake legal action against the auditors, sometimes on a ‘frivolous’ basis, in the belief that the auditor should have prevented misstatements in the financial statements or should have prevented fraud.

Responses to the expectation gap

Responses to the problem of the expectation gap have varied between countries. In some countries, corporate governance codes have been changed to strengthen the role and responsibilities of directors for sound internal control and accounting systems.

The auditor’s report is addressed to the owners of the company, not to other users of the financial statements.

In the context of auditor liability, some countries such as the UK allow the auditor to include an additional paragraph in the audit report, after the opinion paragraph, disclaiming any liability that may arise from the use of the report by persons other than those to whom it is addressed.
Electronic reporting

Many companies now publish their annual reports on their websites. This method of ‘electronic reporting’ has implications for the auditor. It is considered good practice for the auditor to check that the electronic form of the financial statements and auditor’s report are identical to the paper copy.

1.2 The meaning of a ‘true and fair view’

In most countries, auditors performing an audit in accordance with statutory requirements are required to produce a report that makes reference to whether the financial statements give ‘a true and fair view’. In some countries, the audit report is required to give an opinion whether the financial statements ‘present fairly, in all material respects’. The terms ‘true and fair view’ and ‘fair presentation’ have an equivalent meaning.

The meaning of the term ‘a true and fair view’ has not been rigorously defined, either by law or by the auditing profession. Many legal authorities and writers on auditing have developed their own definitions of the term. The main points to note are as follows:

- Assessing whether financial information is true and fair is more an art than a science. The assessment relies heavily on the judgement of the auditor.
- It is appropriate to think of ‘true and fair’ as a combined phrase. Do not try to define ‘true’ and ‘fair’ as separate concepts.
- True and fair will normally imply:
  - compliance with any relevant legislation and accounting standards
  - the use of accurate figures or best possible estimates
  - meaningful presentation and disclosure of information
  - the avoidance of bias, distortion, and manipulation of figures
  - no concealment of material information.
2 THE UNMODIFIED AUDIT REPORT: ISA 700

Section overview

- Definition of an unmodified audit report
- Reaching the audit opinion
- Basic elements of the audit report
- Audit report prescribed by law or regulation
- Audits conducted in accordance with both ISAs and local auditing standards
- Unaudited supplementary information presented with the audited financial statements

2.1 Definition of an unmodified audit report

An **unmodified audit report** is an audit report containing an audit opinion not modified in any way by a ‘qualified’ opinion, and containing no other modifications or additional paragraphs such as an ‘emphasis of matter’ or ‘other matters’ paragraph. These are discussed in a later section.

An **unmodified opinion** should be expressed when the auditor concludes that the financial statements:

- have been prepared in accordance with the identified financial reporting framework, including the requirements of applicable law, and
- give a true and fair view.

An unmodified opinion provides a high level of assurance that a professional, independent examination of the financial statements has not revealed any actual or possible material misstatements in those financial statements.

The general format of the report is regulated by the revised ISA 700 *Forming an opinion and reporting on financial statements*. However, the precise wording of an audit report may be varied at the discretion of the auditor.

Modified reports are the subject of ISA 705 *Modifications to the opinion in the independent auditor’s report* and by ISA 706 *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor’s report*. Both of these ISAs are described later.

2.2 Reaching the audit opinion

In reaching their audit opinion, the auditor is **required** to evaluate whether:

- he has obtained sufficient appropriate audit evidence as to whether the financial statements are free from material misstatement
- uncorrected misstatements are material, individually or in aggregate
- the financial statements give a true and fair view
- the financial statements have been prepared in accordance with the relevant financial reporting framework

and in particular whether

- the financial statements adequately describe the relevant financial reporting framework
Audit, Assurance and Related Services

- the financial statements adequately disclose the entity's significant accounting policies
- the significant accounting policies are appropriate and consistent with the relevant financial reporting framework
- accounting estimates are reasonable
- the information in the financial statements is relevant, reliable, comparable and understandable
- the financial statements provide adequate disclosures
- the terminology used in the financial statements is appropriate.

2.3 Basic elements of the audit report

The basic elements of an unmodified auditor’s report, as given in ISA 700, are as follows:

1. Title
2. Addressee
3. Introductory paragraph
4. Statement of management’s responsibility for the financial statements
5. Auditor’s responsibility
6. Auditor’s opinion
7. Other reporting responsibilities (if applicable)
8. Auditor’s signature
9. Date of the audit report
10. Auditor’s address.

These elements are designed to achieve the objectives of ISA 700, which are for the auditor to:

- form an opinion on the financial statements, based on the conclusions drawn from their audit evidence, and
- express that opinion clearly through a written report that also describes the basis for that opinion.

Title

The auditor’s report should have a title that clearly indicates that it is the report of an independent auditor. This is to distinguish this type of auditor’s report from other reports that might be issued by other auditors (who may not have to abide by the same ethical requirements and requirement for independence as the independent auditor - for example, internal auditors).

Addressee

The report should be appropriately addressed, as required by national law and the circumstances of the engagement. The report is usually addressed to either:

- the shareholders of the entity whose financial statements are being audited, or
- the board of directors of the entity.
Chapter 14: Reporting

Introductory paragraph

The introductory paragraph in the report should:

- identify the entity whose financial statements have been audited
- state that the financial statements have been audited
- identify the title of each statement that makes up the complete set of financial statements (income statement/statement of comprehensive income, statement of financial position, and so on)
- refer to the summary of significant accounting policies and other explanatory information
- specify the date or period covered by each statement.

Directors’ responsibility for the financial statements

This section of the report should describe the responsibilities of those responsible for the preparation and presentation of the financial statements. It should include an explanation that the directors are responsible for:

- the preparation of the financial statements in accordance with the applicable financial reporting framework, and
- for such internal controls as deemed necessary to enable the preparation of financial statements which are free from material misstatement.

Auditor’s responsibility

This section of the report states that:

- the responsibility of the auditor is to express an opinion on the financial statements based on their audit
- the audit was conducted in accordance with ISAs, explaining that those standards require the auditor to:
  - comply with ethical requirements, and
  - plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

The latter gives the reader of the report assurance that the audit has been carried out in accordance with established standards and practices.

This section also describes the ‘scope of the audit’. It refers to the auditor’s ability to perform the audit procedures which they deemed necessary in the circumstances. Any restriction on the scope of the audit can lead to a ‘modified’ audit report (which is explained later).

This section also describes an audit by stating that:

- an audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements
- the procedures selected depend on the auditor’s judgment, including their assessment of the risks of material misstatement of the financial statements. As part of this assessment, the auditor considers relevant internal controls. They do not consider internal controls for the purpose of expressing an opinion on their effectiveness
- an audit also includes evaluating the appropriateness of the accounting policies used, the reasonableness of accounting estimates made by management, and the presentation of the overall financial statements
This part of the (unmodified) report should end with a statement that the auditor believes that the audit evidence they have obtained is sufficient and appropriate to provide a basis for their opinion.

**Auditor's opinion**

When the financial statements have been prepared in accordance with a “**fair presentation**” framework an unmodified opinion should be expressed when the auditor concludes that the financial statements **give a true and fair view** or are **presented fairly**, in all material respects, in accordance with the applicable financial reporting framework.

When the financial statements have been prepared in accordance with a “**compliance**” framework an unmodified opinion should be expressed when the auditor concludes that the financial statements **have been prepared**, in all material respects, in accordance with the applicable financial reporting framework.

This can lead to a two-fold opinion. For example, in the UK, an opinion will be expressed on whether the financial statements:

- give a true and fair view (UK accounting standards) or present fairly (IFRSs), and
- have been properly prepared in accordance with the Companies Act 2006.

Where IFRSs are not used as the financial reporting framework, the reference to the financial reporting framework in the wording of the opinion should identify the jurisdiction of the financial reporting framework.

For some types of companies (e.g. Banks in Pakistan – see later) there may be additional reporting requirements such as reporting in compliance with IFRS for listed companies.

**Other reporting responsibilities**

In some countries, the auditor may have additional reporting responsibilities. For example, they may be required by local legislation to report certain matters if they come to their attention during the course of the audit, or they may be required to report on specific matters such as the adequacy of accounting records.

Such other reporting responsibilities should be addressed in a separate section of the report, following the opinion paragraph, sub-titled “Report on Other Legal and Regulatory Requirements”.

**Auditor's signature**

The report should be signed:

- in the name of the accounting firm, or
- in the personal name of the audit partner, or
- both.

The report is usually signed in the name of the firm because the firm assumes responsibility for the audit.

**Date of the auditor's report**

The report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which they have based their opinion on the financial statements.
This will not be earlier than the date on which the financial statements are signed or approved by the directors/management of the client company.

The date of the report informs the reader that the auditor has considered the effect on the financial statements (and on their audit report) of subsequent events which occurred after the reporting period and up to that date.

**Auditor's address**

The report should give a specific location for the auditor. This will usually be the city where the office responsible for the audit is located.

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**Example:**

An example of an unmodified audit report is set out below.

**INDEPENDENT AUDITOR’S REPORT**

(Appropriate addressee)

**Report on the Financial Statements**

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

**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, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

**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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s 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 presentation of the financial statements.

We believe that the audit evidence that 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 (or “present fairly, in all material respects”) of the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

(Auditor’s signature)
(Date of the auditor’s report)
(Auditor’s address)

2.4 Audit report prescribed by law or regulation

If the auditor is required by law or regulation (e.g. a national auditing standard) to use a specific layout or wording of the audit report, rather than the wording in ISA 700, then the audit report may only refer to ISAs if it includes, as a minimum, the following elements:

- Title
- Addressee
- An introductory paragraph identifying the financial statements audited
- A description of management’s responsibility for the preparation of the financial statements
- A description of the auditor’s responsibility to express an opinion on the financial statements and the scope of the audit: this should include a reference to ISAs and local auditing standards and a description of an audit in accordance with those standards
- An opinion paragraph containing an expression of opinion on the financial statements, and a reference to the applicable financial reporting framework used
- Auditor’s signature
- Date of the auditor’s report
- Auditor’s address.

These headings correspond with those specified by ISA 700 as headings to be included in an unmodified audit report.

2.5 Audits conducted in accordance with both ISAs and local auditing standards

An auditor may be required to conduct an audit in accordance with particular national auditing standards (e.g. in Nigeria, with Nigerian Standards in Auditing (NSAs)) but in doing so may have also complied with “pure” ISAs. This will be the case in Nigeria, where, NSAs are based on the “pure” ISAs.

In this case the audit report may refer to ISAs in addition to the national auditing standards but only where:

- there is no conflict between the national auditing standards and ISAs which would have led the auditor to form a different opinion or not to include an emphasis of matter paragraph (see later) that would have been required by ISAs, and
if the report follows the wording of national auditing standards, it includes, as a minimum, the elements as specified above.

When the report refers to both national auditing standards and ISAs it should clearly identify the jurisdiction of origin of the national standards.

Note that if there is conflict between the national auditing standards that an auditor is required to comply with, and ISAs, then the conflict must be resolved in favour of the national auditing standards.

2.6 Unaudited supplementary information presented with the audited financial statements

The report and accounts issued by a company often contain supplementary information that is not covered by the auditor’s opinion, such as a chairman’s statement, employment report or business review.

The auditor should be satisfied that any unaudited supplementary information that is presented together with the audited financial statements is clearly differentiated from the audited financial statements. This is because unaudited items are not covered by the auditor’s opinion.

If the auditor concludes that the unaudited information is not clearly differentiated, then they should ask management to change how that information is presented. If management refuse to do so then the auditor should explain in their report that the supplementary information has not been audited.

The auditor’s responsibilities in respect of unaudited supplementary information are covered by ISA 720 (see below).
3 AUDIT REPORTING AND THE COMPANIES ORDINANCE 1984

Section overview

- Reporting requirements of the Companies Ordinance 1984 (s255.3 CO84)
- Other audit-related matters
- Penalty for non-compliance with the Companies Ordinance 1984
- The Banking Companies Ordinance 1962 (s35 – audit)
- Insurance Ordinance, 2000 (s48 – audit)
- Pakistan Code of Corporate Governance (the Code)

3.1 Reporting requirements of the Companies Ordinance 1984 (s255.3 CO84)

The Companies Ordinance requires that the auditor make a report to the members of the company on the accounts and books of accounts of the company and on every balance-sheet and profit and loss account or income and expenditure account and on every other document forming part of the balance-sheet and profit and loss account or income and expenditure account, including notes, statements or schedules appended thereto, which are laid before the company in a general meeting during their tenure of office, and the report shall state:

- whether or not they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of the audit;
- whether or not in their opinion proper books of accounts as required by the Ordinance have been kept by the company;
- whether or not in their opinion the balance-sheet and profit and loss account or the income and expenditure account have been drawn up in conformity with the Ordinance and are in agreement with the books of accounts;
- whether or not in their opinion and to the best of their information and according to the explanations given to them the said accounts give the information required by the Ordinance in the manner so required and give a true and fair view:
  - in the case of the balance-sheet, of the state of the company’s affairs as at the end of its financial year;
  - in the case of the profit and loss account or the income and expenditure account, of the profit or loss or surplus or deficit, as the case may be, for its financial year; and
  - in the case of the statement of changes in financial position or sources and application of funds of a listed company, of the changes in the financial position or the sources and application of funds for its financial year;
- whether or not in their opinion:
  - the expenditure incurred during the year was for the purpose of the company’s business; and
  - the business conducted, investments made and expenditure incurred during the year were in accordance with the objects of the company;
and whether or not in their opinion

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

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

Illustration: Auditors’ report to the members – Form 35A (revised May ’15)

Auditors’ report to the members – Form 35A

The Companies Ordinance, 1984 (section 255(3) and rule 17A)

Auditors’ report to the members

Report on the Financial Statements

We have audited the accompanying financial statements (or revised financial statements)(if applicable) of ___________________, which comprise the balance sheet as at _________________, and the profit and loss account, the statement of comprehensive income (if applicable), the statement of changes in equity (if applicable) and the cash flow statement (if applicable) for the year then ended and a summary of significant accounting policies and other explanatory notes and we state that we have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purposes of our audit.

Management’s Responsibility

Management is responsible for the preparation of these financial statements that give a true and fair view in accordance with the approved accounting standards as applicable in Pakistan and the requirements of the Companies Ordinance, 1984. This responsibility includes designing, implementing and maintaining such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors’ Responsibility

Our responsibility is to express an opinion on these statements based on our audit. We conducted our audit in accordance with the International Standards on Auditing as applicable in Pakistan. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation of financial statements that gives a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.
Opinion

In our opinion and to the best of our information and according to the explanations given to us, the financial statements conform with approved accounting standards as applicable in Pakistan, and, give the information required by the Companies Ordinance, 1984, in the manner so required and respectively give a true and fair view of the state of the company’s affairs as at __________ and of the profit/loss, the comprehensive income (if applicable), the changes in equity (if applicable) and its cash flows (if applicable) for the year then ended.

Report on Other Matters required by the Companies Ordinance, 1984

Based on our audit, we further report that in our opinion:

(a) Proper books of accounts have been kept by the company as required by the Companies Ordinance, 1984;

(b) the balance sheet and profit and loss account together with the notes thereon have been drawn up in conformity with the Companies Ordinance, 1984, and are in agreement with the books of accounts and are further in accordance with accounting policies consistently applied except for the change(s) as stated in note(s) __________, with which we concur;

(c) the expenditure incurred during the year was for the purpose of the company’s business;

(d) the business conducted, investments made and the expenditure incurred during the year were in accordance with the objects of the company; and

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

Audit firm’s signature
Name of the engagement partner
Place of signing and date of the auditors’ report

3.2 Other audit-related matters

Commission – additional matters (s255.5 C084)

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

Attendance at general meetings (s255.6 C084)

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

Provided that, in the case of a listed company, the auditor or a person authorised by them in writing shall be present in the general meeting in which the balance-sheet and profit and loss account and the auditor’s report are to be considered.
Auditor access to books and records (s255.7 CO84)

Officers of a company have a legal duty to:

- allow the auditor access to books and papers of the company; and
- give the auditor notice of any general meeting.

If an officer fails to do so when required, or otherwise hinders, obstructs or delays an auditor in the performance of their duties or the exercise of their powers, the officer shall:

- be liable to a fine which may extend to five thousand rupees; and
- in the case of a continuing offence, be liable to a further fine which may extend to one hundred rupees for every day after the first during which the default, refusal or contravention continues.

Reading and inspection of the auditor’s report (s256 CO84)

The auditor’s report shall be read before the company in general meeting and shall be open to inspection by any member of the company.

This is to ensure there is full transparency of the report to the shareholders (to whom the report is, after all, addressed) and follows best practice corporate governance principles.

Signature on the auditor’s report (s257 CO84)

Only the person appointed as auditor of the company, or where a firm is so appointed in pursuance of sub-section (2) of section 254 of the Ordinance, only a partner in the firm practising in Pakistan, shall sign the auditor’s report or sign or authenticate any other documents of the company required by law to be signed or authenticated by the auditor.

The report of auditors shall be dated and indicate the place where it is signed.

Both of these requirements once again promote transparency of the audit process to the shareholders. However, the addition of the named auditor (or firm) and a date also help to emphasise the accountability of the auditor in what is, after all, a process designed to enhance the confidence of the shareholders in the subject matter.

3.3 Penalty for non-compliance with the Companies Ordinance 1984

Company default (s259 CO84)

If a company defaults on complying with any of the provisions described above in sections 6.1 and 6.2 (specifically sections 252-254 and 256-258 of the Ordinance):

- the company and every officer of the company who is knowingly and wilfully a party to the default may be punishable with a fine of up to fifty thousand rupees; and
- in the case of continuing default, may be liable to a further fine of up to two thousand rupees for every subsequent day of default.

Auditor default (s260 CO84)

If any auditor’s report is made, or any document of the company is signed or authenticated otherwise than in compliance with the requirements above (specifically sections 157, 255 and 257 of the Ordinance), or is otherwise untrue or fails to bring out material facts about the affairs of the company or matters to which it purports to relate:
the auditor concerned and the person, if any, other than the auditor who signs the report or signs or authenticates the document, and in the case of a firm all partners of the firm, shall, if the default is wilful, be punishable with a fine which may extend to one hundred thousand rupees.

