Audit & Assurance

Study Text

The Institute of Chartered Accountants of Nigeria

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Audit and Assurance

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of Nigeria (ICAN)

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Foreword

The business environment has been undergoing rapid changes caused, by globalisation and advancement in Information Technology. The impact of these changes on the finance function and the skills set needed by professional accountants to perform their various tasks have been profound. These developments have made it inevitable for the Institute's syllabus and training curriculum to be reviewed to align its contents with current trends and future needs of users of accounting services.

The Institute of Chartered Accountants of Nigeria (ICAN) reviews its syllabus and training curriculum every five years, however, the syllabus is updated annually to take cognisance of new developments in the national and international environments as well as technological disruptions. The Syllabus Review, Professional Examination and Students' Affairs Committees worked assiduously to produce a 3-level, 15-subject ICAN syllabus. As approved by the Council, examinations under the new syllabus will commence with the November 2021 diet.

It is instructive to note that the last four syllabus review exercises were accompanied with the publication of Study Texts. Indeed, when the first four editions of Study Texts were produced, the performances of professional examination candidates significantly improved. In an effort to consolidate on these gains and to further enhance the success rates of students in its qualifying examinations, the Council approved that a new set of learning materials (Study Texts) be developed for each of the subjects. Although, these learning materials may be regarded as the fifth edition, they have been updated to include IT and soft skills in relevant subjects, thereby improving the contents, innovation, and quality.

Ten of the new learning materials were originally contracted to Emile Woolf International (EWI), UK. However, these materials were reviewed and updated to take care of new developments and introduced IT and soft skills in relevant subjects. Also, renowned writers and reviewers which comprised eminent scholars and practitioners with tremendous experiences in their areas of specialisation, were sourced locally to develop learning materials for five of the subjects because of their local contents. The 15 subjects are as follows:

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Foundation Level		
1.	Business, Management and Finance	EWI/ICAN
2.	Financial Accounting	EWI/ICAN
3.	Management Information	EWI/ICAN
4.	Business Law	ICAN

Skills Level		
5	Financial Reporting	EWI/ICAN
6	Audit and Assurance	EWI/ICAN
7.	Taxation	ICAN
8.	Corporate Strategic Management and Ethics	EWI/ICAN
9.	Performance Management	EWI/ICAN
10.	Public Sector Accounting and Finance	ICAN

Professional Level		
11.	Corporate Reporting	EWI/ICAN
12.	Advanced Audit and Assurance	EWI/ICAN
13.	Strategic Financial Management	EWI/ICAN
14.	Advanced Taxation	ICAN
15.	Case Study	ICAN

As part of the quality control measures, the output of the writers and reviewers were subjected to further comprehensive review by the Study Texts Review Committee.

Although the Study Texts were specially produced to assist candidates preparing for the Institute's Professional Examination, we are persuaded that students of other professional bodies and tertiary institutions will find them very useful in the course of their studies.

Haruna Nma Yahaya (Mallam), mni, BSc, MBA, MNIM, FCA
Chairman, Study Texts Review Committee

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Acknowledgement

The Institute is deeply indebted to the underlisted locally-sourced rewriters, reviewers and members of the editorial board for their scholarship and erudition which led to the successful production of these new study texts. They are:

Taxation		
1.	Enigbokan, Richard Olufemi	Reviewer
2.	Clever, Anthony Obinna	Writer
3.	Kajola, Sunday Olugboyega	Writer

Business Law		
1.	Oladele, Olayiwola.O	Writer/Reviewer
2.	Adekanola, Joel .O	Writer

Public Sector Accounting and Finance		
1.	Osho, Bolaji	Writer/Reviewer
1.	Biodun, Jimoh	Reviewer
2.	Osonuga, Timothy	Writer
3.	Ashogbon, Bode	Writer

Advanced Taxation		
1.	Adejuwon, Jonathan Adegboyega	Reviewer
2.	Kareem, Kamilu	Writer

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Case Study		
1.	Adesina, Julius Babatunde	Writer/Reviewer

Information Technology Skills		
1.	Ezeilo, Greg	Reviewer
2.	Ezeribe, Chimenka	Writer
3.	Ikpehai, Martins	Writer

Soft Skills		
1.	Adesina, Julius Babatunde	Reviewer
2.	Adepate, Olutoyin Adeagbo	Writer

The Institute also appreciates the services of the experts who carried out an update and review of the following Study Texts:

Business Management and **Finance**	
1.	Ogunniyi, Olajumoke

Management Information	
1.	Adesina, Julius Babatunde
2.	Ezeribe, Chimenka

Financial Accounting	
1.	Adeyemi, Semiu Babatunde

Financial Reporting	
1.	Okwuosa, Innocent

Performance Management	
1.	Durukwaku, Sylvester

Corporate Strategic Management and **Ethics**	
1.	Adepate, Olutoyin Adeagbo

Audit & Assurance	
1.	Amadi, Nathaniel

Corporate Reporting	
1.	Adeadebayo, Shuaib

Advanced Audit and **Assurance**	
1.	Okere, Onyinye

Strategic Financial Management	
1.	Omolehinwa, Ademola

The Institute also appreciates the services of the following:

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Okwuosa, Innocent, PhD, FCA	Adviser
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Adepate, Olutoyin, B.Sc, MBA, FCA	Member
Enigbokan, Richard Olufemi, PhD, FCA	Member
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Ahmed M. Kumshe, (Prof.), FCA
Registrar/Chief Executive

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Contents

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Skills level
Audit and Assurance

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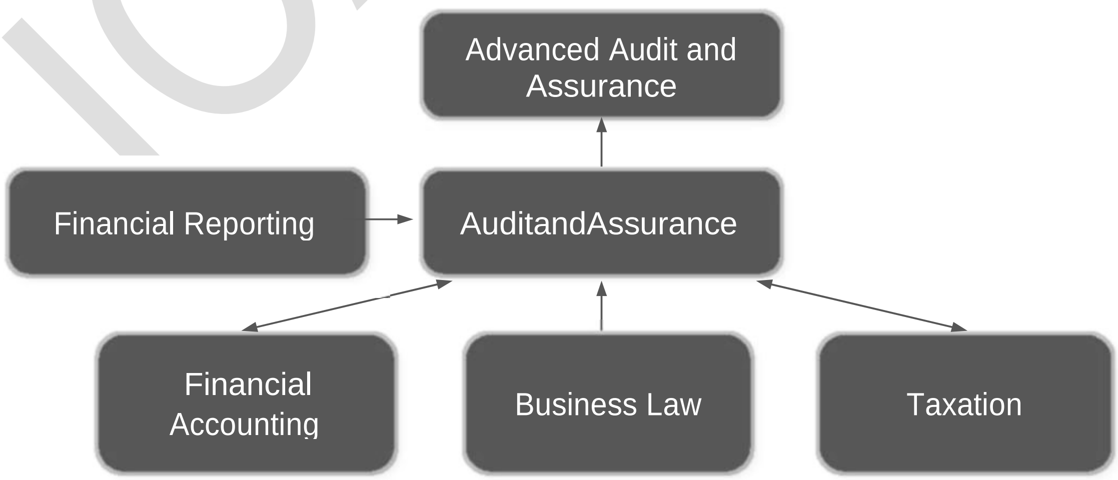
Syllabus

SKILLS LEVEL
AUDIT AND ASSURANCE

Aim
Candidates are expected to possess knowledge of accounting systems, generally accepted accounting principles, audit and assurance principles and practice to build a firm foundation for internal and external audit engagements. There is an emphasis on knowledge of national and international auditing standards and their application to simple situations requiring audit opinion.

Linkage with other subjects

The diagram below depicts the relationship between this subject and other subjects in the syllabus.



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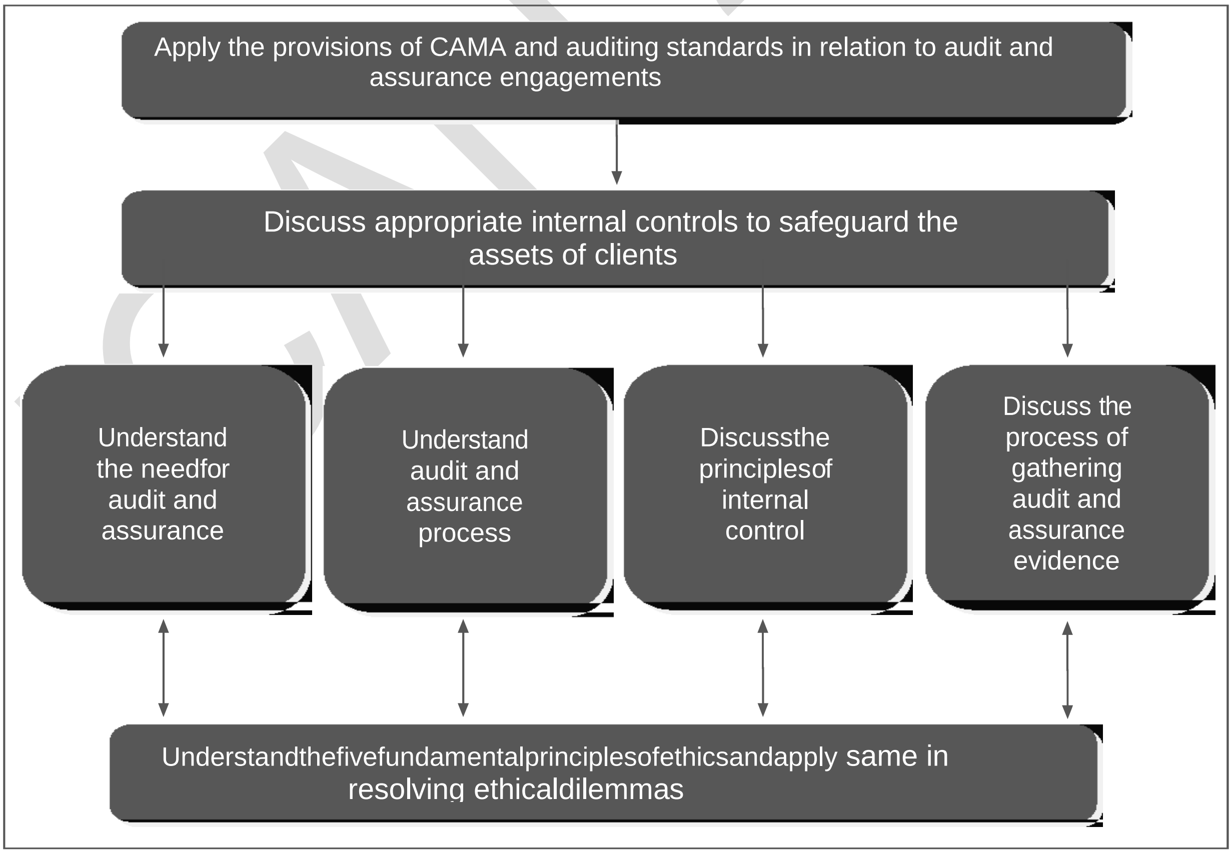
Main competencies

On successful completion of this paper, candidates should be able to:

- Appreciate the objectives, processes and need for external audit and assurance;
- Recognise and explain ethical and legal issues arising in audit and assurance scenarios;
- Apply and advise on the specific provisions of the Companies and Allied Maters Act in carrying out the audit of companies;
- Advise on appropriate internal controls to deter or detect mistakes, errors and frauds in the preparation of financial statements;
- Prepare letters and circularise relevant parties in the course of the audit in accordance with the standards;
- Understand and apply audit evidence that are sufficient and appropriate in aiding the expression of opinion on financial statements, in line with the International Standards on Auditing; and
- Report to those that are charged with the governance of companies, in line with regulations and standards.

Linkage of the main competencies

This diagram illustrates the linkage between the main competencies of this subject and is to assist candidates in studying for the examination.



Syllabus overview		
Grid		**Weighting**
A	Objectives, need for and process of audit and assurance	**30**
B	The nature and use of internal control (ISA 315)	**20**
C	Gathering evidence	**30**
D	Professional ethics and public interest	**20**
	Total	**100**

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Contents and competencies					Chapter
A	**Objectives, need for and process of audit and assurance**				
	1	**Objectives of audit and assurance (ISA 200)**			
		(a)	Discuss the concepts of audit, assurance, attestation services and relationships among them.		1
		(b)	Identify and explain the reasons for audit and assurance.		1
		(c)	Explain the benefits of different types of audit and assurance assignments.		1
		(d)	Discuss the objectives of external audit.		1
		(e)	Identify the parties in audit and assurance engagements including the members of the audit and assurance team and discuss their roles, duties and rights.		1
		(f)	Compare and contrast the different levels of assurance that may be obtained from audit and assurance assignments.		1
		(g)	Discuss audit expectation gap, including reasonable gap and performance gap.		13
		(h)	Discuss the role of the internal audit department in maintaining an effective internal control system.		4
		(i)	Compare internal and external audits.		4
		(j)	Discuss the perculiarities of public sector audit.		5
	2	**The legal and regulatory framework for audit and other assurance engagements**			
		(a)	Discuss the legal and regulatory frameworks for statutory audit and assurance in line with the provisions of:		1
			(i)	Companies and Allied Matters Act 2020;	1
			(ii)	Financial Reporting Council of Nigeria, Act (2011);	1
			(iii)	International Standards on Auditing (ISAs); and	1
			(iv)	International Standards on Assurance Engagements (ISAEs).	1
	3	**Process of audit and assurance**			
		(a)	Explain the basic steps of audit and assurance process in relation to:		
			(i)	Nomination;	3
			(ii)	Acceptance:	3
			(iii)	Engagement;	3
			(iv)	Planning (ISA 300, ISA 320);	5
			(v)	Execution	
				■ Evaluation of internal control;	7, 8
				■ Evidence and obtaining evidence (ISA500);	6

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Contents and competencies					Chapter
				■ Records and working papers;	6
				■ Testing and other works;	6
				■ Evaluating results (ISA540);	13
			(vi)	Conclusion;	13
			(vii)	Reporting (ISA 700).; and	13
			(viii)	Determination and disclosure requirements for key audit matters (ISA 701).	13
		(b)	Explain public interest and the need for professional scepticism in carrying out audit and assurance engagements.		5
		(c)	Discuss the concept of materiality (ISA 320).		5
		(d)	Explain reasonable assurance.		1
		(e)	Explain types of audit opinion and assurance report, including circumstances under which each can be issued.		13
B	**The nature and use of internal control (ISA 315) revised**				
	1	Discuss the meaning, objectives and nature of internal control.			7, 8
	2	Discuss effective internal control.			7, 8
	3	Discuss the different types of internal control.			7, 8
	4	Discuss responsibilities for instituting and evaluating the effectiveness of internal control.			7, 8
	5	Discuss the main components of internal control.			7, 8
	6	Explain how accounting systems and related internal controls may be identified, recorded and analysed.			7, 8
	7	Discuss the techniques required for evaluating internal controls (walk-through, spot check, compliance test, substantive test) (ISA530);			7, 8
	8	Evaluate internal controls in a given scenario.			7, 8
	9	Discuss the limitations of internal control.			7
	10	Discuss the contents of a management letter			7
	11	Discuss internal controls in a computerized accounting environment (ISA 315).			7
	(12)	Discuss information security.			
C	**Gathering evidence**				
	The nature of audit evidence and the selection of sufficient and appropriate audit evidence (ISA 500) and (ISA 570, revised)				
	1	Justify the need to maintain and keep working papers and other documentation.			6
	2	Evaluate the different sources and quality of evidence and the methods of obtaining evidence.			6, 8-12
	3	Document appropriate procedures for gathering evidence based on			6, 8-12

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Contents and competencies				Chapter
	4	Identify the circumstances where written representations may be required (ISA 580).		13
	5	Evaluate the circumstances requiring discussion with senior assurance team members (ISA 450) and advise on how this should be communicated and documented.		13
	6	Business systems and associated information technology risks		14
		Discuss the following:		
		(a)	Statistic analysis;	
		(b)	Algorithm review; and	
		(c)	Artificial intelligence tools in auditing such as repetitive process automation, clone for inventory count, blockchain for audit and assurance tools.	
D	**Professional ethics and public interest**			
	1	Discuss the importance of professional ethics.		2
	2	Differentiate between rule-based and principle-based approaches to professional ethics.		2
	3	Explain the meaning of public interest in the context of audit and assurance.		2
	4	Discuss ethical issues under IFAC code and ICAN professional code of ethics and guide for members.		2
	5	Compare ethical issues in the governance of private and public entities.		2
	6	Discuss actions to deal with ethical dilemmas.		2
	7	Assess the ethical threats to independence and safeguards.		2
	8	Assess the ethical conflicts an accountant faces as an employee in a private or public entity.		2
	9	Assess the ethical conflicts facing an accountant when charged with governance in a private or public entity.		2
	10	Discuss the concept of whistle blowing in relation to audit and assurance - non-compliance with rules and regulations (NOCLAR).		2
F	**Business systems and associated information technology risks**			
	1	Discuss the vulnerability of business systems and associated information technology (IT) to risks.		
	2	Explain types of information technology systems.		

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	3	Explain information technology (IT) risks.	
	4	Explain ways to protect information systems.	
	5	Explain systems audit process.	
	6	Discuss audit of business continuity plan (BCP) or contingency plan.	
	7	Explain audit steps.	
	8	Discuss systems vulnerability audit.	
	9	Explain the procedures for a vulnerability audit.	
	10	Explain data centre audit.	
	11	Explain auditing banking transactions.	
	12	Discuss Big Data analytics and audit of electronic transactions.	
	13	Discuss Artificial Intelligence (AI) and machine learning in the audit process.	
	14	Discuss reporting IT audit activities.	

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Examinable documents

Examinable document	B2 A&A	C2 AAA
International Standards on Auditing (ISAs)		
200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing	Y	Y
210 Agreeing the Terms of Audit Engagements		Y
220 Quality Control for an Audit of Financial Statements		Y
230 Audit Documentation		Y
240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements		Y
250 Consideration of Laws and Regulations in an Audit of Financial Statements		Y
260 Communication with Those Charged with Governance		Y
265 Communicating Deficiencies in Internal Control toThose Charged with Governance and Management		Y
300 Planning an Audit of Financial Statements	Y	Y
315 Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment	Y	Y
320 Materiality in Planning and Performing an Audit	Y	Y
330 The Auditor's Responses to Assessed Risks		Y
402 Audit Considerations Relating to an Entity Using a Service Organisation		Y
450 Evaluations of Misstatements Identified during the Audit	Y	Y
500 AuditEvidence	Y	Y
501 Audit Evidence - Specific Considerations for Selected Items		Y
505 External Confirmations.	Y	Y
510 Initial Audit Engagements – Opening Balances		Y
520 Analytical Procedures	Y	Y

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Examinable document	B2 A&A	C2 AAA
530 Audit Sampling	Y	Y
540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures	Y	Y
550 RelatedParties		Y
560 Subsequent Events		Y
570 Going Concern		Y
580 Written Representations	Y	Y
600 Special Considerations – Audits of Group Financial Statements (including the Work of Component Auditors)		Y
610 Using the Work of Internal Auditors		Y
620 Using the Work of an Auditor's Expert		Y
700 Forming an Opinion and Reporting on Financial Statements	Y	Y
701 Communicating Key Audit Matters in the Independent Auditor's Report	Y	Y
705 Modifications to the Opinion in the Independent Auditor's Report		Y
706 Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report		Y
710 Comparative Information – Corresponding Figures and Comparative Financial Statements		Y
720 The Auditor's Responsibility Relating to Other Information in Documents Containing Audited FinancialStatements		Y
800 Special Considerations – Audits of Financial Statements prepared in Accordance with Special Purpose Frameworks		Y
805 Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or items of a Financial Statement		Y
810 Engagements to Report on SummaryFinancialStatements		Y
International Standards on Review Engagements (ISREs)		
2400 Engagements to Review Financial Statements		Y
2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity		Y
International Standards on Assurance Engagements (ISAEs)		
3000 Assurance Engagements Other than Audits or Reviews of Historical Financial Information		Y
3400 The Examination of Prospective Financial Information.		Y
3402 Assurance Reports on Controls at a Service Organisation.		Y
International Standards on Related Services (ISRSs)		
4400 Engagements to Perform Agreed-upon Procedures Regarding Financial Information.		Y

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Examinable document	B2 A&A	C2 AAA
4410 Compilation Engagements.		Y
IFAC Statements		
ISQC1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services.		Y
IFAC IESBA Code of Ethics forProfessionalAccountants.	Y	Y
Other(s)		
Insurance Act		Y
BOFIA, including prudential guidelines and other circulars issued by CBN from time to time		Y
Money (Prohibition) Laundering Act 2011		Y
Corporate Governance Codes		Y
ICAN Professional Code of Ethics and Guide for Members	Y	Y
Financial Reporting Standards (IFRS)		Y
Companies and Allied Matters Act (CAMA) 1990(asamended)	Y	Y

Note: All the approved and released standards may be examined after six months from date of issue.

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CHAPTER 1

Concept and need for assurance

Contents

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INTRODUCTION

Competencies

Objectives, need for and process of audit and assurance

Objectives of audit and assurance (ISA 200)

A1 (a) Discuss the concepts of audit and assurance.

A1 (b) Identify and explain the reasons for audit andassurance.

A1 (c) Explain the benefits of different types of audit and assurance assignments.

A1 (d) Identify the parties in audit and assurance engagements including the members of the audit and assurance team and discuss their roles, duties and rights.

A1 (e) Compare and contrast the different levels of assurance that may be obtained from audit and assurance assignments.

Need for audit and assurance

A2 (a) Discuss the legal and regulatory frameworks for statutory audit and assurance in line with the provisions of:

(i) CAMA 2020

(ii) BOFIA 2020

(iii) Insurance Act 2003, NAICOM Act,2003;

(iv) Financial Reporting Council of Nigeria Act,2011;

(v) Nigerian standards on auditing (NSA);and

(vi) International standards on auditing (ISA).

Process of audit and assurance

A3 (d) Explain reasonable assurance.

Exam context

This chapter explains the fundamental concepts and background that underpin the audit and assurance syllabus. You need to understand the concept of assurance, when and why it is required and also why it is performed by appropriately qualified independent professionals.

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

- Define the terms audit and assurance and explain the overall objectives of the independentauditor
- Explain the nature and scope of an audit
- Describe the regulatory framework relevant to statutoryaudit
- Explain the roles of IFAC and the IAASB and understand the source and scope of ISAs
- Describe advantages and limitations of statutory audit and other assurance engagements
- Summarise the overall responsibilities of the independent auditor and management (and those charged withgovernance)
- Understand the terms independence, materiality and true andfair

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1. THE MEANING OFAUDIT

Section overview

- Definition and objective of audit
- Concepts of accountability, stewardship and agency
- The auditor's report: independence, materiality and true and fair
- The statutory requirement for audit

1.1 Definition and objective of audit

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

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

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

The applicable financial reporting framework is decided by:

- ❑ legislation within each individual country (in Nigeria CAMA 2020, BOFIA 2020, Insurance Act 2003, FRCN Act 2011), and
- ❑ accounting standards (for example, International Accounting Standards/International Financial ReportingStandards).

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

1.2 Concepts of accountability, stewardship and agency

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

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

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

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

As agents for the shareholders, the board of directors should be accountable to the shareholders. In order for the directors to show their **accountability** to the shareholders, it is a general principle of company law that the directors are

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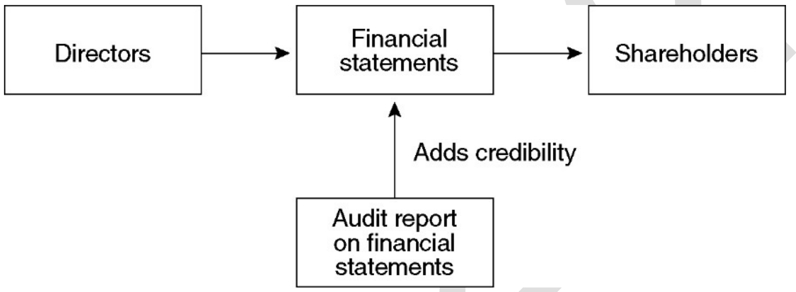
required to prepare annual financial statements, which are presented to the shareholders for their approval.

1.3 The auditor's report: independence, materiality and true and fair view

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

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

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



The key features of the audit report are as follows:

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

Independence of theauditor

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

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

True and fair view (fair presentation)

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

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

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

Materiality concept

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

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

For example, the shareholders of a company with assets of ₦10 million will not be interested if petty cash was miscounted with the result that the amount of petty cash is overstated by ₦100. This is immaterial. However, they will be interested if there are receivables in the statement of financial position of ₦2 million which are not in fact recoverable and which should therefore have been written off as a bad debt.

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

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

1.4 The statutory requirement foraudit

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

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

In Nigeria it is a statutory requirement that an annual external audit is carried out on the financial statements of all limited liability companies.

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2. THE MEANING OF ASSURANCE

Section overview
■ Definition of assurance ■ Levels of assurance ■ Elements of an assurance engagement

a. Definition ofassurance

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

Assurance can be provided by:

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

ii. review.

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

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

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

b. Levels ofassurance

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

i. the amount of work performed in carrying out the assurance process,and

ii. the results of thatwork.

The resulting assurance falls into one of two categories:

iii. **Reasonable Assurance** – A **high (but not absolute)** level of assurance provided by the practitioner's conclusion expressed in a **positive form**. E.g. "*In our opinion the accounts are true and fair*". The objective of a statutory audit is to provide reasonableassurance.

iv. **Limited Assurance** – A **moderate** level of assurance provided by the practitioner's conclusion expressed in a **negative form**. E.g. "*Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view*". The objective of a review engagement is often to provide limitedassurance.

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Assurance provided by audit

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

The assurance of an audit may be provided by external auditors or internal auditors.

v. An **external audit** is performed by an appropriately qualified auditor, appointed by the shareholders and independent of thecompany.

vi. **Internal audit** is a function or department set up within an entity to provide an appraisal or monitoring process, as a service to other functions or to senior management within the entity. Typically, internal auditors are employees of the entity. However, it is also common for entities to 'outsource' their internal audit function, and internal audit work is sometimes carried out by firms of externalauditors.

Many of the practical auditing procedures that will be described in later chapters are the same for both internal and external audit work.

Assurance provided by review

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

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

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

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

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

viii. more costly than a review.

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

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c. Elements of an assuranceengagement

Definition: Assurance engagement

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

Each assurance engagement is classified on two dimensions:

- Either a **reasonable** assurance engagement or a **limited** assurance engagement
- Eitheran**attestation**engagementora**direct**engagement.

IAASB Handbook 2016-17

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

i. A three partyrelationship:

1. **Practitioner** – the individual providing professional services that will review the subject matter and provide the assurance. E.g. the audit firm in a statutoryaudit
2. **Responsible party** – the person(s) responsible for the subject matter. E.g. the Directors are responsible for preparing the financial statements to beaudited
3. **Intended users** – the person(s) or class of persons for whom the practitioner prepares the assurance report. E.g. the shareholders in a statutoryaudit

ii. **Subject matter**: This is the data such as the financial statements that have been prepared by the responsible party for the practitioner to evaluate. Another example might be a cash flow forecast to be reviewed by the practitioner.

iii. **Suitable criteria**: This can be thought of as 'the rules' against which the subject matter is evaluated in order to reach an opinion. In a statutory audit this would be the applicable reporting framework (e.g. IFRS and company law).

iv. **Evidence**: Information used by the practitioner in arriving at the conclusion on which their opinion is based. This must be sufficient (enough) and appropriate(relevant).

v. **Assurance Report**: The report (normally written) containing the practitioner's opinion. This is issued to the intended user following the collection ofevidence.

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Differences amongst audit, assurance and attestation

The terms, assurance, attestation, and audit are sometimes used interchangeably, they represent different types of services. Assurance is a broad term that refers to all aspects of assignments where a practitioner is engaged by other party to give an opinion on a piece of information that has been prepared by another party.

Attestation is an audit-related engagement undertaken by an accountant or firm of accountants, to perform such assignments as, review of data, agreed-upon procedures, compilations, etc. It also includes statutory audit and similar engagements.

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.