If the auditor's report is made with the intent to profit the auditor or any other person or to put another person to a disadvantage or loss or for a material consideration:

the auditor shall, in addition to the penalty provided above, be punishable with imprisonment for a term which may extend one year and with a fine of up to one hundred thousand rupees.

3.4 The Banking Companies Ordinance 1962 (s35 – audit)

The Banking Companies Ordinance 1962 (applicable to banks in Pakistan including any branches and subsidiaries outside Pakistan) requires the auditor, in addition to their core ISA 700 reporting requirements, to state in their report:

whether or not the information and explanations required by them have been found to be satisfactory;

whether or not the transactions of the banking company which have come to their notice have been within the powers of the banking company;

whether or not the returns received from branch offices of the banking company have been found adequate for the purposes of their audit;

whether the profit and loss account shows a true balance of profit and loss for the period covered by such account; and

any other matter which they consider should be brought to the notice of the shareholders of the banking company.

Auditors also state in the bank audit report that their verification covered more than 60% of the total loans and advances of the bank.

Furthermore, the auditor shall report all the matters of material significance to State Bank. Reporting of such information and material shall not constitute breach of confidentiality under any law for the time being in force.

3.5 Insurance Ordinance, 2000 (s48 – audit)

The Insurance Ordinance, 2000 requires the auditor of insurance companies to report an opinion as to whether:

the statements accurately reflect the books and records of the company;

the company has maintained proper books and records;

the statements present fairly the state of affairs of the company as at the balance date and the result of the company for the financial year ended on that date;

in the case of a life insurer, the apportionment required to be performed under section 17 of the Ordinance has been performed in accordance with the advice of the appointed actuary; and

the statements have been prepared in accordance with the Insurance Ordinance, 2000.

The opinion shall be expressed in writing and a copy of the opinion shall be attached by the insurer to the statements to which it relates, when those
statements are delivered to the Securities and Exchanges Commission of Pakistan (SECP).

As well as the primary financial statements (and notes thereto) that fall within the scope of a routine statutory audit (as listed in the scope paragraph of a standard ISA 700 audit report), the audited financial statements of an insurance company also include the following components:

- Statement of premiums;
- Statement of claims;
- Statement of expenses; and
- Statement of investment income.

These additional components will also be incorporated into the scope paragraph of the audit report of an insurance company.

3.6 **Pakistan Code of Corporate Governance (the Code)**

The Code states:

- No listed company shall circulate its financial statements unless the CEO and the CFO present the financial statements, duly endorsed under their respective signatures, for consideration and approval of the Board of Directors.

- It shall be mandatory for the CEO and CFO to have the second quarterly and annual accounts (both separate and consolidated where applicable) initialed by the external auditors before presenting it to the audit committee and the Board of Directors for approval.
4 THE MODIFIED AUDIT REPORT: ISAS 705 AND 706

Section overview

- The nature of a modified audit report
- Emphasis of matter paragraphs and other matter paragraphs: ISA 706
- Emphasis of matter paragraphs
- Other matter paragraphs
- The modified opinion: ISA 705
- Form and content of a modified opinion
- Examples of modified opinions
- Deciding to give a modified opinion
- Modifications in group audit reports
- Audit reports and the exam

4.1 The nature of a modified audit report

Before issuing a modified report, the auditor should discuss with management the reason for the modification. The reason should be explained and the auditor should ask the client entity’s management to amend the financial statements.

- If management make the necessary adjustments, the auditor will not need to issue a modified report.
- If management refuse to make the amendments, a modified report may be the only course of action available to the auditor.

An audit report is said to be modified where either:

- a matter arises which does not affect the opinion given by the auditor, but which gives rise to an emphasis of matter paragraph or an other matter paragraph in the audit report (covered by ISA 706)
- a matter arises which does affect the opinion issued on the financial statements. This will give rise to a qualified opinion, a disclaimer of opinion or an adverse opinion (covered by ISA 705).

A modified audit report can, therefore, either have an unmodified audit opinion or a modified audit opinion.

4.2 Emphasis of matter paragraphs and other matter paragraphs: ISA 706

As discussed above, an audit report may be modified to include an ‘emphasis of matter’ paragraph and/or an ‘other matter’ paragraph. These types of paragraph are the subject of ISA 706 Emphasis of matter paragraphs and other matter paragraphs in the independent auditor’s report.

The purpose of these paragraphs is to provide additional communication in the audit report when the auditor wishes to draw the attention of users to a particular matter in the financial statements. They do not modify the audit opinion.

- An emphasis of matter paragraph draws the attention of users to an item (or ‘matter’) that is included in the financial statements and which the auditor considers fundamental to an understanding of the financial statements.
4.3 Emphasis of matter paragraphs

An ‘emphasis of matter’ paragraph is used to draw the reader’s attention to a matter presented or disclosed in the financial statements which is fundamental to an understanding of those financial statements.

When an audit report contains an emphasis of matter paragraph, the opinion is not modified. It can, therefore, only be used where the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. (If the matter is materially misstated, a modified opinion is required.)

When the auditor includes an emphasis of matter paragraph in the audit report the auditor is required to:

- include it immediately after the opinion paragraph
- use the heading ‘emphasis of matter’ for the paragraph (or another appropriate heading)
- include a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements
- indicate that their opinion is not modified in respect of the matter being emphasised.

Circumstances in which an emphasis of matter paragraph may be necessary

ISA 706 gives the following examples of circumstances in which an emphasis of matter paragraph may be necessary:

- Where there is an uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- Where the entity has adopted a new IFRS early and that has had a pervasive effect on the financial statements.
- To draw attention to a major catastrophe that has had, or continues to have, a significant effect on the entity’s financial position.

Example: Emphasis of matter paragraph – uncertain outcome of a lawsuit

The following illustrative wording is given in ISA 706.

Emphasis of matter

We draw attention to Note X to the financial statements which describes the uncertainty related to the outcome of the lawsuit filed against the company by XYZ company. Our opinion is not qualified in respect of this matter.

ISAs requiring emphasis of matter paragraphs

There are currently two ISAs which require the auditor to use an emphasis of matter paragraph in certain circumstances.
ISA 560 Subsequent events requires an emphasis of matter paragraph to be used in two specific circumstances. These were set out in chapter 9 and relate to the circumstances when a subsequent audit report is issued relating to subsequent events.

ISA 570 Going concern requires an emphasis of matter paragraph to be used to highlight the existence of a material uncertainty relating to a going concern problem. The following illustrative wording for this type of emphasis of matter paragraph is from ISA 570.

(Note that this is only appropriate where the issues relating to the going concern of the entity are not such that a modified audit report should be given. Such matters are considered later in this chapter.)

Example: Emphasis of matter paragraph – going concern uncertainty

The following illustrative wording is given in ISA 570.

**Emphasis of matter**

Without qualifying our opinion, we draw attention to Note X to the financial statements which indicates that the Company incurred a net loss of Rs. ... during the year ended 31 December 20XX and, as of that date, the company's current liabilities exceeded its total assets by Rs. .... These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty which may cast significant doubt about the company's ability to continue as a going concern.

4.4 Other matter paragraphs

As stated above, an ‘other matter’ paragraph is used if the auditor considers it necessary to communicate a matter other than those included in the financial statements that, in their opinion, is relevant to users’ understanding of the audit, the auditor's responsibilities or the audit report. In this case the auditor is required to:

- include the other matter paragraph immediately after the opinion paragraph (and any emphasis of matter paragraph); or

- elsewhere in the report if its content is relevant to the other reporting responsibilities section.

Once again, the inclusion of an ‘other matters’ paragraph does NOT modify the opinion.

Circumstances in which an other-matter paragraph may be necessary

ISA 706 gives the following examples of circumstances in which an ‘other matter’ paragraph may be necessary:

- Where the auditor is unable to resign from the engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence (i.e. a limitation of scope) imposed by management is pervasive (relevant to users' understanding of the audit). This should be rare in practice.

- Where local law or custom allows the auditor to elaborate on their responsibilities in their report (relevant to users' understanding of the auditor's responsibilities or audit report).
If revision of ‘other information’ issued with audited financial statements (e.g. the directors’ report) is considered necessary by the auditor but management refuses to make the revision.

**ISAs requiring an ‘other matter’ paragraph**

A number of ISAs require an ‘other matter’ paragraph to be used, including:

- **ISA 560 Subsequent events**
  - If management amends and re-issues the financial statements, the auditor shall include in the new or amended auditor’s report an Emphasis of Matter paragraph or Other Matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.

- ** ISA 710 Comparative information – corresponding figures and comparative financial statements**
  - When prior period financial statements were not audited.
  - When prior period financial statements were audited by a predecessor auditor.
  - When the auditor’s opinion on prior period financial statements differs from the auditor’s previously expressed opinion on those prior period financial statements in the circumstance where the auditor reports on the prior period financial statements in connection with the current period’s audit.

- **ISA 720 the auditor’s responsibilities relating to other information in documents containing audited financial statements:**
  - Where the auditor is unable to resign from the engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence (i.e. a limitation of scope) imposed by management is pervasive (relevant to users’ understanding of the audit). This should be rare in practice.

### 4.5 The modified opinion: ISA 705

**When the auditor must issue a modified opinion**

ISA 705 Modifications to the opinion in the independent auditor’s report requires the auditor to modify their opinion in the audit report in two situations:

- **Financial statements are materially misstated (material misstatement).** This occurs when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are ‘not free from material misstatement’. In other words the auditor considers that there is a material misstatement in the financial statements.

- **Inability to obtain sufficient appropriate audit evidence (also called ‘limitation on scope’).** This occurs when the auditor is unable to obtain sufficient appropriate evidence to conclude that the financial statements as a whole are free from material misstatement. In other words, the auditor has been unable to obtain sufficient appropriate audit evidence to reach an opinion that the financial statements give a true and fair view; therefore the financial statements may contain a material misstatement.
ISA 705 lists three types of modified opinions:

- a qualified opinion
- an adverse opinion, and
- a disclaimer of opinion.

Each of these types of modifications is explained below.

**Deciding the type of modified opinion required**

The following table from ISA 705 provides a useful summary of when each type of modified opinion is required to be given in the audit report:

<table>
<thead>
<tr>
<th>Nature of matter giving rise to the modification</th>
<th>Auditor’s judgement about the pervasiveness of the effects (or possible effects) on the financial statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial statements are materially misstated</td>
<td>Material but not pervasive</td>
</tr>
<tr>
<td>Inability to obtain sufficient appropriate audit evidence (limitation on scope)</td>
<td>Material and pervasive</td>
</tr>
<tr>
<td>Qualified opinion</td>
<td>Material but not pervasive</td>
</tr>
<tr>
<td>Adverse opinion</td>
<td>Material and pervasive</td>
</tr>
<tr>
<td>Disclaimer of opinion</td>
<td>Material and pervasive</td>
</tr>
</tbody>
</table>

**Qualified opinions**

A qualified audit opinion should be given when, in the opinion of the auditor, there is a material misstatement or an inability to obtain sufficient appropriate audit evidence (limitation on scope), and the effect on the financial statements is material but not pervasive.

Qualified audit opinions are sometimes called ‘except for’ opinions, because the audit report should state that in the auditor’s opinion the financial statements give a true and fair view except for the matter or matters described in the report.

**The meaning of pervasive: disclaimer of opinion or adverse opinion**

Generally, a matter will be material but not pervasive when the auditor encounters a material problem with one or more specific items in the financial statements (such as a problem with inventory or revenue), but the remaining items and the financial statements as a whole provide a true and fair view.

‘Pervasive’ effects on the financial statements are defined by ISA 705 as those that, in the auditor’s judgement:

- are not confined to specific elements, accounts or items of the financial statements; or
- are confined to specific elements in the financial statements, but these represent (or could represent) a substantial proportion of the financial statements; or
- in relation to disclosures in the financial statements, are fundamental to users’ understanding of those statements.

The difference between a ‘material’ and a ‘pervasive’ modification is a matter of judgement. There are no absolute cut-off points or dividing lines that separate one from the other.
Inability to obtain sufficient appropriate audit evidence (limitations on scope)

ISA 705 suggests that a limitation on the auditor’s scope may occur as a result of:

- circumstances beyond the control of the entity, such as when the entity’s accounting records have been destroyed
- circumstances relating to the nature or timing of the auditors work: an example is when the auditor is appointed too late to enable them to attend the physical inventory count
- limitations imposed by management. The management of the client entity may prevent the auditor from obtaining the audit evidence required, for example by:
  - preventing the auditor from observing the physical inventory count
  - preventing the auditor from asking for confirmation of specific account balances (for example, a receivables circularisation).

Inability to obtain sufficient appropriate audit evidence due to a management imposed limitations on scope

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit which is likely to result in a qualified or disclaimer of opinion, the auditor is required to ask management to remove the limitation. If management refuse to do this, the auditor must:

- communicate the matter to those charged with governance
- consider whether it is possible to perform alternative audit procedures in order to obtain sufficient appropriate audit evidence.

If it is not possible to obtain audit evidence in another way and the matter is material but not pervasive the auditor must give a qualified opinion.

If it is not possible to obtain audit evidence in another way and the matter is material and pervasive the auditor must:

- resign from the audit where practicable and not prohibited by law or regulation, or
- if not practicable or possible, issue a disclaimer of opinion.

4.6 Form and content of a modified opinion

The form and content of a modified audit report with a modified opinion differs from an unmodified audit report in several ways. ISA 705 includes the following requirements.

**Basis for modified opinion paragraph**

When a modified opinion is issued, the audit report must include a ‘basis for modified opinion’ paragraph, which should appear just before the audit opinion in the report.

The paragraph is headed ‘Basis for qualified opinion’, ‘Basis for adverse opinion’, or ‘Basis for disclaimer of opinion’, as appropriate. Examples of these types of opinion are shown later.

This ‘basis for opinion’ paragraph must include the following:
For a material misstatement relating to **specific amounts** – a description and quantification of the impact on the financial statements (or a statement that quantification is not possible).

For a material misstatement relating to **narrative disclosures** – an explanation of how the disclosures are misstated.

For a material misstatement relating to the **non-disclosure** of information that should have been disclosed – the nature of the omitted information and, unless prohibited by law or regulation, the omitted disclosures.

If the modification results from an inability to obtain sufficient appropriate audit evidence – the reasons for that inability.

**Opinion paragraph**

This paragraph in the audit report must be headed ‘**Qualified opinion**’, ‘**Adverse opinion**’, or ‘**Disclaimer of opinion**’, as appropriate.

Specific wording is prescribed for the different types of modified opinions which are best illustrated by the examples shown later.

**Auditor’s responsibility paragraph**

The auditor’s responsibility paragraph appears earlier in the audit report, after the statement about management responsibilities for the financial statements. For a **qualified or adverse opinion** this paragraph is amended to state that the auditor believes that the audit evidence obtained is sufficient and appropriate to provide a basis for the modified opinion.

Where the auditor gives a **disclaimer of opinion**, more extensive amendments are required by ISA 705.

**4.7 Examples of modified opinions**

Illustrative examples of the different types of modified opinion are shown below. They are all taken from ISA 705. Where paragraphs in the examples are incomplete, the wording of the report commences or concludes in the same way as in the example of the unmodified report, shown in an earlier section of this chapter.
Example 1: Material misstatement - qualified opinion

This is an example of a qualified opinion, arising from a material misstatement of the financial statements:

Auditor’s Responsibility
... We believe that the audit evidence that we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion
The company’s inventories are carried in the statement of financial position at Rs. XXX. Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from International Financial Reporting Standards. The company’s records indicate that had management stated the inventories at the lower of cost and net realisable value, an amount of Rs. XXX would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by Rs. XXX, and income tax, net income and shareholders’ equity would have been reduced by Rs. XXX, Rs. XXX and Rs. XXX, respectively.

Qualified Opinion
In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view....

Example 2: Material misstatement - adverse opinion

This is an example of an adverse opinion in a group audit report.

Auditor’s Responsibility
... We believe that the audit evidence that we have obtained is sufficient and appropriate to provide a basis for our adverse audit opinion.

Basis for Adverse Opinion
As explained in Note X, the company has not consolidated the financial statements of subsidiary XYZ Company it acquired during 20X4 because it has not yet been able to ascertain the fair values of certain of the subsidiary’s material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under International Financial Reporting Standards, the subsidiary should have been consolidated because it is controlled by the company. Had XYZ been consolidated, many elements in the accompanying financial statements would have been materially affected. The effects on the financial statements of the failure to consolidate have not been determined.

Adverse Opinion
In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the consolidated financial statements do not give a true and fair view....
Example 3: Inability to obtain sufficient appropriate audit evidence (limitation on scope) - qualified opinion

This is an example of a qualified opinion, arising from the auditor’s inability to obtain sufficient appropriate audit evidence. The only paragraphs from the report that are shown here are those that are relevant to the modified opinion.

**Auditor’s Responsibility**

... We believe that the audit evidence that we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

**Basis for Qualified Opinion**

ABC Company’s investment in XYZ company, a foreign associate acquired during the year and accounted for by the equity method, is carried at Rs. XXX on the statement of financial position at 31 December 20X4, and ABC’s share of XYZ’s net income is included in ABC’s income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC’s investment in XYZ at 31 December 20X4 and ABC’s share of XYZ’s net income for the year because we were denied access to the financial information, management and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

**Qualified Opinion**

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view....

Example 4: Inability to obtain sufficient appropriate audit evidence (limitation on scope) - disclaimer of opinion

This is an example of a disclaimer of opinion where the auditor has been unable to obtain sufficient appropriate audit evidence about multiple elements of the financial statements:

We were engaged to audit the accompanying financial statements of ABC Company....

Management is responsible for.....

**Auditor’s Responsibility**

Our responsibility... International Standards on Auditing. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

**Basis for Disclaimer of Opinion**

We were not appointed as auditors of the company until after 31 December 20X4 and thus did not observe the counting of physicals inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at 31 December 20X3 and 20X4 which are stated in the statement of financial position at Rs. XXX and Rs. XXX, respectively. In addition, the introduction of a new computerised accounts receivable system in September 20X4 resulted in numerous errors in accounts receivable. As of the date of our audit report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to
confirm or verify by alternative means accounts receivable included in the statement of financial position at a total amount of Rs. XXX as at 31 December 20X4. As a result of these matters, we were unable to determine whether any adjustments might have been found to be necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the income statement, statement of changes in equity and statement of cash flows.