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3. STATUTORYAUDIT-THE REGULATORY FRAMEWORK

Section overview

- The requirement for an external audit (s401, CAMA 2020)
- Small company audit exemption (s402 of CAMA 2020)
- Eligibility to act as an external auditor
- Rights and duties of auditors

a. The requirement for an external audit (s 401, CAMA 2020)

In most countries there is a legal requirement for listed and other large companies to have an external audit of their published financial statements. This requirement is imposed by law in order to protect the shareholders.

However, in smaller 'family' companies, where the shareholders are also the directors, the requirement for assurance in the form of an external audit is much less important.

As a consequence, many countries have a **small company audit exemption**.

b. Small company audit exemption (s402 CAMA 2020}

Section 401 of CAMA 2020 requires limited companies in Nigeria to have an independent audit. However, section 402 offers exemption from an audit if the company qualifies as a small company as per section 394 of CAMA 2020

A company qualifies as a small company in a year if for that year the following conditions are satisfied:

i. it is a private company having a share capital;

ii. the amount of its turnover for that year is not more than ₦120 million or such amount as may be fixed by the Commission;

iii. its net assets value is not more than ₦60 million or such amount as may befixed by the Commission;

iv. none of its members is an alien;

v. none of its members is a Government or a Government corporation or agency or its nominee; and

vi. the directors between them hold not less than 51 per cent of its equity share capital.

c. Eligibility to act as an external auditor

Self-regulation by the audit profession

Eligibility to act as an external auditor is usually determined by membership of an appropriate 'regulatory body', such as ICAN and registration with the Financial Reporting Council of Nigeria.

The role of such regulatory bodies normally includes the following:

i. Offering professional qualifications for auditors, to provide evidence that auditors possess a minimum level of technical competence.

ii. Establishing procedures to ensure that the professional competence of auditors is maintained. This includes matters, such as:

1. ensuring that audits are performed only by 'fit and proper' persons, who act with professional integrity
2. requiring that the members carry out their audit work in accordance with appropriate technical standards (for example, in accordance with International Standards on Auditing, known as ISAs)
3. ensuring that auditors remain technically competent and up to date with modern auditing practice (for example, by following a programme of continuing professional development)
4. providing procedures for monitoring and enforcing compliance by its members with the rules of the regulatory body. This includes rules and procedures for the investigation of complaints against members and the implementation of disciplinary procedures where appropriate

iii. Maintaining a list of 'registered auditors', which is made available to the public.

Such a system is referred to as a system of **self-regulation**. In such a system, the regulation of auditors is carried out by their own professional bodies.

Regulation by government

The alternative is regulation by government. The government may appoint a public body with similar responsibilities to a self-regulating professional body. The public body may therefore establish rules and procedures:

i. for approving/authorising individuals to perform audit work
ii. for ensuring that authorised auditors have the necessary minimum skills and knowledge to carry out their audit work to a proper standard
iii. for handling complaints and taking disciplinary measures against auditors, where appropriate.

In addition, it is usual for statute law to establish that certain individuals are **ineligible** to act as an external auditor in the context of a given company, even if they are a member of an appropriate regulatory body. These exclusions are designed to help to establish the independence of the auditor.

Per section 403 of CAMA 2020 the following individuals are prohibited by Nigerian law from acting as the auditor of a company:

i. an officer or servant of thecompany;
ii. a person who is a partner of or in the employment of an officer or servant of the company; or
iii. a body corporate.

d. Rights and duties ofauditors

Local company law (for example, in Nigeria, CAMA 2020 will usually:

i. impose certain duties on the external auditor, and
ii. grant him certain rights (or powers) to enable him to carry out his duties.

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Duties of the external auditor

The primary duty of the external auditor is to:

iii. examine the financial statements, and

iv. issue an auditor’s report on the financial statements, which is then presented to the shareholders together with the financial statements.

This auditor’s report will set out the auditor’s opinion as to whether (or not) the financial statements:

v. give a true and fair view (or “present fairly”) the financial position and performance of the company,and

vi. have been prepared in accordance with the applicable financial reporting framework.

In Nigeria, s407 CAMA 2020 requires the auditor to also form an opinion on matters stated in schedule ~~6~~ 5 (s404(2)) to CAMA 2020 as provided below.

vii. Whether the auditors’ have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purpose of their audit.

viii. Whether, the auditors’ opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.

ix. Whether the company's statement of financial position and (unless it is framed as a consolidated profit and loss account) profit and loss account dealt with by the report agree with the books of account and returns.

x. Whether, in the auditors’ opinion and to the best of their information and according to the explanations given them, the said statements give the information required by the Act in the manner so required and give a true and fair view in the case of :

1. the statement of financial position, of the state of the company's affairs as at the end of its year; and
2. the profit and loss account, of the profit and loss for its year; or as the case may be, give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which, by virtue of Part I of the Second Schedule of the Act, are not required to be disclosed.
3. In the case of a holding company submitting group financial statements whether, in their opinion, the group financial statements have been properly prepared in accordance with the provisions of this Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries and associates.

The auditor’s report must state if any of the above were not met.

The outcome of the statutory audit is an **opinion** on the truth and fairness of the financial statements. The word ‘opinion’ implies that the auditor has applied his professional judgement in reaching his conclusion.

This point is arguably one of the limitations of the statutory audit. The audit report expresses an opinion, not a statement of fact. It is therefore open to disagreement.

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In carrying out his audit work, the auditor is unlikely to check every transaction undertaken by the company during the period. There is, therefore, a risk that the judgement he forms may be inappropriate, because in performing the audit he has missed an item of significance.

Rights of the external auditor

External auditors have certain statutory rights, to enable them to perform their statutory duties. The main statutory rights of the auditor per CAMA 2020 (section 410) include the following:

(i) The right of access to all accounting books and records at alltimes.

(ii) The right to all information and explanations (from management) necessary for the proper conduct of theaudit.

(iii) The right to receive notice of all meetings of the shareholders (such as the annual general meeting) and to attend those meetings.

(iv) The right to speak at shareholders' meetings on matters affecting the audit or the auditor. This can be important when the auditors are in disagreement with the directors of the client entity and are unable to communicate with the shareholders effectively by any other method.

(v) If the company uses written resolutions, the auditors should have a right to receive a copy of all such resolutions.

Responsibility of management and those charged with governance

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

(i) Prevention and detection of fraud

(ii) Preparation of the financial statements

(iii) Design and implementation of effective internal controls – for example authorising payments above a certain amount, monthly bank reconciliation and a monthly trade payables control account reconciliation.

They are also responsible for:

i. Providing the auditorwith:
    1. Access to information relevant to the preparation of the financial statements
    2. Additional information relevant to the audit
    3. Unrestricted access to persons whom the auditor needs access to in order to complete the audit

ii. Providing written representations to the auditor at the end of the audit (see later chapter for details)

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2. INTERNATIONAL STANDARDS ON AUDITING (ISAs)

Section overview

- The role of auditing standards
- The process of issuing auditing 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
- Scope of an audit

a. The role of auditing standards

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

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

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

b. 3The process of issuing auditing standards

IFAC

Definition: IFAC (International Federation of Accountants)

IFAC is the global organization for the accountancy profession. It is dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies. IFAC has180 (professional accountancy organizations as) members and associates in130 countries around the world, representing approximately 3 million accountants in public practice, education, government service, industry, and commerce.

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

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

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IFAC includes four boards:

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

ICAN is a member of IFAC.

The IAASB

Definition: IAASB (International Auditing and Assurance Standards Board)

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

Responsibility for ISAs

Both national and international bodies produce auditing standards. This examination requires knowledge of **International Standards on Auditing** (ISAs) which are produced by the IAASB.

Producing a new ISA

The process of producing an ISA is as follows:

i. A subject is selected for detailed study, with a view to eventually issuing an ISA.

ii. After a period of study and research, if there is agreement to proceed, an **exposure draft** is produced. The exposure draft is approved by the IAASB and then distributed widely amongst the profession and others for comment.

iii. Comments and proposed amendments are considered by the IAASB. The draft standard is then modified and approved by the IAASB.

iv. The new ISA is then published.

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

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

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

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

International Standards on Auditing (ISAs)

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

Each ISA contains:

i. An introduction

ii. objectives

iii. definitions (ifnecessary)

iv. requirements which are shown by the word "shall" and are to be applied as relevant to the audit

v. application and other explanatory material which is for guidance only.

International Standards on Quality Control (ISQCs)

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

Other International Standards

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

vi. basic principles and essential procedures (identified in bold type and by the word "**should")**, and

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vii. 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.

Professional judgment

The nature of the international standards requires the professional accountant to **exercise professional judgment** in applying them.

d. ISA200:Overall objectives of the independent auditor and the conduct of an audit in accordance with international Standards on Auditing

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

i. to **obtain reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework; and

ii. 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.

Note that the different types of audit opinion are not examinable in this paper.

ISA 200 **requires** the auditor to:

iii. comply with all **ISAs** relevant to the audit

iv. comply with relevant **ethical requirements**

v. plan and perform an audit with **professional scepticism**

vi. exercise **professional judgement** in planning and performing an audit

vii. obtain **sufficient and appropriate audit evidence** to allow him to obtain reasonable assurance

e. Scope of anaudit

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

i. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements.

ii. 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.

iii. 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.

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iv. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Audit fieldwork is typically performed in two phases:

v. Interim audit – this is performed before the end of the accounting period and may include:

   1. Discussions with staff and management designed to enhance the auditor's understanding of the entity and the environment. This will enable the auditor to more fully plan the audit and hopefully reduce the work performed at year end;

   2. Recording information about the internal control systems that are relevant to theaudit;

   3. Performing some preliminary controls testing or substantive procedures

vi. Final audit – this is performed after the year-end when the draft financial statements are available and include full-year balances.

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

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3. NIGERIAN STANDARDS ON AUDITING (NSAs)

Section overview
■ Nigerian standards on auditing (NSAs)

a. Nigerian standards on auditing (NSAs)

NSAs historically applied in Nigeria but they have now been superseded with Nigeria fully adopting the pure ISAs. This study text and your exam will refer to ISAs throughout. You just need to be aware that NSAs existed.

Nigerian Standards on Auditing (NSAs) were based on the ISAs issued by IFAC. Minor changes were made to reflect local terminology and legislation. However, the underlying substance of 'how to audit' and the approach to a risk-based audit was the same in both ISAs and NSAs.

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4. ADVANTAGES AND LIMITATIONS OF AUDIT AND ASSURANCE

Section overview

- Advantages of statutoryaudits
- Limitations of statutoryaudits
- Assurance on internalcontrols
- Corporate social responsibility and sustainability reports

a. Advantages of statutoryaudits

An external audit provides the following benefits:

i. It increases the credibility of published financial statements.

ii. It confirms to management that they have performed their statutory duties correctly.

iii. It provides assurance to management that they have complied with non-statutory requirements, such as corporate governance requirements (where these are subject to audit or review).

iv. It provides feedback on the effectiveness of internal controls. Where internal controls are weak or inadequate, the auditor will give recommendations for improvement. This will assist management in reducing risk and improving the performance of the company.

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

b. Limitations of statutory audits

The main limitations of an audit are as follows:

i. Its cost. The cost of an audit can be very high. However, if the audit firm is already hired to carry out non-audit work such as accounts preparation or advisory work, the additional cost of an audit may be fairly small.

ii. The disruption caused to a company's staff during the audit. The company's staff may be required to assist the auditors by answering questions, providing documents and other information.

iii. Some items in the subject matter might be estimates whose truth and fairness will not be known with certainty until some point in the future. This means the assurance opinion is ultimately subjective and judgmental.

iv. Most fraud will include an attempt to deliberately conceal the truth or misrepresent information.

v. In order to balance cost and efficiency the auditor routinely uses sampling rather than tests every item.

vi. Irrespective of how robust a client's systems are they will always incorporate some degree of inherent limitation.

vii. Audit evidence is persuasive rather than conclusive.

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c. Assurance on internal controls

Maintaining an effective system of internal control is one of the Directors' many important duties. The Directors are responsible for:

i. ensuring that business risks are identified; and

ii. designing and implementing controls to address those business risks.

Assurance providers are increasingly offering their services to assist management with internal control responsibilities by issuing either type 1 or type 2 reports.

A Type 1 report comprises:

iii. 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

iv. 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 cover a specified period, and may also report on the operating effectiveness of the controls over that period. The report will now also give:

v. the "service auditor's" opinion on the operating effectiveness of the controls, and

vi. a description and the results of his tests of controls.

d. Corporate social responsibility and sustainability reports

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, 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.

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

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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.

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5. CHAPTERREVIEW

Chapter review

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

- Define the terms audit and assurance and explain the overall objectives of the independent auditor.
- Explain the nature and scope of an audit.
- Explain the relationship between audit, assurance and attestation.
- Describe the regulatory framework relevant to statutory audit.
- Explain the roles of IFAC and the IAASB and understand the source and scope of ISAs.
- Describe advantages and limitations of statutory audit and other assurance engagements.
- Summarise the overall responsibilities of the independent auditor and management (and those charged with governance).

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Quick quiz questions

1 The fundamental objective of the audit of a company is to

A Protect the interests of the minority shareholders

B Detect and prevent errors and fraud

C Assess the effectiveness of the company's performance

D Attest to the credibility of the company's accounts

2 The concept of stewardship means that a company'sdirectors

A Are responsible for ensuring that the company complies with thelaw

B Are responsible for ensuring that the company pays its tax by the duedate

C Safeguard the company's assets and manage them on behalf of the shareholders

D Report suspected fraud and money laundering to the authorities

3 Which of the following is not a limitation of statutory audit?

A Audit evidence is persuasive rather than conclusive

B The client can insist on a tight deadline which may mean the audit work cannot be completed

C Some items in the subject matter might be estimates whose truth and fairness will not be known with certainty until some point in the future

D Most fraud will include an attempt to deliberately conceal the truth or misrepresent information

4 What are the auditing standards relevant to statutory audit?

A Statements of Auditing Standards

B International Accounting Standards

C International Financial Reporting Standards

D International Standards on Auditing

5 Which one of the following is NOT a duty of the auditor?

A Duty to report to the company's bankers

B Duty to report to the members

C Duty to sign the audit report

D Provide an opinion on the financial statements

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Quick quiz answers

1 D

2 C

3 B

4 D

5 A

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Skills level

Audit and Assurance

CHAPTER 2

Professional ethics and codes of conduct

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Contents

INTRODUCTION

Competencies

Professional ethics and public interest

D1	Discuss the importance of professionalethics.
D2	Differentiate between rule-based and principle-based approaches to professional ethics.
D3	Explain the meaning of public interest in the context of audit and assurance.
D4	Discuss ethical issues under IFAC code and ICAN professional code of ethics and guide for members.
D5	Compare ethical issues in the governance of private and public entities.
D6	Discuss actions to deal with ethical dilemmas.
D7	Assess the ethical threats to independence and safeguards.
D8	Assess the ethical conflicts an accountant faces as an employee in a private or public entity.
D9	Assess the ethical conflicts facing an accountant when charged with governance in a private or public entity.
D10	Discuss the concept of whistle blowing in relation to audit and assurance (non-compliance with rules and regulations -NOCLAR).

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.

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

- Describe the fundamental principles of the IFAC Code of Ethics
- Explain the concepts of rules vs. principles-based systems and the public interest
- Apply the conceptual framework to identify threats to the fundamental principles and suggest appropriate safeguards across a range of common scenarios
- Assess ethical conflicts facing accountants in business or practice
- Discuss how an accountant should respond to a suspected instance of NOCLAR

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1 FUNDAMENTALPRINCIPLES

Section overview

- The application of professional ethics
- Acting in the public interest
- Principles-based ethics codes and rules-based ethics codes
- The fundamental principles
- Due skill and care

1.1 The application of professional ethics

Introduction

The law regulates some aspects of auditing to a degree. Company law regulates the requirement for external auditing, but internal auditing is not normally subject to statutory regulation.

However, all accountants who are members of a professional body such as ICAN are required to comply with the regulations of that professional body. Such professional regulations therefore apply to both external auditors and assurance providers and internal auditors.

The reason for the wide reach of ethical guidelines is that the accountancy profession accepts that it has a responsibility to act in the public interest. See next section for explanation of 'public interest'.

ICAN's Code of Ethics

This chapter describes IFAC's Code of Ethics for Professional Accountants published by the IESBA (hereafter referred to as 'The Code').

You also need to be aware that ICAN adopted the IESBA Code into their own localised code called 'The Professional Code of Conduct and Guide for Members'. Note that the substance remains largely unchanged.

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

Although the guidance applies to all members, the examination is primarily concerned with how the rules apply to an external auditor or assurance provider. In providing a code of ethics, ICAN is complying with one of its regulatory functions, which is to ensure that statutory audits are performed only by fit and proper persons who act with professional integrity.

1.2 Acting in the publicinterest

An aspect of professional bodies, which separates a profession from a trade, is that members of the profession are expected to act in the public interest. It is therefore a responsibility of the accountancy profession '**not to act exclusively to satisfy the needs of a particular client or employer**'.

When the demands or needs of a client or employer appear to be contrary to the public interest, accountants should consider the public interest.

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So what is the public interest? Professional codes of ethics do not provide a clear definition, but it is usual to associate the public interest with matters such as:

- detecting and reporting any serious misdemeanour or crime
- protecting health and public safety
- preventing the public from being misled by a statement or action by an individual or an organisation
- exposing the misuse of public funds and corruption in government
- revealing the existence of any conflict of interests of those individuals who are in a position of power or influence.

1.3 Principles-based ethics codes and rules-based ethics codes

It would be possible for a regulatory body to issue a code of ethics for accountants that contains specific rules about how they should act in specific situations. This would be a rules-based code of ethics.

Rules-based codes have several weaknesses:

- There are many different situations that an accountant might face where an ethical decision must be made. Circumstances can be complex and varied, and it is impossible to plan for every type of ethical problem that will arise, and make a rule in advance – without knowing the exact details of the situation – of what course of action the accountant must take.
- Over time, the type of situations (ethical dilemmas) that an accountant might face could change, as the business environment changes. It might therefore be necessary to review and update the rule book regularly.
- Ethical views differ between countries and cultures. Behaviour that might be considered slightly unethical in one country might be perfectly normal and acceptable in another country. A rule book cannot easily make allowances for national and cultural differences in ethical viewpoint.

A principles-based code of ethics for accountants is a code that specifies general principles of ethical behaviour, and requires the professional accountant to act in accordance with the principles. The accountant is required to use judgement in deciding whether in each case a particular course of action is a 'proper' or 'ethical' one.

Both the IFAC and ICAN codes of ethics are principles-based codes.

1.4 The fundamental principles

There are five **fundamental principles** in The Code. These are set out below:

- **Integrity**. Members shall be straightforward and honest in all professional and business relationships. Integrity implies not just honesty but also fair dealing and truthfulness.
- **Objectivity**. Members are not to compromise professional or business judgements because of bias, conflict of interest or undue influence of others.
- **Professional competence and due care**. Members have a duty to attain and maintain their professional knowledge and skill at the level required to ensure that a client or employer receives a competent professional service, based on current technical and professional standards and relevant

legislation. Members shall act diligently and in accordance with applicable technical and professional standards.

- **Confidentiality**. Members shall respect the confidentiality of information acquired as a result of professional and business relationships and shall not disclose such information to third parties without authority or unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships must not be used for the personal advantage of members or third parties.
- **Professional behaviour**. Members shall comply with relevant laws and regulations and avoid any conduct the professional accountant knows or should know might discredit the profession.

1.5 Due skill andcare

It is a fundamental principle that ICAN members should carry out their work with **professional competence and due care**. This requirement reinforces a basic principle of the law of contract as it operates in many countries – that a contract for the provision of services should be performed with a reasonable degree of skill and care.

The concept of 'due care' or 'reasonable care' is important. The implication is that audit work performed by an auditor for a client must be adapted to the specific circumstances and characteristics of the client. There is no such thing as a 'standard' audit.

If the auditor fails to exercise a proper degree of care, a number of consequences may follow:

- There may be legal claims against the auditor in the law of contract or the law of tort. ('Tort' means wrong doing.)
- There may be disciplinary proceedings against the auditor by ICAN.
- The auditor or audit firm may earn a reputation in the business community for poor standards of work, and may therefore lose clients.

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2 THE CONCEPTUAL FRAMEWORK

Section overview

- Introduction to the conceptual framework
- Threats
- Safeguards

2.1 Introductiontotheconceptualframework

The application of the fundamental principles set out above is considered by The Code within a **conceptual framework**. This framework acknowledges that these principles might be threatened by a broad range of circumstances. This approach identifies the following five potential categories of threats to the fundamental principles:

- **Self-interest** threat (for example, if the auditor earns a large proportion of his revenue from a particular client, he may be unwilling to upset that client by issuing an unfavourable auditor's report).
- **Self-review** threat (for example, if the auditor performs accountancy work for a client in addition to the audit, he may find himself in a situation where he is reviewing his own work and may therefore not be as critical of it as he might be if he was reviewing someone else's work).
- **Advocacy** threat (for example, supporting the client in a legal case may lead to a perceived loss of independence).
- **Familiarity** threat (for example, acting for a client for a long period of time may mean that the auditor becomes less critical of that client's reporting practices).
- **Intimidation** threat (for example, a strong finance director may intimidate junior members of the audit team and persuade them not to report errors found during their testing).

Members are required to identify, evaluate and address such threats. If identified threats are not at a level that would be regarded as acceptable (being where a reasonable and informed third party would conclude that compliance with the fundamental principles has been compromised) these must be addressed by:

- eliminating the circumstances creating the threat, or
- applying safeguards to reduce the threats to an acceptable level, or
- declining or ending the specific professional activity.

So, for example, an appropriate safeguard to mitigate the specific familiarity threat described above might be to change the partner in charge of the audit (and possibly the whole audit team) every few years. In the example of an advocacy threat above, it might be appropriate to not act for the client in that capacity or to resign from the audit as no safeguard will reduce the threat to an acceptable level. The Code also requires the auditors to form an overall conclusion on whether the actions planned or taken eliminate the threats or reduce them to an acceptable level.

Although The Code goes on to cover specific areas (such as gifts and hospitality, long association with an audit client and the provision of other services), this framework approach recognises that it is impossible to define every situation that

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creates threats and specify the appropriate mitigating action. The different types of threats and possible safeguards are considered in more detail below.

Example:

Your assurance firm is auditor of Happy Goods. The audit manager has just become engaged to the managing director’s (MD’s) daughter, who he met through a mutual friend.The managing director owns 51% of the shares in Happy Goods.

Required

List the threats to independence which might arise as a result of the above, explaining clearly why these are threats.

Answer

An **intimidation threat** might arise because the MD could exert influence over the audit manager via any influence he might have over his daughter. Alternatively, as the relationship between the audit manager and his future father-in-law develops direct intimation might be possible.

A **familiarity threat** might arise, again, as the relationship between the audit manager and the MD develops. The audit manager may become less critical of the reporting or operational practices at this client.

A **self-interest threat** might arise because the MD owns a majority shareholding in Happy Goods and his daughter (who may well inherit the shares at some point in the future) therefore has a vested interest in the performance of the organization - as will her husband (i.e. this threat is probably greater once the marriage has taken place.)

2.2 Threats

In the exam you could be required to recognise threats in a given situation and to explain why those threats arise. The framework gives a list of circumstances which could give rise to each of the five threats. These are set out below but these lists are not exhaustive. The later sections of this chapter then look in more detail at some of the more common situations which might be tested in the exam, the threats which arise and the action which should be applied to address the threats.

Self-interest threats

Self-interest threats may occur as a result of the financial or other interests of members or their **immediate** or **close family members**. An immediate family member is defined by the Code as a spouse (or equivalent) or dependant. A close family member is a parent, non-dependent child, brother or sister, who is not an immediate family member.

Such financial interests might cause members to be reluctant to take actions that would be against the interests of the client. For example, if a member holds shares in a client company, he may be unwilling to give an unfavourable auditor's report. This would threaten the fundamental principle of objectivity.

Circumstances which may give rise to self-interest threats for members include:

- financial interests, loans or guarantees

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- incentive-based 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.

Self-review threats

Self-review threats occur when a previous judgement needs to be re-evaluated by members responsible for that judgement. For example, where a member has been involved in maintaining the accounting records of a client he may be unwilling to find fault with the financial statements derived from those records. Again, this would threaten the fundamental principle of objectivity.

Circumstances which may 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 threats

Advocacy threats occur when members promote a position or opinion on behalf of a client to the point that subsequent objectivity may be compromised. Although it is natural for members to support their client's or employer's position this could mean that they adopt a position so closely aligned with that of their client or their employer that there is an actual or perceived threat to the fundamental principle of objectivity.

Circumstances which 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 auditclient
- acting as an advocate for an assurance client in litigation or dispute with third parties.

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For example a client entity may ask its audit firm to represent it in a legal dispute with the tax authorities about the amount of tax payable. The audit firm should refuse to act in this way, because by acting as advocate for the client in this way, its objectivity would come under threat.

Familiarity threats

Familiarity threats occur when, because of a close relationship, members become too sympathetic to the interests of others. Circumstances which may 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 businessdecisions
- acceptance of gifts or preferential treatment, unless the value is trivial and inconsequential
- 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.

In auditing, a familiarity threat occurs when a senior member of the audit team (such as the audit engagement partner) has worked on the same audit for several years. There is a risk that the individual will become too familiar with the audit client and its management, and may then be unable to take an objective view and make objective decisions concerning the audit.

Intimidation threats

Intimidation threats occur when a member’s conduct is influenced by fear or threats (for example, when he encounters an aggressive and dominating individual at a client or at his employer). Circumstances which 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’sdecisions
- being threatened with litigation
- being pressured to inappropriately reduce the amount of work performed in order to reduce fees.

2.3 Safeguards

Safeguards which may remove or reduce threats to members fall into three categories:

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

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Each of these categories is considered below. Later sections of this chapter consider the specific threats which might apply to specific situations.

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 the ICAN'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.

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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.

Example:

Following on from the previous example suggest specific, appropriate safeguards which could be put in place to mitigate the identified threats.

Answer

The most appropriate safeguards would be to:

- Remove the manager from the audit of Happy Goods Ltd, and
- ensure that he has no significant influence over the audit team (for example, by ensuring that the members of the audit team are not close friends of his).

Failing that, the following safeguards could be implemented:

- Confirm that the MD's daughter is not dependent on him in anyway (financially or otherwise).
- Review the manager's work on the audit.
- Ensure that the manager is aware of the requirement for independence.
- Discuss the potential ethical issue with the client and request that the manager has no involvement with the MD during the course of the audit (he is more likely to deal with the FD). (Though this will not help if the relationship between the manager and the MD is already developing (as they may meet outside the audit environment) or if the MD has significant influence over his fellow-directors. However, it may be that no such close relationship is forming, especially if the daughter is not close to her father and is not financially dependent on him.)

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3 INDEPENDENCE, OBJECTIVITY AND INTEGRITY

Section overview

- Actual and perceived independence
- Fees and pricing
- Family and personal relationships
- Close business relationships
- Financial interests
- Loans and guarantees
- Employment or former employment with assurance clients
- Long association of senior personnel with assurance clients
- Provision of non-assurance services
- Inducements, including gifts and hospitality
- Actual and threatened litigation

3.1 Actual and perceived independence

For an audit or other assurance report to be of value, the assurance provider:

- **must be independent** (actual independence), and also
- must be seen to be independent (perceived independence).

The opinion of an assurance provider must be an independent opinion given by a professional person with appropriate skills in assurance work, and the opinion must not be influenced by anyone else. In particular, the assurance work must not be influenced by the opinions and views of the management of the client company. This is why the fundamental principle of **objectivity** is so important.

Independence of the assurance provider (and in particular, of a statutory auditor) is a matter of public confidence in the assurance or audit process. As discussed above, in the context of the conceptual framework, members need to be fully aware of situations that may damage their independence and objectivity. Such situations are referred to as **threats** to independence. Any threats to independence may be reduced by **safeguards** put in place by an assurance firm.

Although the 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:

- fees andpricing
- family and personal relationships
- close business relationships
- financial interests
- loans and guarantees
- employment or former employment with assurance clients
- long association of senior personnel with assurance clients
- provision of non-audit services

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- gifts and hospitality
- actual and threatened litigation.

3.2 Fees and pricing

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 creates a **self-interest or intimidation 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 ICAN or another professional accountant.