**Disclaimer of opinion**

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

### 4.8 Deciding to give a modified opinion

The auditor will give a modified opinion only if they are satisfied that:

- the reasons for giving a modified opinion are justified; and
- the management of the client entity are unable or unwilling to take action to remove the necessity for a modified opinion.

For example, suppose that the management of a client entity decides that a material non-current asset should not be depreciated. The auditor should first of all satisfy themselves that there is no acceptable reason for the management’s view and that the asset should be depreciated.

- The auditor should review the audit file and check for any information about this matter from previous audits.
- He should consider whether there might be an acceptable reason for a departure from the requirements of international financial reporting standards and GAAP, in order to give a true and fair view.
- If the auditor is still satisfied that management is incorrect in their opinion, they should meet with the management and:
  - Discuss their reasons for not depreciaing the asset
  - Obtain a representation from them confirming that the asset will not be depreciated
  - Decide whether the effect of this action by management on the financial statements is material or ‘material and pervasive’ and so what form of modified opinion is necessary
  - Warn management that the audit opinion will be modified unless management change their view
- If management still refuse to change their view, issue a modified opinion, which will be either a qualified opinion or an adverse opinion.
4.9 Modifications in group audit reports

The same principles apply in forming an opinion on group financial statements as with forming an opinion on single entity financial statements. For example:

- Is the practitioner confident that sufficient appropriate audit evidence has been obtained to support their opinion on the group financial statements?
- Has an overall review been performed which provides consistency across the conclusions reached from audit testing and demonstrate that all queries raised have been adequately addressed?

In drawing a conclusion for the audit report on the group financial statements the group auditor will need to consider the work performed on components (particularly significant components) and the audit opinions reached thereon. This will contribute to their judgement as to whether a material misstatement exists in the group accounts (and if so whether pervasive or not) and/or a limitation of scope exists for the group audit (and again, whether it is pervasive or not).

The group auditor would not normally make reference to component auditors or the audit opinions on component financial statements in the group audit report, except potentially as follows:

When the group audit opinion is modified because the group engagement team was unable to obtain sufficient appropriate audit evidence in relation to the financial information of one or more components, the Basis for Modification paragraph in the auditor’s report on the group financial statements should describe the reasons for that inability without referring to the component auditor, unless such a reference is necessary for an adequate explanation of the circumstances.

4.10 Audit reports and the exam

For the exam, you may be expected to study an audit report that contains errors and identify and explain what those errors are. Alternatively, you may be asked to discuss what audit opinion would be appropriate in a particular situation.

The key issues to consider are as follows.

- Do the financial statements give a true and fair view? (Remember, misstatements do not affect the true and fair view if they are immaterial.)
- If they do, the audit opinion will be unmodified.
- If the draft financial statements give a true and fair view, is there any item that justifies an ‘emphasis of matter’ paragraph? Usually, an emphasis of matter paragraph is something that could affect the going concern assumption.
- If the financial statements do not give a true and fair view, what is the item of contention? Is it something that involves a disagreement with management (a misstatement) or is there inadequate audit evidence (a limitation on scope)?
- Is the matter material but not pervasive? If so, a qualified audit opinion is appropriate (‘except for...’).
- If the matter is material and pervasive, either an adverse opinion or a disclaimer of opinion is appropriate. (These are rare in practice, but of course they could feature in an exam question!)
Here are some examples.

**Example 1**

You are the manager in charge of the audit of Colorosso, a limited liability company. Your auditors’ report for the previous financial year to 31 December Year 7 was signed, without modification, in February Year 8.

The scope of the audit for the year to 31 December Year 8 has been limited. This is because the company’s chief executive officer fled the country in April Year 8, taking the accounting records with them.

You have identified a valuable training opportunity for Farooq, one of your audit team. As a training exercise, you have asked Farooq to draft the extracts for the basis of opinion and opinion paragraphs that would not be standard wording in an unmodified auditor’s report.

Farooq’s draft extracts were produced as follows:

‘**Basis of opinion** (extract)

However, the evidence available to us was limited because accounting records were missing at the beginning of the year and it was not possible to reconstruct them completely.

**Opinion** (extract)

Because of the possible effect of the limitations in the information available to us, we do not express an opinion on the financial statements.’

**Requirements**

(a) Identify and comment on the principal matters relevant to forming an appropriate opinion on the financial statements of Colorosso for the year ended 31 December Year 8.

(b) Discuss the suitability of Farooq’s draft extracts.

**Answer**

**Tutorial note**

To answer this requirement, you need to:

- identify the principal matters relevant to forming an appropriate opinion
- comment on these matters
- identify whether Farooq’s report indicates that Farooq has identified and considered these matters
- reach a conclusion about whether Farooq’s report is suitable. This may involve setting out what would have been suitable if Farooq’s report is not suitable.

**Matters relevant to forming an opinion**

The following matters are relevant to forming an appropriate opinion.

(1) The accounting records for the opening three or four months of the year are missing.

(2) The accounting records are missing because the former CEO absconded with them. There must be some reason why they took the accounting records: fraud is a possible reason.
(3) The audit opinion for the previous financial year was unmodified. This would imply that the opening balances for the current year and comparative figures for the previous year are correct. However, this might not be the case.

(4) If there is a possibility of fraud, this would raise doubts about the correctness of the audit report for the previous year. There may have been fraud last year that was undetected fraud. And this might have caused material misstatement within the prior year’s financial statements.

(5) There is an inability to obtain sufficient appropriate audit evidence (limitation on scope) for the year to 31 December Year 8.

<table>
<thead>
<tr>
<th>Comments on these matters</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Matter listed above</strong></td>
</tr>
</tbody>
</table>
| (1) | This constitutes a limitation on the scope of the audit (item 5 above). The auditors will not be able to obtain sufficient appropriate audit evidence about the relevant period. Therefore, the audit opinion will be modified.  
The modification should (a) give details of what records are missing and why, or (b) cross-reference to where this information is given in the financial statements.  
The extent of the modification will depend on which records are missing and where the auditors’ scope is limited. It is likely that the information with regard to the income statement/statement of comprehensive income is limited, but possibly not the statement of financial position. A modification might be limited to a qualification (‘except for’) over the statement of comprehensive income for the first few months of the year. |
| (2) | However, there is an indication in the manner in which the CEO has taken the accounting records that there may have been a fraud. It is, therefore, probable that the auditors will have to modify the opinion even if they are able to reconstruct the financial records as it will not be possible to gain sufficient appropriate evidence about the possible fraud. |
| (3) and (4) | The previous audit report cannot be withdrawn but the auditors are not precluded from modifying their opinion for the current year on the basis of the comparative figures for the previous year. It is probable that any fraud in progress at the start of this financial year could have affected the previous financial year, unknown to the auditors at the time. |

**Conclusion about Farooq’s draft**

Farooq is correct to modify the opinion on the grounds of an inability to obtain sufficient appropriate audit evidence (a limitation on scope). However, the draft should:

- make reference to the exact nature of the problem/possible fraud
- take account of a possible modification in relation to the comparative figures for the previous financial year
- take account of the fact that the problem may be limited to the statement of comprehensive income.
Example 2

A client company has recently prepared draft financial statements for the year to 31 December Year 2. During the year, the company closed a factory that made a loss-making product which contributed 14% to total sales revenue in the previous year and 10% in the current year.

The closure is permanent. It is mentioned in the directors’ report and in the annual business review, but not in the financial statements themselves.

Required

What should be the auditor’s view of this situation?

Answer

The factory appears to have been a separate component of the company’s business, making a separate product that contributed materially to total sales income.

The closure represents a discontinued operation, and failure to disclose the details is a failure to comply with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations. It is also in breach of the requirements of IAS 7 Statements of Cash Flow and IFRS 8 Operating Segments which also require disclosures relating to discontinued operations.

The matter is material, but is not pervasive. If management do not amend the financial statements to provide the required disclosures, a qualified audit opinion (for a misstatement) would be appropriate.

Example 3

A client company has prepared draft financial statements for the year to 31 December Year 3. In February Year 4 a legal claim was made against the company, claiming substantial damages. The company’s lawyers have advised that the claim has less than 50% chance of success. If it did succeed, the company would have sufficient cash resources to meet the claim in full.

The matter is disclosed in the draft financial statements in a note, as a material contingent liability.

Required

Should the audit opinion be unmodified, and if so, should the report contain an ‘emphasis of matter’ paragraph?
Answer

The claim was made after the end of the reporting period, and is a non-adjusting event. The probability that the claim will be successful is less than 50% (on the assumption that the lawyers have given a reasonable opinion).

It is, therefore, appropriate to disclose the item as a contingent liability (in this case, a material non-adjusting event after the reporting period). The auditor should, therefore, give an unmodified opinion.

An ‘emphasis of matter’ paragraph is normally only used when the matter involves considerable uncertainty. ‘Considerable uncertainty’ usually exists only when there is some concern about the going concern status of the entity or about a matter that could have a major impact on the financial statements. In this case, we are told that the company has sufficient cash resources to meet the legal claim in full, in the event that it is successful.

It, therefore, appears that considerable uncertainty does not exist, and an ‘emphasis of matter’ paragraph would be inappropriate.
5 OTHER INFORMATION PUBLISHED WITH THE AUDITED FINANCIAL STATEMENTS: ISA 720

Section overview

- The nature of ‘other information’
- ISA 720: Other information in documents containing audited financial statements

5.1 The nature of ‘other information’

**Definition: Other Information**

ISA 720 defines ‘other information’ as:

‘Financial and non-financial information (other than the financial statements and the auditor’s report thereon) which is included, either by law, regulation or custom, in a document containing audited financial statements and the auditor’s report thereon.’

The published annual reports of major companies contain a significant amount of information that is not required by statute or by accounting standards.

The annual financial report is often used partly as a ‘public relations’ document, communicating a wide range of information from the company to shareholders and others, possibly in a report from the chairman or the chief executive officer.

If you have not done so already, you should read the published report and accounts of several public companies that have adopted international accounting standards and look at the information that they include. Published reports and accounts are normally available from the company’s web site (often in the ‘investor relations’ section).

In doing this, you should note the following:

- the scope and contents of the report (in particular, what ‘non-financial’ information is published)
- the comments and reports on corporate governance matters.

It would also be helpful, for your auditing studies, to look at:

- the form and content of the audit report.
- the accounting policies applied.
- any accounting or auditing problems that may be evident from the financial statements.

5.2 ISA 720: Other Information in documents containing audited financial statements

One of the main benefits of the audit process is that audited information possesses a higher degree of credibility (and reliability) than equivalent information that has not been audited.

There is a possibility that the credibility of audited information may suffer if:

- information that has not been audited is published together with audited information (often in the same printed document) and
the ‘un-audited’ information contains errors or is inconsistent with the audited information.

The audit report makes it clear what information has been subject to audit. However, there is a high risk of misunderstanding and a possibility that users of the financial statements will not make the distinction between audited information and other information.

For this reason, ISA 720 requires that auditors should read this ‘other’ information in order to identify:

- material inconsistencies with the audited financial statements; or
- material misstatements of fact.

An inconsistency exists when the other information contradicts information contained in the audited financial statements. For example, the directors’ report might state that revenue was Rs. 116m whereas the financial statements show revenue of Rs. 108m.

A misstatement of fact exists when the other information is incorrectly stated or presented, but the information is not related to matters in the audited financial statements. For example, the directors’ report might refer to a workforce of 5,000 employees spread across 27 countries whereas the auditor knows that the workforce is around 3,000 employees across 21 countries.

**Action if inconsistencies are not removed**

If the auditor judges that financial statements need to be revised and management refuse to do so, then the auditor should qualify their audit opinion.

If the auditor judges that the other information needs to be revised and management refuse to do so, then the auditor should:

- include an other matters paragraph in their audit report; or
- withhold their audit report; or
- where allowed by law, withdraw from the audit.

If a material inconsistency is identified after the date of the auditor’s report the auditor should follow the provisions of ISA 560 Subsequent events.

**Action if misstatements are not removed**

If the auditor becomes aware of an apparent material misstatement of fact they should:

- discuss the matter with management; and
- if they consider that there is an apparent material misstatement of fact, request management to take legal advice; and
- consider the legal advice received by the entity.

If the auditor concludes that there is a material misstatement of fact which management refuses to correct they should:

- notify those charged with governance; and
- take any further appropriate action (such as taking legal advice about the matter).
Chapter 14: Reporting

6 THE IMPACT ON THE AUDIT REPORT OF OPENING BALANCES AND COMPARATIVES: ISAS 510 AND 710

Section overview

- ISA 510: Initial audit engagements – opening balances
- ISA 710: Comparative information – corresponding figures and comparative financial statements

The audit work needed on opening balances and comparatives (ISAs 510 and 710) was described in an earlier chapter. The auditor must consider the possible impact of this work on the audit report.

6.1 ISA 510: Initial audit engagements – opening balances

The audit report is required by ISA 510 to be modified where the auditor:

- is unable to obtain sufficient appropriate audit evidence regarding the opening balances (qualified (“except for”) or a disclaimer of opinion)
- concludes that there is a misstatement in the opening balances that materially affects the current period’s financial statements and the misstatement is not properly accounted for/disclosed (qualified (“except for”) or adverse opinion)
- concludes that accounting policies have not been consistently applied (or a change of accounting policy has not been properly accounted for / disclosed) (qualified (“except for”) or adverse opinion)

or where

- the prior period’s audit report was modified, and the matter is still relevant and material to the current period’s financial statements (modify as appropriate).

6.2 ISA 710: Comparative information – corresponding figures and comparative financial statements

Financial statements include audited figures for the current financial year (just ended) and for the previous financial year, which are presented as comparative information.

The audit opinion should not normally refer to the corresponding figures, unless the following circumstances apply:

<table>
<thead>
<tr>
<th>Circumstance</th>
<th>ISA 710 requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>The auditor gave a qualified opinion for the previous financial period and</td>
<td>Modify this year’s audit report.</td>
</tr>
<tr>
<td>the problem remains unresolved.</td>
<td></td>
</tr>
<tr>
<td>The auditor finds a material misstatement in the prior period financial</td>
<td>Give a qualified or adverse opinion on</td>
</tr>
<tr>
<td>statements, on which an unmodified opinion was previously</td>
<td>the current period financial statements,</td>
</tr>
<tr>
<td></td>
<td>in respect of the</td>
</tr>
<tr>
<td>Circumstance</td>
<td>ISA 710 requirement</td>
</tr>
<tr>
<td>------------------------------------------------------------------------------</td>
<td>-----------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>given, and the corresponding figures have not been appropriately restated.</td>
<td>corresponding figures included.</td>
</tr>
<tr>
<td>The prior period financial statements were audited by another auditor</td>
<td>Use an “other matter” paragraph to explain this fact and the type of opinion given.</td>
</tr>
<tr>
<td>The prior period financial statements were not audited.</td>
<td>Use an “other matter” paragraph to state this fact. (However, the auditor remains responsible, per ISA 510, for obtaining sufficient appropriate evidence on opening balances.)</td>
</tr>
</tbody>
</table>
Chapter 14: Reporting

7 THE IMPACT OF GOING CONCERN ON THE AUDIT REPORT:
ISA 570

Section overview

- Introduction
- Where the use of the going concern assumption is appropriate but a material uncertainty exists
- Management’s attitude to disclosure of material uncertainty
- Where the use of the going concern assumption is inappropriate
- Going concern - summary

7.1 Introduction

If indications are found which suggest that the going concern basis might not be appropriate for preparing the financial statements, the auditor is required by ISA 570 to consider the implications for their audit report.

The form of the report will depend on the auditor’s judgement. There are two possible views they could take:

- the use of the going concern assumption is appropriate but a material uncertainty exists; or
- the use of the going concern assumption is inappropriate.

If management is unwilling to make or extend a going concern assessment (see previous chapter on ISA 570) the auditor is also required to consider the implications of this for their audit report.

7.2 Where the use of the going concern assumption is appropriate but a material uncertainty exists

Where the auditor considers that the going concern assumption is appropriate, but a material uncertainty exists, they must consider whether the financial statements:

- adequately describe the principal events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern and management’s plans to deal with those events or conditions; and
- disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern.

If there is adequate disclosure, then the auditor should express an unmodified opinion. However, they should use an emphasis of matter paragraph to:

- highlight the uncertainty; and
- draw attention to the relevant note in the financial statements.

An example of such an emphasis of matter paragraph was given earlier in the chapter.

If there is not adequate disclosure, the auditor should express a qualified or adverse opinion.
7.3 Management's attitude to disclosure of material uncertainty

The management of a client company will probably be reluctant to include a disclosure about material uncertainty in relation to the going concern assumption. There are several reasons for this.

- Admitting that there is material uncertainty about whether the company can continue as a going concern for the next 12 months can be seen as a sign of management failure. Management will probably be reluctant to admit their responsibility for failure to the company's shareholders.

- A statement that there is material uncertainty about the ability of the company to continue in business will make the situation even worse for the company. Banks will be reluctant to lend more money and may withdraw existing lending facilities. Suppliers may be reluctant to supply more goods without a credit guarantee (which the company would have to buy from an insurance company). Customers may stop buying the company’s products due to concern that the company will not be in existence to provide after-sales service.

- Employees will become more concerned for job security, and many might look for jobs with other employers. Staff turnover would, therefore, increase.

It is also possible that management do not accept that there is material uncertainty about the ability of the company to continue in business. There could therefore be genuine disagreement between management and the auditor on this issue.

As indicated above, if management refuse to provide suitable disclosure the audit opinion should be modified.

7.4 Where the use of the going concern assumption is inappropriate

Where the financial statements have been prepared on the going concern basis, but the auditor considers the going concern assumption is inappropriate, the auditor should express an adverse opinion.

The auditor may give an unmodified opinion if the financial statements have been prepared on an alternative acceptable basis (for example, a break-up basis) and there is adequate disclosure of this basis. An emphasis of matter paragraph may be required in the audit report to highlight the alternative acceptable basis.