For clients who are public interest entities (which includes all listed or 'public' companies), the IFAC Code of Ethics states that where total fees from the client and its related entities represent 15% of the income of the audit practice for two consecutive years there is a presumed self-interest threat. Note that ICAN's Code of Ethics adopts the higher threshold of 25%.

In such cases the firm shall disclose to those charged with governance that the total of fees represents more than 15% (25% per ICAN's Code of Ethics). The firm shall also consider other safeguards such as performing a post-issuance review (and/or a pre-issuance review if fees significantly exceed 15% (25% per ICAN's Code of Ethics)).

Overdue fees

If fees from an assurance client remain unpaid for a long time, a **self-interest threat** might 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:

- Obtaining partial payment of the overduefees
- involving an additional professional accountant who did not take part in the assurance engagement 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.

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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.

3.3 Family and personalrelationships

Family and personal relationships between a member of the assurance team and a director, officer or certain employees at the client might 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.

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 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

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example above, the audit junior would not be assigned to the receivables section of the audit)

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.

Note

A past exam paper has included a case study-type question including a situation where the audit engagement partner proposed that his daughter should be a member of the **audit team**. There is no ethical rule that prohibits this. However, the audit firm should consider whether the inclusion of two or more family members in the same audit team might affect the **perceived** independence of the audit team members. Especially if one of the family members is more senior than the other, there may be some risk of undue influence and so loss of independence. In these circumstances it would be prudent to keep one of the family members out of the audit team.

3.4 Close businessrelationships

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

- A 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 the relationship is prohibited. 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.

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

- ❑ eliminating or reducing the number of transactions
- ❑ removing the individual from the assurance team.

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.

3.5 Financial interests

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 might create a **self-interest threat**.

Neither an **assurance team member** (nor his 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.

3.6 Loans and guarantees

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.

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3.7 Employment or former employment with assurance clients

Employment with assurance clients

Individuals who have previously been on the assurance team could leave the assurance firm to work for the assurance client. Depending on:

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

Significant **self-interest, familiarity or intimidation threats** might arise. 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
- when a former key audit partner joins a **public interest entity** audit client, independence would be deemed to be compromised unless, subsequent to the partner ceasing to be a key audit partner, the public interest entity had issued audited financial statements covering a period of **not less than twelve months** and the partner was not a member of the audit team with respect to the audit of those financial statements.

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)
- having an appropriate reviewer review the work of the former team member.

Similar threats could also arise where a member of the assurance team knows he is 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 his 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
- have an appropriate reviewer review any significant judgements made by that individual while on the team.

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Recent service with an assurance client

If a former director, officer or employee of an assurance client becomes a member of the assurance team there might 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 he carried out. He 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 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.

3.8 Long association of senior personnel with assurance clients

Using the same senior personnel on an assurance engagement over a long period of time might 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 or other senior individuals
- arranging for an additional professional accountant to review the work done by the senior staff
- carrying out independent quality control reviews.

For the **audit of public interest entities** the Code states that a key audit partner (e.g. the engagement partner, a quality review partner or an engagement partner of a significant component) should be rotated after no more than **seven years.** The time after which an individual can return to the audit is known as the 'cooling off' period and this varies as follows.

Individual's role (for seven consecutive years)	Cooling off period
Engagement partner	Five consecutive years
Engagement quality control reviewer	Three consecutive years
Key audit partner in anyother capacity	Two consecutive years

The seven years limit may be extended up to one extra year (to a total of eight years) in exceptional circumstances if partner continuity is essential, for example due to serious illness of the incoming partner.

When an audit client **becomes a public interest entity** the length of time an individual has served that client as a key audit partner should be considered when deciding when the individual should be rotated:

- The general rule is that the key audit partner may serve for a further period of **seven** years minus time already served as a key audit partner when the client was a non-public interest entity.
- If the key audit partner has served for a period of six or more years when the client was a non-public interest entity then they can serve as a key audit partner for a **further two years** after the client becomes a public interest entity.

If the firm has such a limited number of staff that such rotation is not practicable, other safeguards should be applied such as arranging for an additional professional accountant to review the work done.

3.9 Provision of non-assurance services

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)**.

Prohibition on assuming management responsibilities

Providing non-assurance services may result in the firm assuming management responsibility. The Code prohibits the firm from acting in a managerial capacity for a client and explains that this creates self-review, self-interest, familiarity and advocacy threats. Examples of activities that are considered as management responsibility include:

- setting policies and strategic direction
- hiring or dismissing employees
- directing and taking responsibility for the actions of employees
- authorising transactions
- controlling or managing bank accounts or investments
- deciding which recommendations of the firm to implement
- reporting to those charged with governance on behalf of management.
- taking responsibility for the preparation of financial statements or designing, monitoring and maintaining internal controls.

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To avoid assuming management responsibility, a firm must ensure that the client designates an individual to be responsible for all client decisions and oversee services.

The Code considers various categories of non-assurance work. The ones of most relevance to your exam are considered here.

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:

- determining accounting policies
- 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 as long as the client is responsible for making all decisions. Such advice is considered to be part of the normal audit process.

The Code **specifies** that for **public interest entities** the audit firm **may not provide** accounting or book-keeping services, including payroll services and the preparation of financial statements.

For **non-public interest entity 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.

For audit clients that are not public interest entities, audit firms should **not provide valuation services** where:

- the matter is material to the financial statements, and
- involves a significant degree of subjectivity.

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Where the audit client is a public interest entity, audit firms shall **not provide valuation services** where the matter is material to the financial statements.

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

Performing certain tax services creates **self-review** and **advocacy** threats. The Code considers these threats in the context of four categories of services:

Service	Explanation
Tax return preparation	Providing such services does not generally create a threat to independence if management takes responsibility for the returns including any significant judgments made.
Tax calculations for the purpose of preparing the accounting entries	So long as appropriate safeguards are in place (e.g. using a separate team; partner/senior staff review; engaging an external tax professional), firms may prepare the accounting entries for non-public interest entities. Tax calculations for the purpose of preparing accounting entries for public interest entities are prohibited. *[Prior to 2016 this was allowable in emergency situations]*.
Tax planning and other tax advisory services	Acceptable when the advice is clearly supported by tax authority/ other precedent and appropriate safeguards are in place such as: ❑ using professionals who are not members of the audit team to perform the service ❑ having a tax professional, who was not involved in providing the tax service, advise the audit team on the service and review the financial statement treatment ❑ obtaining advice on the service from an external tax professional ❑ obtaining pre-clearance or advice from the tax authorities. Planning and advice would not be acceptable where: ❑ the effectiveness of the tax advice depends on a particular accounting treatment or presentation in the financial statements ❑ the audit team has reasonable doubt about the accounting treatment ❑ the consequences of the tax advice would be material.

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Service	Explanation
Assistance in the resolution of tax disputes	This may be provided in some cases, although not when the firm acts as an advocate of the client and the effect on the financial statements is material. When assistance is provided, safeguards shall be applied such as: ❑ using professionals who are not members of the audit team to perform theservice ❑ having a tax professional, who was not involved in providing the tax service, advise the audit team on the service and review the financial statement treatment, or ❑ obtaining advice on the service from an external tax professional.

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. Audit firms are prohibited from providing such services to clients that are public interest entities.

For clients that are not public interest entities, the Code requires the following safeguards:

- ❑ the client must acknowledge its responsibility for the system of internal controls;
- ❑ the client must designate a competent employee, preferably senior management, to be responsible for management decisions in respect of the design and implementation of the system;
- ❑ the client must make all such management decisions;
- ❑ the client must evaluate the adequacy and results of the design and implementation of the system;
- ❑ the client shall be 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. A firm may not loan personnel to audit clients unless:

- it is for a short period oftime
- the individual is not providing non-assurance services that are prohibited under the Code
- the individual does not assume management responsibilities, and
- the audit client is responsible for directing and supervising the loaned staff.

Safeguards could include:

- the individuals loaned having no subsequent audit responsibility for any area they were involved in during their assignment
- not including the loaned personnel on the audit team at all
- conducting an additional review of the work carried out by the loaned personnel.

Litigation support services

Such services may include:

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

Providing litigation support services to an audit client might create a **self-review or advocacy threat,** depending on:

- the legal and regulatory environment
- the nature of the service
- whether the outcome of the litigation will have a material impact on the financial statements.

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 materiality and complexity of the matter and degree of judgement necessary. Safeguards include:

- using professionals who are not members of the audit team to provide services, and
- a review of the audit or legal work by an appropriate individual not involved in the audit or legal services work.

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However, the Code states that 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 might create **self- interest, familiarity and intimidation threats**. The level of the threat will depend on the nature of the request, the role of the person to be recruited and any relationship between the candidate being recruited and firm. **Safeguards** include:

- ❑ the decision as to who is hired must be made by the client,and
- ❑ the service should be provided by individuals who are not part of the audit team.

The firm **cannot** act as a negotiator on the client's behalf and shall not provide a recruitment service to any audit clients where services relate to:

- ❑ searching for candidates,or
- ❑ undertaking reference checks for a director or other senior staff member for a position with significant influence over the preparation of the financial statements.

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. Audit firms **should not** promote, deal in or underwrite an audit client's shares.

In other cases, **safeguards** should be considered such as:

- ❑ not making management decisions
- ❑ having a review of the audit or corporate finance work,and
- ❑ separate teams for the audit and corporate finance work.

3.10 Inducements,including gifts and hospitality

Accepting inducements (such as gifts or hospitality) from an assurance client might create **self-interest, familiarity and intimidation threats**.

The Code **specifies** that inducements shall only be accepted where the value is **trivial and inconsequential**.

Accountants need to remain aware of threats raised by clients offering inducements to immediate or close family members by existing or prospective clients as these may also have the intention of improperly influencing their behaviour.

3.11 Actual and threatened litigation

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 creates **self-interest or intimation threats**. The significance of the threat will depend on the materiality of the litigation and whether the litigation relates to a previous assurance engagement.

Safeguards should include:

- ❑ 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.

Example:

Your firm is the auditor of Happy Days, an entity which provides hospitality packages at race courses 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 race course 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.
- ❑ That the firm also provide internal audit services.

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 Code states that inducements should only be accepted where the value is clearly trivial and inconsequential (self-interest threat). This would be likely to be a considerable "perk" for audit team membersand, 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.

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4 CONFIDENTIALITY AND CONFLICTS OF INTEREST

Section overview

- Duty of confidentiality
- Recognised exceptions to the duty of confidentiality
- Conflicts of interest

4.1 Duty of confidentiality

Basic principles

One of the five fundamental principles of the Code is that of **confidentiality**. As discussed above, this principle states that information obtained in the course of professional work should not be disclosed to others, except where:

- **consent has been obtained** from the person or entity to which the information relates, or
- there is a legal or professional right or duty to disclose (as described below).

In addition, information gained when acting in a professional capacity should not be disclosed in order to:

- gain a personal advantage, or
- gain an advantage for another party.

One of the reasons for this requirement for auditors is that auditors need to obtain full and open disclosure of information from a client in order to carry out their duties. If the client cannot be assured of the confidentiality of this information, he may be unwilling to provide the auditors with all the information that they need.

Practical guidelines

A chartered accountant should maintain confidentiality even in a social environment. The chartered accountant should be alert to the possibility of inadvertent disclosure, particularly in circumstances involving long association with a business associate or a close or immediate family member. It can be all too easy in a relaxed social environment, particularly with colleagues, to forget one's duty of confidentiality. In reality most breaches are entirely accidental.

Scope of the duty of Confidentiality per the Code not only covers existing clients. A chartered accountant should also maintain confidentiality of information disclosed by a prospective client or employer.

A chartered accountant should also consider the need to maintain confidentiality of information within the firm or employing organization. If for example the audit firm audits two competing clients, each of those clients may be worried about the disclosure of confidential information to their competitor via the auditor. In such a scenario the audit firm should use separately staffed audit teams and implement other safeguards to prevent the internal disclosure of confidential information.

A chartered accountant should take all reasonable steps to ensure that staff under the chartered accountant's control and persons from whom advice and assistance is obtained respect the chartered accountant's duty of confidentiality.

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The need to comply with the principle of confidentiality continues even after the end of relationships between a chartered accountant and a client or employer. When a chartered accountant changes employment or acquires a new client, the chartered accountant is entitled to use prior experience. The chartered accountant should not, however, use or disclose any confidential information either acquired or received as a result of a professional or business relationship.

4.2 Recognised exceptions to the duty of confidentiality

There are some recognised exceptions to the duty of confidentiality. Where one of these exceptions applies, the member may be required to disclose the information to a third party, or may voluntarily choose to disclose confidential information.

Obligatory disclosure

An ICAN member is **obliged** to:

- ❑ disclose relevant information to an appropriate authority if he knows, or has reason to suspect, that a client has committed **treason, terrorism, drug trafficking, or money laundering**
- ❑ disclose information **if forced to do so by the process of law** (for example, a court case might require the production of audit documents for inspection by the court).
- ❑ disclose information to state agents such as EFCC and ICPC, acting with specific authority and in the interest of the state.

In these circumstances, the requirements of the law override the duty of confidentiality.

Voluntary disclosure

Voluntary disclosure of confidential information is permitted in the following circumstances:

- ❑ to protect the member's interests (for example, in making a defence against an official accusation of professional negligence)
- ❑ in the public interest (for example, making disclosures to the tax authorities of non-compliance by a client company with tax regulations)
- ❑ when authorised by local statute
- ❑ to non-governmental bodies which have the power to force such disclosure.

4.3 Conflicts of interest

Conflicts between members and clients

ICAN 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 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 aclient
- ❑ the receipt of commission from a third party for the introduction of a client (for example, an audit firm may be paid a commission by another entity, such as a firm of brokers, for introducing the entity to its client companies).

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Safeguards against a conflict of interest might include:

- disclosure of the conflict/commission to the client, and
- obtaining the informed consent of the client.

Conflicts between competing clients

An 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 audit 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 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.

Conflicts between those charged with governance and an organisation

Both public and private sector entities have individuals responsible for overseeing the strategic direction and financial reporting process in addition to being accountable for the organisation as a whole (called those charged with governance). Conflicts of interest may arise for individual accountants serving in this role.

Examples include:

- Where the accountant acts in a governance position for more than one organisation (for example, as a non-executive director) and acquires confidential information from one organisation that can be used to advantage (or disadvantage) the other organisation.
- Where the accountant's governance role includes approving the company's investments and by approving these investments, the accountant will increase the value of their (or an immediate family member's) personal investment portfolio.

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5 ETHICAL CONFLICT RESOLUTION

Section overview

- Overview
- Non-resolution

5.1 Overview

In evaluating compliance with the fundamental principles, an accountant may be required to resolve a conflict in the application of fundamental principles.

Consider the following:

- Relevant facts;
- Ethical issues involved;
- Fundamental principles related to the matter in question;
- Established internal procedures; and
- Alternative courses of action.

Having considered these issues, an accountant should determine the appropriate course of action that is consistent with the fundamental principles identified whilst bearing in mind the consequences of each possible course of action.

If the matter remains unresolved, the accountant should consult with other appropriate persons within the firm or employing organisation for help in obtaining resolution.

Where a matter involves a conflict with, or within, an organisation, an accountant should also consider consulting with those charged with governance of the organisation, such as the board of directors or the audit committee.

Issues and relevant discussions should be documented.

5.2 Non-resolution

If a significant conflict cannot be resolved, an accountant may wish to obtain professional advice from the appropriate committee of the Institute or legal advisors, and thereby obtain guidance on ethical issues without breaching confidentiality.

If, after exhausting all relevant possibilities, the ethical conflict remains unresolved, an accountant should, where possible, refuse to remain associated with the matter creating the conflict. The accountant may determine that, in the circumstances, it is appropriate to withdraw from the engagement team or specific assignment, or to resign altogether from the engagement, the firm or the employing organisation.

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6 RESPONDINGTO NON-COMPLIANCE WITH LAWS AND REGULATIONS (NOCLAR)

Section overview

- Non-compliance framework
- Auditor responsibilities

6.1 Non-compliance framework

The IFAC Code provides additional guidance for all professional accountants on how to respond when encountering non-compliance with laws and regulations (NOCLAR). This non-compliance can be intentional or non-intentional and examples include:

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

The NOCLAR framework explains:

- The process to be followed when a professional accountant encounters a suspected fraud or illegal act (i.e. NOCLAR); and
- The circumstances in which a professional accountant would override the fundamental principle of confidentiality and disclose the matter to an appropriate authority (also known as whistle-blowing).

Under the framework, auditors cannot simply resign from an engagement because of identified or suspected NOCLAR without the matter being appropriately addressed.

6.2 Auditorresponsibilities

Where a professional accountant becomes aware of a matter relating to NOCLAR they must:

- obtain an understanding of the matter;
- advise management to take appropriate and timely actions (if not already done so). i.e.to
- rectify, remediate or mitigate the consequences of non-compliance;
- deter the commission of the non-compliance where it has not yet occurred; or
- disclose the matter to an appropriate authority; and

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- determine whether further action is needed by considering the appropriateness of management's response. This includes determining whether:
- the response is timely;
- the NOCLAR has been adequately investigated;
- action has been, or is being, taken to rectify, remediate or mitigate the consequences of NOCLAR;
- action has been, or is being, taken to deter the commission of any NOCLAR not yet occurred;
- appropriate steps have been, or are being, taken to reduce the risk or re-occurrence (e.g. with additional controls or training);
- the NOCLAR has been adequately disclosed to an appropriate authority.

Subsequently, the professional accountant shall determine if further action is needed in the public interest. In making this assessment they should consider factors such as the legal and regulatory framework, the urgency of the matter, the integrity of management and whether NOCLAR is likely to recur.

Further action might include:

- disclosing the matter to an appropriate authority even when there is no legal or regulatory requirement to do so; or
- withdrawing from the engagement and the professional relationship where permitted to by law or regulation.

The professional accountant may disclose the matter to an appropriate authority if:

- the entity is engaged in bribery;
- the entity is regulated, and the matter is of such significance as to threaten its operating license;
- the matter could result in adverse consequences to the financial markets;
- products harmful to the public health or safety are likely to be sold; or
- the entity is promoting a scheme to its clients to assist them in evading taxes.

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7 CHAPTER REVIEW

Chapter review

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

- Describe the fundamental principles of the IFAC Code of Ethics
- Explain the concepts of rules vs. principles-based systems and the public interest
- Apply the conceptual framework to identify threats to the fundamental principles and suggest appropriate safeguards across a range of common scenarios
- Assess ethical conflicts facing accountants in business or practice
- Discuss how an accountant should respond to a suspected instance of NOCLAR

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Quickquizquestions

1 The five fundamental principles in the IFAC Code of Ethics do NOT include:

A Materiality

B Integrity

C Competence and due care

D Professional behaviour

2 Which threat to independence arises if an audit client threatens the auditor with litigation?

A Professional competence and due care

B Intimidation threat

C Conflict of interest

D Familiarity threat

3 One of the independence rules states that overdue fees to a previous auditor are not acceptable. What is the best explanation for the above?

A It may give a false impression of the bank reconciliation

B Any company that breaches its credit limits MUST be avoided

C Overdue fees effectively constitute a loan, which is forbidden

D The new auditor is allowed to take that fee once it is paid

4 Which one of the following may auditors NOT perform for their client?

A Taking management decisions

B Preparation of accounting records

C Preparing tax computations

D Advising on weaknesses in the internal control systems

5 An auditor may have to disclose certain information. When might that never be the case?

A Under a court order

B In the public interest

C For use on a different audit client

D Disclosure to the authorities of suspicion of money laundering

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Quick quiz answers

1	A
2	B
3	C
4	A
5	C

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CHAPTER 3

Obtaining an engagement

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Contents

INTRODUCTION

Competencies

Process of audit and assurance

A3 (a) Explain the basic steps of audit and assurance process in relation to:

(i) Nomination;

(ii) Acceptance; and

(iii) Engagement;

Exam context

Students need to be familiar with the commercial, legal and ethical process in accepting new clients and engagements. This chapter explains the key points and includes references to the ICAN Code of Ethics (i.e. the Professional Code of Conduct and Guide for Members) and Companies and Allied Matters Act 2020 (CAMA 2020).

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

- Explain the commercial legal process around obtaining and accepting new audit appointments.
- Explain the ethical considerations with respect to client and engagement acceptance and changes in professional appointment.
- Describe the process for resignation and removal of the auditors.
- Describe the requirements of ISA 210 with respect to the preconditions for accepting appointment as an auditor and also for setting up the engagement letter.

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1 OBTAINING AND ACCEPTING A NEW AUDIT ENGAGEMENT

1.1 Introduction

Several commercial and ethical matters should be considered by an **external** auditor when considering the acceptance of a new audit engagement. Auditors and clients must also follow the legal requirements set out in the CAMA 2020

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

1.2 Obtaining audit work

Advertising and publicity – general guidelines

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

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

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

Advertising and publicity – ICAN Code of Ethics

The ICAN Code of Ethics (chapter 8) states:

A Chartered Accountant in public practice should not bring the profession into disrepute when marketing professional services. The Chartered Accountant in public practice should be honest and truthful and should not:

- make exaggerated claims for services offered, qualifications possessed, or experience gained; or
- make disparaging references to unsubstantiated comparisons to the work of another Chartered Accountant.

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If the Chartered Accountant in public practice is in doubt whether a proposed form of advertising or marketing is appropriate, the Chartered Accountant in public practice should consult through the Registrar/Chief Executive of ICAN.

Fees

Where reference is made in promotional material to fees:

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

Introductions

Fees and commissions are often paid to third parties for the introduction of potential new clients in many countries. **Safeguards must be in place** to reduce the threats to the fundamental principles (e.g. disclosure to the client).

However, paragraph 7.1.5 of ICAN's code of ethics states that in Nigeria:

- A Chartered Accountant in public practice shall not pay or receive a referral fee to obtain a client, for example, where the client continues as a client of another Chartered Accountant in public practice but requires specialist services not offered by the existing Chartered Accountant. The payment of such a referral fee may also create a self-interest threat to objectivity and professional competence and due care.

Tendering

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

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

Sometimes, an audit firm may use a technique known as '**low-balling**' when it tenders for audit work. Low-balling means deliberately quoting a low (and perhaps unprofitable) fee in order to obtain the audit work. A low-balling strategy may be linked to an intention to:

- increase the fee to a more realistic level over a period of years, or
- make up the shortfall in the fee for the basic audit work with more profitable fees for non-audit services.

Low-balling itself is not considered unethical but it creates a potential **self-interest threat** to independence. Therefore the firm must be able to demonstrate that appropriate time and qualified staff are available to ensure that a quality audit is performed in accordance with ISAs.

1.3 Accepting an appointment: ethical matters

Chapter 4 of the ICAN Code of Ethics includes procedures that auditors must follow to ensure that their appointment is valid.

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

Client acceptance

Before accepting a new client relationship, a Chartered Accountant in public practice should consider whether acceptance would create any threats to compliance with the fundamental principles. Potential threats to integrity or professional behaviour may be created from, for example, questionable issues associated with the client (its owners, management and activities).

Client issues that, if known, could threaten compliance with the fundamental principles include, for example

- client involvement in illegal activities (such as money laundering)
- dishonesty; or
- questionable financial reporting practices.

The significance of any threats should be evaluated. If identified threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate or reduce them to an acceptable level.

Appropriate safeguards may include

- obtaining knowledge and understanding of the client, its owners, managers and those responsible for its governance and business activities
- securing the client's commitment to improve corporate governance practices or internal controls.

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

Acceptance decisions should be periodically reviewed for recurring client engagements.

Engagement acceptance

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

A Chartered Accountant in public practice should evaluate the significance of identified threats and, if they are other than clearly insignificant, safeguards should be applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include but are not limited to:

- Acquiring an appropriate understanding of the nature of the client's business, the complexity of its operations, the specific requirements of the engagement and the purpose, nature and scope of the work to be performed.

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- Acquiring knowledge of relevant industries or subject matters.
- Assigning sufficient staff with the necessary competencies.
- Using experts where necessary.
- Agreeing on a realistic time frame for the performance of the engagement.
- Complying with quality control policies and procedures designed to provide reasonable assurance that specific engagements are accepted, only when they can be performed competently.

When a Chartered Accountant in public practice intends to rely on the advice or work of an expert, he should evaluate whether such reliance is warranted, by considering factors such as reputation, expertise, resources available and applicable professional and ethical standards, information which may be gained from prior association with the expert or from consulting others.

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

Procedures after accepting anappointment

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

- It should ensure that the current auditor (if any) has resigned from the audit in a proper manner, or has been removed from office in accordance with any appropriate local legislation.
- It should ensure that its appointment is valid in law and is properly documented.
- It should prepare and submit an engagement letter to the board of the new client (see section on ISA 210 below).

Changes in professional appointment

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

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

- When a member is first approached by a prospective client to act or be nominated, he should explain that he has 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 appointment as auditor should not be accepted.
- If the current auditor does not provide any information relevant to the appointment, the new auditor should accept or reject the engagement based on other available knowledge.

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- If the current auditor does provide such information, the new auditor should assess all the available information and take a decision about whether or not to accept the audit work.

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

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.

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 he 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 his attention by the predecessor firm, which needs to be properly investigated. Such disclosure should be no wider than is necessary.

Defamation

It is likely that an existing Auditor who communicates to a prospective successor, matters damaging to the client or to any individual concerned with the client's business will have a strong measure of protection were any action for defamation to be brought against him, in that the communication will be protected by qualified privilege.

This means that he should not be liable to pay damages for defamatory statements even if they turn out to be untrue, provided that they are made without malice.

The chances of an incumbent being held to have acted maliciously are more provided that:

- he states only what he sincerely believes to be true; and
- he does not make reckless imputations against a client or individual connected with it which he can have no reason for believing to be true.

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 he may need from the latter's alternative (where appropriate), the administrators of the estate or other sources.

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Transfer of Books and Papers

A replaced auditor or adviser should transfer promptly to the client, or to his successor after the latter has been duly appointed, all books and papers which are in his possession and which belong to the client unless he is exercising a lien thereon for unpaid fees. *Members should be aware that the courts have held that no lien can exist over books or documents of a registered company, which, either by statute or by article of association of the company, have to be available for public inspection.*

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 he has 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 his continuing responsibilities to his client.
- Notification should always be given to the existing chartered accountant.
- Provision of all opinion 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.

1.4 Appointment of auditors (s.401 CAMA 2020)

Every company shall at each annual general meeting appoint an auditor or auditors to audit the financial statements of the company, and to hold office from the conclusion of that, until the conclusion of the next, annual general meeting.

At any annual general meeting a retiring auditor, however appointed, shall be re-appointed without any resolution being passed unless:

- he is not qualified for re-appointment; or
- a special resolution has been passed at that meeting appointing some other person instead of him or providing expressly that he shall not be re-appointed; or
- he has given the company notice in writing of his unwillingness to be re-appointed:

Provided that where notice is given of an intended resolution to appoint some person or persons in place of a retiring auditor, and by reason of the death, incapacity or disqualification of that person or of all those persons, as the case may be, the resolution cannot be proceeded with, the retiring auditor shall not be automatically re-appointed.

Where at an annual general meeting, no auditors are appointed or re-appointed, the directors may appoint a person to fill the vacancy.

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The company shall, within one week of the power of the directors becoming exercisable, give notice of that fact to the Commission; and if a company fails to give notice as required by this subsection, the company and every officer of the company who is in default shall be guilty of an offence and shall be liable to a penalty as the Commission shall specify in its regulations.

Subject as hereinafter provided, the first auditors of a company may be appointed by the directors at any time before the company is entitled to commence business (by ordinary resolution with special notice) and auditors so appointed shall hold office until the conclusion of the next annual general meeting:

Provided that

- the company may at a general meeting remove any such auditors and appoint in their place any other person who has been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than 14 days before the date of the meeting; and
- if the directors fail to exercise their powers under this subsection; the company may, in a general meeting convened for that purpose, appoint the first auditors and thereupon the said powers of the directors shall cease.

The directors may fill any casual vacancy in the office of auditor but while any such vacancy continues, the surviving or continuing auditor or auditors, if any, may act.

In principle, the **remuneration of the auditor** is set by whoever appoints him. However, in practice, where the shareholders make the appointment, it is usual to delegate to the board of directors the power to set the auditor’s remuneration. The directors are likely to be more familiar than the shareholders with the nature and scope of the work involved in the audit process, and so the appropriate level of fees for that work. (The board of directors may delegate the task of recommending or approving the audit fee to the audit committee.)