7.5 Going concern - summary

The permutations described above relating to the impact of going concern on the audit report are summarised in the following diagram:
Impact of going concern (GC) on the audit report

GC basis is appropriate

- Material uncertainty exists
  - Uncertainty is adequately described in a note: EMPHASIS OF MATTER
  - Uncertainty is NOT adequately described in a note: QUALIFIED OR ADVERSE OPINION

GC basis is NOT appropriate

- No material uncertainty exists: NO MODIFICATION
- GC basis is still used
- Alternative basis is used (e.g. break-up)
  - Uncertainty is adequately described in a note: EMPHASIS OF MATTER
8 COMMUNICATING WITH THOSE CHARGED WITH GOVERNANCE: ISA 260

Section overview

- Introduction
- Matters to be communicated
- The communication process
- Actions when an audit report is to be modified

8.1 Introduction

In most countries, the auditor communicates to the shareholders (as they are the owners of the company) by means of their audit report. In addition, ISA 260 Communication with those charged with governance, requires that the external auditor should communicate formally to those charged with governance to provide useful feedback about the audit.

In the case of a company, those charged with governance are the board of directors or the audit committee (which is a sub-committee of the board of directors). In your exam, it will usually mean the directors of the company.

The auditor’s objectives in respect of ISA 260 are to:

- communicate their responsibilities and give an overview of the planned scope and timing of the audit
- obtain information relevant to the audit
- provide timely observations arising from the audit which are significant to management’s responsibility to oversee the financial reporting process
- promote effective communication between the auditor and those charged with governance.

As a result of the communication, the auditor should be satisfied that there is sufficient documentation of all the significant matters in the audit and that these have been brought to the attention of the individuals in the client entity who are accountable to its owners.

8.2 Matters to be communicated

The auditor is required by ISA 260 to communicate the following matters:

- His responsibilities in relation to the audit, including notification that:
  - he is responsible for forming and giving an opinion on the financial statements prepared by management; and
  - the audit does not relieve management or those charged with governance of their responsibilities.
- An overview of the planned scope and timing of the audit.
Any significant findings from the audit. These are often called the **management letter points** and are usually communicated along with any deficiencies in internal control as required by ISA 265 (see below). They include:

- the auditor’s views on the entity’s accounting policies, estimates and financial statement disclosures
- any significant difficulties encountered during the audit
- any significant matters arising from the audit already brought to the attention of management and written representations requested

*Note: This requirement does not apply if those charged with government are involved in managing the entity as they will already be aware of these issues. The significant matters do not include material weaknesses in internal controls as such a report is a requirement of ISA 265, not ISA 260 (see later section).*

- any other matters arising from the audit that are significant to the oversight of the financial reporting process.

For **listed entities** a statement (which must be made in writing):

- that the audit team / firm have complied with relevant ethical requirements in respect of independence
- of all matters relevant to independence (such as relationships and non-audit fees) and the safeguards applied.

### 8.3 The communication process

The communication with those charged with governance may be provided either **in writing or orally**. It could take place as a discussion between the auditor and an appropriate level of management, perhaps with the audit committee in the case of a larger company.

However, where oral communication would not be adequate, ISA 260 requires that communication is in writing, in the form of a letter or report. If communication is oral then the matters communicated, to whom and when must be documented.

Communication must be made on a **timely basis**. The appropriate timing will vary depending on the matter to be communicated. Communication in respect of planning matters will be likely to be made early in the engagement. Any significant difficulties encountered during the audit should be communicated as soon as practicable, especially if likely to lead to a modified opinion.

### 8.4 Actions when an audit report is to be modified

ISAs 705 and 706 require the auditor to communicate any planned modification to the auditor’s report with those charged with governance. This is to ensure that those charged with governance understand that a modification is to be made and the reasons for it. Early communication also gives those charged with governance an opportunity to provide the auditor with further information and explanation prior to the issuance of the auditor’s report.
Other actions to consider when an audit report is to be modified include:

- External consultation – e.g. with legal counsel
- Re-consider management’s integrity and whether there is a need to revise the audit strategy and plan (particularly relevant if the modification is due to a management imposed limitation on scope).
- Withdrawal from the engagement if the matter is sufficiently serious (and if withdrawal allowed by law). In such a case, it is always advisable to seek legal advice.

Note that ISA 210 requires an auditor to decline an engagement if there has been a limitation on the scope of the audit prior to commencement of the audit which is expected to result in a disclaimer of opinion (unless required to undertake the engagement by law).
Chapter 14: Reporting

9 COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL: ISA 265

Section overview

- Introduction and requirements of ISA 265
- The management letter

9.1 Introduction and requirements of ISA 265

ISA 315, covered largely in an earlier chapter, requires the auditor to communicate material weaknesses in internal control identified during the audit to management. This requirement is embodied in ISA 265 Communicating deficiencies in internal control to those charged with governance and management.

Deficiency and significant deficiency

A deficiency is defined by ISA 265 as where:

- a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
- a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

A significant deficiency is one which merits the attention of those charged with governance.

The differentiation between (not significant) deficiency and significant deficiency is a matter of professional judgement for the auditor. ISA 265 provides guidance in making this judgement, such as:

- A deficiency or combination of deficiencies that either have resulted in, or could result in, a material misstatement, are almost certainly significant;
- Consider:
  - the susceptibility to loss or fraud of the related asset or liability;
  - the subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates;
  - the volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.

Example: Deficiency vs. Significant Deficiency

Controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent the overstatement of trade receivables due to irrecoverable debts not being identified (and provided against).

Controls include:

- The system automatically generates ‘payment due reminders’ that are sent to customers as soon as their accounts become overdue. Subsequent auto-reminders are sent on a weekly basis.
- The receivables ledger clerk phones customers whose accounts are overdue to request immediate payment.
The financial controller reviews an aged receivables analysis on a monthly basis to identify irrecoverable debts.

The auditor might judge that an isolated breakdown in just one of these controls does not represent a significant deficiency in internal control as there are other compensating controls that would prevent a material misstatement.

However, the auditor might judge that a concurrent breakdown in all three controls for a sustained period does in fact constitute a significant deficiency in internal control due to the much greater risk that material irrecoverable trade receivables exist and have not been identified.

Communication with those charged with governance and management

ISA 265 requires the auditor to:

- Communicate significant deficiencies identified during the audit to those charged with governance in writing on a timely basis.
- Communicate any other deficiencies to an appropriate level of management.

The communication of significant deficiencies must be in writing and is required to cover:

- A description of the deficiencies and an explanation of their potential effects.
- Sufficient information to allow those charged with governance and management to understand the context of the communication, including an explanation that:
  - the purpose of the audit was to express an opinion on the financial statements;
  - whilst the audit did include consideration of internal controls in order to design appropriate audit procedures, this was not done for the purpose of expressing an opinion on the effectiveness of internal control; and
  - the matters being reported are limited to those deficiencies identified during the audit and considered of sufficient importance to be reported.

The above should make it clear that the report covers only those weaknesses that have been discovered as a result of the audit work that has been undertaken. It is a by-product of a statutory audit and is not the result of a full review of systems and controls. As a consequence, other weaknesses may exist that are not mentioned in the report.

The auditor will also usually state that such communication has been provided for the purposes of those charged with governance and that it may not be suitable for other purposes.

9.2 The management letter

Although it is now a requirement of both ISA 315 and ISA 265, the management letter or letter of weakness has long been seen as an extra service provided to the client by the external auditor. If management address the points in the letter, the controls in place will be improved. This may enable future audits to focus on the more efficient systems-based approach. This in turn may reduce the cost of the audit to the client.
The report is prepared and sent after the results of the tests of control are known – usually after the **interim audit**.

The report may later be updated after the **final audit**, if further weaknesses have been found or if weaknesses that were reported previously have not yet been dealt with.

In line with ISA 265’s requirement to give a description of the deficiencies and an explanation of their potential effects, the report will usually identify the following information for each weakness reported:

- The nature of the weakness in the present system, in terms of both design and operation. (In other words, is there a control weakness ‘on paper’? If there is no control weakness ‘on paper’, are the controls applied effectively in practice?)
- The implication of this weakness in controls.
- Recommendations for improvement.

The auditor should ask management to provide a response and action plan for each weakness identified in the report. They should also mention that the contents of the report will be followed up in future audits.

An earlier chapter looked at the identification of specific control “risks” and asked for suggestion of controls to mitigate these risks. This topic could also be tested in the exam in the context of the preparation of a management letter.

### Example

You are the auditor of AdviceCo. During your audit of the purchases cycle you have identified the following weaknesses:

1. Payables ledger clerks amend standing data held on the standing data masterfile when they are instructed to do so by the buying manager.
2. The financial director signs cheques made out to suppliers without sight of any supporting documentation.

**Required**

In respect of the above weaknesses set out the consequences of each weakness and the recommendations you would suggest as they might appear in the management letter.

### Answer

#### Weakness 1

**Consequence**

Inappropriate amendments could be made leading to a loss to AdviceCo. For example, incorrect standing data could lead to incorrect discounts being claimed or supplies being purchased from non-authorised suppliers.

**Recommendation**

All amendments to standing data should be instigated on standard documentation, counter-signed by the buying director. This documentation should be retained and subsequently reviewed by a responsible official (such as the financial controller) to ensure that the correct amendments have been made and that the amendments were properly authorised.
**Weakness 2**

**Consequence**

A supplier could be overpaid or paid twice or a cheque could be paid to an entity which has not supplied the organisation (if an employee wishes to commit fraud).

**Recommendation**

Cheque signatories should inspect supporting documentation such as original purchase invoices made out to AdviceCo. This check should be evidenced by signature on the invoices being paid. This will help prevent double payment of the same invoice and payment to an organisation that did not make a supply to the company.

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The following illustration demonstrates an alternative columnar format for presenting control weaknesses in an exam answer:

<table>
<thead>
<tr>
<th>Weakness</th>
<th>Possible effect</th>
<th>Recommendation</th>
<th>Management’s response</th>
</tr>
</thead>
<tbody>
<tr>
<td>Details of employees leaving the company are sent on an e-mail from the personnel department to payroll without subsequent confirmation.</td>
<td>There is no check to ensure that all e-mails sent are actually received in the payroll department. This could result in payments being made to former employees.</td>
<td>Introduce a control to ensure all e-mails are received.</td>
<td>Agreed. New control to be installed immediately.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Personnel should use sequentially-numbered e-mails.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Payroll should send a confirmation for each ‘leaver email’ received.</td>
<td></td>
</tr>
</tbody>
</table>
Chapter 14: Reporting

10 SPECIALISED AREAS

Section overview

- ISA 800 Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks
- ISA 805, Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
- ISA 810, Engagements to Report on Summary Financial Statements

10.1 ISA 800 Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks

ISAs in the 100 to 700 series apply to an audit of financial statements. ISA 800 deals with special considerations in the application of those ISAs to an audit of financial statements prepared in accordance with a special purpose framework.

Although such special considerations cover:

- acceptance of the engagement
- planning and performance of the engagement, and
- forming an opinion and reporting on the engagement

the bulk of the ISA is concerned with reporting. An audit report on such financial statements will add credibility to those financial statements.

Considerations when accepting the engagement

The auditor is required to determine the acceptability of the financial reporting framework applied by obtaining an understanding of:

- the purpose for which the financial statements have been prepared
- the intended users of those financial statements
- the steps taken by management to determine that the framework is acceptable in the circumstances.

The special purpose framework could be a fair presentation framework or a compliance framework, as discussed under ISA 700 above.

Considerations when planning and performing the audit

ISA 200 requires the auditor to comply with all ISAs relevant to the audit. ISA 800 requires the auditor to determine whether any special consideration is needed.

ISA 315 requires the auditor to obtain an understanding of the entity’s selection and application of accounting policies. If the special purpose financial statements have been prepared in accordance with the provisions of a contract then ISA 800 requires them to obtain an understanding of any significant interpretation of the contract that management has made in the preparation of those financial statements.
Forming an opinion and reporting considerations

When forming an opinion and reporting on special purpose financial statements the auditor is **required to follow ISA 700 and other relevant reporting ISAs**. The table below shows how the requirements of ISA 700 (and ISA 706) are applied by ISA 800.

<table>
<thead>
<tr>
<th>ISA 700/706 requirements</th>
<th>How applied by ISA 800</th>
</tr>
</thead>
<tbody>
<tr>
<td>The auditor must evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework (ISA 700).</td>
<td>For financial statements prepared in accordance with the provisions of a contract the auditor must evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.</td>
</tr>
<tr>
<td>Provisions covering the form and content of audit reports (ISA 700)</td>
<td>The report must also describe the purpose for which the financial statements are prepared and, if necessary, the intended user (or refer to a note which gives that information). If management has a choice of financial reporting frameworks in this instance, the section on management’s responsibilities must refer to its responsibility for making an acceptable choice.</td>
</tr>
<tr>
<td>Use of an emphasis of matter paragraph (ISA 706)</td>
<td>The report must include an emphasis of matter paragraph alerting users to the fact that the financial statements have been prepared in accordance with a special purpose framework and that, as a result, they might not be suitable for another purpose.</td>
</tr>
</tbody>
</table>

**Example: Audit report on special purpose financial statements**

An example of an audit report on special purpose financial statements prepared in accordance with the financial reporting provisions established by a regulator (in this example a fair presentation framework) is set out below. The additional wording, per ISA 800, is shown in italics in square brackets.

**INDEPENDENT AUDITOR’S REPORT**

(Appropriate addressee)

**Report on the financial statements**

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31st, 20X4, 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 other explanatory information. [The financial statements have been prepared by management based on the financial reporting provisions of Section Y of Regulation Z].
Management’s responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with [the financial reporting provisions of Section Y of Regulation Z], and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s 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 presentation of the financial statements.

We believe that the audit evidence that 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 (or present fairly, in all material respects,) of the financial position of ABC Company as of December 31st, 20X4, and of its financial performance and its cash flows for the year then ended in accordance with [the financial reporting provisions of Section Y of Regulation Z].

[Basis of Accounting]

Without modifying our opinion, we draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist ABC Company to meet the requirements of Regulator DEF. As a result, the financial statements may not be suitable for another purpose.

Other matter

ABC Company has prepared a separate set of financial statements for the year ended December 31st, 20X4 in accordance with International Financial Reporting Standards on which we issued a separate auditor’s report to the shareholders of ABC Company dated March 31st, 20X5.]

(Auditor’s signature)

(Date of the auditor’s report)

(Auditor’s address)
10.2 ISA 805 Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement

The International Standards on Auditing (ISAs) in the 100–700 series apply to an audit of financial statements and are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. ISA 805 deals with special considerations in the application of those ISAs to an audit of a single financial statement or of a specific element, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, ISA 800 also applies to the audit.

ISA 200 requires the auditor to comply with all ISAs relevant to the audit. ISA 805 requires the auditor of single financial statements and specific elements, accounts or items of a financial statement to apply ISA 200 irrespective of whether they are engaged as the auditor of the entity’s complete set of financial statements.

ISA 210 continues to apply and requires the auditor to consider whether application of the chosen financial reporting framework will result in a presentation that provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement, or element.

Forming an opinion and reporting considerations

When forming an opinion and reporting on a single financial statement or a specific element, the auditor is still required to follow ISA 700 and other relevant reporting ISAs, adapted as necessary in the circumstances of the engagement.

Note that if the auditor of the single financial statement or specific element is also engaged to report on the full set of financial statements they must provide separate reports for the two engagements.

The auditor shall not express an unmodified opinion on an element if that element constitutes a major portion of the entity’s complete set of financial statements and their opinion on the complete set of financial statements as a whole is adverse or they have disclaimed an opinion.
Example

An auditor’s report on a single financial statement prepared in accordance with a fair presentation framework.

INDEPENDENT AUDITOR’S REPORT

(Appropriate addressee)

We have audited the accompanying balance sheet of ABC Company as at December 31, 20X4 and a summary of significant accounting policies and other explanatory information (together “the financial statement”).

Management’s Responsibility for the Financial Statement

Management is responsible for the preparation and fair presentation of this financial statement in accordance with those requirements of the Financial Reporting Framework in Jurisdiction X relevant to preparing such a financial statement, and for such internal control as management determines is necessary to enable the preparation of the financial statement that is free from material misstatement, whether due to fraud or error.

Auditor’s Responsibility

Our responsibility is to express an opinion on the financial statement 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 statement is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statement. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statement, 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 statement 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, if any, made by management, as well as evaluating the overall presentation of the financial statement.

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 statement presents fairly, in all material respects, the financial position of ABC Company as at December 31, 20X4 in accordance with those requirements of the Financial Reporting Framework in Jurisdiction X relevant to preparing such a financial statement.

[Auditor’s signature]

[Date of the auditor’s report]

[Auditor’s address]
10.3 **ISA 810 Engagements to Report on Summary Financial Statements**

Many local jurisdictions allow entities to provide certain users, perhaps employees, with financial statements in a summarised form. These summarised statements present the aspects of the entity’s financial performance and financial position which are considered to be the main parts that are useful and necessary for the majority of users.

The entity may ask its auditors to issue a report on these summary statements to add credibility to the information contained in the document. ISA 810 *Engagements to report on summary financial statements* provides guidance on this area.

The objectives of the auditor, per ISA 810 are to:

- determine whether it is appropriate to accept the engagement to report on Summary Financial Statements (SFS)
- and, if engaged, to:
  - form an opinion on the SFS based on evidence obtained; and
  - express that opinion clearly in a written report that also describes the basis for that opinion.

**Requirements of ISA 810**

The auditor should not report on the SFS unless they have already issued an opinion on the full financial statements from which the SFS are derived.

Before accepting an engagement to report on SFS the auditor should:

- decide whether the criteria applied by management in the preparation of the SFS are acceptable
- obtain management’s agreement that it is responsible for:
  - preparing the SFS in accordance with the above criteria
  - making the “full” (i.e. audited) financial statements available to the users of the SFS
  - including the auditor’s report on the SFS in any document which contains the SFS.

The “applied criteria” may be established by law or regulation.

The auditor should perform the following procedures as a basis for their opinion on the SFS:

- Evaluate whether the SFS adequately disclose:
  - their summarised nature and identify the full financial statements
  - the criteria applied in the preparation of the SFS.
- When the SFS are not accompanied by the full financial statements, consider whether the SFS describe clearly where the full financial statements are available or the law or regulation which states that they need not be.
- Compare the SFS to the full financial statements to ensure they agree with or can be derived from the latter.
Evaluate whether:

- the SFS have been prepared in accordance with the applied criteria
- the SFS contain sufficient information so as not to be misleading
- the full financial statements are readily available (unless not required to be).

Where the auditor is able to give an **unmodified opinion** on the SFS one of the following phrases should be used:

- “The SFS are consistent, in all material respects, with the audited financial statements, in accordance with [applied criteria]”, or
- “The SFS are a fair summary of the audited financial statements, in accordance with [applied criteria]”.

The term ‘true and fair’ (or its equivalent) is not used in the report, because the SFS will not contain all the information required by a recognised financial reporting framework.

**Reporting**

The auditor’s report on the SFS should include the following elements:

- **Title**
- **Addressee**
- An introductory paragraph that:
  - identifies the SFS on which the auditor is reporting
  - identifies the full financial statements
  - refers to the auditor’s report on the above, its date and the type of opinion given in that report (e.g. unmodified)
  - states that neither set of financial statements reflects the effect of events that occurred after the date of the audit report on the full financial statements (if the report on the SFS is dated later than the audit report on the full financial statements – note that it cannot be dated earlier)
  - states that the SFS do not contain all the disclosures required by the financial reporting framework applied in the preparation of the full financial statements and that reading the SFS is no substitute for reading the full financial statements.
- A description of management’s responsibility for the SFS (the preparation of the SFS in accordance with the applied criteria).
- A statement that the auditor is responsible for expressing an opinion on the SFS based on the procedures required by this ISA.
- An opinion.
- Auditor’s signature.
- Date of the auditor’s report.
- Auditor’s address.
Note that the auditor might have issued a qualified opinion on the full financial statements or used an emphasis of matter or other matter paragraph but may nevertheless be satisfied that the SFS are properly derived from those full financial statements. In this situation, the auditor’s report should also describe:

- the basis for the opinion
- any effect of the opinion on the SFS.

If the opinion was an adverse or disclaimer of opinion the auditor’s report on the SFS should state that it is inappropriate to express an opinion on the SFS.

**Example**

An example of a report on SFS is set out below. This example is based on circumstances where an unmodified opinion was expressed on the full financial statements and the auditor’s report on the SFS is dated later than the “full” auditor’s report.

### REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS

(Appropriate addressee)

The accompanying summary financial statements, which comprise the summary statement of financial position as at 31st December 20X4, the summary statement of comprehensive income, summary statement of changes in equity and summary statement of cash flows for the year then ended, and related notes, are derived from the audited financial statements of ABC Company for the year ended 31st December 20X4. We expressed an unmodified audit opinion on those financial statements in our report dated 15th February 20X5. Those financial statements, and the summary financial statements, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements.

The summary financial statements do not contain all the disclosures required by [describe financial reporting framework applied in the preparation of the audited financial statements]. Reading the summary financial statement, therefore, is not a substitute for reading the audited financial statements of ABC Company.

**Management’s responsibility for the Summary Financial Statements**

Management is responsible for the preparation of a summary of the audited financial statements in accordance with [describe established criteria].

**Auditor’s responsibility**

Our responsibility is to express an opinion on the summary financial statements based on our procedures, which were conducted in accordance with International Standard on Auditing (ISA) 810 Engagements to report on summary financial statements.

**Opinion**

In our opinion, the summary financial statements derived from the audited financial statements of ABC Company for the year ended 31st December 20X4 are consistent, in all material respects, with those financial statements, on the basis described in Note X..

[Auditor’s signature]

[Date of the auditor’s report]

[Auditor’s address]
### 11  CHAPTER REVIEW

#### Chapter review

Before moving on to the next chapter check that you can:

- Audit opening balances and comparatives
- Explain the impact of going concern on the audit report as required by ISA 570
- Describe in detail the contents of an audit report
- Identify when the basic audit report should be modified, and if so, how
- Explain the auditors’ duties with respect to other information in documents containing audited financial statements as per ISA 720
- Discuss which matters should be communicated with those charged with governance, and describe the communication process
- Describe the form, content and use of specialised audit reports
Current issues

Contents

1 Ethical issues
2 The accountancy and auditing profession
3 Transnational audits
4 Small companies
5 The impact of social and environmental matters on the statutory audit
6 Social and environmental reports and audits
7 Exposure drafts and other current issues
8 Chapter review
INTRODUCTION

Learning outcomes

Professional ethics, Quality Control and current development

E 4 Current development in auditing profession; Exposure draft issued by IAASB; Draft conceptual framework and other development projects of IAASB

Exam context

As students progress into more senior positions within their firms it becomes even more important for them to keep abreast of current affairs in the audit and assurance industry.

This chapter summarises a number of key current affairs. There is also a section that deals with social and environmental audit and assurance, another growing market for practitioners.

By the end of this chapter students will be able to:

■ Discuss current affairs impacting the audit and assurance profession
■ Describe the demand for social and environmental reporting
■ Summarise what is involved in a social and environmental audit
■ Explain the current debates and the Exposure Drafts in circulation
1 ETHICAL ISSUES

Section overview

- Introduction
- Regulation of auditing: an ethical framework or a rulebook?
- Auditor independence
- The provision of non-audit services to audit clients
- Auditor rotation

1.1 Introduction

Students need to be aware of current issues in auditing. These issues include ethical issues and the problem of auditing and exemption from audit of small companies.

Students should monitor the professional press for further developments over the course of their studies.

1.2 Regulation of auditing: an ethical framework or a rulebook?

There are generally recognised to be two methods of regulating the behaviour of individuals:

- a rulebook approach: this sets out the rules about what must and what must not be done - ‘you must not do that’
- a framework approach: this sets out principles that should govern behaviour, with reasoned arguments to support the principles - ‘you should understand why it is not acceptable to do that’.

Both approaches may be enforced by sanctions against individuals who do not comply.

There are a number of advantages of adopting a framework approach as opposed to a rulebook approach for regulating the behaviour of accountants and auditors.

- It is impossible to develop rules that will deal with all situations.
- In a rules-based system, the rules may be interpreted too narrowly. If so, the rules cease to be of practical value, because they cannot be applied with confidence in practice (unless there is a very detailed set of rules).
- An ethical framework is therefore more flexible. It sets out general principles, and requires accountants to apply the general principles to the circumstances of each case that arises.
- It may also be argued that accountants are professionals with an ethical code of conduct. Consequently, they do not need to have their behaviour regulated by detailed and strict rules and regulations.

1.3 Auditor Independence

It is well established that independence is fundamental to the credibility of the audit process. Much of the current thinking on independence has been developed by the Securities and Exchange Commission (SEC) in the USA. The work of the SEC has followed on from the corporate scandals in the US in 2001 and 2002, such as Enron and WorldCom. Similar proposals have been put forward in the UK and in other countries.
In January 2003, the SEC adopted rules to implement the **Sarbanes-Oxley Act 2002** on corporate governance. The rules aim to strengthen auditor independence and require additional disclosures to investors about the services provided to corporations by an independent accountant.

The SEC approved the following measures:

- The rules relating to non-audit services were revised, in cases where the independence of the firm would be impaired if it provided the non-audit services to the audit client.

- Rules for the rotation of audit partners. Certain partners on the audit engagement team should be ‘rotated’ (changed) after no more than five or seven consecutive years, depending on the partner’s involvement in the audit. However, some small accounting firms may be exempt from this requirement.

- Establish rules that an accounting firm would not be considered to be independent if certain members of management of the clients had been members of the accounting firm’s audit engagement team within the one-year period preceding the commencement of the audit.

- A firm should not be considered to be independent from an audit client if any audit partner involved in the audit has obtained payment (for the firm) for services relating to engagements with the client for services other than audit, review and attestation services.

- The auditors should be required to report certain matters to the client’s audit committee, including reports on any ‘critical’ accounting policies that are being used by the client.

- The audit committee of the client should be required to approve in advance all audit and non-audit services provided to the client by the auditor.

- There should be disclosure to shareholders of information about audit and non-audit services provided to the client by the auditor, and the fees for those services.

### 1.4 The provision of non-audit services to audit clients

#### Non-audit services that might impair the firm’s independence

The **Sarbanes-Oxley Act** (mentioned above) lists nine non-audit services that are considered to impair the firm’s independence if they are provided to an audit client by the firm. These are set out below.

1. **Book-keeping or other services related to the accounting records or financial statements of the audit client**

   The rules prohibit an accountant from auditing the book-keeping work performed by his or her accounting firm on behalf of a client.

2. **Financial information systems design and implementation**

   The rules prohibit a firm from providing any service related to the information systems of the audit client, unless it is reasonable to conclude that the results of these services will not be audited.

   These rules do not prevent a firm from working on the hardware or software systems of an audit client, if these are unrelated to the client's financial statements or accounting records and provided that the provision of these services by the firm is approved in advance by the audit committee.
(3) **Appraisal or valuation services, fairness opinions, or contribution-in-kind reports**

All these activities are essentially services involving a report from an accountancy firm on the valuation used in a transaction.

The rules prohibit an accounting firm from providing such services, unless the results of these services will not be audited as part of the audit of the financial statements.

(4) **Actuarial services**

The rules prohibit an accounting firm from providing any actuarial advisory service to an audit client that involves a decision about amounts to be recorded in the financial statements (and related accounts) of the audit client.

Such a service may apply, for example, to the valuation of pension funds (which is connected to the valuation of pension fund liabilities).

An accounting firm may, however, assist a client in understanding the methods, models, assumptions and inputs used in computing an amount.

(5) **Internal audit outsourcing services**

The rules prohibit the accounting firm from providing any internal audit service that has been outsourced by the audit client, where the internal audit work relates to the audit client’s internal accounting controls, financial systems or financial statements.

This means that internal audit work relating to operational controls and compliance (operational audits, VFM audits and compliance audits) by the accounting firm are permissible.

(6) **Management functions or human resources**

The rules prohibit an accounting firm from:

- acting (even in a temporary capacity) as a director, officer or employee of an audit client; or
- performing any decision-making, supervisory, or ongoing monitoring function for the audit client.

The independence of an accounting firm will also be impaired if the firm provides assistance to the audit client in connection with any senior level management appointment. An accountant’s independence is impaired with respect to an audit client when the accountant:

- seeks out prospective candidates for managerial, executive or director positions within the client company; or
- acts as negotiator, on the audit client’s behalf, with any person who has applied for a senior management position; or
- undertakes reference checks of prospective candidates for a senior management position.

- Under this rule, an accountant’s independence will also be impaired when the accountant:

  - engages in psychological testing or other formal testing or evaluation programmes; or
— recommends or advises the audit client to hire a specific candidate for a specific job.

(7) **Broker or dealer, investment adviser, or investment banking services**

Acting as a broker-dealer, promoter or underwriter on behalf of an audit client will make the accountant an advocate for the audit client and will impair their independence.

(8) **Legal services**

An accounting firm is prohibited from providing to an audit client any service that could be provided only by someone qualified to practise law in the jurisdiction in which the service is provided.

(9) **Expert services unrelated to the audit**

The rules prohibit an accounting firm from providing expert opinions to an audit client, for the purpose of advocating that audit client’s interests in litigation or in any regulatory or administrative proceeding or investigation.

**Advantages and disadvantages of the auditor providing non-audit services**

**Advantages**

The accounting firm is in an excellent position to provide its client with non-audit services. This is because:

- it already has an extensive knowledge of its client, the client’s business and its systems, and
- it should therefore be able to provide the additional non-audit services to the client at a lower cost than other accountancy firms, and with less disruption to the client.

Non-audit work also makes accounting firms more attractive in the recruitment market, because a wider range of work experience can be offered to trainees.

**Disadvantages**

However, there are some obvious disadvantages to providing non-audit services.

- The accounting firm may be seen by the world at large to lack independence from the client, because of the large fees it receives for audit and non-audit work. (This was a criticism levelled at the Houston office of accounting firm Andersens, following the collapse of Enron.)
- Accountants from the accounting firm may find themselves in a position where they are making management decisions. (If so, their independence is impaired.)

**1.5 Auditor rotation**

The need for auditor rotation has been a topic of discussion, following various major corporate failures in recent years. There has been a general perception that in many cases of corporate collapse, the accounting firm was ‘too close’ to the audit client, and had failed to detect the warning signs of collapse for the client to take appropriate preventative measures.

It has therefore been suggested that there should be a regular change in the individuals who perform the audit of a client company. This should prevent the auditor from becoming too familiar with the client and key members of the client’s staff as a result of developing a long and ‘comfortable’ relationship.
There are two different suggestions about how auditor rotation should be achieved.

- **Audit partner rotation.** The accounting firm may remain as auditors of the same client company for an unlimited number of years (or until the company decides to change its auditors). However the ‘lead’ engagement partner and other key members of the audit team should be ‘rotated’ regularly.

- **Audit firm rotation.** Alternatively the accounting firm itself should remain as auditor of a client company for no longer than a specified maximum number of years, say five years or seven years. Note that in many countries this would require legislative amendment as the law frequently provides that auditor’s appointment is for one year renewable indefinitely.

Audit partner rotation has been adopted in most countries. However, audit partner rotation is not visible to the world at large. In contrast, accounting firm rotation would provide a public demonstration of auditor independence.

**Arguments in favour of accounting firm rotation**

There are several arguments in favour of the rotation of firms providing independent audit including:

- In a long-term audit relationship, the auditors may become too close to management of the client company. This may weaken their professional scepticism and independence. They may be more likely to compromise when disagreements with management occur, in order to preserve the relationship – and the audit, and their fees.

- Even if rotation would not protect the independence of the accounting firm, it improves the public **perception** of independence, and so may increase confidence in the quality of external audits.

**Arguments against accounting firm rotation**

However, there are also a number of arguments against the rotation of firms providing independent audit including:

- There may be negative effects on audit quality and effectiveness in the first years following a change. This is because the new auditors may take several years to familiarise themselves with their new client and its procedures. There is some evidence to suggest that there may be a higher instance of audit failures in the first years following a change of auditors. If this evidence is valid, the connection between company failures and a change of auditors might reflect an inability of the newly-appointed auditor to identify problems in the client company.

- There are also substantial costs from changing auditors regularly, as the auditor attempts to familiarise themself with the new client. More management time is also needed to assist the new auditor to learn about the client company, its operations and its systems.

- There is no evidence that compulsory audit firm rotation has a positive impact on auditor independence and audit quality.

- The market for auditing listed companies is dominated by the ‘Big Four’ accountancy firms. If this domination of the audit market continues (which is probable), it may be difficult to change auditors easily. The other large firms may not have available resources to take on the audit, or may not be ‘independent’ because of other non-audit services that they already provide.
2 THE ACCOUNTANCY AND AUDITING PROFESSION

Section overview

- The current structure of the auditing profession
- Incorporation and the problem of auditors' liability

2.1 The current structure of the auditing profession

Because of increasing globalisation of companies, the auditing profession now has three tiers:

- the ‘Big Four’ international firms (Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers (PwC))
- the second tier – smaller firms but still with numerous offices and international resources
- the small firms.

The ‘Big Four’ came about from mergers and take-overs within the profession. They have the resources, expertise and geographical coverage to be able to audit the largest global entities. However, this level of amalgamation has left little choice for the largest clients and little competition for those large accounting firms.

2.2 Incorporation and the problem of auditors' liability

In most countries, accountancy and auditing practices were originally established as sole practitioners or (where permitted by local law) partnerships.

With these business structures (sole practitioner and partnership) the owner or owners have unlimited liability for the liabilities of the practice. This would include liabilities arising from legal claims against the firm for negligent audit work. The owners' personal assets as well as business assets are at risk if the firm itself cannot pay claims against it.

This principle of unlimited liability was intended to promote public confidence in the auditing profession and to encourage auditors to carry out their work with due care.

However, problems began to emerge as businesses grew and the size of claims against auditors increased.

One response to this was the introduction of requirements for practising accountants to carry professional indemnity insurance, so that liabilities arising from legal claims against a practitioner or partners can be met through an insurance policy. However the premiums for professional indemnity insurance began to rise as the size of claims increased. This has imposed an increasing financial burden on accountancy firms, particularly on smaller firms.

A more recent development for giving financial protection to accountants has been a movement towards removing ‘unlimited liability’ status of auditors. A number of approaches are available to achieve this. They include the following:

- accountancy practices may be permitted by law to trade as limited liability companies
- Accountancy practices may be permitted by law to trade as limited liability partnerships (this is permitted, for example, under UK law).
- Statute law may place a maximum limit on the size of legal claims against the auditor.
- The auditor may be able to agree with the audit client a maximum limit on legal claims (by the client company), as a formal term in the written contract under which the audit is performed.
3 TRANSNATIONAL AUDITS

Section overview

- Definition
- Transnational Audit Committee

3.1 Definition

A transnational audit is an audit of financial statements which are or may be relied upon outside the audited entity’s home jurisdiction for the purposes of significant lending, investment or regulatory decisions; this will include audits of all financial statements of companies with listed equities or debt and other public interest companies which attract particular public attention due to their size, products or services provided. Examples include Coca-Cola, Nike, Apple, Honda, Nissan, Total, Wal-Mart and LG.

IFAC’s Transnational Audit Committee (TAC) gives the following illustrations of transnational audits:

Example 1: Pakistani Company raising debt finance in Singapore.

This will qualify as a transnational audit as it is reasonable to assume that providers of debt finance in Singapore will use the financial statements of the company, prepared and audited by Pakistani standards, in making decisions.

Example 2: International charity taking donations through various national branches and making grants around the world.

This will qualify as a transnational audit as it is operating across national boundaries and is of public interest (being a charity). There is a reasonable expectation that the financial statements of this charity will be used by someone, perhaps donors, in countries other than the one it is domiciled in.

As companies subject to transnational auditing are generally listed, they will have a large amount of regulation in terms of listing requirements and corporate governance requirements which the auditors must be aware of.

Their listed status may also affect the standards by which their financial statements are prepared and audited, for example, if they are listed on a European stock market, the financial statements will have to be prepared according to international financial reporting standards and audited in accordance with international standards on auditing.