1.5 Removal of auditors (s.409 CAMA, 2020)

As seen above, in certain circumstances the directors are empowered to appoint auditors. However, it would not be appropriate for the directors to have the power to remove the auditors from office.

For example, it would be inappropriate for the directors to have the power to remove the auditors because there may be a disagreement between the directors and the auditors about an item in the financial statements or about the conduct of the audit. The directors could silence the auditors by dismissing them. Clearly, it would be more appropriate for the directors to recommend the appointment of new auditors to the shareholders, and for the shareholders to decide.

If the auditors resign from office they are required to give their reasons to the shareholders and notify the authorities of their removal.

In Nigeria it is the ordinary shareholders who are able to dismiss the auditor by passing an ordinary resolution (with special notice) at a General Meeting.

When this occurs the company shall within 14 days give notice of that fact in the prescribed form to the Commission and if a company fails to give the notice required, the company and every officer of it who is in default shall be guilty of an offence and liable to a penalty as the Commission may specify in its reglations.

1.6 Resignation of auditors (sections 412 and 413 CAMA, 2020)

The auditor may choose to resign during his period of office. The reasons for this might include:

- ❑ A consistent lack of integrity is demonstrated by management and/or those charged with governance;
- ❑ Significant fees remain unpaid;
- ❑ The audit firm can no longer maintain its independence (e.g. following a corporate action);
- ❑ The client is no longer profitable for the audit firm.

However, company law provides certain safeguards to ensure that the shareholders are made aware of any relevant circumstances relating to the auditor's resignation.

The procedures for the resignation of the current auditors are:

- ❑ The resignation should be made to the company (at its registered office) in **writing**. The company should submit this resignation letter to the appropriate regulatory authority.
- ❑ The auditor should prepare a **statement of the circumstances**. This sets out the circumstances leading to the resignation, if the auditor believes that these are relevant to the shareholders or creditors of the company. If no such circumstances exist, the auditor should make a statement to this effect.
- ❑ The company should send this statement to:
  - the Commission within 14 days of receipt;
  - all persons entitled to receive a copy of the company's financial statements (principally the shareholders) – unless the Commission rules that the Auditor is seeking to defame the company with needless publicity
- ❑ The auditors may require the directors to call a meeting of the shareholders in order to discuss the circumstances of the auditor'sresignation.

If default is made in complying with the above provisions, the company and every officer of it who is in default shall be guilty of an offence and liable to a penalty as the Commission shall specify in its regulations.

2 AGREEING THE TERMS OF AUDIT ENGAGEMENTS (ISA 210)

Section overview

- Preconditions
- Engagement letters

2.1 Preconditions

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

- ❑ establishing whether the **preconditions for an audit are present**;and

- confirming that there is a **common understanding between the auditor and management**.

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

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

The auditor is **required** to refuse the engagement where:

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

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.

2.2 Engagement letters

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

The content of the engagement letter

The engagement letter shall include details of the following:

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

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

- More details on the scope of the audit, such as reference to applicable legislation, regulations, ISAs, 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

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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.

Example:

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

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

Answer

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

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

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

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

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Recurring audits

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

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

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

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

Acceptance of a change in the terms of engagement

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

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

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

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3 CHAPTER REVIEW

Chapter review

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

- Explain the commercial legal process around obtaining and accepting new audit appointments.
- Explain the ethical considerations with respect to client and engagement acceptance and changes in professional appointment.
- Describe the process for resignation and removal of the auditors.
- Describe the requirements of ISA 210 with respect to the preconditions for accepting appointment as an auditor and also for setting up the engagement letter.

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Quick quiz questions

1 What mechanism is used by the shareholders to remove an auditor?

A Special resolution (with ordinary notice) at a general meeting

B Ordinary resolution (with general notice) at a special meeting

C Special resolution (with general notice) at an ordinary meeting)

D Ordinary resolution (with special notice) at a general meeting

2 When an auditor resigns from office from a private company, which MUST hesupply?

A A statement of circumstances relating to the resignation, such as significant disagreements over policy or suspicions of fraud

B A statement of 'no circumstances', i.e. that there are no significant disagreements over policy or suspicions of fraud

C Either (a) or (b), depending on the situation

D Neither (a) nor(b)

3 Assuming that it is not the first appointment of the auditor, who is responsible for the appointment of the auditor?

A The shareholders in a general meeting

B The managing director

C The board of directors in a board meeting

D The audit committee

4 The independent auditor's primary responsibility is to:

A the directors

B the company's creditors (payables)

C the company's bank

D the shareholders.

5 You have been proposed as auditor of a company. What is the first step that you should take?

A Obtain the client's permission to communicate with the existing auditor

B Obtain the existing auditor's working papers

C Obtain a copy of the company's most recent board minutes

D Obtain a copy of the existing auditor's letter of engagement

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Quick quiz answers

1 D

2 C

3 A

4 D

5 A

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CHAPTER 4

Internal audit

Contents

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INTRODUCTION

Competencies

Objectives, need for and process of audit and assurance

A2 (b) Discuss the role of the internal audit department in maintaining an effective internal control system.

A2(c) Compare internal and external audits.

Exam context

Internal audit is an increasingly common feature of an organisation's system of internal control. Internal audit is one of the requirements of Codes of Corporate Governance such as the Nigerian SEC Code of Corporate Governance and the UK Corporate Governance Code.

Students need to be familiar with the concept, form and duties of internal audit and understand how their work differs from that of the external auditor.

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

- Describe the concept and role of internal audit
- Compare external and internal audit
- Explain the nature and purpose of different types of audit assignments that internal audit might perform such as operational audits, value for money, best value and financial audits
- Briefly describe the contents and layout of a typical internal audit report
- Summarise how regulation and ethics impacts internal audit
- Explain how internal audit can be outsourced including the benefits and problems of doing so

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1 CONCEPT AND ROLE OF INTERNAL AUDIT

Section overview

- Purpose and functions of internal audit
- Benefits of internal audit
- Independence of the internal auditors and other problems with internal audit
- Internal audit and risk assessment
- Management of risk
- Comparison of external and internal audit

1.1 Purpose and functions of internal audit

Internal audit consists of audit, investigation or review work carried out on a voluntary basis by an entity, for its own control purposes. The internal audit work may be carried out by the entity's own full-time internal audit staff, or by an external accountancy firm.

There is no regulatory or statutory requirement for internal audit; therefore an entity will only carry out internal audit work if it considers the benefits sufficient to justify the cost.

Internal audit functions

Since there are no regulatory requirements for internal audit, the nature of internal audit work can vary substantially between different entities, depending on their size and structure, the nature of their business, the extent of regulation within their industry and markets, the extent of computerisation of the entity's main operational systems, the attitude of senior management to risk management, the nature and scale of the perceived control risks, and soon.

ISA 610 *Using the work of internal auditors* (which is outside the scope of this syllabus) states that internal auditing activities will usually include one or more or the following:

- **Monitoring of internal control**. The establishment of an adequate internal control system is a responsibility of management and is an important aspect of good corporate governance. Because the internal control system needs to be monitored on a continuous basis, large companies are likely to establish an internal audit function to assist management in this role. Internal audit is therefore usually given specific responsibility by management for reviewing internal controls, monitoring their operation and recommending improvements via a report to the directors.
- **Examination of financial and operating information**. This may include review of the means used to identify, measure, classify and report such information or specific inquiry into individual items including detailed testing of transactions, balances and procedures. As you will see from later chapters, work in this area is very similar to that carried out by the external auditor.
- **Review of the economy, efficiency and effectiveness of operations**. This could include a review of non-financialcontrols.
- **Review of compliance** with laws, regulations and other external requirements and with internal requirements such as management policies and directives.

- **Special investigations** into particular areas such as suspectedfraud.

The majority of these activities will be classed as **operational internal audit assignments.** These are audits of specific processes and operations performed by the entity and are covered in Section 2 below. However, internal audit could also be asked to perform **other assignments** such as value for money audits.

The range of audit and investigation work that may be performed by internal auditors can be listed more specifically as follows:

- Carrying out audits into the adequacy of financial controls in specific areas of the accounting system
- Carrying out audits into the adequacy of operational controls in specific areas of the operational systems of the entity
- Auditing the adequacy of controls in the entity's IT systems
- Reviewing the economy, efficiency and effectiveness of particular operations or activities: these reviews are called value for money (VFM) audits
- Carrying out checks into compliance with key aspects of legal or regulatory requirements to which the entity is subject. For example a bank may use internal auditors to check compliance by the bank with regulations for the prevention or detection of money laundering. Similarly an oil company may use internal auditors to check into compliance with health and safety regulations at its operating sites.
- Examination and review of financial information produced by the entity.
- Special investigations, such as investigations into suspected cases of fraud within the entity.

1.2 Benefits of internal audit

Internal audit work costs money and should therefore provide benefits to justify the costs. The justification for internal audit may come from:

- Improvements in financial controls or operational controls within the entity
- Improvements in compliance with key laws and regulations, thereby reducing the risk of legal action or action by the regulators against the entity
- Improvements in the economy, efficiency or effectiveness of operations

There may be other benefits of internal audit.

- If the internal auditors carry out checks into the effectiveness of financial controls within the entity, the external auditors may decide that they can rely to some extent on the work done by internal audit. This would save time and effort when carrying out theirown audit work. If the external auditors do rely to some extent on the work of internal audit, there may be a reduction in the external audit fee.
- The existence of an internal audit department may enhance the reputation of the entity for sound corporate governance in the opinion of customers and investors.

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1.3 Independence of the internal auditors and other problems with internal audit

Auditors should be independent. However internal auditors cannot achieve the same **degree of independence** as that required of the external auditor. Full-time internal auditors are employed by the entity and rely on the entity for their job and salary. Even external firms that carry out internal audit work for a client entity may lack independence, because the audit work is not a regulatory requirement and the firm therefore relies on the client's attitude for their future fee income.

Methods of trying to ensure independence

For full-time internal auditors, one of the biggest problems with independence is that the auditors must report to someone within the entity, and both the independence and the status of the chief internal auditor will depend on who he reports to within the management hierarchy.

- In order to achieve as much independence as possible it is important that the internal auditor report to the highest level of management, or to the audit committee if there is one.
- However, even if the chief internal auditor reports to the finance director, there is a threat to his independence, because much of the work of the internal auditors will involve investigations into activities and controls for which the finance director is responsible.

Various measures can be taken to try to protect the independence of the internal auditors

- **Reporting lines**. The chief internal auditor may report to the audit committee and not to the finance director or chief accountant.
- **Deciding the scope of internal audit work**. The scope of work carried out by the internal auditors should not be decided by the finance director or line management responsible for the operations that might be subjected to audit. This is to avoid the risk that the internal auditors might be assigned to investigations of non-contentious areas of the business. The scope of internal audit work should be decided by the chief internal auditor or by the audit committee.
- **Rotation of internal audit staff**. Internal auditors should not be allowed to become too familiar with the operations that they audit or the management responsible for them. To reduce the familiarity threat, internal auditors should be rotated regularly, say every three to five years, and at the end of this time they should be assigned to other jobs within the entity.
- **Appointment of the chief internal auditor**. The chief internal auditor should not be appointed by a senior executive who may have some self-interest in wishing to appoint a 'yes man' who will not 'cause trouble'. Instead, the audit committee should be responsible for appointing a new chief internal auditor, subject perhaps to approval by the board of directors.
- **Designing internal controls**. The internal auditors should not be responsible for the design of internal controls within the entity. If they did, they would be required to audit their own work, which is unacceptable. Senior management in accounting and finance or line management should have responsibility for the design and implementation of internal controls, taking advice where appropriate from the external auditors when control weaknesses are identified during the external audit.

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Weaknesses and limitations of internal audit

Since internal audit is not a regulatory requirement, there is no requirement for internal auditors to be professionally qualified for the work they do (although there may be a professional institute or association of internal auditors).

It is therefore a matter for the entity setting up the internal audit function what **qualifications or experience** it requires of the members of its internal audit team.

In contrast, the external auditor has to comply with regulations set by government and his professional body covering technical and professional standards and qualifications. However an internal auditor who is a member of a professional body (such as the ICAN) will need to comply with the requirements of that body in any work that they do.

Arguments against having an internal audit department, referred to already, include:

- the cost of having one
- the problems that may arise with ensuring the independence of the internal auditors.

1.4 Internal audit and risk assessment

Internal control systems are put in place by the directors (executive management) in order to help them manage the company's 'governance' risks. Risk can be thought of as anything which may prevent an organisation from achieving its objectives. It may be convenient in this context to think of risks as the risks of errors or fraud, or the risk that information will be unreliable.

Risk is extremely relevant to the role of the internal auditor. His work may often involve carrying out a risk assessment exercise, designed to identify the main areas of risk to which the organisation is exposed. The internal auditor will report these risks to management, and will perhaps make suggestions about how the risks can be managed.

It is useful to analyse the risks that are considered by internal auditors into three main categories. These are:

- **Operational risk**. These are the risks that the operating activities of an entity may be disrupted, either deliberately or unintentionally and in error. Employees may make mistakes, and do something wrong or forget to do something. Machines may break down. There may be poor security arrangements, poor supervision, weak management or an ineffective organisation structure. Operational risk refers to anything that might go wrong with operational activities.
- **Financial risk**. These are the risks of what might happen if there are changes in the financial environment, such as interest rates, taxation law or exchange rates. Financial risk also includes credit risk, which is the risk of non-payment or late payment by customers.
- **Compliance risk**. These are risks that the entity may fail to comply with relevant rules and regulations, resulting in penalties being imposed by regulatory authorities or fines being paid to injured parties. Examples of compliance risk vary according to the nature of a company's activities: they may include the risks of non-compliance with health and safety law, anti-pollution law, employment law, and soon.

1.5 Management ofrisk

In many cases, it is not possible for management to eliminate risk entirely. Instead, measures are taken to 'manage' risk, and:

- limit the probability that an adverse event will occur, or reduce the frequency of adverse events, and
- limit the impact of an adverse event when or if it does occur.

Approaches to risk management that an internal auditor may recommend to management include the following:

- **Acceptance**. Risk acceptance means accepting the risk and doing nothing to reduce the possibility that an adverse event will happen and doing nothing to limit the consequences if an adverse event does occur. This approach is normally only acceptable if the risk is insignificant.
- **Reduction**. Risk reduction involves taking measures to reduce the probability that an adverse event will happen, or reducing the consequences of an adverse event. Measures to reduce risk may involve instituting appropriate **controls** to minimise the risks to which the entity is exposed. Most **internal controls** are designed as **risk reduction measures**.
- **Avoidance**. Risk avoidance means avoiding transactions or situations that would create an exposure to a risk. For companies, it is normally impossible to avoid risks entirely without withdrawing from a business operation entirely.
- **Transfer**. Risk transfer means transferring the risk to a third party, often in return for a payment. The most commonly-used example of risk transfer is probably the use of insurance. With insurance, risks are transferred to an insurance company in exchange for the payment of a premium.

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1.6 Comparison of external and internal audit

Internal and external auditors often carry out their work using similar procedures. This is something to bear in mind when answering 'practical' questions on auditing in an examination.

However, there are a number of fundamental differences between the two audit roles. These are summarised in the following table:

	External audit	Internal audit
Duties and responsibilities	To express an opinion on the truth and fairness of the annual financial statements. The external auditor will therefore carry out whatever work he deems necessary to reach that opinion.	To examine systems and controls and assess risks in order to make recommendations to management for improvement. The internal auditor's work programme will therefore to a large extent be dictated by management.
Qualification to act	Set out by statute. This ensures that the external auditor is independent of the entity and suitably qualified.	No statutory requirements – management select a suitably competent person to act as internal auditor. It is therefore possible that the internal auditor may not be as competent as the external auditor, depending on management's recruitment criteria.
Appointed by	The shareholders. This ensures independence.	Management. In order to give as much independence as possible the internal auditor should therefore report to the highest level of management.
Duties set out by	Statute. (See above under role and work.)	Management (See above under role and work.)
Report to	The shareholders. (See above, under appointed by.)	Management. (See above under appointed by.)

You should also bear in mind that the external auditor has no specific responsibility for fraud and error, other than to report whether or not the financial statements give a true and fair view; the external auditor will be concerned that there has been no**material** undetected fraud or error during the period. This is covered in a later chapter.

The internal auditor may be given specific responsibility for investigating suspected fraud or error by management, and he is likely to have much lower materiality thresholds.

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2 OPERATIONAL INTERNAL AUDIT ASSIGNMENTS

Section overview

- Definition of an operational internal audit assignment
- General approach
- Specific functions
- Procurement operations

2.1 Definition of an operational internal audit assignment

Operational internal audit assignments involve the internal auditor being asked by management to look at a particular aspect of the entity's operations, such as marketing activities or the human resources department.

Operational internal audit assignments are therefore defined as audits of specific processes and operations performed by an organisation. They are also known as **management audits**, or **efficiency audits**.

The purpose of an operational internal audit assignment is to assess management's performance in the specific area of operations that is subject to the audit, and to ensure that company policy and control procedures are adhered to.

The audit will identify areas for improvement in efficiency and performance, and improvements in management.

2.2 General approach

The general approach to an operational internal audit assignment will be determined by the purpose of the audit. For each area of operations that is subject to an operational internal audit assignment, the internal auditor should assess:

- the **adequacy** of the policies, procedures and controls adopted, and
- the **effectiveness** of the policies, procedures and controls.

Adequacy of policies and procedures

The internal auditor should assess whether the policies and procedures are adequate for their purpose. The key question that needs to be answered is:

Will the policies achieve the relevant objectives?

The policies, procedures and controls should therefore be reviewed by the internal auditor in the context of the objectives which they are designed to achieve.

Effectiveness of policies and procedures

If policies and procedures seem to be adequate, the internal auditor should then ask whether they are being applied properly. The key question that needs to be answered is:

Are the processes operating effectively?

This will involve the internal auditor testing the processes, using techniques similar to those used in tests of control (covered in a later chapter).

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2.3 Specific functions

Some examples of specific functions that may be subject to an operational audit include:

- **Procurement**: operations concerned with purchasing.
- **Marketing**: operations associated with obtaining information about customer needs and trying to increase sales demand.
- **Treasury**: Treasury operations are concerned with management of the entity's short-term and long-term financing. A Treasury department may be responsible for managing the long-term and short-term borrowing of the entity, the investment of short-term surplus cash, the management of the entity's cash, and managing financial risks such as exchange rate risks and interest rate risks.
- **Human resources management**: operations concerned with managing people – the employees of the entity.

For any area of operations subject to an operational internal audit assignment, the internal auditor needs to consider:

- The risks
- the control procedures for managing and limiting the risk, and whether these are adequate
- how the control procedures can be tested, to make sure that they are working effectively.

Each of the four areas of operations is considered in turn below.

2.4 Procurement operations

In many organisations, procurement is the specific responsibility of a buying department or purchasing department. Organising this activity in a centralised department should help to ensure that spending is managed and controlled.

The main risks with procurement are as follows:

- The entity may buy items that it does not really need or cannot afford.
- It may pay prices that are higher than necessary. Items might be available at a lower price.
- Some payments to suppliers may be fraudulent; for example, some suppliers may receive payments for items they have not supplied.
- The entity might pay suppliers the wrong amount.
- The entity may take too long to pay (longer than the time agreed in the terms of credit with the supplier). This could have an adverse effect on the business reputation of the entity.

Various controls can be applied to manage these risks:

- The entity might establish an authorised list of suppliers, and (as a matter of policy) goods and services can be purchased only from suppliers on the list. (There may be exceptions to the policy guidelines. For example, a company policy may be that a supplier must be on the authorised list if more than one purchase order is ever placed with the supplier, but for one-off purchases, a supplier does not need to be on the list.)

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- There should be procedures for the requisition of goods and services, and procedures for the authorisation and approval of purchase orders. For example, requisitions to purchase store items may be generated by the store department's inventory control system, and the authorisation for the purchase and the placing of the purchase order should be made by individuals at a suitable level of seniority, depending on the size and value of the order.
- There should be established policies and procedures in the buying department for negotiating favourable prices with suppliers.
- For very large purchase contracts, it may be a policy requirement that a system of tendering should be used, and more than one supplier should be asked to tender for the contract.
- Supplier performance should be monitored. Have they delivered goods on time and to the specified quality?
- The payments system should be subject to suitable controls. (These are largely financial controls and so should be subject to the annual external audit.)
- There should be a control reporting system that reports to management on supplier performance and any breach of purchasing policy guidelines and procedures.

To test the effectiveness of these policies, procedures and controls, the internal auditor should carry out a number of checks:

- He may carry out a check on a sample of purchase orders, tracing the order from the original purchase requisition, through authorisation and placing the order, to delivery, invoicing and payment. Were the correct procedures followed? Was the purchase authorised properly? Was the order placed with a supplier on the approved list? Was the pricing correct? Were the items delivered on time? Was the invoice correct? Was it paid within the allowed credit period?
- The internal auditor should also review the controls applied by management. If reports are provided to management about purchases that did not follow the approved procedures, what action did management take?

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3 NATURE AND PURPOSE OF OTHER INTERNAL AUDIT ASSIGNMENTS

Section overview

- Introduction
- Value for money audits
- Problems with VFM audits
- Best value audits
- Financial audits
- Information technology (IT) audits

3.1 Introduction

The internal auditors work on behalf of management and report to management. The type of work they do will therefore be dictated by what management wants them to do. However, it is possible to list the other work that might be done by internal auditors under the following broad headings:

- Value for money audits
- Best value audits
- Financial audits
- Information technology (IT) audits.

3.2 Value for money audits

The value for money (VFM) audit originated in public sector organisations as a way of assessing financial performance. In public sector organisations, conventional profit-based measures are not appropriate because the objectives of these organisations are not usually to make a profit. The concept of value for money and the VFM audit has now been widely adopted by commercial organisations as a means of assessing performance on a broader basis than just profit.

Value for money, as the term suggests, means getting good value from the money that an entity spends. Value for money is obtained from a combination of the '3 Es':

- economy
- efficiency
- effectiveness.

Economy means not spending more than is necessary to obtain the required resources. At a very basic level, it means buying supplies from the cheapest suppliers of materials of the desired quality, avoiding excessive salary payments to employees and avoiding unnecessary spending on other items of cost.

Efficiency means getting a high volume of output from the resources that are used. The efficiency of employees is often referred to as 'productivity'. Efficiency can be achieved by making better use of equipment and machines (reducing non-use time), improving employee productivity, making better use of available accommodation or getting better use out of marketing spending, and so on.

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Effectiveness means achieving the objectives of the entity with the resources that it uses. Using resources efficiently has no value if the resources are not used in a way that achieves objectives. For example, a manufacturing company may improve efficiency and produce a larger quantity of output with its available machines. However, if the extra output cannot be sold, the organisation will not achieve its objective of increasing profit.

The 3Es are summarised in the table below:

	Meaning	Measurement
Economy	'Doing it cheaply'	Compare money spent with inputs acquired
Efficiency	'Doing it well'	Compare inputs used with output achieved
Effectiveness	'Doing the right thing'	Compare output achieved with objectives

Measuring the 3Es is important for the purpose of a VFM audit. The internal auditor should measure each of the three Es in order to assess whether sufficient value for money is being achieved, or whether improvements can be made.

The right hand column of the table shows that there are four variables involved in the measurement of value for money:

- the money spent
- inputs acquired with the money spent, and inputs used
- output produced with the inputs used
- objectives achieved.

Overall, VFM therefore provides a link between **money spent** and **objectives achieved**.

Good overall performance is dependent on a high level of achievement on all of the 3Es. For example, it is no good saving money by purchasing low grade materials (good economy) if those materials break and are wasted in the production process (poor efficiency).

VFM audits focus on the organisation's performance in a given area by looking at each of the 3Es with the objective of identifying areas where VFM might be improved. The internal auditor can then make suitable recommendations to management.

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Example:

Consider a VFM audit approach to employee and payroll costs.

Questions which the auditor could consider in this area might include the following:

- ❑ Does the organisation recruit staff with a sufficient, but not excessive level of competence for the tasks which they will be performing?
- ❑ Do staff go through appropriate training and development programmes?
- ❑ Are staff rewarded and motivated in an appropriate way?
- ❑ Are staff effectively supervised and managed in their day-to-day work?

The VFM audit will consider these issues in terms of achieving value for money:

- ❑ Are employment costs unnecessarily high?
- ❑ Are employees sufficiently productive in the work that they do?

3.3 Problems with VFM audits

The VFM concept and VFM audits have proved to be a useful tool in assessing organisational performance, but there are problems involved in applying the principles in practice. These include the following:

Measurement difficulties

It is not always possible to measure efficiency or effectiveness. Whereas it is relatively easy to measure the output of a manufacturing activity, it is not so easy to measure the output of a service department in an organisation, such as the human resources department, the training department or even the internal audit department itself.

Some functions in an organisation may not have quantified objectives. Again, this is typically a problem with service departments. Without clear objectives, it is not possible to measure effectiveness.

Possible over-emphasis on cost savings

VFM audits often focus on ways of reducing costs. It is often possible to reduce costs by finding ways to improve economy and possibly efficiency. However, this is likely to lead to a quality problem. Effectiveness may be overlooked. By cutting costs, the quality of output may fall, and customers may stop buying the products that the entity makes.

Calculating VFM measures

VFM auditors may assess economy, efficiency and effectiveness by making comparisons with other organisations, or with other departments in the same organisation. In order to have meaning, all performance measures should be calculated on a comparable basis. Whereas the calculation of profit is tightly regulated by accounting standards, there are no regulations about the measurement of the 3Es. This can make it difficult to undertake meaningful performance comparisons between organisations and possibly between units in the same organisation.

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3.4 Best valueaudits

'Best value' is a relatively new concept, introduced into local government authorities by the UK government. There is some evidence that the concept of best value is now used by some private sector organisations as a means of measuring performance.

The fundamental concept of best value is 'continuous improvement'. Organisations can attempt to achieve continuous improvement by focusing on the '4Cs', as set out below:

- **Challenge –** Ask how a service is provided and, more importantly, why it is provided. If there is no satisfactory answer to these questions, consider withdrawing the service. In other words, challenge the need to provide any service and challenge the way in which it is provided.
- **Compare –** Make comparisons with other (similar) organisations. Use comparisons to look for ways of improving.
- **Consult –** Discuss the services provided with the users of those services. Meet with your customers. Make sure that the services provided meet the needs of their users.
- **Compete –** Use fair competition as a means of improving performance. For example, when two companies would like to provide a service, use fair competition between the two companies to obtain best value. The two companies may be asked to tender for the work, and the contract should be awarded to the company offering the best value (which may be the lower price).

The internal auditor's role in best value auditing is to establish:

- whether the organisation has best value procedures in place,and
- whether those procedures are achieving their objective of promoting continuous improvement.

3.5 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.

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3.6 Information technology (IT) audits

IT audits are a specific application of one of the key roles of the internal audit function, which is to assess internal controls. In the case of IT audits, the controls involved are those that operate within the organisation's computer systems.

IT controls

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 internal auditor needs to be satisfied that all these controls are effective.

General controls are controls over the environment in which the computer based information system is designed, developed, operated and maintained. Examples of general controls include but are not limited to:

- formal authorisation procedures for any changes to programs
- secure back-ups
- restricted access to data files

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 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.

Examples include control totals and making sure all data is authorised before input.

The general audit approach to computer-based systems is covered in a later chapter.

Information security

The use of IT within organisations has grown rapidly providing new ways to connect and carry out business but this has also brought new risks. Data breaches and cyber-security events are increasing threats to IT systems and could result in:

- loss/theft of data
- loss of intellectual property
- theft of funds
- sensitive information leaked
- disruption to day-to-day business
- prevention of timely access to information (e.g. if a patient's health records cannot be accessed in a hospital)

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- damaged reputation (causing loss of future income from customers or funds from investors)
- financial costs, such as, the cost of investigating and fixing the incident , legal costs or fines for breaching regulations

The internal auditor is well placed in the organisation to identify these threats and bring them to the attention of the board.

Assessing and monitoring IT controls to prevent and detect cyber events is a growing role for the internal auditor. Organisations may employ one or more computer specialists in their internal audit department to perform this role.