Such audits demonstrate the need for harmonised global standards in accounting and auditing.

3.2 Transnational Audit Committee

The Transnational Audit Committee is a committee of IFAC. It represents and meets the needs of the Forum of Firms, which are firms that participate in transnational auditing.

Specific responsibilities of the TAC include:

- Identifying audit practice issues. When the issues suggest changes in auditing or assurance standards may be required, recommendations are made to the appropriate IFAC standard setting boards that the issue be reviewed.
Providing a forum to discuss ‘best practices’ in areas including quality control, auditing practices, independence, and training and development.

Proposing members to the IFAC Regulatory Liaison Group and identifying qualified candidates to serve on IFAC standard setting boards.

Acting as a formal conduit for interaction among transnational firms and international regulators and financial institutions with regard to audit quality, systems of quality control, and transparency of international networks.
4 SMALL COMPANIES

Section overview

- An audit is an audit
- Audit exemption for small companies
- The audit of smaller entities
- IAASB Alert: Applying ISAs proportionately with the size and complexity of an entity

4.1 An audit is an audit

‘An audit is an audit’ is a phrase that may be used to argue that the essential features of all audits are the same, regardless of the nature or size of the entity under audit.

There is some truth in this view. For example, all audits are regulated by ISAs, and all audits result in an opinion from the auditor about whether the financial statements give a ‘true and fair view’.

However, the audit process itself differs significantly between clients, depending on:
- the key characteristics of the client (such as the size of the client and its operations); and
- the audit strategy adopted for that client.

The entity’s size is a key feature of an entity that has a significant impact on the audit approach. Smaller entities may require a very different audit approach from large entities.

4.2 Audit exemption for small companies

Many countries do not require ‘small’ companies to undergo a statutory annual audit. However, the definition of ‘small company’ varies between countries. For example:
- in the UK legislation currently exempts from audit all companies with annual revenue not exceeding £6.5 million.
- in the US, only companies listed with the SEC are required to have an annual audit.

It is worth noting that small companies which are exempt from the statutory audit requirement (in countries which allow such exemption) may still choose voluntarily to have an audit of their financial statement in order to enjoy the benefits an independent audit may bring. Benefits may include, for example, enhanced credibility when attempting to attract new capital.

A number of arguments for and against exemption are presented below.

Arguments for audit exemption for small entities

There are various arguments in favour of the view that small companies should have an exemption from statutory external audits.

- Audit costs are high: the resources could be spent by smaller entities to obtain more useful financial services.
 Providers of loan finance (for example, banks) will normally attach their own specific conditions to borrowings. These conditions are often independent of the content of the borrower’s financial statements.

 Filing deadlines for the accounts of smaller companies are often long after the reporting date. The audited financial statements are therefore often ‘out of date’ and of limited use, by the time they become available for inspection.

 Many countries allow smaller companies to publish ‘abbreviated’ financial statements. Consequently only a limited amount of audited information is available to users of the statements.

**Arguments against audit exemption**

There are also various arguments against the view that small companies should have an exemption from statutory external audits. Some of these arguments emphasise the potential benefits of annual audits.

 If the financial statements have been prepared by a part-qualified accountant, an audit provides some assurance that they provide a true and fair view and do not contain material misstatements.

 The audit is valuable, especially to user groups other than the shareholders (such as trade suppliers, tax authorities), by giving them some reassurance about the financial statements of small entities.

 Shareholders, especially minority shareholders, should be entitled to receive financial statements from the entity that have been independently audited.

 The external audit imposes a level of discipline on companies, in matters relating to accounting and internal control. The auditors can advise management on ways of improving internal control.

 The audit may identify areas where efficiency and cost savings can be made by the entity. These savings would have the effect of reducing the overall cost of the audit.

 If a small company expects to approach its bank in the future to ask for loan finance, the bank may demand to see audited financial statements (for the purpose of assessing the loan application).

 The tax authorities are more likely to accept audited financial statements as a valid basis for computing the company’s tax liability.

 If the small company expects to grow, it will become large enough at some time in the future to require a statutory annual audit. If there are material errors in its financial statements, the cost of its first statutory audit could be high.

**4.3 The audit of smaller entities**

Standard audit practice requires the auditor to gain an understanding of the business and its environment in developing an audit strategy. Applying this principle to the audit of smaller entities will allow the auditor to focus attention on the main features of the client, which will affect the audit approach.

The key issue in deciding the audit approach is likely to be internal control, and the limited nature of the control system.
Segregation of duties is likely to be weak, due to the restricted numbers of staff employed by smaller entities.

Owners or senior management are likely to dominate all major aspects of the business activities. This is useful as a form of supervisory control, but the internal controls over management themselves are likely to be very weak and ineffective.

In an expanding business, senior management may be closely involved in developing the business, leaving them with little time for supervisory controls or for implementing and monitoring other controls.

Record-keeping and documentation of system and controls may be informal and inadequate. This further weakens the internal control system.

**Audit approach to smaller entities**

The table below summarises the main additional points for the auditor to consider when dealing with a smaller entity.

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<th>Area</th>
<th>Comment</th>
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<tbody>
<tr>
<td>Acceptance of the audit appointment</td>
<td>The auditor should be aware of the possible risks to independence, resulting from:</td>
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<td></td>
<td>close involvement with management</td>
</tr>
<tr>
<td></td>
<td>pressure by management to reduce the audit fee.</td>
</tr>
<tr>
<td>Engagement letter</td>
<td>This formalises the relationship between the auditor and the client.</td>
</tr>
<tr>
<td></td>
<td>If necessary, it separates the accounts preparation function from the auditing function.</td>
</tr>
<tr>
<td>Planning and recording</td>
<td>This process will be similar to the audit engagement for larger entities, but is likely to be simpler. The audit team may be very small so communication and co-ordination should be easier. A brief memorandum prepared at the completion of the previous audit, updated in the current period based on discussion with the owner-manager, may be sufficient as the documented audit strategy for the current audit.</td>
</tr>
<tr>
<td>Accounting systems</td>
<td>The accounting systems may not be adequate for audit purposes, and the auditor may not be able to rely on the controls in place. As a result, control risk is likely to be high.</td>
</tr>
<tr>
<td>Substantive procedures</td>
<td>Substantive procedures are likely to form the basis of the audit work, if controls are weak. However, it is difficult to reach a conclusion on the completeness of accounting records, where the audit is based only on substantive procedures.</td>
</tr>
<tr>
<td>Audit evidence</td>
<td>High-quality evidence may be more difficult to find than in a larger entity.</td>
</tr>
</tbody>
</table>
Chapter 15: Current issues

<table>
<thead>
<tr>
<th>Area</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Materiality</td>
<td>A smaller entity’s profit before tax may be consistently negligible, as the bulk of any profit may be taken out by the owner-manager as remuneration. A benchmark such as profit before remuneration and tax might therefore be more relevant.</td>
</tr>
<tr>
<td>Analytical procedures</td>
<td>Smaller entities may not have interim or monthly financial statements which can be used for analytical review purposes. ISA 315 suggests that the auditor may be able to use an early draft of the entity’s year-end financial statements.</td>
</tr>
<tr>
<td>Management representations</td>
<td>These are often more important in smaller entities than large entities. However, the auditor must look for evidence to support the management representations.</td>
</tr>
<tr>
<td>Going concern</td>
<td>A smaller entity may be more able to quickly respond to opportunities, but it may also be more vulnerable to a bank withdrawing support. The continued financial support of the owner-manager may be vital to the survival of the entity and the auditor will need to assess the risk of that support failing.</td>
</tr>
<tr>
<td>Audit report</td>
<td>There may be insufficient evidence as to the completeness and accuracy of the records, which may lead to a qualified audit opinion.</td>
</tr>
<tr>
<td>Review of financial statements</td>
<td>This is the same as for the audit of any other company, except that smaller entities may be exempt from certain reporting requirements (for example, from the application of certain requirements of International Financial Reporting Standards).</td>
</tr>
</tbody>
</table>

4.4 IAASB Alert: Applying ISAs proportionately with the size and complexity of an entity

In August 2009 the IAASB issued a questions & answers (Q&A) publication to highlight how the design of the International Standards on Auditing (ISAs) issued by the IAASB under the Clarity Project enables them to be applied in a manner proportionate with the size and complexity of an entity.

Specifically, while ISAs apply to audits of entities of all sizes and complexities, the Q&A focuses on matters that are likely to be of particular relevance to their application in the context of an audit of a small- and medium-sized entity (SME).

The key points include:

- **The auditor’s objectives are the same for audits of entities of different sizes and complexities.** This, however, does not mean that every audit will be planned and performed in exactly the same way. The ISAs recognise that the specific audit procedures to be undertaken to achieve the auditor’s objectives and to comply with the requirements of the ISAs may vary considerably depending on whether the entity being audited is large or small and whether it is complex or relatively simple. The requirements of the ISAs, therefore, focus on matters that the auditor needs to address in an audit and do not ordinarily detail the specific procedures that the auditor should perform.
Often, SMEs engage in relatively simple business transactions. This means that their audits under the ISAs will generally be relatively straightforward. The alert offers a number of illustrations:

- the typically simpler structure and processes in an SME often mean that the auditor may obtain an understanding of the entity and its environment in accordance with ISA 315 quite readily and document this in a straightforward manner.
- Similarly, internal control in the context of an SME may be simpler.

The ISAs help guide the auditor in their application to an SME audit by:

- Specifying alternative procedures regarding understanding the entity’s risk assessment process when the entity has not established such a process
- Specifying a choice of audit procedures based on the particular circumstances e.g. choice of responses to assessed risks for accounting estimates under ISA 540
- They indicate if a requirement is conditional where those charged with governance and management are the same
- Individual ISAs also include useful guidance that assists the auditor in understanding or applying specific requirements in the ISAs in the context of an SME audit

The auditor shall comply with all ISAs relevant to the audit. However, for an SME audit several of the ISAs may not be relevant as the circumstances in which the ISA applies may not exist in the engagement. For example:

- ISA 402 if the SME does not use a service organization
- ISA 510 if the SME audit is continuing and not an initial engagement
- ISA 600 if the SME audit engagement is not a group audit
- ISA 610 if the SME has no internal audit function
- ISAs 800, 805 and 810 if the SME audit engagement is to report on general purpose financial statements

Even if an ISA is relevant, not all of its requirements may be relevant. E.g.

- Holding an engagement team discussion if it is only a one-person team
- Performing specified substantive and other follow-up procedures if the auditor has not identified previously unidentified or undisclosed related parties or significant related party transactions

Audit documentation assists the auditor in an SME audit. E.g.

- Assists in planning and performing the audit
- Provides a record of matters of continuing relevance
- Enhances the quality of the auditor’s judgments

The ISAs recognise it is unrealistic to expect every aspect of an audit to be documented. E.g. documenting compliance with matters for which compliance is demonstrated by documents included within the audit file. E.g. An audit plan demonstrates the audit was planned.
5 THE IMPACT OF SOCIAL AND ENVIRONMENTAL MATTERS ON THE STATUTORY AUDIT

### Section overview
- ISA 250: Consideration of laws and regulations in an audit of financial statements
- Other relevant ISAs
- IAPS 1010: The consideration of environmental matters in the audit of financial statements
- Substantive procedures to detect a material misstatement due to environmental matters

#### 5.1 ISA 250: Consideration of laws and regulations in an audit of financial statements

As discussed in a previous chapter, ISA 250 requires the auditor to obtain sufficient appropriate evidence in respect of non-compliance with laws and regulations which might be expected to have a direct effect on material amounts and disclosures in the financial statements. Non-compliance could be over a variety of social or environmental matters such as:

- health and safety legislation
- equal opportunities legislation, or
- anti-pollution legislation.

Social or environmental matters can have a direct impact on the statutory audit. This is because a breach of social or environmental legislation may have a material impact on the financial statements. For example, if an entity is in breach of social or environmental legislation (or other regulations):

- it may need to include a provision for fines or penalties in its financial statements
- it may need to disclose a contingent liability for a possible settlement in a court case, where the entity is facing a civil lawsuit for damages arising from a breach of environmental or social regulations
- it may be required by law to improve working conditions or rates of pay, which will affect labour costs
- it may be necessary to write down the value of certain assets due to impairment.

#### 5.2 Other relevant ISAs

There are some other ISAs that include a reference to social or environmental aspects of the external audit.

**ISA 315: Identifying and assessing the risks of material misstatement through understanding the entity and its environment**

The auditor should evaluate the environmental risks facing a client entity, and the controls that are in place to manage those risks. ISA 315 therefore requires the auditor to be aware of:

- relevant environmental legislation
the nature of the production processes used by the entity, and
- the general impact of the entity’s activities on its physical environment.

Environmental risks will include:
- contingent liabilities arising from legal claims against the entity, as a result of environmental damage or a breach of environmental protection regulations
- provisions that may be required for restoration costs
- expenditure that may be required to modify or clean the production processes and re-design products, in order to meet environmental regulations.

**ISA 330: The auditor’s responses to assessed risks**

ISA 330 requires the auditor to design audit procedures that take into consideration the environmental risk assessment. Designing suitable audit procedures to assess environmental risk will probably require a high level of professional judgement from the auditor. In particular, judgement may be required as to whether a liability exists, and if so, how it should be measured. As a result:
- the auditors may need to take advice from external experts, and
- written management representations should be obtained about the environmental risks.

**ISA 540: Audit of accounting estimates**

ISA 540 includes a requirement that the auditor should review the approach taken by management to making estimates that relate to environmental risks.

**5.3 IAPS 1010: The consideration of environmental matters in the audit of financial statements**

*Whilst IAPS 1010 has been formally withdrawn the substance of its contents remains a useful reference.*

**Environmental matters** were defined by IAPS 1010 as:
- initiatives to prevent, reduce or repair damage to the environment or to conserve resources
- consequences of violating environmental laws or regulations, and
- consequences of environmental damage.

For many companies, environmental matters are not significant. However, where environmental matters are significant there may be a risk of material misstatement in the financial statements. For example, environmental risks may be significant for an oil exploration company, a chemical production company or a provider of energy from nuclear power.

The following examples were given of environmental matters that might affect the financial statements:
- The introduction of new environmental laws and regulations may lead to an impairment of assets. For example, new laws may be introduced relating to assets containing dangerous substances such as asbestos. When this
happens, entities may be required to recognise the impairment of non-current assets that contain the substance.

- An entity may be guilty of non-compliance with legal requirements concerning environmental matters, such as emissions or waste disposal. In some cases, there may be new environmental legislation with retrospective effect. In all these circumstances, the entity may be required to make **accruals** for remediation work, and for paying compensation or legal costs.

- Some entities incur **environmental obligations** as a direct by-product of their core businesses. This applies, for example, to companies in the extraction industries (oil and gas exploration or mining), chemical manufacturers and waste management companies.

- A **provision** may be required as a result of **constructive obligations** that the entity incurs from a voluntary initiative. For example, an entity may have identified contamination of land. Although under no legal obligation, it may have decided to remedy the contamination (or it may be expected to remedy the contamination, because of its past actions), because of its concern for its long-term reputation and its relationship with the community.

- An entity may need to disclose in the financial statements the existence of a **contingent liability** where the expense relating to environmental matters cannot be reasonably estimated.

- In extreme situations, non-compliance with certain environmental laws and regulations may affect the ability of an entity to continue as a **going concern**. This may affect the disclosures and the basis of preparation of the financial statements.

**Risk assessment and internal control**

IAPS 1010 stated that in order to obtain a general understanding of relevant environmental laws and regulations, the auditor should carry out the following procedures:

- The auditor should use their existing knowledge of the entity’s industry and business.

- The auditor should ask the management of the entity questions about the environmental laws and regulations that may be expected to have a fundamental effect on the operations of the entity.

- The auditor should also ask the management of the entity questions about the entity’s policies and procedures regarding compliance with relevant environmental laws and regulations. Managers with responsibility for environmental matters should be questioned, as well as senior management.

- The auditor should discuss with management the policies or procedures that the entity has adopted for identifying, evaluating and accounting for litigation claims and assessments.

The auditor may find evidence of a risk of a material misstatement in the financial statements due to environmental matters. For example, evidence of such a risk may be discovered in the following circumstances:

- The auditor might discover the existence of a report about material environmental problems, prepared by environmental experts, internal auditors or environmental auditors.
The auditor might discover evidence of a violation of environmental laws and regulations, which is mentioned in correspondence with regulatory agencies, or a report issued by a regulatory agency.

The auditor may find that the name of the entity is included in a public register, or plan, for the restoration of soil contamination.

There may be reports or comments in the press or other media about the entity and its involvement or responsibility for major environmental problems.

The auditors may find comments relating to environmental matters made in solicitors' letters to the entity.

The auditors might suspect environmental risks when they find large or unusual fees charged by environmental consultants, or large payments of penalties as a result of a violation of environmental laws and regulations.

5.4 Substantive procedures to detect a material misstatement due to environmental matters

The external auditors may design substantive tests for detecting a material misstatement in the financial statements due to environmental matters. The substantive tests may consist of the following checks:

- A review of documents such as:
  - minutes of meetings (board meetings, audit committee meetings, environmental committee meetings)
  - industry information
  - media comment
  - environmental reports and audits
  - internal audit reports
  - due diligence reports
  - reports from regulators
  - correspondence with environment agencies
  - correspondence with solicitors.

- The auditors may use an external expert to provide advice (in accordance with ISA 620).

- The auditors may use the work done by the internal audit department to investigate environmental risks and controls within the entity.

- The auditor may make some inquiries about the insurance cover obtained by the entity for its environmental risks.

- The auditors should obtain written representations from management that they have considered the effects of environmental matters on the financial statements, and that:
  - they are not aware of any material liabilities or contingencies arising from environmental matters, including those resulting from illegal or possibly illegal acts
  - they are not aware of environmental matters that may result in a material impairment of assets, or
• if they are aware of such matters, they have disclosed all the relevant facts to the auditor.

The auditor should ask about the policies and procedures of management for assessing the need to write-down the carrying amount of assets, in situations where any impairment of assets has occurred due to environmental matters. The auditor should also consider the adequacy of any write down of assets that the entity has made.

The auditor should ask about the policies and procedures that are used by the entity to help identify liabilities, provisions or contingencies arising from environmental matters.

The auditor should ask about events or conditions that may give rise to liabilities, provisions or contingencies arising from environmental matters. For example, the auditor should ask whether there have been:
• violations of environmental laws and regulations
• penalties arising from violations of environmental laws and regulations, or
• claims and possible claims for environmental damage.

If the entity has identified a need for site clean-up costs, restoration costs or penalties arising from non-compliance with environmental laws and regulations, the auditors should inquire about any related legal claims or possible legal claims.

The auditor should ask whether there is any correspondence from regulatory authorities relating to environmental matters. When such correspondence exists, the auditor should consider whether the correspondence indicates the existence of a liability, provision or contingent liability.

When property (land or buildings) has been abandoned, purchased or closed during the period, the auditor should ask about regulatory requirements for cleaning up the site, or about the intentions of the entity with regard to clean-up, future removal of the building and site restoration at the end of the asset’s life.

The auditor should perform analytical procedures and consider, as far as practicable, the relationships between financial information and quantitative environmental information. For example, the auditor might analyse the entity’s environmental records and establish whether there is a relationship between raw materials consumed and waste production/emissions.

The auditor should review and test the process used by management to develop accounting estimates and disclosures relating to environmental matters. A review might consist of obtaining an estimate from an independent expert to corroborate the estimates of management. Alternatively, the auditor might be able to verify the estimates of management from subsequent events after the reporting period.

For all liabilities, provisions, or contingencies related to environmental matters, the auditor should consider whether the assumptions underlying the estimates are appropriate, and whether the amount of the liability, provision or contingency is reasonable.

The auditor should review the adequacy of the disclosures in the financial statements about the effects of environmental matters.
6 SOCIAL AND ENVIRONMENTAL REPORTS AND AUDITS

Section overview

- The significance of social and environmental reporting
- Environmental reports
- Environmental audits
- Social reports and audits
- Audit evidence for social and environmental reports
- Assurance on social, environmental and sustainability reports

6.1 The significance of social and environmental reporting

Under pressure from public opinion, many entities are now aware of social and environmental issues, and the effect that the entity has on social and environmental matters in the countries where it operates. If it fails to recognise social and environmental problems, and is not seen to be doing something about them, an entity’s reputation may be at risk. Reputational risk can have consequences for customer demand for the entity’s products. Many members of the public may refuse to buy goods from companies, or invest in the shares of companies, unless those companies have ‘healthy’ social and environmental policies.

The senior management of some major entities would argue that they show more concern for social and environmental matters than governments.

It has therefore become increasingly important for companies to demonstrate their social and environmental policies, by publishing social and environmental reports, or through their web sites, advertising and media reports.

In most countries including Pakistan, reporting on social and environmental issues is voluntary. However, the EU has recently issued an accounts modernisation directive, requiring quoted companies to publish a business review each year. This review should include information about a range of issues, including social and environmental matters.

Environmental policies

An entity’s environmental policies might cover such matters as:
- energy consumption
- pollution
- the use of natural resources and sustainability of the business
- use of re-cycled materials.

Social policies

Social policies might cover such areas as:
- employee rights (for example, rights to trade union membership)
- employee training and development
human rights
• child labour in developing countries
• equal opportunities
• health and safety matters
• relationship with the local community
• supporting local, national and international good causes.

Many large companies now publish a social and environmental report, sometimes called a sustainability report. The aim of such reports is to demonstrate that the company has a strong social and environmental conscience, and is actively engaged in improving social and environmental conditions.

Credibility can be added to these reports by an independent verification statement from a firm of accountants or similar firm of independent external experts.

6.2 Environmental reports

Many larger entities whose activities have an environmental impact now publish an annual environmental report or sustainability report. This may be published as part of the company’s annual report. More often, it is published as a separate document.

The contents of environmental reports are not regulated, and although the external auditors may review the reports, they are not included within the scope of the statutory audit opinion. However, some entities engage external ‘environmental experts’ to review and report on their environmental reports.

An environmental report is seen as an important indicator of the commitment that the entity is giving to its impact on the physical environment and the future of the planet and its peoples.

An environmental report may cover such matters as:
• environmental performance targets and the extent to which they have been achieved
• relevant environmental regulations imposed on the entity, and the extent to which they are complied with
• compliance with industry standards or other environmental standards
• the entity’s policy on ‘sustainable development’. Sustainability refers to the ability of the entity to meet the needs of the present generation of customers without adversely affecting future generations. For example, a supplier of timber may have a policy of re-forestation of large geographical areas, to replace timber that they cut down.

Example: Royal Dutch Shell plc Sustainability Report

Shell is an integrated energy company that aims to meet the world’s growing demand for energy in ways that are economically, environmentally and socially responsible.

Shell has been publishing an annual sustainability report since 1997 which focuses on the sustainability challenges and subjects that matter most to people who have an interest in their activities.
Shell includes contributions from non-governmental organisations, investors, media, rating agencies and public opinions as well as teams and individuals within Shell covering topics such as:

- The arctic – climate change, communities, ecosystems
- Biofuels – standards and sustainability clauses
- Climate change – carbon capture and storage, energy efficiency, greenhouse gas emissions, lower-carbon technologies
- Contractors, suppliers and JVs – local economic development and employment, worker welfare and labour rights
- The environment – biodiversity, decommissioning, oil spills, performance
- Human rights – code of conduct, indigenous peoples, labour rights, security
- Safety – asset integrity, assurance, performance, response capability
- Social performance – community engagement, feedback and investment
- Sustainability in Shell – principles, sharing benefits, sustainability strategy
- Technology and innovation – new and advanced technologies and fuels, renewable energy

6.3 Environmental audits

An environmental audit can be defined as:

‘…a management tool, comprising a systematic, objective assessment of how well an entity is performing with the aim of safeguarding the environment by enhancing management control of environmental practices including compliance with appropriate legislation and regulations.’

An environmental audit may be performed by:

- the entity’s external auditors, or
- the internal auditors, or
- external environmental experts.

Environmental audits are not subject to the same high level of regulation as financial audits. However, if an environmental audit is performed by professionally qualified accountants, it would be subject to the usual requirements of codes of professional practice for accountants.

Typically, an environmental audit involves an assessment of all impacts of the entity’s activities on the environment, including:

- compliance with environmental regulations, for example on pollution of land, water and air
- waste disposal
- recycling policies
- sourcing of raw materials.

The accountant performing an environmental audit will determine the environmental policies that the organisation has in place, and assess the entity’s performance based on measurable performance criteria. For example, actual performance measures for pollution might be compared with pre-established targets.
6.4 Social reports and audits

Many entities now publish a ‘social report’ or social information, often together with an environmental report. These reports may be subject to an audit or review process, by the entity’s external auditors, internal auditors or external experts.

An extract from the ‘Our Approach’ section of Shell’s 2014 Sustainability Report gives some indication of the topics that these reports might cover.

Example: Extracts from Shell’s 2014 Sustainability Report

The core values of honesty, integrity and respect for people are reflected in our business principles, which govern the way we work. These principles are applied to the environment and in all our relationships with business partners and neighbours.

The Shell General Business Principles (SGBP) detail our responsibilities to shareholders, customers, employees, business partners and society. They set the standards for the way we conduct business with integrity and our respect for the environment and local communities. All Shell employees and contractors, and those at joint ventures we operate, are expected to understand and behave according to our business principles at all times. We encourage suppliers and joint ventures that we do not operate, to apply equivalent principles.

Human rights

We have the responsibility and commitment to respect human rights. Our human rights policy is informed by the UN Guiding Principles on Business and Human Rights, and applies to all of our employees and contractors. Since 2010, we have been working to integrate human rights into existing policies, systems and practices. We embrace a diverse and inclusive work force and have an equal opportunities policy.

We consult with international organisations, companies, civil society and relevant bodies to understand and respond to current and emerging human rights issues. We also work with oil and gas industry bodies to help other companies adopt human rights practices. For example, in 2014, we helped IPIECA (the global oil and gas industry association for environmental and social issues) develop a manual about community grievance mechanisms to offer practical tools for the industry to implement mechanisms for communities. Our human rights approach focuses on four key areas:

Communities

We assess the potential environmental, health and community impacts of our projects. We have community feedback mechanisms in place to enable people neighbouring our operations to raise concerns about the impacts of our activities and remedy any issues.

Security

We aim to keep employees, contractors and facilities safe, while respecting the human rights and security of local communities. We implement the Voluntary Principles on Security and Human Rights (VPSHR) and include them in our private security contracts and in our engagements with public security forces. We conduct annual risk assessments in our relevant operations and provide training to relevant employees and contractors.
Labour rights

The UN Global Compact, of which we are a signatory, details labour rights within its principles. We apply the core International Labour Organisation conventions on workers’ rights and respond to current and emerging issues on the implementation of the Global Compact principles. We also work to reflect this throughout our supply chain.

Supply chain

The Shell Supplier Principles were introduced in 2011 and apply to all our suppliers and contractors. They set out the expectations we have of our suppliers and contractors about labour conditions as well as business integrity, health, safety and social performance. In 2014, we developed a guide on worker welfare for our projects.

6.5 Audit evidence for social and environmental reports

In most countries there are currently only limited statutory requirements or no statutory requirements at all, about social and environmental reporting. However, the situation is constantly evolving and continues to attract frequent debate.

In the European Union, for example, public interest entities companies (i.e. large, predominantly listed companies) have been required to include some information about social and environmental risks in their annual business review. More recently the EU voted in 2014 to accept a new directive on the disclosure of non-financial information including social and environmental issues.

Example: EU Directive to enhance business transparency on social and environmental matters 2014 (effective 2017)

In 2013, the Commission issued a proposal to enhance business transparency on social and environmental matters. This proposal was adopted in 2014 to be effective for financial years 2017 onwards.

Certain public interest entities (PIEs), particularly those with more than 500 employees, must:

- Report on environmental, social and employee-related, human rights, anti-corruption and bribery matters; and
- Describe their business model, outcomes and risks of their policies regarding these topics, as well as their diversity policy for management and supervisors.

Companies are encouraged to use standardised, recognised frameworks, such as the Global Reporting Initiative (GRI) Sustainability Reporting Guidelines and the U.N. Guiding Principles on Business and Human Rights.

Since companies normally decide what to include in their social and environmental report, the report may contain very few verifiable numbers and may consist largely of narrative (‘words, not numbers’).

However some companies have chosen to include quantified performance measurements in their social and environmental report. (Some companies publish ‘sustainability reports’. These report figures for financial performance, social performance and environmental performance. Sustainability reports are sometimes referred to as ‘triple bottom line reporting’, because they present performance reports for each of these three areas.)
When social and environmental reports include quantified performance figures, performance is often reported by comparing actual performance against target for a number of different ‘key performance indicators’ or KPIs. The KPIs vary according to the nature of the company and its business.

To make these reports more convincing and believable to users, the figures may be audited to verify that they are reliable.

**Example: KPIs**

The KPIs and sources of audit evidence in the table below are illustrative only. They provide an indication of the nature of performance measurements for social and environmental issues. The selection of KPIs is a matter of choice for the company itself, and the performance measurements used therefore vary widely. (Remember that social issues include matters relating to employment and employees as well as matters relating to society as a whole and the ‘corporate citizenship’ of the company.)

<table>
<thead>
<tr>
<th>Key performance indicator</th>
<th>Possible source of audit evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Social indicators: employees</strong></td>
<td></td>
</tr>
<tr>
<td>% of employees who are women, or from particular ethnic groups or in particular age groups (as evidence of non-discrimination)</td>
<td>Personnel file</td>
</tr>
<tr>
<td>Staff turnover ratio</td>
<td>Personnel files</td>
</tr>
<tr>
<td>Spending on employee training</td>
<td>Cash book or training account in the main ledger</td>
</tr>
<tr>
<td>Absentee levels</td>
<td>Payroll records, records of medical evidence of ‘sick leave’</td>
</tr>
<tr>
<td>Injuries at work: number or expressed as a % of the work force</td>
<td>Health and safety records</td>
</tr>
<tr>
<td><strong>Social indicators: customers and general public</strong></td>
<td></td>
</tr>
<tr>
<td>Customer satisfaction measurements: number of complaints as a % of sales orders</td>
<td>Records in sales administration</td>
</tr>
<tr>
<td>Spending on charitable causes, or investment in particular communities</td>
<td>Cash book or relevant expenditure account in the main ledger</td>
</tr>
<tr>
<td><strong>Environmental indicators</strong></td>
<td></td>
</tr>
<tr>
<td>Increase or reduction in consumption of natural resources (water) and energy</td>
<td>Invoices from utility companies</td>
</tr>
<tr>
<td>Pollution levels</td>
<td>Official regulatory measurements</td>
</tr>
<tr>
<td>% of waste re-cycled</td>
<td>Observation and inspection of related records</td>
</tr>
<tr>
<td>Investment in environmentally-friendly materials (such as re-cycled paper)</td>
<td>Observation, inquiries of the relevant staff and purchase orders</td>
</tr>
</tbody>
</table>
6.6 Assurance on social, environmental and sustainability reports

One option for organisations to enhance the credibility of their social, environmental and sustainability reports is to commission a voluntary assurance engagement from an independent practitioner. Depending on the nature of the engagement this could take the form of:

- an assurance engagement in accordance with ISAE 3000
- an ‘agreed-upon’ procedures engagement in accordance with ISRS 4400

The most common approach is to agree a limited assurance engagement in accordance with ISAE 3000 with a narrower scope of procedures than typically found in a statutory audit.
7 EXPOSURE DRAFTS AND OTHER CURRENT DEBATES

Section overview

- Reporting on audited financial statements: new and revised ISAs
- ED December 2012: Responding to a Suspected Illegal Act
- XBRL: The emerging landscape
- Significant unusual or highly complex transactions
- Reform of the audit profession
- The auditor’s responsibilities relating to other information
- ED Addressing disclosures in the audit of financial statements
- Integrated reporting
- Audit quality

7.1 Reporting on audited financial statements: new and revised ISAs

ED 2013: Proposed new and revised ISAs relating to reporting on audited financial statements

The auditor’s opinion on the financial statements is valued; however, many have called for the auditor’s report to be more informative – in particular, for auditors to provide more relevant information to users based on the audit that was performed.

In response the IAASB issued an exposure draft in July 2013 which proposed a number of revisions to ISAs aimed at improving the auditor’s report on audited financial statements.

The proposed ISAs represented a significant change in practice, but enhanced auditor reporting is viewed as critical to the perceived value of the financial statement audit and thus to the continued relevance of the auditing profession.

Expected benefits from the ISA revisions include:

- The primary beneficiaries of the IAASB’s work on auditor reporting will be investors, analysts and other users of the auditor’s report. An audit enhances the credibility of financial statements and can directly or indirectly improve the quality of financial reporting. Because the auditor’s report is the key deliverable addressing the output of the audit process for users of the audited financial statements, the IAASB is of the view that changes in auditor reporting may have positive benefits to audit quality or users’ perception of it. This in turn may increase the confidence that users have in the audit and the financial statements, which is in the public interest.

- Enhanced communicative value of the auditor’s report, providing more transparency about the audit that was performed.

- Increased attention by management and those charged with governance to the disclosures in the financial statements to which reference is made in the auditor’s report (e.g., key audit matters, going concern, etc.), which may further improve the quality of financial reporting.

- Renewed focus of the auditor on matters to be reported, which could indirectly result in an increase in professional scepticism, among other contributors to audit quality.
Enhanced communications between the auditor and those charged with governance, for example more robust dialogue about the key audit matters that will be communicated in the auditor’s report.

The proposed ISAs were unanimously approved by the Public Interest Oversight Board (PIOB) in September 2014 and new and revised Auditor Reporting standards were issued on 15th January 2015. These standards are effective for audits of financial statements for periods ending on or after December 15, 2016.

The key enhancements to auditor reporting incorporated in the new and revised ISAs include:

<table>
<thead>
<tr>
<th>ISA</th>
<th>Proposed revision</th>
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</thead>
<tbody>
<tr>
<td>ISA 700 (Revised), Forming an Opinion and Reporting on Financial Statements</td>
<td>Revisions to establish new required reporting elements, including a requirement for the auditor to include an explicit statement of auditor independence and disclose the source(s) of relevant ethical requirements, and to illustrate these new elements in illustrative auditor’s reports</td>
</tr>
<tr>
<td>ISA 701 (New), Communicating Key Audit Matters in the Independent Auditor’s Report</td>
<td>New standard to establish requirements and guidance for the auditor’s determination and communication of key audit matters. Key audit matters, which are selected from matters communicated with those charged with governance, are required to be communicated in auditor’s reports for audits of financial statements of listed entities. Auditors of financial statements of entities other than listed entities may also be required, or may decide, to communicate key audit matters in the auditor’s report.</td>
</tr>
<tr>
<td>ISA 260 (Revised), Communication with Those Charged with Governance</td>
<td>In light of proposed ISA 701, amendments to the required auditor communications with those charged with governance, for example, to include communication about the significant risks identified by the auditor</td>
</tr>
<tr>
<td>ISA 570 (Revised), Going Concern</td>
<td>Amendments to establish auditor reporting requirements relating to going concern, and to illustrate this reporting within the auditor’s report in different circumstances</td>
</tr>
<tr>
<td>ISA 705 (Revised), Modifications to the Opinion in the Independent Auditor’s Report</td>
<td>Amendments to clarify how the new required reporting elements of proposed ISA 700 (Revised) are affected when the auditor expresses a modified opinion, and to update the illustrative auditor’s reports accordingly</td>
</tr>
<tr>
<td>ISA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report</td>
<td>Amendments to clarify the relationship between Emphasis of Matter paragraphs, Other Matter paragraphs and the Key Audit Matters section of the auditor’s report</td>
</tr>
<tr>
<td>Conforming Amendments to Other ISAs</td>
<td>Conforming amendments related to communicating key audit matters in ISAs 210, 220, 230, 510, 540, 580, 600, 710.</td>
</tr>
</tbody>
</table>
The following illustration shows an example of the revised unmodified audit report as presented in the appendix to the revised ISA 700. This will enable you to visualise some of the main changes that will become mandatory in December 2016, including:

- Opinion paragraph at the start
- New sections on key audit matters, going concern and 'other information'
- Extended description of auditor’s responsibilities.