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4 INTERNAL AUDIT REPORTS

Section overview

- Status of internal audit reports
- Structure of the internal audit report

4.1 Status of internal audit reports

Internal auditors are employees of the entity, who therefore work on behalf of management. When they prepare an audit report, they report their findings to management.

Reports by auditors to management are sometimes called 'private reports'. There are no legal requirements or other formal requirements regulating internal audit reports. A report from the internal auditors may therefore take any appropriate form. Internal audit reports should be prepared in the same way as any other internal business report.

4.2 Structure of the internal audit report

A possible structure for an internal audit report is the same as for any other business report, and may therefore be as follows:

- Introductory items
  - Title of the report
  - The person or group of people to whom the report is addressed
  - The person or department that has prepared the report (the internal auditor)
  - Date of the report
  - Possibly its status (for example, 'Confidential')
- Executive summary. The executive summary of a report sets out the purpose of the report, the main points in the report, and the conclusions and recommendations.

  For example, an internal audit report should set out the purpose of the report. This will involve an explanation of the purpose of the audit. It should then go on to describe how the audit was conducted, in order to achieve its objective. The main findings of the audit should be explained, together with any conclusions the auditor reached and recommendations about what should be done as a result of those conclusions.

  The purpose of an executive summary is that any person reading the report should be able to understand the main content of the report by reading the summary. This means that a 'busy executive' can save time and does not have to read the entire detail of the report in full.

  Another reason for having an executive summary is that a person intending to read the report in full can get an idea about what the main part of the report will contain. This can make it easier to understand the detail of the report, because the executive summary puts the detail of the report into a structured context.

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- Main text of the report. The main text of the report follows the executive summary. This goes into more detail than the executive summary, and so is longer. However, it should be structured in the same way as the executive summary, presenting findings and conclusions in the same order.

  The main part of the report should avoid excessive detail. Supplementary details should be provided in appendices.

- Appendices. Appendices provide additional detailed information and analysis that the reader of the report can refer to if he or she wishes. Appendices may include valuable detailed information, but should not contain vital information that is not also included in the main body of the report and the executive summary.

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5 REGULATION AND ETHICS OF INTERNAL AUDIT

Section overview

- Regulation of internal audit
- Ethics of internal audit

5.1 Regulation of internal audit

There are no specific legal requirements regulating the internal audit process. Rather than being controlled by statute, internal audit is controlled by management in the same way that other functional departments in the organisation are controlled by management.

ISAs do not have mandatory authority for internal auditors. However, they can be seen as indicative of good audit practice, and are therefore frequently adopted by internal audit departments.

Internal auditors are not required to be a member of a regulatory body such as ICAN. However, in recruiting internal auditors, management will often look for qualified accountants (or will expect recruits to the internal audit department to become student members of an accountancy body and obtain a professional qualification).

The Institute of Internal Auditors (IIA) is a global body to which internal auditors may belong. However, membership is not mandatory.

5.2 Ethics of internal audit

All members of ICAN are bound by its ethical guidelines. Therefore, matters such as objectivity and confidentiality are just as important to an ICAN member working as an internal auditor as they are to a member acting as an external auditor.

Clearly, there is a potential problem with objectivity and independence in the case of an internal auditor, because he is (usually) an employee of the company.

In order to operate effectively, internal auditors need a degree of independence within the structure of the organisation. This may be achieved in any of the following ways:

- The internal audit department should be responsible to and accountable to members of senior management who have no financial responsibilities. For example, the internal audit function might report directly to the audit committee. Alternatively, the internal audit department may report to a senior executive manager such as the finance director, but in addition should be required to report periodically to the audit committee.
- Internal auditors should not be involved in carrying out non-audit tasks. Their independence can be protected to some extent by making them audit specialists.
- Internal auditors should have unrestricted access to the information necessary to their audit work.
- The internal audit department should have the support of management at all levels.

The IIA has issued ethical guidance for its members that are broadly similar to the guidance issued by ICAN.

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6 OUTSOURCING INTERNAL AUDIT

Section overview

- The nature of outsourcing
- Benefits of outsourcing
- Possible problems of outsourcing

6.1 The nature of outsourcing

In some circumstances, a company may decide to **outsource** its internal audit function. Outsourcing means giving the work that was previously done by the entity's own employees to an external entity. When internal audit work is outsourced, the work is usually given to the audit firm that does the external audit for the company, or to another firm of accountants.

The main reasons for outsourcing internal audit work are as follows:

- The cost of maintaining a permanent internal audit function may be very high.
- Smaller companies may have a need for an internal audit function, but not on a permanent basis.

6.2 Benefits of outsourcing

There are several advantages of outsourcing internal audit work:

- **Staff recruitment**. There is no need for the company to recruit and train its own internal audit staff. An internal audit function can be instantly available by hiring the services of an accountancy firm.
- **Auditor skills**. The outside supplier is likely to have specialist staff available, such as computer audit experts. Internal auditors with an IT specialisation may be difficult to recruit as full-time employees.
- **Costs and flexibility**. The cost of the internal audit function is a variable cost rather than a fixed cost. A company therefore only pays for the internal audit time that it uses.
- Outsourcing is likely to be more economical for a small entity that does not have enough audit work to justify a full time internal audit team.

6.3 Possible problems of outsourcing

If internal audit work is outsourced to the company's external auditors, independence problems may arise for the external auditor. These should be assessed and managed in accordance with the ethical rules described in an earlier chapter.

There are also other problems with outsourcing internal audit work:

- **Changing personnel**. The internal auditors provided by an external firm may change continually, and there may be a lack of continuity as a consequence. The internal auditors who are used may not have an understanding of the client's business.
- **Cost**. An accountancy firm will charge high fees for internal audit services.

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- **Confidentiality**. The internal auditors provided by an external firm will be expected to maintain complete confidentiality about the client's affairs. However, the risk of a 'leak' may be higher than if full-time internal auditors are employed.
- **Control**. An entity may not have the same control over its internal audit work if the work is outsourced.
- **Conflict of interest**. If internal audit work is carried out by the entity's firm of external auditors, the internal auditors and external auditors may have a conflict of interest (affecting their independence and objectivity).

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7 CHAPTER REVIEW

Chapter review

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

- Describe the concept and role if internal audit
- Compare external and internal audit
- Explain the nature and purpose of different types of audit assignments that internal audit might perform such as operational audits, value for money, best value and financial audits
- Briefly describe the contents and layout of a typical internal audit report
- Summarise how regulation and ethics impacts internal audit
- Explain how internal audit can be outsourced including the benefits and problems of doing so

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Quick quiz questions

1 Which of the following is NOT a process normally reviewed by an operational internal audit assignment?

A Procurement

B Marketing

C External audit

D Human resources

2 Which of the following could NEVER be the responsibility of an internal auditor?

A Risk management

B Organisational control

C Corporate governance

D Audit report to shareholders

3 Value for money does NOT involve

A Effectiveness

B Extension

C Efficiency

D Economy

4 The activities of an internal auditor would NOT normally include?

A Assisting the external auditor

B Assessing internal control effectiveness

C Ensuring corporate governance compliance

D Producing monthly management accounts

5 Which of the following is true about an internal audit department?

A They must be used by the external auditors

B They tend to perform work that is the responsibility of the directors

C They tend to determine the length of the audit

D They inform the external auditor as to the best time to conduct the audit

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Quick quiz answers

1 C

2 D

3 B

4 D

5 B

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CHAPTER 5

Audit planning and risk assessment

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Contents

INTRODUCTION

Competencies

Objectives, need for and process of audit and assurance

A2 (d) Discuss the peculiarities of public sector audit

A3 (a) Explain the basic steps of audit and assurance process in relation to:

(iv) Planning (ISA 300, ISA 320).

A3 (b) Explain public interest and the need for professional scepticism in carrying out audit and assurance engagements.

A3 (c) Discuss the concept of materiality (ISA 320).

Exam context

So far your studies have provided the context that underlies the performance of an independent external statutory audit. In this section we start to focus on the actual mechanics of performing an external audit.

International Standards on Auditing (ISAs) were recently clarified (i.e. revised and/or redrafted as appropriate) to reflect the modern risk-based approach to auditing. The clarified ISAs support the philosophy that a well-planned audit will enable the auditor to achieve the objective of performing an ISA-compliant audit and express an opinion on the financial statements. This chapter introduces the ISAs relevant to the planning phase of an external audit.

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

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

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1 PLANNING AN AUDIT: ISA 300

Section overview

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

1.1 The purposeof an audit plan

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

Content of an audit plan

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

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

Risk assessment and the audit plan

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

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

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

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

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

1.2 Professional scepticism

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

"An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence".

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

1.3 Introduction to ISA 300

The **objective** of the auditor, per ISA 300 *Planning an audit of financial statements* is to plan the audit work so that the audit will be performed **in an effective manner.**

Adequate planning **benefits** the audit by:

- helping the auditor to devote appropriate attention to important areas of the audit
- helping the auditor to identify and resolve potential problems
- helping the auditor organise and manage the audit engagement so that it is performed in an effective and efficient manner
- assisting in the selection of staff with appropriate experience and the proper assignment of work to them
- allowing for the direction and supervision of staff and review of their work.

ISA 300 **requires** the auditor to:

- involve the whole **engagement team** in planning the audit
- establish an understanding of the **terms of the engagement** as required by ISA210
- establish an **overall strategy** for the audit that sets the scope, timing and direction of the audit and that guides the development of the audit plan
- develop an **audit plan** which includes a description of the nature, timing and extent of planned risk assessment procedures and planned further audit procedures
- **document** the overall audit strategy and the audit plan, including any significant changes made during the audit.

1.4 Contents of the overall audit strategy and the audit plan

The overall audit strategy

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

- Determining the characteristics of the engagement that define its **scope** such as:
  - the financial reporting framework used (for example, international financial reporting standards)
  - any industry specific reporting requirements
  - the location of the components of the entity (for example, there might be overseas branches).

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- 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.

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 are as)
- 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.

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1.5 Interim audit and final audit

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

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

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

ISA 330 also states:

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

Typical **interim audit procedures** include:

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

Typical **final audit procedures** include:

- Substantive testing. Note that where substantive testing was performed at the interim phase auditors typically test the subsequent period between interim audit and period end
- Tests to ensure conclusions formed at interim audit remain valid
- Obtaining third party confirmations such as bank letters and trade receivables confirmations
- Analytical review
- Subsequent events review
- Obtaining written representations
- ISA 330 specifically states that the following procedures can only be performed at or after the period end:
  - Agreeing the financial statements to the accounting records
  - Examining adjustments made during the course of preparing the financial statements; and

- Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalized.

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2 UNDERSTANDING THE BUSINESS AND MATERIALITY: ISAs 250,315 AND 320

Section overview

- Understanding the entity and its environment
- Understanding the accounting and internal control systems
- Risk and materiality
- Materiality: ISA 320
- Compliance with laws and regulations: ISA 250

2.1 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 (covered in later chapters).

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

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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).

Each of these procedures or methods will be described in more detail in later chapters that deal with the techniques of gathering audit evidence as each of them is also a technique for gathering audit evidence. However, they are all used at this stage to help the auditor identify areas of risk and to plan his audit approach.

With regard to the entity and its environment ISA 315 **requires** the auditor to obtain an understanding of the following (requirements in respect of internal controls are considered below):

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

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

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

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2.2 Understanding the accounting and internal control systems

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

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

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

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

2.3 Risk and materiality

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

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

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

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

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

The auditor should consider:

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

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

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

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

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

2.4 Materiality: ISA 320

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

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

ISA 320 *Materiality in planning and performing an audit* states that, in assessing what is or is not material, auditors are entitled to assume that users:

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

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

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

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

ISA 320 contains the following **requirements.**

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

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

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

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

Setting materiality levels

Materiality levels are often based on 'quantitative' factors, and expressed as a percentage of revenue, profit or asset values, such as 1% of revenue or 5% of pre-tax profit. The following benchmarks are often applied:

Metric	Benchmark %
Profit before tax	3-7
Revenue	1-3
Equity (net assets)	3-5
Total assets	1-2

Example: Materiality

The materiality level for inventory valuation may be set at 5% of pre-tax profit.If the auditor finds, as a result of audit tests, that his estimate of inventory differs from the client's measurement by an amount that is more than 5% of pre-tax profit, the error would be considered material.

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

Illustration: Materiality

Draft financial statements for XYZ Ltd show the following:

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

Materiality for the financial statements as a whole

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

Performance materiality

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

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

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

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

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

2.5 Compliance with laws and regulations: ISA 250

ISA 250 Consideration of laws and regulations in an audit of financial statements sets out the **objectives** of the auditor in this area as being to:

- 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 specified audit procedures to help identify such instances of non-compliance
- respond appropriately to discoveries of non-compliance or suspected non-compliance.

Relevant laws and regulations might include such matters as employee rights legislation, health and safety law, consumer protection legislation or the current tough laws now in place in many countries relating to money laundering activities. Non-compliance with, for example, health and safety laws could leave the company open to heavy fines or even the threat of closure, and it may be necessary to make provision or disclosure in the financial statements. Hence such non-compliance could have "a direct effect on material amounts and disclosures in the financial statements".

ISA 250 **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.

All identified or suspected instances of non-compliance and the results of discussions with management and/or other parties are **required** to be **documented.**

If the auditor **identifies or suspects non-compliance**, 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 proved, take legal advice.
- If there is insufficient evidence of suspected non-compliance, consider the impact on the audit report.
- Consider whether the non-compliance impacts on other areas of the audit (for example, on the overall risk assessment).

The auditor also needs to consider how to report the non-compliance – to those charged with governance and/or to shareholders and/or to the authorities. The reporting **requirements** of ISA 250 are as follows:

Reporting non-compliance to those charged with governance

- Unless all of those charged with governance are also involved in management of the entity and are therefore already aware of these matters, the auditor must communicate these matters to those charged with governance.
- If the non-compliance is **intentional and material** the communication should be made as soon as practicable.

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- If the auditor suspects that those charged with governance are **involved in the non-compliance** he must communicate to the next highest level of management (e.g. an audit committee). If no higher authority exists, the auditor must consider taking legaladvice.

Reporting non-compliance in the audit report

- If the auditor concludes that the non-compliance has a material effect on the financial statements and has not been adequately reflected in them, then he must give a qualified or adverse opinion.
- If the scope of the auditor's work is restricted by management such that he cannot reach an opinion, then he must give a qualified opinion or disclaim his opinion.
- If the auditor cannot decide whether non-compliance has occurred due to the nature of the circumstances, rather than because of any restrictions imposed on him by management, he must consider the impact on his audit report.

Reporting non-compliance to the authorities

If the auditor has identified or suspects non-compliance he must determine whether he has a responsibility to report to third parties. In certain circumstances, or jurisdictions, this may override the auditor's duty of confidentiality to his client. For example, in the UK, the auditor has a legal duty to report suspicions of money laundering.

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3 AUDIT RISK: ISA 330

Section overview

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

3.1 Risk-based approach to auditing

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

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

3.2 Responses to assessed risks: ISA 330

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

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

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

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

In summary, the auditor is required to:

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

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

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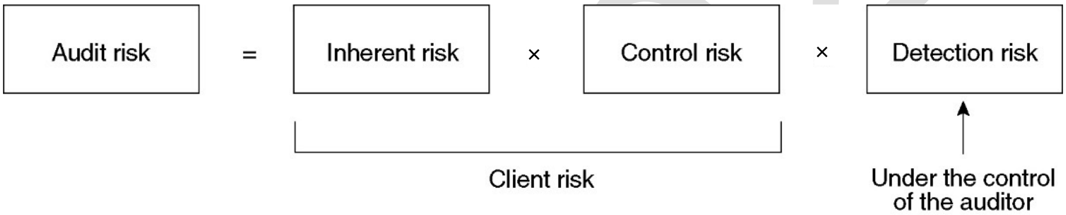
3.3 The audit risk model

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

> **Definition: Audit risk**
>
> The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.
>
> *IAASB Handbook – Glossary of terms*

Audit risk is the risk (chance) that the auditor reaches an inappropriate (wrong) conclusion on the area under audit. For example, if the audit risk is 5%, this means that the auditor accepts that there will be a 5% risk that the audited item will be mis-stated in the financial statements, and only a 95% probability that it is materially correct.

The audit risk model can be expressed as follows:



This model can be stated as a formula:

AR = IR × CR × DR

where:

AR = audit risk

IR = inherentrisk

CR = control risk, and

DR = detection risk.

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

Inherent risk

> **Definition: Inherent risk**
>
> The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
>
> *IAASB Handbook – Glossary of terms*

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

- ❑ the nature of the items themselves. For example, estimated items are inherently risky because their measurement depends on an estimate rather than a precise measure; or

- the nature of the entity and the industry in which it operates. For example, a company in the construction industry operates in a volatile and high-risk environment, and items in its financial statements are more likely to be misstated than items in the financial statements of companies in a more low-risk environment, such as a manufacturer of food and drinks.

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

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

Control risk

Definition: Control risk

The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

IAASB Handbook – Glossary of terms

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

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

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

Detection risk

Definition: Detection risk

The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

IAASB Handbook – Glossary of terms

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

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

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In preparing an audit plan, the auditor will usually:

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

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

Example: Audit risk

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

Required

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

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

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

Answer: Audit risk

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

(b) $AR = IR \times CR \times DR$

Then $DR = AR/(IR \times CR)$

$DR = 0.10/(0.50 \times 0.80)$

Therefore DR = 0.25 = 25%

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

3.4 Exam technique: identifying risks

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

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Example: Identifying risks

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

Required

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

Answer: Identifying risks

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

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

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

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

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

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

Example: Identifying inherent risks

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

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

Required

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

Answer: Identifying inherent risks

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

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

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

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

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

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

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

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

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4 FRAUD: ISA 240

Section overview

- Consideration of frauds in the audit of financial statements
- The auditor's responsibilities relating to fraud: ISA 240

4.1 Consideration of frauds in the audit of financial statements

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

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

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

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

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

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

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

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

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

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

Fraudulent financial reporting includes:

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

- intentionally misapplying accounting principles,

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

Misappropriation of assets includes:

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

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

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

Fraud risk factors might include the following:

- The need to meet the expectations of third parties (for example, the entity is trying to obtain additional finance).
- Management being remunerated via profit-related bonuses.
- An ineffective control environment (covered in a later chapter).
- The entity’s profitability being under threat (for example, due to increased competition or rapid changes in technology).
- The nature of the industry or the entity’s operations providing opportunities for fraud (for example, complex transactions or significant accounting estimates).
- Low morale amongst staff or poor communication and/or enforcement of ethical standards by management.
- Personal pressure on staff to misappropriate assets (for example, personal financial problems or the threat of redundancy).

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- Opportunity to misappropriate assets (for example, large amounts of cash held or processed or highly portable or valuable inventory).
- Poor internal controls over assets (for example, lack of segregation of duties – covered in a later chapter).

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. He must also consider whether there is any statutory duty to report to the authorities.

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5 NOT-FOR-PROFIT ORGANISATIONS

Section overview

- Auditing of not-for-profit organisations
- NFPOs: the audit approach
- Public sector audit

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 audit 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.

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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.

Auditarea	Comments
Planning	Consider: ■ the objectives and scope of the auditwork ■ any local regulations thatapply ■ the environment in which the organisationoperates ■ 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.
Auditevidence	■ 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.

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Auditarea	Comments
	■ There should be a review of the final financial statements, including a review of the appropriateness of the accounting policies.
Reporting	■ If a report on an NFPO is required by law, the standard external auditor's 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: – title – addressee – the audit opinion – basis for opinion – responsibilities of auditors versus the responsibilities of management – other reporting responsibilities – date, name, signature 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 a limitation on the scope of the audit if obtaining audit evidence is a problem.
- There may be a lack of predictable income or identifiable relationship between expenditure and income which could make analytical review less appropriate.
- Restricted funds may exist where the organisation is only allowed to use certain funds for specific purposes.
- There may be sensitivity to key statistics such as the proportion of revenue used in administration (particularly for a charity).

5.3 Public sector audit

As you have seen above the principles of an independent audit of a public sector entity performed in accordance with ISAs are the same as any other audit performed in accordance with ISAs. The key difference is the nature of the underlying entity being audited which will impact audit risk and audit approach.

Many countries establish quasi-autonomous non-governmental organisations (QUANGOs) which are tasked with auditing public sector entities. QUANGOs may or may not perform their work in accordance with ISAs and may or may not be independent in the full definition of the term per IFAC’s (or ICAN’s) code of ethics.

You will study public sector audit in more detail in paper *B5 Public Sector Accounting and Finance*.

6 CHAPTER REVIEW

Chapter review

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

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

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Quick quiz questions

1 Which of the following is correct in relation to materiality?

A A matter is material only if it changes the auditreport

B A matter is material if the auditor and the directors both decide that further work needs to be done in the area under question

C A matter is material only if it affects directors' emoluments

D A matter is material if its omission or misstatement would reasonably influence the decisions of an addressee of the auditors' report

2 Which one of the following is NOT considered to be part of planning?

A Background i.e. industry

B Previous year's audit i.e. any qualifications in the report

C Considering the work to be done by the client staff e.g. internal audit

D Considering whether the financial statements show a true and fairview

3 Audit risk is composed of 3 factors. Which of the following is NOT one of those factors?

A Compliance risk

B Detection risk

C Control risk

D Inherent risk

4 Which of the following would NOT be considered at the planning stage?

A The timing of the audit

B Analytical review

C Last year's written representation letter

D Obtaining written representations

5 Inherent risk would normally be considered to be highwhere:

A a company sells standardized products that are simple and easy to manufacture

B the directors have not changed in the last 5 years

C an internal audit department has just been setup

D The role of finance director was vacant for six months and was then filled by the former sales director.

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Quick quiz answers

1 D

2 D

3 A

4 D

5 D

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CHAPTER 6

Evidence and sampling

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Contents

INTRODUCTION

Competencies

Objectives, need for and process of audit and assurance

A3 (a) Explain the basic steps of audit and assurance process in relation to:

(v) Performance:

- Evidence and obtaining evidence (ISA 500);
- Records and working papers; and
- Testing and other works.

Gathering evidence

The nature of audit evidence and the selection of sufficient appropriate audit evidence (ISA 500)

C1 Justify the need to maintain and keep working papers and other documentation.

C2 Evaluate the different sources and quality of evidence and the methods of obtaining evidence. *(See also chapters 8-12)*

C3 Document appropriate procedures for gathering evidence based on a given scenario (ISA 505, ISA 520). *(See also chapters 8-12)*

Exam context

This chapter provides general guidance as to the different types of evidence that an auditor can seek to generate in order to be able to form an opinion on the financial statements. The student is introduced to the concept of 'assertions' which provides context and an objective for each audit procedure.

The techniques described in this chapter can be thought of as an auditor's tool-kit which is then applied in the audit of specific areas, such as trade receivable, revenue and inventory. The application of these techniques to specific areas is addressed in later chapters.

The student will learn that not all procedures are relevant to every audit. The auditor must use their judgment to design responses to the particular risks identified in the planning phase (described in a previous chapter).

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

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

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1 AUDIT EVIDENCE: ISA 500

Section overview

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

1.1 General principles of gathering audit evidence

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

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

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

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

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

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

- Consider the **relevance and reliability** of the information to be used as audit evidence.
- If information to be used as audit evidence has been prepared using the work of a **management's expert**:
  - evaluate the competence, capabilities and objectivity of that expert
  - obtain an understanding of the expert's work, and
  - evaluate the appropriateness of his report as audit evidence.
- When using **information produced by the entity** evaluate whether the information is sufficiently reliable (accurate, complete, precise and detailed).

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- Use effective means of **selecting items for testing** (covered in detail later in this chapter under ISA 530 *Audit sampling*).
- If audit evidence from one source is **inconsistent** with that obtained from another source, or the auditor has **doubts over the reliability of evidence** – consider:
  - what additional audit procedures are needed, and
  - the effects on any other aspects of the audit.

1.2 Sufficient and appropriate audit evidence

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

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

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

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

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

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

Deciding how much audit evidence is needed

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

Other factors that the auditor will consider are:

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

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1.3 The quality of audit evidence

Relevance

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

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

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

- **A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others**. E.g. Inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off.

- Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. **Relevant audit evidence would include identifying conditions that indicate performance of a control, and deviation conditions**. The presence or absence of those conditions can then be tested by the auditor.

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

Reliability

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. But….note that

- **Internally generated audit evidence is more reliable when the related controls areeffective.**

- **Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference**. For example, observation of the operation of a control by the auditor is more reliable than inquiry about the operation of that control.

- **Audit evidence is more reliable when it exists in documentary form**. This could be paper, electronic or other medium. For example, a written record of a meeting made at the time is more reliable than a subsequent oral representation of the matters discussed.
- **Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies**, or documents that have been filmed, or otherwise transformed into electronic form. This is because the reliability of those other forms may depend on the controls over their preparation and maintenance.

1.4 Procedures for generating audit evidence

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

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

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

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

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

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

Procedure	Explanation/application
Inspection (looking at an item)	▪ Of tangible assets ▪ Of entries in accounting records ▪ Of documents (e.g.invoices)
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 ▪ A limitation of observation is that the person performing the procedure may act differently when being observed

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Procedure	Explanation/application
Inquiry	▪ Seeking information from knowledgeable persons inside or outside the entity, ▪ Evaluating responses to those enquiries, and ▪ Corroborating those responses with other audit evidence ▪ In respect of some matters, the auditor may consider it necessary to obtain written representations from management and/or those charged with governance to confirm responses to oral inquiries. These are coverred by ISA 580 which is covered in a later chapter.
External confirmation	▪ A specific type of inquiry – seeking confirmation from a third party (e.g. a bank or trade receivable)
Recalculation	▪ Checking the mathematical accuracy of documents or records (e.g. adding up the list of year-end trade receivables)
Reperformance	▪ Independently carrying out procedures or controls, which were originally performed by the client (e.g. reperforming the aging of year-end trade receivables)
Analytical procedures	▪ Evaluating and comparing financial and/or non-financial data for plausible relationships and investigating unexpected fluctuations ▪ For example, comparing last year's gross profit percentage to this year's and ensuring any change is in line with expectations

Example: Evidence procedures

An auditor wishes to:

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

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

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

Required

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

Answer: Evidence procedures

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

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

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

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1.5 What if the audit evidence is not sufficient?

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

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

1.6 The financial statement assertions

Definition: Assertions

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

IAASB Handbook – Glossary of terms

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

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

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

- ❑ **Occurrence**: Transactions and events that have been recorded in the books of accounts or disclosed have occurred, and such transactions and events relate to the entity.

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- **Completeness**: All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
- **Accuracy**: Amounts and other data relating to recorded transactions and events have been recorded appropriately, and all related disclosures have been appropriately measured and described.
- **Cut-off**: Transactions and events have been recorded in the correct accounting period.
- **Classification**: Transactions and events have been recorded in the proper accounts.
- **Presentation**: Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

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

- **Existence**: Assets, liabilities and equity interests exist.
- **Rights and obligations**: The entity holds or controls the rights to assets, and liabilities are those of the entity.
- **Completeness**: All assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
- **Accuracy**, **valuation and allocation**: Assets, liabilities and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded, and related disclosures have been appropriately measured and described.
- **Classification**: Assets, liabilities and equity interests have been recorded in the proper accounts.
- **Presentation**: Assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

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

Summary of assertions about:	
Transactions/events and related disclosures	**Account balances and related disclosures**
Occurrence	Existence
	Rights and obligations
Completeness	Completeness
Accuracy	Accuracy, valuation and allocation
Cut-off	
Classification	Classification
Presentation	Presentation

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Example:

Required

Using your accounting knowledge from Paper Financial Accounting, apply the appropriate assertions to the audit of sales of goods.

Answer

Transaction assertions:

Occurrence: All sales invoices reflected in the accounting records relate to goods dispatched by the entity during the current year.

Completeness: All goods despatched have been invoiced and all such sales invoices have been entered into the accounting records.

Accuracy: All invoices have been correctly priced and discounts properly applied, and they have been accurately entered in the accounting records.

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

Classification: All sales invoices have been posted to the sales account in the nominal ledger.

Presentation and disclosure assertions

Occurrence: The figure for "Revenue" in the financial statements agrees to the sales account in the nominal ledger.

Completeness: All entries in the sales account in the nominal ledger have been included in the "Revenue".

Classification: "Revenue" is properly disclosed in the financial statements in the income statement (under IAS 1's two statement format) or statement of comprehensive income (single statement format) for the current year.