Example: An example of the proposed new unmodified audit report is set out below.

<table>
<thead>
<tr>
<th>INDEPENDENT AUDITOR’S REPORT</th>
</tr>
</thead>
<tbody>
<tr>
<td>To the Shareholders of ABC Company [or Other Appropriate Addressee]</td>
</tr>
<tr>
<td>Report on the Audit of the Financial Statements</td>
</tr>
<tr>
<td>Opinion</td>
</tr>
<tr>
<td>In our opinion, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of ABC Company (the Company) as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).</td>
</tr>
<tr>
<td>We have audited the financial statements of the Company, which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.</td>
</tr>
<tr>
<td>Basis for Opinion</td>
</tr>
<tr>
<td>We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor’s Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company within the meaning of [indicate relevant ethical requirements or applicable law or regulation] and have fulfilled our other responsibilities under those ethical requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.</td>
</tr>
<tr>
<td>Key Audit Matters</td>
</tr>
<tr>
<td>Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements. Key audit matters are selected from the matters communicated with [those charged with governance], but are not intended to represent all matters that were discussed with them. Our audit procedures relating to these matters were designed in the context of our audit of the financial statements as a whole. Our opinion on the financial statements is not modified with respect to any of the key audit matters described below, and we do not express an opinion on these individual matters.</td>
</tr>
<tr>
<td>Valuation of Financial Instruments</td>
</tr>
<tr>
<td>The Company’s disclosures about its structured financial instruments are included in Note 5. The Company’s investments in structured financial instruments represent [x%] of the total amount of its financial instruments. Because the valuation of the Company’s structured financial instruments is not based on quoted prices in active markets, there is significant measurement uncertainty involved in this valuation. As a result, the valuation of these instruments was significant to our audit. The Company has determined it is necessary to use an entity-developed model to value these instruments, due to their unique structure and terms. We challenged management’s</td>
</tr>
</tbody>
</table>
rationale for using an entity-developed model, and discussed this with [those charged with governance], and we concluded the use of such a model was appropriate. Our audit procedures also included, among others, testing management’s controls related to the development and calibration of the model and confirming that management had determined it was not necessary to make any adjustments to the output of the model to reflect the assumptions that marketplace participants would use in similar circumstances.

Revenue Recognition Relating to Long-Term Contracts
The terms and conditions of the Company’s long-term contracts in its [name of segment] affect the revenue that the Company recognises in a period, and the revenue from such contracts represents a material amount of the Company’s total revenue. The process to measure the amount of revenue to recognise in the [name of industry], including the determination of the appropriate timing of recognition, involves significant management judgment. We identified revenue recognition of long-term contracts as a significant risk requiring special audit consideration. This is because side agreements may exist that effectively amend the original contracts, and such side agreements may be inadvertently unrecorded or deliberately concealed and therefore present a risk of material misstatement due to fraud. In addition to testing the controls the Company has put in place over its process to enter into and record long-term contracts and other audit procedures, we considered it necessary to confirm the terms of these contracts directly with customers and testing journal entries made by management related to revenue recognition. Based on the audit procedures performed, we did not find evidence of the existence of side agreements. The Company’s disclosures about revenue recognition are included in the summary of significant accounting policies in Note 1, as well as Note 4.

Going Concern
The Company’s financial statements have been prepared using the going concern basis of accounting. The use of this basis of accounting is appropriate unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so. As part of our audit of the financial statements, we have concluded that management’s use of the going concern basis of accounting in the preparation of the Company’s financial statements is appropriate. Management has not identified a material uncertainty that may cast significant doubt on the entity’s ability to continue as a going concern, and accordingly none is disclosed in the financial statements. Based on our audit of the financial statements, we also have not identified such a material uncertainty. However, neither management nor the auditor can guarantee the Company’s ability to continue as a going concern.

Other Information
[The illustrative wording for this section is subject to the IAASB’s finalization of proposed ISA 720 (Revised). The content of this section may include, among other matters: (a) a description of the auditor’s responsibilities with respect to other information; (b) identification of the document(s) available at the date of the auditor’s report that contain the other information to which the auditor’s responsibilities apply; (c) a statement addressing the outcome of the auditor’s work on the other information; and (d) a statement that the auditor has not audited or reviewed the other information and, accordingly, does not express an audit opinion or a review conclusion on it.]

Responsibilities of [Management and Those Charged with Governance or other appropriate terms] for the Financial Statements
Management is responsible for the preparation and fair presentation of these financial statements in accordance with IFRSs, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. [Those charged with governance] are responsible for overseeing the Company’s financial reporting process.

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

The material below can be located in an Appendix to the auditor’s report. When law, regulation or national auditing standards expressly permits, reference can be made to a website of an appropriate authority that contains the description of the auditor’s responsibilities, rather than including this material in the auditor’s report.

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

• Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

• Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control.

• Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

• Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

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

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

Report on Other Legal and Regulatory Requirement

[The form and content of this section of the auditor’s report would vary depending on the nature of the auditor’s other reporting responsibilities prescribed by local law, regulation, or national auditing standards. Depending on the matters addressed by other law, regulation or national auditing standards, national standard setters may choose to combine reporting on these matters with reporting as required by the ISAs (shown in the Report on the Audit of the Financial Statements section), with wording in the auditor’s report that clearly distinguishes between reporting required by the ISAs and other reporting required by law or regulation.]

The engagement partner responsible for the audit resulting in this independent auditor’s report is [name].

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

[Auditor Address]

[Date]
ED January 2015: Proposed ISA 800 (Revised), Special considerations – audits of financial statements prepared in accordance with special purpose frameworks, and ISA 805 (Revised), Special considerations – audits of single financial statements and specific elements, accounts or items of a financial statement.

In finalizing the revised and new reporting standards, the IAASB agreed that it would be in the public interest to develop a separate exposure draft (ED) to consider how such changes should affect:

- ISA 800, which deals with special considerations in the application of the ISAs (100-700 series) to an audit of financial statements that are prepared in accordance with a special purpose framework. (This ISA is written in the context of a complete set of financial statements prepared in accordance with a special purpose framework.); and
- ISA 805, which deals with special considerations in the application of the ISAs (100-700 series) to an audit of a single financial statement or a specific element, account or item of a financial statement.

However, the IAASB agreed that any amendments to ISA 800 or ISA 805 would be limited to the reporting in such engagements and are not intended to substantively change the underlying premise of audits of financial statements prepared in accordance with a special purpose framework (i.e., engagements to which ISA 800 applies), or audits of single financial statements and audits of a specific element, account or item of a financial statement (i.e., engagements to which ISA 805 applies) in accordance with the extant ISAs.

7.2 ED December 2012: Responding to a Suspected Illegal Act

Confidentiality is one of the five fundamental principles in the Code. The principle imposes an obligation on all professional accountants to refrain from disclosing outside their accounting firm or employing organization confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose. Section 140, Confidentiality identifies three circumstances where professional accountants are required, or may be required, to disclose confidential information:

- Disclosure is permitted by law and is authorised by the client or the employer;
-Disclosure is required by law; and
-There is a professional duty or right to disclosure when not prohibited by law.

In November 2010, the IESBA approved a project proposal to provide additional guidance for all professional accountants on how to respond when encountering a suspected fraud or illegal act. The project was to address two main elements, the process to be followed when a professional accountant encounters a suspected fraud or illegal act, and the circumstances in which a professional accountant would override the fundamental principle of confidentiality and disclose the matter to an appropriate authority.

The exposure draft provides background for, and an explanation of, the proposed changes to the Code of Ethics for Professional Accountants (the Code) to address the circumstances where a professional accountant in public practice or business shall, or has a right to, override the fundamental principle of confidentiality and disclose a suspected illegal act to an appropriate external authority.
The IESBA recognises that ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements states that the auditor’s professional duty to maintain confidentiality of client information may preclude reporting identified or suspected non-compliance with laws and regulations to a party outside of the entity. Subject to responses to the proposals on exposure, the IAASB will consider whether consequential changes to ISA 250 may be needed in light of changes to the Code.

7.3 **XBRL: The emerging landscape**

The IAASB issued a Question and Answer paper in January 2010 to highlight the growing interest in, and use of, XBRL and raise awareness about how XBRL-tagged data is prepared and how it may affect financial reporting. The IAASB also clarified that the IAASB’s auditing pronouncements currently do not impose requirements on auditors with respect to XBRL-tagged data or the representation of this data.

**Key messages**

- XBRL is an electronic business information format expected to provide benefits in the preparation, analysis and communication of business information.
- The use of XBRL can vary by jurisdiction and may be driven by regulatory requirements or voluntary application.
- Under the current International Standards on Auditing (ISAs), auditors are not required to perform procedures or provide assurance on XBRL-tagged data in the context of audited financial statements. Accordingly, the auditor’s report in accordance with the ISAs on the financial statements does not cover the process by which XBRL data is tagged, the XBRL-tagged data that results from this process, or any representation of XBRL-tagged data.
- The IAASB is currently undertaking a consultation to determine the needs of preparers and users of XBRL-tagged data. This consultation will assist the IAASB in assessing whether it is necessary and in the public interest to develop a pronouncement addressing association with and/or assurance on XBRL-tagged data.

7.4 **Significant unusual or highly complex transactions**

Material misstatement of financial statements, including fraudulent financial reporting, can arise from significant unusual or highly complex transactions, especially those that pose difficult “substance over form” questions, such as transactions not in the ordinary course of business undertaken with related parties. The ISAs give particular attention to the accounting for and disclosure of such transactions in the context of the auditor’s identification and assessment of risks of material misstatement, whether due to error or fraud, and the auditor’s responses thereto.

The IAASB issued a Question and Answer paper in August 2010 to highlight requirements and application and other explanatory material in the ISAs that focus on specific audit considerations relating to significant unusual or highly complex transactions, including significant transactions outside the normal course of business and those occurring at or near period end. They recognised that significant unusual or highly complex transactions may by nature carry a higher risk of material misstatement and therefore merit greater attention.
The underlying concepts of professional judgement and scepticism were re-emphasised.

7.5 Reform of the audit profession

Following the global economic crisis that began in 2007/08 European legislators have discussed whether there is a need to reform the audit profession. Whilst not obviously of immediate relevance to Pakistan, students should be aware of such important discussions in the global accounting profession given the principles involved and that fact that decisions might ultimately impact the Pakistan accounting profession. Two key discussions are summarised below.

EC green paper on audit

In October 2010 the EC Commissioner for Internal Markets, Michel Barnier, issued a ‘green paper’ entitled ‘Lessons from the Crisis’. The paper discussed a number of potential reforms to the Audit Profession including ideas such as:

- Mandatory auditor rotation (i.e. not just partner rotation, but the whole firm)
- Mandatory joint audits for large companies
- Expanding the audit report
- Reducing existing barriers to entry into the audit market in order to improve competition
- Restricting (or even banning!) the provision of non-audit services to audit clients e.g. risk management, book-keeping and accounting records preparation, legal and valuation services, tax advisory and consulting services
- Audit quality certification

The paper has prompted lively debate at many levels including the accountancy institutes, boards of directors, audit committees, government bodies and various industry experts. The arguments range from a conclusion of significant blame to the suggestion that audit quality was not a factor in the crisis.

One theme that does seem to be generally accepted is the need for greater transparency of both the audit process and maintenance of independence.

EU audit reform – directive and regulation

In 2014 the EU finalised their review of the European audit profession and issued guidelines (a directive and a regulation) for adoption by EU member states by mid-2016. The key points of the new guidance are as follows:

- Directive (applies to all statutory audits)
  - Amended provisions on independence and objectivity
  - Further guidance on quality assurance (e.g. QC reviews are required a minimum of 6-yearly for non-PIE auditors, and 3-yearly for PIE auditors), penalties and sanctions
  
  [PIE means ‘public interest entity’ which includes listed entities as well as non-listed entities for which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities].

- Regulation (applies to public interest entity audits/auditors only)
  - Mandatory auditor rotation
Chapter 15: Current issues

- Generally a minimum of 10 years, although member states can require shorter periods
- Extends to a maximum of 20 years so long as a public tender takes place on the expiry of, at most, the first 10 years

- Partner rotation
  - Key audit partners to rotate after a maximum of 7 years (same as IESBA code) with a 3 year cool-off period (2 years per IESBA code)

- Introduces a list of prohibited non-audit services (e.g. payroll services, bookkeeping and preparing accounting records and financial statements, valuation services, most tax services, most legal services, internal audit services, most human resources services, and promoting, dealing in or underwriting shares in the audited entity)

- Fees for ‘permissible non-audit services’ are limited to 0.7 times the average statutory audit fee paid in the last three consecutive years

- Introduces revisions to audit reporting both externally (to the public) and internally (to the audit committee)

- Creates a new audit oversight body – The Committee of European Audit Oversight Bodies (CEAOB) – which replaces the European Group of Auditor Oversight Bodies (EGAOB)

- Mandatory joint audits were not imposed
- Audit committees
  - All PIEs must have an audit committee (subject to some exemptions for SMEs or subsidiaries where there is a committee at group level)
  - Comprise non-executive directors (NEDs) only, all of whom must have sector competence
- The independent auditor’s report
  - All reports
    - Must include a statement on material going concern uncertainty
  - PIE audit reports only
    - Must include descriptions of the most significant assessed risks of material misstatement, the auditor’s responses and key observations thereon
    - Include a declaration that prohibited non-audit services have not been provided
    - Disclose the non-audit services actually provided

7.6 The auditor’s responsibilities relating to other information

Over recent years there have been significant developments in corporate reporting, particularly in relation to companies’ annual reports, as well as the importance ascribed by users to the information in annual reports beyond the audited financial statements and the auditor’s report thereon. The weight that users place on this other information, and the need for increased clarity regarding the auditor’s involvement with such other information, has notably increased.
since extant ISA 720 was issued. In light of these developments, the IAASB sought to revise ISA 720 to bring greater clarity and enhanced consistency around the world regarding the auditor’s responsibilities related to other information.

The IAASB issued an exposure draft in April 2014 which proposed amendments to ISA 720 to address the above developments. These amendments consider three main areas:

- Extending the scope of ISA 720 to include documents accompanying audited financial statements and the auditor’s report thereon;
- Requiring the auditor to read the other information for consistency not only with the audited financial statements but also with their understanding of the entity and the environment acquired during the course of the audit;
- Extending the auditor’s report to include a reference to their responsibilities with respect to ‘other information’ and the outcome of their work thereon.

ISA 720 (Revised) was issued in April 2015 to reflect the above proposed amendments. The revised ISA is effective for audits of financial statements for periods ending on or after 15th December 2016.

7.7 ED Addressing disclosures in the audit of financial statements

Disclosures are a fundamental part of financial statements, seen as an increasingly important way for preparers to communicate deeper insights about the entity’s financial position and financial performance than is possible through the primary financial statements alone.

Over the past decade, financial reporting disclosure requirements and practices have evolved. They now provide more extensive decision-useful information that is more detailed and often deals with matters that are subjective such as assumptions, models, alternative measurement bases and sources of estimation uncertainty.

As these financial reporting disclosures continue to evolve, challenges have arisen for preparers and auditors in addressing new types of quantitative and non-quantitative information. At the same time, concerns have been raised by preparers, investors and auditors that the resulting higher volume of note disclosures has, in some cases, increased the risk that useful or relevant information may be obscured.

The IAASB has issued an exposure draft that proposes changes, mainly to application material in the ISAs, as an appropriate response to the concerns raised about the need to clarify the expectations of auditors when auditing financial statement disclosures. The proposed guidance also aims to address the need for additional guidance to assist auditors in addressing the practical challenges arising from the evolving nature of disclosures.

The proposed amendments can be summarised as follows:

- Clarifying the meaning of disclosures (ISA 200);
- Guiding auditors to address audit considerations relating to disclosures early in the audit (ISAs 210, 260 and 300);
- Disclosure considerations in identifying, assessing and responding to risks of material misstatement (ISAs 240, 315, 320 and 330);
- Clarifying and elaborating expectations of auditors when evaluating misstatements and forming an opinion (ISAs 450 and 700).
7.8 Integrated reporting

There is now a trend towards more diverse corporate reporting incorporating quantitative and qualitative information within both financial and non-financial reports. ‘Integrated reporting’ embraces an ‘all-in-one’ approach by consolidating multiple themes such as governance, strategy, risk management, sustainability and financial reporting within the same ‘umbrella’ report.

Integrated reporting is promoted by the IIRC (International Integrated Reporting Council) which aims to drive the implementation of integrated reporting across the world.

Integrated reporting has an impact on audit within the scope of ISA 720 The Auditor’s Responsibilities Relating To Other Information In Documents Containing Audited Financial Statements.

7.9 Audit quality

Global financial stability is supported through high quality reporting. Audits can help foster trust in the quality of reporting. This highlights the importance of audit quality - a topic of continuous debate - and of relevance to all stakeholders in the financial reporting supply chain.

With this in mind the IAASB developed the Framework for Audit Quality which it launched in February 2014. The Framework describes in a holistic manner the different elements that create the environment for audit quality at the engagement, firm, and national levels, as well as relevant interactions and contextual factors. The framework was covered in an earlier chapter.

The IAASB continues to promote the audit quality agenda with its latest:

- work plan, entitled: “Enhancing Audit Quality and Preparing for the Future”; and
- consultation paper entitled “Enhancing Audit Quality in the Public Interest”.

The consultation paper highlights the board’s discussions on the topics of professional scepticism, quality control and group audit, flagging potential standard-setting activities the IAASB could take to enhance audit quality such as:

- incorporating a new “Quality Management Approach” (QMA) into ISQC 1. QMA would emphasise the responsibility of firm leaders for a more proactive, scalable and robust response to managing quality risk that could more easily adapt to a rapidly changing business environment;
- redesigning the quality control standards (ISQC 1 and ISA 220);
- strengthening the requirements for ‘Engagement Quality Control Reviews (EQCR)’. 
## 8 CHAPTER REVIEW

### Chapter review

Check that you can:
- Discuss current affairs impacting the audit and assurance industry
- Describe the demand for social and environmental reporting
- Summarise what is involved in a social and environmental audit
- Explain the current debates and the Exposure Drafts in circulation
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Certified Finance and Accounting Professional Audit, Assurance and Related Services

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