Accuracy: The sales account in the nominal ledger has been properly added to arrive at the "Revenue" figure in the financial statements.

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

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1.7 Types of audit procedures

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

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

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

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

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2 AUDIT DOCUMENTATION: ISA 230

Section overview

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

2.1 Audit documentation (audit file)

Audit documentation is the record of:

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

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

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

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

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

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

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

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

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

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2.2 Reasons for preparingsufficient and appropriate audit documentation

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

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

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

Other purposes of audit documentation include the following.

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

2.3 The form, content and extent of audit documentation

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

- Audit programs
- analyses
- summaries of significant matters
- letters of confirmation and representation
- checklists, and
- correspondence(s).

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

- a permanent file, and
- a current file.

Permanent file

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

- the legal constitution of the company
- other important legal documents such as loan agreements
- a summary of the history, development and ownership of the business
- a summary of accounting systems and procedures

- copy of previous year's financial statements, together with key ratios and trends.

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

Current file

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

- The final financial statements and audit report.
- A summary of audit adjustments, including those not included in the final reported figures.
- Audit planning material (the audit plan, materiality threshold calculations, risk assessments).
- Audit control material (these are items used to control the progress of the audit, such as time budgets, review points, and points for consideration by the audit partner)
- Audit letters (audit letters are explained in a later chapter)
- For each audit area (for example, inventory, receivables)
  - an audit programme (detailing the work to be done on that area)
  - details of items selected for testing, the tests performed, problems encountered (together with their resolution) and the conclusion reached on that area
  - 'lead schedules' giving the figures for the audit area, as they appear in the final financial statements, cross-referenced to relevant audit tests.

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

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

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Illustration: Audit working paper

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

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

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

Results:

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

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

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

Dr Purchases	₦ 800	
Cr Trade payables		₦ 800

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

<u>**Key**</u>

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

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

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

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

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

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

the auditor is **required** to document:

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

2.4 The use of computer-based audit working papers

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

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

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

Using these packages has several advantages:

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

2.5 Ownership, custody and confidentiality of audit documents

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

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

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

3 AUDIT SAMPLING: ISA 530

Section overview

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

3.1 The nature of sampling

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

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

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

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

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

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

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3.2 The relationship between sampling and the audit risk model

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

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

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

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

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

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

3.3 Sampling risk and statistical sampling

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

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

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

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

- ❑ For tests of controls – that controls are more effective than they actually are and for tests of details – that a material misstatement does not exist when in fact it does.
- ❑ For tests of controls – that controls are less effective than they actually are and for tests of details – that a material misstatement exists when in fact it does not.

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The auditor is more concerned with the first type of incorrect conclusion as this type is more likely to lead to an inappropriate audit opinion.

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

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

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

3.4 Sample design,size and selection of items for testing

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

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

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

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

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

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

Statistical sampling or non-statistical sampling?

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

The benefits of statistical sampling techniques are as follows:

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

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The disadvantages of statistical sampling techniques are as follows:

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

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

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

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

For example, if the objective of the audit testing is to confirm the accuracy of trade receivable balances, the population should include **all** trade receivables balances as at a specified date. Alternatively, the audit objective might be more limited in scope – perhaps to confirm the accuracy of those trade receivables balances in excess of ₦2m. The population should then consist of all receivables balances over ₦2m.

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

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

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

The sample selection method

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

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

- ❑ **Random sampling**: All items in the population have an equal chance of selection. This is typically achieved by the use of random numbers to select items fortesting.
- ❑ **Systematic sampling**: With systematic sampling, a random starting point is chosen from the population and then items are selected with a standard gap between them (for example, every 10th item). For example, suppose

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that a sample will be 10% of the items in a population and the items in the population can be arranged in a sequence, such as listed in invoice number order, or account number order or date order. A systematic sample would be to select one of the first 10 items in the list at random, and then to select every 10th item in the list for testing in order to obtain the 10% sample.

- **Haphazard sampling**: The auditor selects the sample on an arbitrary basis, for example, choosing any 100 invoices from a file. This is not a scientifically valid method and the resulting sample may contain a degree of bias. It is therefore not recommended for use with statistical sampling techniques.

What constitutes a misstatement or deviation

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

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

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

Tolerable misstatement or rate of deviation

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

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

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

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

Expected misstatement or rate of deviation

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

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

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

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

3.5 Performing audit procedures on the sample

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

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

The auditor is also **required** to:

- investigate the **nature and cause** of any misstatements/deviations and evaluate their possible effect
- if the auditor considers the misstatement or deviation to be an **anomaly** he must obtain a high degree of certainty about this and perform additional audit procedures to obtain sufficient evidence that the misstatement or deviation does not affect the rest of the population.

Investigation of the nature and cause of the misstatements/deviations may lead the auditor to conclude that the problem lies within one time period, type of transaction, or location (for example, perhaps when a temporary member of staff was being employed). In this case he might decide to extend audit procedures performed on that time-period/type of transaction/location.

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

3.6 Projecting misstatements and evaluating the results of audit sampling

The auditor is **required** to evaluate:

- the results of the sample. For **tests of details** this will include projecting the misstatements found in the sample to the entire population
- whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. If the conclusion is that it has not then the auditor will need to consider carrying out additional audit procedures.

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

Example:

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

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

Required

Explain:

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

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

Answer

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

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

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

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

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4 CHAPTER REVIEW

Chapter review

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

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

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Quick quiz questions

1 Which of the following describes sampling risk?

- A The risk of the auditor carrying out a test the ‘wrong way round’
- B The risk of reliance on unsuitable audit evidence
- C The risk that the sample does not reflect the population
- D The risk of the auditor reaching the wrong conclusions from testing

2 Which of the following is NOT a typical method of sample selection used by auditors?

- A Systematic selection
- B Pervasive selection
- C Random selection
- D Haphazard selection

3 Which of the following are you unlikely to see in the current file of auditors’ working papers?

- A Memorandum & articles of association
- B Audit planning memorandum
- C Summary of unadjusted errors
- D Details of the work done on the inventory count

4 According to ISA 500, the strength of audit evidence is determined by which two qualities?

- A Appropriateness and competence
- B Sufficiency and appropriateness
- C Reliability and extensiveness
- D Objectivity and independence

5 Which of the following are all financial statement assertions?

- A Completeness, amount, existence, valuation
- B Completeness, observation, existence, presentation and disclosure
- C Completeness, observation, existence, rights and obligations
- D Completeness, presentation and disclosure, rights and obligations, measurement

Quick quiz answers

1 C

2 B

3 A

4 B

5 D

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Skills level
Audit and Assurance

CHAPTER 7

Internal control

Contents

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INTRODUCTION

Competencies

Objectives, need for and process of audit and assurance

A3 (a) Explain the basic steps of audit and assurance process in relation to:

- Performance: Evaluation of internal control

The nature and use of internal control (ISA 315)

B1 Discuss the meaning, objectives and nature of internal control.

B2 Discuss effective internal control.

B3 Discuss the different types of internal control.

B4 Discuss responsibilities for instituting and evaluating the effectiveness of internal control.

B5 Discuss the main components of internal control.

B6 Explain how accounting systems and related internal controls may be identified, recorded and analysed.

B7 Discuss the techniques required for evaluating internal controls (walk-through, spot check, compliance test, substantive test) (ISA 530);

B8 Evaluate internal controls in a given scenario.

B9 Discuss the limitations of internal control.

B10 Discuss the contents of a management letter.

B11 Discuss internal controls in a computerized accounting environment (ISA 315).

(Note: The above objectives are addressed through a combination of chapters 7 and 8)

Exam context

Auditors are required by International Standards on Auditing to understand and assess an audit client's system of internal controls. The auditor must then use their judgment to determine whether to test all or part of the internal control system as part of their response to the assessed risk of material misstatement in the financial statements.

This chapter explains the various components of a system of internal controls and the different types of controls that exist. The next chapter then looks at the testing of controls.

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

- Understand the meaning, importance and relevance of internal control
- Understand how the auditor assess and uses internal controls
- Explain the five components of internal control
- Discuss the limitations of internal controls
- Explain the different types of controls
- Evaluate internal controls and explain the impact of this evaluation on the auditor's risk response
- Describe different methods used for recording internal control systems including narrative notes, questionnaires and flowcharts
- Provide an overview of the risks of some specialised IT systems including online systems and Electronic data interchanges

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1 THE IMPORTANCE OF INTERNAL CONTROL

Section overview

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

1.1 The auditor's assessment of internal controls

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

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

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

- ❑ inherent risk, and
- ❑ control risk.

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

1.2 The meaning of internal control

Definition: Internal control

The 'Committee of Sponsoring Organisations of the Treadway Commission' (COSO) describes internal control as follows:

Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- *Effectiveness and efficiency of operations*
- *Reliability of reporting*
- *Compliance with applicable laws and regulations*

The following points should be noted from this definition:

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

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1.3 How the audit or uses internal controls

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

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

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

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

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

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

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

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

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

This point is made in the Turnbull Report on Internal Control (in the UK), which comments that:

‘A sound system of internal control reduces, but cannot eliminate, the possibility of poor judgement in decision-making; human error; processes being deliberately circumvented by employees and others; management overriding controls; and the occurrence of unforeseeable circumstances.’

The auditor must therefore:

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

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

- Where the auditor concludes that the system of controls is weak, and that the controls therefore cannot be relied on, he will have to carry out

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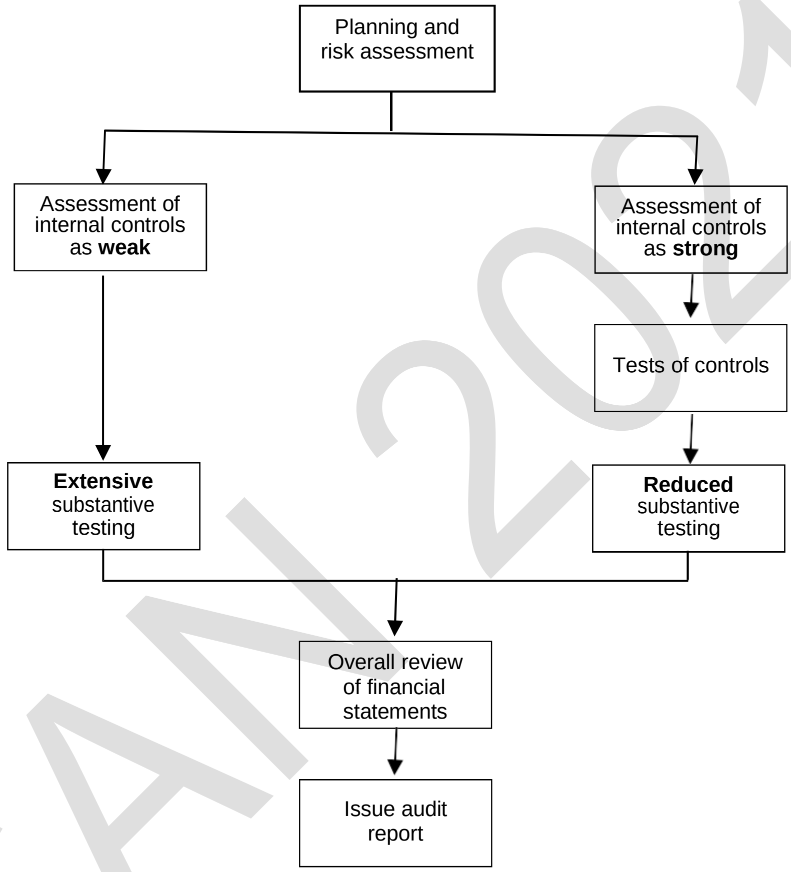
extensive substantive procedures. When an audit relies heavily on substantive procedures, the approach to the audit is called a **transactions-based approach**

- If the auditor judges that the internal controls are strong, he will carry out tests on the controls (in order to verify his opinion about them) and should need a smaller amount of substantive testing. When an audit is based mainly on a favourable assessment of the internal controls, the approach to the audit is called a **systems-based approach**.

The diagram below summarises the audit approach.



2 THE COMPONENTS OF INTERNAL CONTROL

Section overview

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

2.1 The internal control system and internal controls

A distinction should be made between:

- an internal control system, and
- internal controls.

The Turnbull Report on Internal Control defines an internal control system as follows:

'An internal control system encompasses the policies, processes, tasks, behaviours and other aspects of a company that, taken together:

- *facilitates its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives. This includes the safeguarding of assets from inappropriate use or from loss and fraud, and ensuring that liabilities are identified and managed;*
- *help ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation;*
- *help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.'*

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

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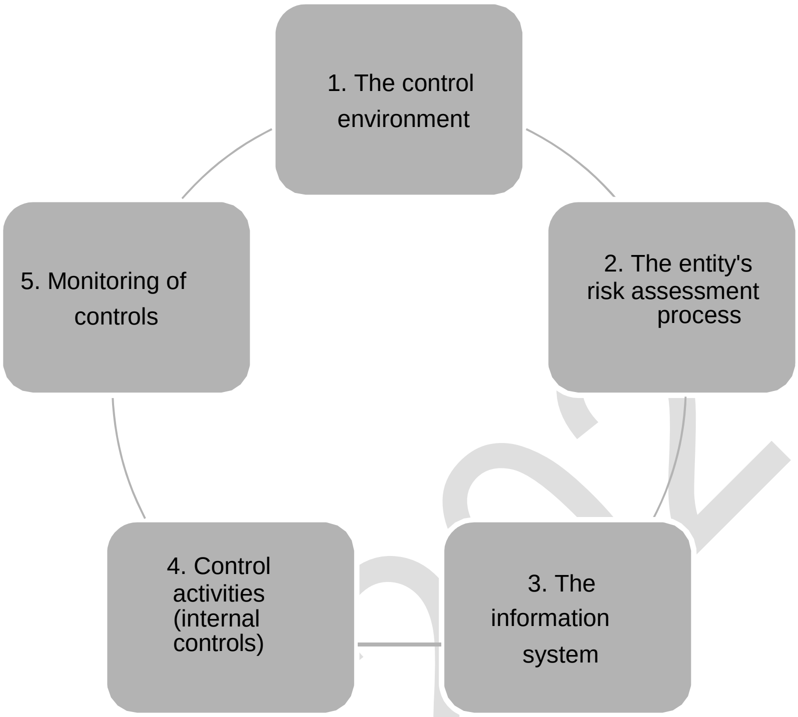
2.2 Thefivecomponentsofinternalcontrol

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



ISA 315 requires the auditor to:

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

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

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

2.3 The control environment

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

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

The control environment includes the following elements:

- Communication and enforcement of integrity and ethical values
- Commitment to competence

- Participation of management
- Management's philosophy and operating style
- Organisational structure
- Assignment of authority and responsibility
- Human resource policies and practices

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

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

Evaluating the control environment

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

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

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

2.4 The entity's risk assessment process

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

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

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

Risks can arise or change due to circumstances such as:

- changes in the entity's operating environment
- new personnel
- new or revamped information systems
- rapid growth

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- new technology
- new business models, products or activities
- corporate restructurings
- expanded foreign operations
- new accounting pronouncements.

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

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

2.5 The information system

An information system consists of:

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

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

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

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

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

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2.6 Control activities

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

Control activities are the specific procedures designed:

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

Categories of control activities (internal controls)

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

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

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Example: Control activities

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

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

Required

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

Answer

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

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

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

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

Segregation of duties: Different employees should be responsible for taking and in putting orders, dispatching goods and flagging up the dispatch note.

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

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

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

General IT controls

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

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

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

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

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

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

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Examples of general controls

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

Control area	Controls
Development of computer-based information systems and applications	New computer systems may be designed and developed for a 'computer user' (the client company) by an in-house IT department or by an external software company. ■ Appropriate IT Standards should be used when designing, developing, programming and documenting a new computer system. ■ There should be controls to ensure that tests are carried out on new systems before they are introduced. ■ A new computer system design should be formally approved by the system 'user'. ■ There should be a segregation of duties between the designers and testers of systems. ■ Staff should be given training in the use of a new system before they use it for 'live' operations.
Documentation and testing of program changes	■ When a computer system is operational, it may be necessary to update and amend some of the programs in the system. There should be suitable general controls over the development of new versions of programs. ■ There should be controls to ensure that formal testing procedures on new program versions before they are used for 'live' operations ■ All new versions of programs must be authorised at an appropriate level of management. ■ Staff should be given training, where appropriate, in the use of a new program version before they use it for 'live' operations.
Prevention or detection of unauthorised program changes	There is a risk that new programs will be introduced without proper authorisation.The risks are particularly serious in companies that have large purpose-written computer systems, and where the computer systems are operated on large computers (main frame computers or mini computers) in a centralised computer centre. ■ There should be a segregation between the tasks of programmers (who write new programs) and computer operators (who use the programs).

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Control area	Controls
	■ There should be full documentation of all program changes. ■ There should be restricted access to programs (program files), and only authorised programmers should have access to them. ■ Program logs should be maintained, to record which programs and which versions are used. ■ There should be virus protection for programs (using anti-virus software) and there should be back-up copies of all programs (in the event of 'malicious' changes to programs used in operations).
Prevention of the use of incorrect programs or data files	In large computer systems, there may be several versionsofaprogramatanytime, not just one 'current version'. For example, when a new version is written, the 'old' version may be kept. It is important to ensure that the correct version of the program is used. ■ Computer operating staff should be suitably trained, and should follow standard operating procedures for checking the version of the program they are using. ■ Job scheduling: there should be formal job scheduling in large computer centres, and a job schedule should specify the version of the program to be used. ■ Supervision.Supervisors should monitor the activities of operating staff. ■ Reviews by management. Management should carry out periodic reviews, to make sure that the correct versions of programs are being used.
Prevention of unauthorised amendments to data files	In addition to the risk that there may be unauthorised access to program files and unauthorised amendment of programs, there is also a risk that data files will be accessed without authorisation (by an employee or an external 'hacker'). ■ Physical access to computer terminals may be restricted to authorized employees. ■ Access to programs and data files may be restricted using passwords. There should be rigorous checks by management to ensure that a password system is being used effectively by employees (so that passwords are not easy to 'guess') ■ Firewalls (software and hardware) can be used to prevent unauthorised external access via the internet.

Control area	Controls
Ensuring continuity	
	■ There should be controls over maintaining secure second copies of all programs and data files ('back-up copies').The back-up copies can be used if the original copies are damaged or corrupted. ■ There should be measures for the protection of equipment against fire, power failure and other hazards. ■ The company should have disaster recovery plans, such as an agreement with another entity to make use of its computer centre in the event of a disaster such as a fire or flood. ■ The company should make suitable maintenance and service agreements with software companies, to provide 'technical support' in the event of operating difficulties with the system. ■ Off-site storage or back ups as part of measures to ensure continuity of operations.

Application controls

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

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

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

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

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

Each of these areas is considered in turn below.

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

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

Segregation of duties

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

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

Example: Segregation of duties

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

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

A segregation of duties can help to reduce these risks:

Transaction stage	Responsibility
Initiation – Replenishment of inventory item is required	Warehouse staff/stores staff
Purchase order–Item ordered	Purchasing officer.The purchasing officer is able to check the material requisition from the stores staff

Custody–Item received	Goods inwards officer.The items actually delivered are checked physically and counted.This is a check that items have actually been delivered in good condition, as stated in the supplier's delivery note
Recording – Invoice received, checked and processed	Accounts clerk. The invoice from the supplier is checked against the delivery note and the original purchase order.The amount payable is recorded in the accounts system.
Payment–Invoice is paid	Cashier.The amount payable to the Supplier is eventually paid by a different person in the accounts department.

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

2.8 Control weaknesses and the exam

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

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

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

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

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

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

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

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

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

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

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

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

2.9 Monitoring of controls

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

2.10 Understanding the control system: walk-through tests

ISA 315 requires the auditor to:

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

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

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

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

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2.11 Specific IT controls

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

Control totals

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

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

Check digits

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

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

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

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

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

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

The six-digit customer code is therefore 234672.

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

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

Range checks and existence checks

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

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

Batch totals

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

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

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

On-screen prompts

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

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3 LIMITATIONS OF INTERNAL CONTROL SYSTEMS

Section overview

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

3.1 Reasons why internal controls may be ineffective

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

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

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

3.2 Problems for small entities

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

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

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

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

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

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- There may be a lack of evidence as to how systems are supposed to operate. The auditor will need to rely more on enquiry than on review of documentation.
- There may be lack of evidence of controls. (How does the auditor know that the controls exist and are being applied?).
- Management may override other controls that are in place.
- Management may lack the expertise necessary to control the entity effectively.
- There is unlikely to be any independent person within the management team as there would be within "those charged with governance" in a large entity.

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

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4 RECORDING INTERNAL CONTROL SYSTEMS

Section overview

- The need to record internal control systems
- Recording methods
- Questionnaires

4.1 The need to record internal control systems

The auditor must gain an understanding of each of the five components that make up the client's internal control system. This is to enable the auditor to carry out an evaluation of the systems and to conduct an audit risk assessment. The outcome of this assessment and evaluation will establish his overall approach to the audit – whether it will be systems-based or transactions-based.

The auditor's work on internal control is therefore an important element of gathering audit evidence, because it influences the direction that the audit work will take. As with all other significant audit evidence, it must be properly documented in the audit working papers – probably in the permanent audit file.

4.2 Recording methods

The principal methods available to the auditor for recording internal control systems are:

- Narrative notes
- Systems flowcharts
- questionnaires.

Narrative notes

Narrative notes are a written description of the control system and the controls that are in place. They are used mainly to make a record of the control activities involved in processing transactions.

Narrative notes are simple to prepare, but can become lengthy. They may be time-consuming to prepare initially. When narrative notes are long, it may also be time-consuming to update them when the system or the controls change.

Ideally, narrative notes should be written clearly, but should not be longer than necessary to provide a full description.

Systems flowcharts

Systems flowcharts provide a representation of accounting systems in the form of a diagram. For each type of transaction, they show the documents generated, the processes applied to the documents and the flow of the documents between the various departments involved. Flowcharts therefore show the flow of work by showing how documents are transferred within a system (and filed) and how they are used.

As they are in the form of a diagram, flowcharts present an immediate visual impact of the system. This can sometimes help the auditor to identify weaknesses in controls more easily than by reading narrative notes.

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However, some expertise is needed to draw a good flowchart and to use it to assess the effectiveness of controls. In addition, although flowcharts work well with standard accounting systems and transactions, they may not be appropriate for documenting specialised areas of accounting.

4.3 Questionnaires

Questionnaires are widely used by auditors to document systems. Questionnaires can be prepared in advance as standard documents. They are also ideally suited for use by the auditor in an electronic form, which means that standard questionnaires are available and ready for use on the auditor's laptop computer.

A questionnaire is a list of questions about controls in a particular aspect of operations or accounting.

There are two main types of questionnaire. Each has a different objective. They are:

- the internal control questionnaire (ICQ)
- the internal control **evaluation** questionnaire (ICEQ).

Internal control questionnaire (ICQ)

An internal control questionnaire (ICQ) is designed to establish whether appropriate controls exist, that meet specific control objectives. Each question requires a 'Yes' or a 'No' answer, and deals with a particular type of control. The auditor has to establish the answer to each of the questions, and fill in the questionnaire.

ICQs are usually drawn up in such a way that:

- a 'Yes' answer to a question indicates a control strength,and
- a 'No' answer to a question indicates a control weakness.

For example, the following ICQ questions might be included in a questionnaire dealing with procedures for assessing the credit-worthiness of potential new customers:

Are credit references taken on all potential new customers?	YES/NO
Are credit limits set for customers?	YES/NO

Example:

As part of his evaluation of internal controls, the auditor wishes to establish each of the following:

(a) That the correct product prices are charged on sales invoices to customers.

(b) That raw materials delivered are of the correct specification and in the correct quantity.

Required

Draft ICQ questions that could be used to establish the existence of appropriate controls.

Answer

(a) Is a check carried out to match the price on a sales invoice to the official price list?

YES /NO

(b) Are raw materials counted and checked against the purchase order when the materials are delivered?

YES /NO

An ICQ not only provides the auditor with a means of recording the system and its controls; it also assists with the evaluation process. The auditor can review the Yes/No answers to gain an overall picture of the reliability of the system under review.

The ICQ approach above has the advantage of producing a document that is relatively simple for the auditor to complete. So the questionnaire can often be completed by a relatively junior member of the audit team. However, the questionnaire can become lengthy (with a large number of questions) and so time-consuming to complete.

Checking ICQs

Instead of preparing new internal control questionnaires each year, it is often more practical and sensible to take the ICQs from the previous year's audit, check their accuracy and where appropriate bring them up to date. To do this the following steps should be taken:

- ❑ Obtain the ICQs from the previous year's audit file.
- ❑ Look at any control weaknesses that are indicated in these ICQs and find out whether the client entity has taken any action during the year to deal with them.
- ❑ Check the accuracy of each ICQ through a series of checks and enquiries: review the system documentation, interview the staff responsible for the controls and carry out walk-through tests. Identify the controls that apply and compare these with the findings in the ICQ. Make any amendments and updates as necessary.
- ❑ Having obtained an up-to-date set of ICQs, assess whether control weaknesses exist.

Internal control evaluation questionnaire (ICEQ)

In recent years the auditing profession has responded to this by developing a second type of questionnaire, the internal control evaluation questionnaire (ICEQ).

The idea behind the ICEQ is to draw up a small number of **key control questions** designed to establish whether major weaknesses may exist in a control system:

- ❑ Using an ICQ, the auditor is looking for 'good news' and expects to find particular controls in place.
- ❑ Using an ICEQ, the auditor is on the look-out for 'bad news' and the possibility that controls may be weak.

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Like an ICQ, an ICEQ contains a (shorter) list of questions, for which the answer is Yes or No. A questionnaire is normally designed so that a Yes answer indicates good controls and a No answer indicates weak controls.

An earlier example showed how ICQ questions might be written, relating to controls over the creditworthiness of customers. An ICEQ approach in this same area might consider just one key control question, as follows:

Is there reasonable assurance that goods can only be despatched to authorised customers whose account balance is within their credit limit?	YES/NO

Although the ICEQ approach typically produces a document that is shorter than an ICQ, ICEQs may suffer from the disadvantage that the questions are less precise and may need more knowledge and experience on the part of the auditor to answer them.

Choosing which type of questionnaire to use is a matter of preference for the auditor or the audit firm.

As in the case of the ICQ, the ICEQ approach also serves a dual purpose for the auditor – both to record and to evaluate the internal control system.

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5 EVALUATION OF CONTROLS AND AUDIT RISK ASSESSMENT

Section overview

- The purpose of evaluating controls
- The evaluation process
- Managemen tletter

5.1 The purpose of evaluating controls

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

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

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

5.2 The evaluation process

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

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

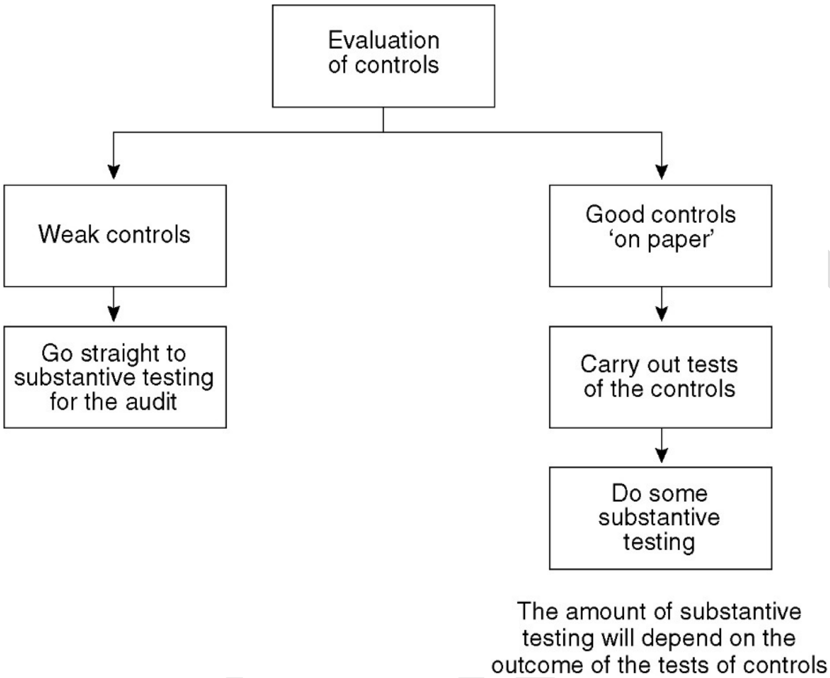
If the auditor's initial assessment of the control systems shows that those systems are weak, then he will move straight to substantive testing and will not bother to carry out tests of controls.

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

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

In view of this ISA 330 **requires** that substantive procedures are carried out for each **material class of transactions, account balances and disclosure**.

These terms are considered in a later chapter on substantive procedures.



5.3 Management letter

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

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

Illustration: Management letter

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

6 THE RISKS OF SPECIALISED IT SYSTEMS

Section overview

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

When evaluating the general controls and application controls in a client's computer systems, the auditor needs to take account of the type of computer-based information system that the client is using.

The types of system may require special attention:

- Microcomputer systems
- Online systems
- electronic data interchange systems.

6.1 Microcomputer systems

A microcomputer system is a system where the client company uses a number of 'desktop' computers located throughout the organisation, rather than a large 'centralised' computer-based information system with a mainframe computer or minicomputer.

Companies may use a microcomputer system because it is more efficient and cost-effective than a centralised system with a large single computer. Another commercial advantage of microcomputer systems is that the systems can often be operated (and possibly even programmed) by the user's operating staff (for example, accounts clerks) with little technical training.

Microcomputer systems may, however, generate problems of audit risk for the auditor, for the following reasons:

- It may be difficult to ensure adequate physical security of the equipment, because desktop computers for the system may be in many different locations.
- For similar reasons, there may be problems in connection with security of the data and storage media (disks of datafiles).
- The wide access available in most of these systems introduces problems of authorisation. There is the possibility of unauthorised amendments to programs or data files. The risks in this area can be minimised by the use of passwords to restrict access to certain files.
- Programs may be written or modified by the user (one of the potential attractions to the entity of the use of 'micros') but this may cause processing and software problems.
- The auditor should want to see adequate documentation for software systems. When software is purchased 'off-the-shelf' documentation should be provided by the software supplier.

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6.2 Onlinesystems

These are computer-based information systems that allow users direct access to centrally-held data and programs through remote terminals linked together in a network.

Companies use online systems because they can offer several benefits, such as:

- immediate entry of transactions into the system (for example, sales transactions in a retail outlet can be input from the check-out desk from 'electronic point of sale' terminals linked to a central computer in anetwork)
- immediate updating of master files (such as the immediate updating of inventory records as soon as inventory is requisitioned)
  - enquiry systems (such as immediate answers to price enquiries from customers).

Again, although they can be efficient and effective for the client company, online systems can create concerns about audit risk for the auditor. Controls should be in place to minimise the risks that arise from the use of on line processing systems by the client.

Controls in an online system are a mixture of general controls and application controls.

General controls in online systems

- Access controls need to be strong because transactions are processed immediately by online systems. It is therefore important that unauthorised access to the programs and data files should beprevented.
- Programming controls should be built in to prevent or detect unauthorised changes to programs or standing data.
- Transaction logs should be used to create an 'audit trail'. An **audit trail** refers to the ability of the auditor to trace a transaction through all its processing stages. An audit trail can be provided by a record ('log') of how the computer has processed any transaction. An audit trail may not exist in 'paper form' in an online system, but the computer program should be written so as to generate the audit trail on request for any transaction.
- Firewalls should be used. These are software or hardware devices that protect the network 'server' (computer) from unauthorised access via the internet.

Application controls in online systems

Applications systems that run on online computer systems should have application controls that are suitable for the nature of the processing system. For example:

- There should be pre-processing authorisation. This means that individuals should be required to log on to the system before they can use the program.
- Program checks (data validation checks) can be carried out on the input data. These include check digit checks, range checks, existence checks and completeness checks. These programmed checks help to ensure the completeness and accuracy of processing (for example, the correct number of digits in product codes).

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- ‘Balancing’. This is the immediate checking of control totals of data submitted from a remote terminal, before and after processing.

6.3 Electronic data interchange (EDI) systems

EDI systems are systems that allow the electronic transmission of business documents, such as purchase orders, invoices or payroll information.

EDI systems may operate:

- within the organisation (for example, the sales department may use an EDI system to send copies of customer orders to the accounting department), or
- externally (for example, a company may submit payroll data to an external agency or ‘bureau’ for processing, and a company may send a purchase order electronically to a supplier).

In an EDI system, the transmitted ‘documents’ are automatically entered into the (different) computer system of the receiver of the message. For example, a purchase order sent to a supplier by EDI is read automatically into the sales order computer system of the supplier, and so can be processed without the need for manual intervention.

Once again, although EDI systems may improve the operational efficiency of the organisation, they may create the following additional problems for the auditor:

- There is a lack of a paper audit trail. (A ‘paper’ audit trail is one where a transaction can be followed through the stages of its processing, by going from one paper document to another. With EDI, the system needs an electronic audit trail for transactions, and the computer system should be able to provide one.)
- There is an increased level of dependency on the computer systems of the organisation and possibly on outsiders. Any computer failure may therefore have an increased impact on the client’s organisation. General controls for IT will therefore be extremely important.
- There is a risk of possible loss or corruption of data in the process of transmission.
- There are also security risks in the transmission of data. Unauthorised individuals may be able to read transmitted data.

Auditors should expect to see controls in place to minimise the risks inherent in EDI systems. Typically, controls will cover such matters as:

- controls over transmission of data (encryption, acknowledgement systems, authentication codes)
- monitoring and checking of output
- virus protection systems
- contingency plans and back up arrangements.

(Note: Authentication codes are used so that senders and receivers of transmitted data have to authenticate their identity before data is transmitted. Encryption involves translating data into ‘coded’ form for transmission, and then re-translating it at the recipient’s end.)

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6.4 E-commerce

E-commerce is any commercial activity that takes place via connected computers over a public network. A common example is a mail order company selling goods over the internet such as Amazon.

As the volume and materiality of transactions being executed through e-commerce channels continues to grow in society the auditor must ensure they have considered the associated audit risks and planned and performed their audit procedures accordingly.

Some of the areas the auditor will consider include:

- The skills and knowledge needed by the auditor to understand the effect of e-commerce on the entity's activities: the more complex the e-commerce activities, the greater the skills and knowledge required by the auditor.
- The extent of the knowledge of the business needed by the auditor. E-commerce may have a significant impact on the client's business environment. It may increase security risks and it may also broaden the geographical markets for the client, since customers can communicate through the internet from anywhere in the world.
- Additional business risks arising from e-commerce: the loss of 'transaction integrity', the use of inappropriate accounting policies (for example, in respect of the capitalisation of website development costs,) and legal and regulatory risks.
- Internal control considerations. Internal controls may exist within the e-commerce system, but there may not be an adequate audit trail for transactions on the client's website.

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7 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you:

- Understand the meaning, importance and relevance of internal control
- Understand how the auditor assess and uses internal controls
- Can explain the five components of internal control
- Can discuss the limitations of internal controls
- Can explain the different types of controls
- Can evaluate internal controls and explain the impact of this evaluation on the auditor's risk response
- Can describe different methods used for recording internal control systems including narrative notes, questionnaires and flowcharts
- Can provide an overview of the risks of some specialised IT systems including on-line systems and Electronic data interchanges

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Quick quiz questions

1 The degree of effectiveness of an internal control system depends on:

A The design of the internal control system and the implementation of the controls

B The design of the internal controls and the implementation of the control system

C The implementation of the controls and the correctness of the accounting records

D The design of the internal control system and the correctness of the accounting records

2 According to ISA 315, which of the following is NOT an element of the control environment?

A Participation of management

B Information processing

C Commitment to competence

D Human resource policies and practices

3 According to ISA 315, which of the following is NOT a control activity?

A Performance reviews

B Physical controls

C Organisational structure

D Segregation of duties

4 A walk-through procedure is designed to do what?

A To check that materiality levels are acceptable

B To act as a checklist to see if all substantive tests have been performed

C To provide assurance within a letter of representation

D To confirm that the auditor's understanding of the internal control system is correct

5 Which of the following is true about a small company compared to a large company?

A There is likely to be more reliance on internal controls

B There is more chance of an internal audit department

C There is less opportunity for segregation of duties

D There is more likely to be an audit committee

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Quick quiz answers

1 A

2 B

3 C

4 D

5 C

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Skills level
Audit and Assurance

CHAPTER 8

Tests of controls

Contents

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INTRODUCTION

Competencies

Objectives, need for and process of audit and assurance

A3 (a) Explain the basic steps of audit and assurance process in relation to:

- Performance: Evaluation of internal control

The nature and use of internal controls (ISA 315)

B1 Discuss the meaning, objectives and nature of internal control.

B2 Discuss effective internal control.

B3 Discuss the different types of internal control.

B4 Discuss responsibilities for instituting and evaluating the effectiveness of internal control.

B5 Discuss the main components of internal control.

B6 Explain how accounting systems and related internal controls may be identified, recorded and analysed.

B7 Discuss the techniques required for evaluating internal controls (walk-through, spot check, compliance test, substantive test) (ISA 530);

B8 Evaluate internal controls in a given scenario.

(Note: The above objectives are addressed through a combination of chapters 7 and 8)

Gathering evidence

The nature of audit evidence and the selection of sufficient appropriate audit evidence (ISA 500)

C2 Evaluate the different sources and quality of evidence and the methods of obtaining evidence. *(See also chapters 6,9-12)*

C3 Document appropriate procedures for gathering evidence based on a given scenario (ISA 505, ISA 520). *(See also chapters 6,9-12)*

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Exam context

The testing of controls is a particularly efficient audit approach when large volumes of data are involved and the internal control system is sufficiently robust and operational.

The previous chapter explained the various components of a system of internal controls and the different types of controls that might exist. This chapter now looks at specific tests of controls relevant to the audit of financial statements.

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

- Understand the key transaction cycles and associated controls for
  - Sales
  - Purchases and expenses
  - Payroll
  - Bank and cash
  - Inventory
  - Non-current assets
- Discuss controls in smaller entities
- Plan tests of controls
- Describe computer assisted audit techniques

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1 TESTS OF CONTROLS ANDTHE MAIN TRANSACTION CYCLES

Section overview

- Planning tests of controls
- Computer-assisted audit techniques
- The major transaction cycles
- Controls and tests of controls in the exam

1.1 Planning tests of controls

The auditor takes a systems-based approach wherever possible. He focuses on testing the systems and internal controls that produce the financial reporting figures, rather than the figures themselves. If the systems and the controls are satisfactory, the figures produced by the systems should be reliable.

Two conditions are necessary before the auditor can adopt a systems-based approach:

- The systems and controls in place should be **designed** to minimise the risks of misstatements. The auditor carries out this check of controls in his procedures for the documentation and evaluation of thecontrols.
- The systems and controls should actually **operate** effectively. The auditor gains evidence that the controls operate in practice by performing **tests of control**.

1.2 Computer-assisted audit techniques

Where systems are IT based, specialised techniques of obtaining audit evidence may be required. These are known as **computer-assisted audit techniques** (CAATs).

CAATs can be defined as any technique that enables the auditor to use IT systems as a source of generating audit evidence. They involve the use of computer techniques by the auditor to obtain audit evidence.

- CAATs are often necessary in the audit of IT systems because these systems may not provide an adequate audit trail.
- In addition, processing is ‘invisible’ because it is electronic. Therefore, the auditor needs to ‘get inside the computer’ to check the completeness and accuracy of the processing. CAATs allow the auditor to achieve this.

Two commonly-used types of CAATs are:

- audit software,and
- test data.

It is **test data** which is of most relevance to **tests of control**. The technique provides evidence of the operation of specific application controls in a given system. Audit software is more relevant to substantive testing and is therefore considered in a later chapter.

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Test data

The use of test data involves the auditor processing a sample of data through the IT system and comparing the results obtained from the processing with pre-determined results.

A potential problem with using test data is that it will only give audit evidence at the time that test data is processed. Procedures may therefore be written into the client entity's computer information systems that will generate data for audit purposes **every time the process is run**. One way of achieving this without corrupting the client's data files with the test data is to establish an extra 'dummy' department, to which the test data results are allocated. Only the auditor should have access to the data stored in this dummy department.

Disadvantages of CAATs

CAATs give the auditor the ability to audit the processing of transactions in an IT system. However, there are some disadvantages with using CAATs. They can be expensive, and the use of CAATs should be evaluated on a cost benefit basis.

The costs related to the use of CAATs may include:

- ❑ purchasing or developing theprograms
- ❑ keeping programs up-to-date for changes in hardware andsoftware
- ❑ training audit staff in the use of computer systems to run the CAATs. CAATs are of no value unless auditors are properly trained in how to use them.

Example: Test data

Looking back to the system described in the previous chapter in relation to Dolally,set out four examples of how test data could be used to test that system. You need not restrict the controls you are testing to those in your previous answer.

Answer: Test data

1. Input a dummy order where you are aware that the goods are out ofstock and ensure that the order does not lead to a despatch note being produced). (The system above did not specify how this situation would be dealt with. There would probably be some sort of pending orders file, checked against inventory levels daily).
2. Input a dummy order where you know that the goods are in stock and ensure that a dispatch note is produced. View the dispatch note on screen and trace it through to the copy in the distribution centre.
3. Input dummy despatch notes without subsequently flagging them up for invoicing and ensure they appear on the exception report.
4. Flag up dummy dispatch notes and check invoices are raised.

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1.3 The major transaction cycles

The auditor will focus much of his audit work on the major '**transaction cycles**' which taken together cover the majority of the day-to-day transactions of the business.

The major transaction cycles are:

- sales(revenue),
- purchases,and
- payroll.

These three transaction cycles will have a direct effect on both the statement of financial position and the income statement (two statement format) or statement of comprehensive income (one statement format). Tests of control are also applied to key statement of financial position headings linking into the main transaction cycles:

- bank and cash
- inventory,and
- revenue and capital expenditure (non-current assets).

Much of this chapter presents lists of risks, control objectives, suitable controls and tests of controls, for different aspects of the main transaction cycles. These lists are not complete or comprehensive, instead they are intended to provide detailed guidance about how tests of control may be designed and applied.

1.4 Controls and tests of controls in the exam

The exam paper may include a case study question that describes a transaction cycle of a client entity. You may be required to identify suitable internal controls and tests of controls that would be appropriate. Alternatively you may be required to comment on control weaknesses in the system.

The following sections of this chapter describe in general terms the control objectives, controls for achieving those objectives and ways of testing the effectiveness of those controls, for each of the main transaction cycles. Remember however that in the exam itself you may be required to apply these general concepts to a specific case study.

You may find it useful to think about controls and tests of controls in terms of:

- Risks. What are the risks that weaknesses in the transaction processing system could mean that the financial statements do not give a true and fair view?
- What should be the control objective? What is the purpose of having controls? What should the control be intended to achieve, or prevent? The objective of controls should be to eliminate or reduce the risk.
- Having established the reason for needing controls, the next step is to devise controls that will help to achieve the control objective.
- An auditor should be aware of the control objectives for each of the transaction cycles, and should assess the effectiveness of the controls that the client entity has in place to achieve those objectives. (If there are obvious weaknesses in the controls, the auditor should notify these to the client entity's management).

- If the auditor is satisfied that the controls seem adequate, he should devise tests to establish whether they work in practice. The auditor therefore devises and carries out tests of control.

Tests of control should therefore be seen within the context of:

- Risks
- Control objectives
- Controls
- Tests of those controls.

If you are required to suggest suitable tests of controls in answer to an exam question, you should be able to explain **why** the control is needed and how the test will establish the effectiveness of the control. It may help you to present tests of controls in a tabular form in your answer, as follows:

Test of control	Reason for the control

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2 THE SALES SYSTEM

Section overview

- Elements of the sales system
- Customer ordering
- Despatch of goods and invoicing
- Recording sales and accounting

2.1 Elements of the sales system

Excluding the collection of payments from credit customers, the main elements of the sales accounting system may be classified as follows:

- Receiving orders from customers
- Dispatching the goods and invoicing customers
- Recording sales and amounts receivable in the accounts

For each of these elements of the system, we can identify risks, control objectives, design internal controls and devise ways of checking whether the controls are applied in practice (tests of control).

2.2 Customer ordering

Risks

So what are the risks in a system of receiving and processing customer orders? The following list is not complete, but contains some of the risks.

- Orders may be accepted from new customers and new customers may be given credit, without checking the customer's references or without formal authorisation of a credit account for the customer with a credit limit.
- Orders may be accepted from existing customers that take them over their credit limit.
- Some orders are overlooked and are not processed.
- Some orders are processed twice.
- The customer is given a price discount without proper authorisation.

Control objectives

Suitable control objectives may therefore be as follows:

- Giving credit to new customers and existing customers must be controlled, and must be consistent with company policy.
- All orders from customers are processed correctly. Orders should not be processed if they would take the customer above his agreed credit limit.

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Principal controls

Suitable controls may be as follows:

- There should be a segregation of duties, and the individuals who process orders from customers should not also carry out credit reference checks on new customers or credit limit checks on existing customers. The latter could be done manually by reference to a file of approved credit limits, or it could be a programmed control whereby the system will only accept an order if the customer will still be within his credit limit.
- All new customer accounts, and their credit limit, should be authorised.
- Orders should be recorded on sequentially-numbered documents or the system should allocate sequential numbers to documents.
- For every sales order, a despatch note should be produced (manually, or generated by the system from the order details). Goods should not be despatched to customers without a dispatch note.

Tests of control

How might an auditor test whether these controls are actually applied in practice? The client can assist the auditor by collecting evidence that the controls have been applied. One way of doing this is to use the customer order document to record that checks have been completed; for example, by providing space on the order form for individuals to sign their name or write their initials as confirmation that they have carried out a particular task.

Here are some suggested tests of control:

- The auditor can establish which individuals take orders and process them, and which individuals carry out credit reference checks on new customers and credit limit checks on existing customers. The auditor could observe these individuals to see if procedures are being properly followed. In an IT system he could use test data to check that orders which would take a customer over his credit limit would be rejected by thes ystem.
- Further evidence that credit checks have been carried out can be checked by looking at the signatures or initials of credit checking staff on customer orders or by using test data as described above.
- Evidence that new customer accounts have been approved should be checked by looking for the signature of the manager giving the authorisation on the appropriate approval document.
- The auditor can look at lists of customer orders, sequentially numbered, and confirm that for every customer order there is a despatch note number. Alternatively, for an integrated IT system, he can follow test data through from order to despatch note and confirm that sequences are complete by viewing documents onscreen.

It is important to remember that this list of controls and tests of controls is not complete, but it may help you to understand the process by which tests of control are carried out, and the way in which they should give the auditor the evidence that he needs for a systems-based approach to the audit. You need to take care in the exam that the controls or tests of controls you suggest are appropriate to the system described, taking careful note of which parts of the system are manual and which are IT-based. The control objectives will be the same for both types of systems – it is the specific controls (and therefore also tests of controls) that will sometimes be different.

ICAN 2021

2.3 Despatch of goods and invoicing

The same approach can be applied to the despatch of goods and invoicing.

Risks

Here are some of the risks in this part of the sales system:

- For some customer orders, goods are not despatched.
- For some customer orders the goods are dispatched twice.
- Goods are despatched to customers who do not have sufficient credit (either because no credit terms have been agreed, in the case of a new customer, or because the order takes an existing customer above his credit limit).
- Invoices are not produced for goods that have been despatched to some customers.
- Customers may claim that they did not receive the goods that have actually been delivered to them.
- Returns from customers are not properly recorded, so that the client company does not know the correct figure for sales net of sales returns.

Control objectives

Control objectives may therefore be as follows:

- Goods should be despatched for every authorised customer order.
- Goods should not be despatched twice, for the same sales order.
- Customers should acknowledge the receipt of goods.
- For every despatch note, there must be an invoice.
- Invoices should be for the correct amount.
- For all goods returned by customers, there must be an authorised credit note.

Principal controls

Suitable controls may be as follows:

- Despatch notes or Goods Delivery Notes (GDNs) should be numbered sequentially, and should be attached to a copy of a specific customer order. The GDN should be signed by an authorised member of the despatch staff. Sequential numbering of GDNs allows a check to be made that all deliveries can be accounted for.
- Customers should sign a delivery note for the receipt of goods, as confirmation of receipt.
- The signed delivery note should be attached to a copy of the despatch note and customer order. Copies of these documents should be transferred to the accounts department after despatch, so that a sales invoice can be produced.
- Each sales invoice should be linked to a copy of the despatch note and customer order or produced automatically from them.
- Sales invoices should be sequentially numbered or the system should allocate sequential numbers to documents.

ICAN 2021

- There should be a segregation of duties, and the individuals who despatch goods should not be the same as those who prepare sales invoices or process the customer orders.
- Credit notes should be sequentially numbered and authorised.
- There should be periodic checks by someone in the accounts staff on the accuracy of invoices or strong IT controls to ensure the accuracy of invoices.

Tests of control

The auditor needs to test whether these controls operate properly. Here are some suggested tests of control:

- Some delivery notes should be checked to confirm that customers do sign them.
- The auditor can check that the segregation of duties does exist.
- There should be a check to ensure that all GDNs have been sequentially numbered, and that if there is any non-sequential numbering of GDNs an error report has been produced by the system to explain the reason for the error.
- The auditor should check that (sequential) lists of invoices show a customer order number and a despatch not enumber.
- The auditor should check a list of credit notes to make sure that they cross-refer to a sales invoice number.
- Credit notes should be checked to make sure that they contain the authorisation signature of the appropriate manager or have been raised, on the computer, only by a member of staff with authority to do so.
- The auditor can observe the despatch process in operation.
- There should be documentary evidence that a member of the accounts staff has carried out arithmetical checks on the accuracy of invoices. Alternatively, the auditor may prove that there are strong IT controls which will ensure the accuracy of invoices by checking the calculations himself.

Remember that for each test of control, there should be a purpose. In other words, what control is being tested and how does the test succeed in doing this? For example:

Test of control	Reason for the control
Review error reports on non-numerical sequencing of GDNs and ask about action taken to investigate or deal with the error.	Test to ensure that all GDNs have been in numerical sequence, and if not that errors can be satisfactorily explained.
Test a sample of GDNs for the customer’s signature	To ensure that the customer did receive the goods and has acknowledged receipt.
Observe the dispatch process	To check that goods are despatched only where a GDN exists and that the goods actually despatched correspond with the details on the GDN.

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Test of control	Reason for the control
Observe the credit checking process	To ensure that authorisation isnot given for the despatch of goods if this would take the customer over his credit limit.
Observe the dispatch process	To check that goods are despatched only where a GDN exists and that the goods actually despatched correspond with the details on the GDN.
Observe the credit checking process	To ensure that authorisation is not given for the despatch of goods if this would take the customer over his credit limit.

2.4 Recording sales and accounting

Again, a similar approach can be taken in identifying tests of control for the recording of sales in the accounting system.

Risks and control objectives

Risk	Control objective
There is a risk that invoices and credit notes may not be recorded in the accounting system.	All invoices and credit notes are recorded in the accounting system.
There is a risk that invoices and credit notes are recorded in the wrong customer accounts.	All invoices and credit notes shall be recorded in the correct customer accounts.
There is a risk that debts may be written off as uncollectable ('bad') without proper consideration.	Debts only to be written-off as uncollectable following proper consideration and appropriate authorisation.

Principal controls

Suitable controls may be as follows:

- ❑ Invoices and credit notes should be sequentially numbered.
- ❑ Regular statements should be sent to customers.
- ❑ Control account reconciliations should be carried out on trade receivables.
- ❑ Bad debts must be authorised.
- ❑ There are procedures for identification and follow-up of overdue accounts and unpaid invoices.

Tests of control

Here are some suggested tests of control:

- ❑ Lists of invoices and credit notes can be checked to make sure that there is sequential numbering or documents can be viewed onscreen.

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- There should be a segregation of duties between the individuals who prepare and send out invoices, and individuals who collect payments, and individuals who follow up late payments.
- The auditor can check that statements are produced and despatched to customers.
- The auditor can look for documentary evidence that control total checks have been made.
- There should be documentary evidence that proper authorisation is given for a debt to be written off as bad.
- There should be individuals responsible for collecting overdue debts, and evidence of their work. Alternatively the auditor might check that an exception report is regularly produced by the system, listing all overdue debts, and look for evidence that this is followed up.

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3 THE PURCHASES AND EXPENSES SYSTEM

Section overview

- Elements of the purchases and expenses system
- Placing orders
- Receiving goods and invoices
- Recording and accounting for purchases and expenses

3.1 Elements of the purchases and expenses system

Excluding the procedures for making payments to suppliers, the main elements of the accounting system for purchases and other expenses may be classified as follows:

- Placing orders (which includes requisitioning an order and actually placing the order with a supplier)
- Receiving goods (or services) and receiving invoices
- Recording and accounting for purchases and expenses.

The same basic approach to devising tests of control can be taken as for the sales system. The risks, control objectives, controls and tests of control listed here are not comprehensive. They are intended to show you the approach that can be taken.

Again, the control objectives will be the same for all systems, but the controls and therefore tests of controls, are likely to differ to some extent between manual and IT systems.

3.2 Placing orders

Risks and control objectives

So what are the risks in a system of ordering goods or services from suppliers? The following list is not complete, but contains some of the risks:

Risk	Control objective
Orders for goods or services are made without approval or authorisation. This could mean goods or services are ordered for personal rather than business use.	All purchase orders must be properly authorised.
Orders may be placed with suppliers who are not on the 'approved list'.	Orders should not be placed with 'non-approved' suppliers.
For large orders, suppliers are not asked to submit tenders. When suppliers are asked to tender, the order might not be given to the supplier quoting the lowest price.	Competitive price quotations should be obtained for all large orders.

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Principal controls

Suitable controls may be as follows:

- There should be a segregation of duties. Individuals who make a requisition for new supplies of inventory should not be the individuals who place the order with the supplier.
- Purchase orders should be sequentially numbered.
- There should be a procedure for placing suppliers on the 'approved list'. In an IT system, physical controls must exist over access to the master file of approved suppliers.
- All orders must be placed with suppliers on an approved list. The purchase order may include an 'approved supplier reference number'. In an IT system the system must only be able to address orders to approved suppliers as on the masterfile.
- Orders above a certain value must be authorised by a senior manager, who should confirm that competitive tenders have been obtained from suppliers.

Tests of control

Here are some suggested tests of control:

- The auditor can check that the segregation of duties does exist.
- The auditor can look at lists of sequentially-numbered purchase orders or view documents on screen. Alternatively, he could submit test data in the form of an order and check it is allocated the next number in the sequence.
- The auditor should ask management to provide documentary evidence that the procedure for placing suppliers on the approved list operates as intended. In an IT system, the controls over the master file of approved suppliers will need to be tested.
- Purchase orders can be checked to make sure that they contain an approved supplier reference number.
- Large orders can be checked for management authorisation.

3.3 Receiving goods and invoices

Risks and control objectives

Here are some risks and control objectives for this part of the purchases transaction cycle:

Risk	Controlobjective
There is a risk that goods may be accepted from a supplier without having been ordered. Or suppliers may claim to have delivered goods, but may actually not have done so.	All receipts of goods are recorded and checked against a purchase order.
There is a risk that the company may fail to claim discounts from suppliers for orders above a certain size, or as regular customers of the supplier.	Discounts are claimed from suppliers where these are available.

Risk	Controlobjective
There is a risk that suppliers may invoice for goods that have not actually been delivered.	Ensure that invoices are only accepted for goods actually delivered.

Principal controls

In this area there is little difference between manual and IT systems as this part of an IT system will be dependent on controls over the physical receipt of goods and invoices, which will be carried out by employees as opposed to by a computer program. Suitable controls may be as follows:

- ❑ A copy of all delivery notes should be retained, with a signature of the member of staff who took receipt and checked the goods.
- ❑ Goods received notes should be produced for each delivery, from the delivery note or after a physical count of the items received.
- ❑ A member of the accounts staff or purchasing staff must be responsible for checking discounts allowed by suppliers.
- ❑ There should be a segregation of duties between the individuals who take delivery of goods, those who place the orders and those who record the purchase invoices in the accounting system.
- ❑ All purchase invoices should be checked against a purchase order and a goods received note.

Tests of control

Here are some suggested tests of control:

- ❑ The auditor should check that delivery notes, goods received notes and purchase invoices are matched with each other. There should be evidence that they have been checked against each other; for example, the person making the check should sign or initial the purchase invoice.
- ❑ The auditor should look for any evidence that invoices, purchase orders or goods received notes cannot be properly matched (indicating that the controls are not working in practice and a control objective is not being achieved).
- ❑ The auditor should look for documentary evidence that discounts are checked and claimed from suppliers when available.
- ❑ The auditor should check that the segregation of duties does exist.

3.4 Recording and accounting for purchases and expenses

Risks and control objectives

Here are some risks and control objectives for this part of the purchases transaction cycle:

Risk	Controlobjective
There is a risk that purchase invoices will be recorded for goods or services that were not provided.	Purchase invoices should only be recorded for goods or services actually provided.

Risk	Controlobjective
There is a risk that purchase invoices will be incorrectly recorded in the accounts of suppliers.	Correctly record purchase invoices in supplier accounts.
There is a risk that credit will not be claimed from suppliers for goods returned.	Ensure that credit is taken for all purchase returns.

Principal controls

Suitable controls may be as follows:

- Purchase invoices must be checked against purchase orders before they are recorded in the accounts. If the purchase order number is not printed on an invoice, it should be written on the invoice by the individual making the check or entered onto the system alongside the invoice details.
- Regular statements should be received from suppliers, and the balance on the statement should be checked against the account balance in the trade payables ledger.
- There should be regular control account reconciliations for trade payables.
- A debit note should be created each time that goods are returned to a supplier. Debit notes should be sequentially numbered and matched with the supplier's credit note when it is received. An IT system could produce a regular exception report of unmatched debit notes for follow up by an employee.

Tests of control

Here are some suggested tests of control:

- The auditor should look for evidence that purchase invoices are matched against purchase orders. Evidence may be provided by a signature or initials on the purchase invoice of the individual making the check or by checking references on screen.
- There should be evidence that statements from suppliers are checked and approved. Again, evidence may be provided by a signature or initials on statements of the individual making the check.
- The auditor should look for documentary evidence of control account reconciliations.
- The auditor should be able to check a list of sequentially-numbered debit notes, cross-referenced to a supplier's credit note.

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4 THE PAYROLL SYSTEM

Section overview

- Elements of the payroll system
- Calculating gross wages and salaries
- The calculation of tax and other deductions
- Recording wages and salaries payable in the accounts
- Payment of wages and salaries
- Possible control weaknesses in a payroll system

4.1 Elements of the payroll system

A similar approach can be taken to designing tests of controls in the payroll system. Elements of the payroll system may be classified as follows:

- Calculating gross wages and salaries
- Recording wages and salaries payable in the accounts
- The calculation of tax and other deductions from wages and salaries
- The payment of wages and salaries.

Some risks, control objectives, principal controls and tests of control are suggested below for each element of the payroll transaction cycle. However, the control objectives, principal controls and tests of control are now presented in tabular form, for ease of reading.

4.2 Calculating gross wages and salaries

Risks and control objectives

Risk	Controlobjective
Wages and salaries may be paid to individuals who are not employees.	Ensure that only 'real' employees are paid: for example wages or salaries should not continue to be paid to former employees who have now left, or that payments are not made to 'phantom' employees.
Employees may be paid for work they have not done.	Ensure that employees are paid only for work they have done: for example to make sure that employees are not paid for overtime work if they have not done it.
Gross wages and salaries could be calculated incorrectly.	Ensure that gross pay is calculated correctly.

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Principle controls and tests of controls

Examples of control objectives	Examples of principal controls	Tests of control
Wages and salaries should not be paid to individuals who are not employees.	There should be a segregation of duties: the individual responsible for preparing wages and salaries should not be the person who actually pays them.	The auditor can check that the segregation of duties does exist.
	The gross pay for each individual employee should be authorised by an appropriate person.	The auditor should check that departmental payroll lists are properly authorised.
	There should be formal authorisation of new employees.	Documentation for authorising new employees and putting them on the payroll file (manual or computerised) should be checked.
Salaries should be calculated correctly.	There should be formal personnel records, giving details of each employee and his or her rate of pay, and dates of starting and leaving employment.	The payroll file should be checked.
Employees paid time-based wages should only be paid for time they have worked.	There should be time sheets for hourly-based employees, and these should be authorised by an appropriate supervisor.	Time sheets can be checked. These should include the signature of the manager or supervisor confirming the hours worked by the individual employee.
	Alternatively, a clock card system might operate.	For a clock card system, the auditor will need to test the controls in operation (such as to ensure that employees cannot clock in for each other).
Payments should not be made except for work done and unless properly authorised. Payroll calculations should be accurate.	A senior manager should check the total payroll cost each week or month, to make sure that the total amount does not appear excessive.	Authorised payroll lists should be checked. These should contain the signature or initials of the manager who checked the list.

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Examples of control objectives	Examples of principal controls	Tests ofcontrol
	In a computerised payroll system, exception reports might also be produced, for example, reporting gross wages over pre-set parameters and then followed up by management.	Test data could be used to check that the exception reporting system is working properly. Exception reports could be reviewed for evidence of follow up (e.g. annotated explanations).
	Bonus payments to individuals must be authorised.	Check a sample of bonus payments to ensure that the payments are properly calculated and authorised.

4.3 The calculation of tax andother deductions

Risks and control objectives

Risk	Controlobjective
Taxation and other deductions could be calculated incorrectly.	Taxation and other deductions from pay should be calculated correctly.
Discretionary deductions are made without the consent of an employee.	Voluntary deductions from pay (for example, for pension contributions) should only be made with the consent of the employee.

Principle controls and tests of controls

Examples of control objectives	Examples of principal controls	Tests ofcontrol
Taxation and other deductions from pay should be calculated correctly.	Payroll procedures (IT or manual) should provide for the deduction of all appropriate deductions, using up-to-date rates of tax.	The auditor can review any manual procedures for calculating deductions, and the tax rates used. In an IT system, general IT controls will be important to check that the system was properly developed, tested and implemented. Test data could be used and results compared to independently calculated figures.

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Examples of control objectives	Examples of principal controls	Tests ofcontrol
Voluntary deductions from pay (for example, for pension contributions) should only be made with the consent of the employee.	Senior management should check the total amount of deductions each week or month.	The auditor can check that a senior manager has approved total deductions, evidenced by his or her signature on the appropriate document.
	All voluntary deductions must be authorised in writing by theemployee, and this written authorisation should be kept in the payrollfile.	The payroll file can be checked against the calculation of deductions in employee wages or salaries, to confirm that voluntary deductions are authorised.

4.4 Recordingwagesandsalariespayableintheaccounts

Risks and control objectives

Risk	Control objective
Gross pay, deductions and net pay may not be properly recorded in the accounts.	Gross pay, deductions and net pay should be properly and accurately recorded in the accounts.

Principle controls and tests of controls

Examples of control objectives	Examples of principal controls	Tests of control
Gross pay, deductions and net pay should be properly and accurately recorded in the accounts.	The accounts are prepared from payroll data that has been approved by a senior manager.	There should be evidence that the payroll has been formally approved. (In an integrated IT system, the nominal ledger accounts will be automatically updated.)
	Accounting for payroll should be completed within a strict timescale.	There should be checks on the procedures for recording payroll and the time within which the work is done.
	There should be control accounts for payroll, with regular reconciliations between control totals and the payroll records of all individual employees.	There should be documentary evidence of control account reconciliations and review of these reconciliations.

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4.5 Payment of wages and salaries

Risks and control objectives

Risk	Control objective
Incorrect amounts of net pay could be paid over to employees.	The correct amounts of net pay should be paid to employees.
Incorrect amounts of deductions could be paid over to the authorities.	The correct amount of deductions is paid to the appropriate authority (for example, the tax authority).
Payment could be made to the wrong employee.	Payments of net wages and salaries are made only to the proper person (the employee).

Principle controls and tests of controls

Examples of control objectives	Examples of principal controls	Tests of control
The correct amounts of net pay should be paid to employees.	When wages and salaries are paid by automated bank transfer, the list of payments should be authorised by an appropriate manager.	Authorised lists of payments can be checked.
The correct amount of deductions is paid to the appropriate authority (for example, the tax authority).	There should be formal procedures and a formal timetable for the payment of deductions, and recording payments in the accounts.	The procedures for payments of deductions and manual recording of payments in the accounts can be checked. (In an integrated IT system, the nominal ledger accounts will be automatically updated for deductions.)
Payments of net wages and salaries are made only to the proper person (the employee).	Bank statements should be used to check that payments have been properly recorded in the accounts.	Evidence of bank reconciliation checks can be obtained.

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Examples of control objectives	Examples of principal controls	Tests of control
Payments are correctly recorded in the accounts.	There should be controls within the accounting system to ensure that there is reconciliation between total amounts payable and total paid.	The accounts can be checked to confirm that payrolls each week or month (total payable and total paid) are reconciled. Again, this will not be necessary in an integrated IT system, provided that the auditor is satisfied that the system is working properly, perhaps by processing a "dummy" payroll run.

Note: The suggested control objectives, controls and tests of control in the above table assume that all wages and salaries are paid by bank transfer. When payments of wages are in cash, or where casual labour is paid in cash, additional controls will be needed.

4.6 Possible control weaknesses in a payroll system

Remember that in the exam, you may be asked to identify control weaknesses in a payroll system, given information about procedures in a client entity described in a case study-type of question. The following are possible weaknesses that may exist.

- Weaknesses in the system for recording time spent at work. When employees are paid by the hour, there will be a system of 'clocking on' and 'clocking off', typically using employee identity cards and a time recording device. Alternatively, employees may be required to arrive at work at a given time, and use identity cards and a recording device to record their arrival at work. The risk is that employees will 'clock on' on behalf of a colleague, using the identity card that the colleague has given him. (A control to prevent this from happening is that the 'clocking on' process should be observed eachday.)
- Overtime payments may not be properly authorised. Is the overtime authorised? If so, has the amount of the payment been checked and authorised?
- Responsibility for making the payroll payments. The actual payments of wages and salaries (often direct payments through the banking system) may be made by a junior person in the accounts department without proper authorisation.
- The payroll lists for each department may not be properly authorised. This creates a risk that payments may be made to 'phantom' employees.

Some weaknesses in a payroll system may be risks that are common to other types of IT system too, for example:

- Weaknesses in the use of passwords. An IT system may use passwords to prevent unauthorised access to files and records. However, the passwords used may be ‘guessed at’, particularly if they are names of family members or domestic pets, or names included in home addresses. Passwords should be difficult to guess (ideally a combination of letters and numbers) and should be changed regularly.
- Weaknesses in the use of e-mails. Important information may be sent by e-mail. However, since the information is not on paper (in ‘hard copy’ form) there is a greater risk that it will be overlooked or forgotten. In a payroll system, notification that employees have left their job may be sent to the payroll department by e-mail. If the e-mail is not acted upon, there is a risk that former employees will continue to be paid, even after they have left.

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5 THE BANK AND CASH SYSTEM

Section overview

- Risks and control objectives
- Principal controls and tests of control
- Petty cash

5.1 Risks and control objectives

Bank and cash is often one of the most sensitive areas of an audit, in the sense that it is the asset which is most likely to be misappropriated. However, it may not be an area of high audit risk in practice, because the client company should be aware of the potential high level of risk and should therefore set up appropriate control systems.

Auditors will be particularly interested in establishing that **all** receipts belonging to the organisation have been recorded – **completeness** is a key assertion in the area of cash receipts.

The term 'cash' is used below to mean both notes and coins, and also money in a bank account. Many entities try to reduce the risks of misappropriation of cash (banknotes) by arranging receipts and payments through their bank.

Cash payments are also an area of potential risk. Payments might be made to unauthorised persons, or individuals might be paid more than they should be paid.

So in summary:

Risk	Control objective
Cash received may not be recorded in the accounting records.	All money received is recorded.
Cash received may not be deposited in the bank.	All money received is banked.
Monies such as cheques, notes and coins may be lost or stolen due to insufficient safeguarding.	All money held as cheques, notes and coins is properly safeguarded.
Unauthorised payments may be made.	All payments are properly authorised.

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5.2 Principal controls and tests of control

Some of the principal controls for cash, and tests of those controls, are suggested below:

Control objectives	Principal controls	Tests of control
All money received is recorded	There should be segregation of duties. The handling of cash should be kept separate from other accounting functions.	Check that segregation of duties does exist.
	Controls over receipts by post There should be supervision of the opening of mail. There should be a listing of all money received. Mail and cheques should be date-stamped.	**Controls over receipts by post** Observe that mail opening and cash handling procedures are being followed. Check amounts recorded as receipts from customers against the remittance advices (document from the customer confirming the amount paid).
	Cash sales Only a restricted number of employees should be authorised to receive cash. Cash tills and till rolls should be used to record cash sales. Another person should check the actual cash received against the till roll total. Restrict the employees who are able to receive cash If the till rolls are not produced, receipts should be given for cash receipts, and a copy of receipts retained. Receipts should be sequentially numbered.	**Cash sales** Check amounts in receipt books or on till rolls to paying-in slips, the cash book and bank statements. Check whether bankings are made daily. Check payments out of cash takings, if any. Check for evidence that till roll totals or receipts totals are checked against cash received by an authorised person.

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Control objectives	Principal controls	Tests of control
All money received is banked	There should be daily banking, if possible.	Check the frequency of banking receipts.
	The amount of cash payments received should be recorded, and subsequently checked against the amount banked.	Check that receipts are recorded in the cash book and that the bank statement matches the cash receipts recorded on a daily basis.
Proper safeguards should exist over money held	**Bank** There should be established procedures for opening new bank accounts. There should be restrictions on individuals authorised to prepare and hold cheques. There should be safe custody of cheque books. In a manual system there should be no pre-signed cheques. In an IT system there must be strong physical controls over access to pre-signed cheques, such as being kept in a safe until the next payment run and batch and control totals used over cheque numbers.	**Bank** Confirm that new bank accounts have only been opened under established procedures. Observe which individuals are involved with company cheques. Enquire as to custodyof cheque books and check to see whether any cheques are blank and pre-signed. In an IT system, observe a payment run and that pre-signed cheques are removed from the safe immediately before being printed and returned immediately afterwards. Arrange for a cheque to be missed out of the run and ensure the system flags it up as missing.
	Cash Notes and coin should be kept in a secure place, such as a safe. Only a very limited number of employees should have access to the cash. Receipts of cash and payments of cash must be recorded.	**Cash** Review the nature of cash payments made. Observe cash custody procedures.

Control objectives	Principal controls	Tests of control
All payments should be properly authorised, made to the correct person and are properly recorded	**Cheque payments** Cheque requisition forms should be used to request payments, backed by supporting documentation.	**Cheque payments** Review paid cheques for payee, date, amount andsignature.
	Cancellation of documentation once cheque has been prepared. There should be established authority levels for cheque signing (usually two signatures required for cheques above a certain amount). Payments must be recorded promptly. All cheques must be numbered sequentially.	Agree payments in the cheque book (or automated payment listing) to entries in the accounting records, bank statements and supplier statements. Review the documents supporting requisitions for payment. Review the sequence of cheque numbers (see also above under safeguarding pre-signed cheques).

5.3 Pettycash

Risks and control objectives

Risk	Controlobjective
Petty cash may be stolen.	To avoid or reduce the risk of petty cash being stolen.
Spending from petty cash may not be properly authorised.	To ensure that all spending out of petty cash is properly authorised
Incorrect amounts may be withdrawn from the bank when replenishing petty cash to the upper limit.	To ensure that only the correct amounts of cash are withdrawn from the bank to go into petty cash.
Spending out of petty cash may not be recorded, or may be recorded incorrectly.	To ensure that all spending out of petty cash is accounted for.

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Principal controls

The controls that commonly apply to petty cash systems (where the *imprest* system is used), and tests of those controls, are as follows.

Control objectives	Principal controls	Tests of control
To avoid or reduce the risk of petty cash being stolen	Petty cash should be kept in a locked cash box in the office safe, or if there is no safe in a locked drawer in the accountant's desk. This is a basic physical control over cash. The maximum amount held in petty cash should be restricted to about one month of petty cash spending. This is to avoid holding unnecessarily large amounts of cash that might be stolen. There should be occasional checks of petty cash by a senior person (not the person responsible for holding and issuing petty cash) to ensure that the person responsible for holding petty cash has not been taking money fraudulently.	Observe that petty cash is kept physically secure. Review the journal entries for petty cash and confirm these are not for more than one month of petty cash spending. Examine documentary evidence to determine how frequently the checks of petty cash by an appropriate individual not responsile for holding or issuing petty cash occur. Determine whether any discrepancies noted in these checks are investigated.
To ensure that all spending out of petty cash is properly authorised	All petty cash spending should be authorised in advance by a properly authorised person (and not by the person withdrawing the cash). Authorisation should be indicated by signing and dating the petty cash voucher which is kept in the petty cash box until the petty cash is 'topped up' the next time and the petty cash expenses are recorded in the petty cash book.	Check a sample of petty cash vouchers have been signed and dated by an appropriate individual.

Control objectives	Principal controls	Tests of control
To ensure that only the correct amounts of cash are withdrawn from the bank to go into petty cash	When money is withdrawn from the bank to 'top up' petty cash, the amount of the cheque for the cash withdrawal should be checked against the total of the petty cash vouchers in the petty cash box. The amount of cash withdrawn should equal the total on the petty cash vouchers since the previous cash withdrawal from the bank.	Observe the process of cash withdrawal to 'top up' petty cash to ensure that the total cash withdrawal is checked to the total petty cash vouchers.
To ensure that all spending out of petty cash is accounted for	All withdrawals of petty cash should be recorded on a petty cash voucher and vouchers must be sequentially numbered. This is to prevent the fraudulent withdrawal of cash and failures to record cash withdrawals Receipts should be provided for petty cash spending and attached to the petty cash voucher. There should be a system for the regular recording of petty cash expenses in the petty cash book. Each entry in the petty cash book should include the voucher number, to provide a check that all expenses are recorded (a check on completeness)	Confirm that all (or a sample of) petty cash vouchers have a receipt attached. Check that petty cash vouchers are sequentially numbered and are issued in order. Check that every entry in the petty cash book has a corresponding voucher number. For a sample of entries in the petty cash book, determine whether these have been recorded on a timely basis by agreeing to the date on the voucher and receipt.

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6 THE INVENTORY SYSTEM AND NON-CURRENT ASSETS

Section overview

- The inventory system
- Non-current assets

6.1 The inventory system

Inventory is often a 'material' aspect of the financial statements and can also be a relatively high risk area. Consequently, the auditor will usually want some assurance as to controls in place for inventory.

The tests of control suggested below do **not** repeat tests which have been dealt with in respect of sales and purchases. The tests here focus on other aspects, primarily inventory movements and security. Audit work on the valuation of inventory is normally performed at the substantive testing stage and will be dealt with in a later chapter.

The main **risks** associated with inventory are as follows:

- Inventory records are inaccurate.
- Inventory may be stolen or damaged.
- Inventory may be valued at incorrect amounts.
- Too little inventory may be held, so that customers' orders cannot be fulfilled.
- Too much inventory may be held, and therefore too much money tied up.

Control objectives	Principal controls	Tests of control
Recording inventory		
Inventory records should be complete, accurate and include only items belonging to the company. All inventory movements should be recorded and authorised.	There should be segregation of duties (ordering inventory, custody of inventory, accounting for inventory). There should be proper documentation for all issues of inventory from the store. All goods received should be checked and recorded Appropriate inventory records should be properly maintained.	The auditor can look for evidence that inventory movements (as recorded in the inventory department) agree with despatch documents and goods received documents. The auditor should look for documentation providing evidence that inventory movements are properly authorised.

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Control objectives	Principal controls	Tests of control
Physical safeguards		
Inventory is protected against loss and damage.	There should be restricted access to storage areas. Regular inventory counts should be performed using appropriate procedures.	The auditor should look for compliance with access restrictions. The auditor should obtain confirmation that periodic inventory counts are performed, and that counts are checked against records of what inventory levels should be.
Valuation		
Inventory should be correctly valued at the lower of cost and net realisable value.	IAS 2 should be applied. There should be procedures for identifying obsolete and slow moving inventory items.	The auditor should look for evidence of how inventory valuations are reviewed, in order to apply the principles of IAS2.
Inventory management		
Appropriate levels of inventory should be held at all times.	There should be maximum and minimum inventory levels for all inventory items of value. There should be appropriate re-order levels and re-order quantities.	The auditor should carry out a review for excessive inventory levels (possibly via exception reports in an IT system). (This check is often performed in conjunction with the inventory count or ‘stock take”). The auditor should also monitor the frequency of out-of-stock situations.

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6.2 Non-current assets

The main **risks** associated with non-current assets are as follows:

- Non-current assets which the company does not need could be ordered.
- Expenditure on non-current assets may be recorded at incorrect amounts, or as revenue instead of capital expenditure.

Control objectives	Principal controls	Tests of control
Authorisation		
All expenditure on non-current assets should be properly authorised.	Appropriate authorisation procedures should be in place. Documentation and analysis should be produced to support (capital) expenditure requests. There should be approval procedures for the payment of invoices to the suppliers of non-current assets.	Many tests of control for the purchase of non-current assets are similar to those for the purchase of inventory items. The auditor should also look for documentary evidence of capital expenditure authorisations.
Recording		
All expenditure on non-current assets should be properlyrecorded. Expenditure should be properly analysed as capital or revenue.	Invoices must be analysed and account codes entered on the invoices. Management should review the analysis of purchased items as capital or revenue items, to ensure compliance with standard accounting practice.	The auditor should check the capital/revenue analysis of invoices. The auditor should check that entries are made in the non-current asset register.
Rights and obligations		
The entity has rights to non-current assets purchased and recorded.	Ownership documentation (e.g. invoices, contracts, leases, title deeds for property) should be checked to ensure the entity owns the non-current asset prior to recording in the non-current assets register.	The auditor should look for documentary evidence of checking of ownership. The auditor should check ownership documents for a sample of additions and ensure they relate to the entity.

7 OTHER ISSUES WITH TESTS OF CONTROLS

Section overview

- Tests of controls in smaller entities
- Exam technique: generating controls and tests of control

7.1 Tests of controls insmaller entities

Control systems in smaller entities are often less sophisticated than those in larger organisations. This is largely due to a lack of resources. In particular, a proper segregation of duties is often very difficult in small entities. It is also likely in small entities that there will be extensive involvement in control activity by senior management or the entity's owner.

In the case of smaller entities, the auditor will look for the existence of 'minimum business controls'. The minimum business controls should be identified, recorded and tested, as in any other type of control system.

The auditor is unlikely to be able to use the controls existing in a small entity as a basis for using a systems-based approach to the audit; therefore, a large amount of substantive testing is likely to be adopted. However, the auditor may be able to rely on the controls which are in place as a means of gaining assurance on certain aspects of the audit, for example on the completeness of the accounting records.

7.2 Examtechnique: generating controls and tests of control

Most of this chapter has presented lists of risks, control objectives, internal controls and tests of control, for different aspects of business and accounting operations. You do not have to learn all these lists, because each accounting system and each business is different. Their control objectives and appropriate controls also differ.

What you may need to be able to do in the exam is to apply general principles to any particular system or business described in an exam question.

The approach that we recommend is the approach that has been explained and illustrated in this chapter. However, it is extremely important that you should understand this approach so that you can apply it in the exam. It is worth summarising again!

- ❑ Consider the things that could go wrong with the system. This should give you the**risks.**
- ❑ Consider what the controls will need to achieve in order to mitigate those risks. This should give you the **control objectives**.
- ❑ Think of **controls** which would help to **prevent** or **detect** the problem. You may be able to base these on some of the examples given in this chapter. Alternatively, you may find it helpful to use the list of control activities from ISA 315 and their sub-types (performance reviews (including management controls), application controls (including authorisation, arithmetic and accounting controls), general IT controls, physical controls and segregation of duties).

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- Design audit procedures to **test** the operation of the control. In doing this, you may find it helpful to think of the key audit testing procedures – inspection, observation, enquiry, confirmation, re-calculation and re-performance and to consider the use of test data.

Example: Controls

Your audit client operates a chain of fast-food restaurants. Six types of standard meals are available and are heated when customers place their orders. The meals are ordered weekly by the restaurant managers from the distribution centre at head office. At the end of each week, unused meals from the previous week are sent back to the distribution centre for disposal.

Required

List the controls which your client should have in operation to prevent losses to the entity as a result of the above system.

Answer: Controls

- Managers should be required to produce a monthly reconciliation of meals bought, meals sold and meals returned to head office.
- Meals sold per this reconciliation should be agreed to the monthly sales figure (a difference could indicate theft).
- Where returns are above a pre-determined level, management at head office should investigate to identify over-ordering or a downturn in demand.
- Where returns are verylow, management at head office should investigate to ensure that customers have not been turned away due to a lack of inventory.
- Strict physical controls should operate to ensure that inventory is not damaged intransit (e.g.refrigerated lorries) or once at the branch (e.g. sufficient, properly working refrigerators).
- Authorisation limits should be set for the number of meals any branch can order (based on budgets and past usage).
- Head office should carry out surprise inventory counts at branches.

As an alternative, the examiner might require you to identify the risks to which a business might be exposed as a result of poor internal controls. These risks are the same as the control objectives not being met (for example, for sales, the risk that not all goods dispatched are invoiced). However, you could also be asked to set out the **consequences of those risks** and suggest **controls** which would address them.

Example: Consequences

An entity selling goods on credit terms is exposed to the risk of invoicing errors.

Required

Set out the possible consequences of the above risk and suggest suitable internal controls which could be implemented to address the above risk.

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Answer: Consequences

Possible consequences

- Sales and receivables will be misstated.
- Customer goodwill may be lost, if they are charged too high a price (especially if this happens repeatedly).
- The time taken to correct the errors will result in delays in the payment of invoices by customers and could lead to cash flow problems. (If customers have been undercharged the difference may never be recovered.)
- If process charged or quantities entered are too low goods could be despatched to customers who would have been over their credit limits if the correct price had been charged. Again, this may result in the non-recovery of debts.

Internal controls to address

- Invoice checked for accuracy with respect to dispatch note details, pricelist and any discounts agreed with that customer (or generally available for bulk purchases) and casts checked.
- Or, in an IT system, invoice produced automatically with strong physical controls over master files and good general IT controls).
- Data entry edit controls (e.g. field and range checks) if invoices are raised individually but then put on to an IT system.
- Independent authorization of amendments to customer details and price lists.
- Amendments to standing data printed out and reviewed.

Example:

Using the list of internal controls in the example immediately above, set out the audit procedures you could use to test the operation of each of those controls.

Answer

- Select a sample of sales invoices, check costs and agree to details per dispatch note, master price list and bulk/customer specific discounts.
- Input a sample of dummy dispatch notes and ensure invoice generated by the system is accurate.
- In put a sample of dummy sales invoices, with prices/amounts outside the pre-set parameters and within complete files to ensure these are rejected by the system.
- Review amendment forms for customer details or prices and ensure properly authorised.
- Review printouts of standing data amendments for evidence of review.

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8 CHAPTER REVIEW

Chapter review

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

- Understand the key transaction cycles and associated controls for
  - Sales
  - Purchases and expenses
  - Payroll
  - Bank and cash
  - Inventory
  - Non-current assets
- Discuss controls in smaller entities
- Plan tests of controls
- Describe computer assisted audit techniques

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Quick quiz questions

1 Which one of the following is NOT an internal control you would expect to see in a sales system?

A All goods received notes are authorised by the customer

B All orders are checked against credit limits

C All invoices are recorded on pre-numbered sequential documents

D All cash is banked on the same day as it was received

2 Which one of the following is NOT an internal control you would expect to see in a purchases system?

A Preferred suppliers are used

B All invoices are stamped to create the company's own invoice system

C Employees are only paid for work done

D There is a list of authorised cheque signatories

3 Which of the following is NOT an internal control?

A Authorising purchase orders

B Ensuring cash is locked away

C Performing an external confirmation of receivables

D The opening of the post should not be the same person who banks the cheques

4 Which of the following is a transaction cycle?

A Bank and cash

B Inventory

C Payroll

D Non-current assets

5 Which of the following is NOT a main element of the sales transaction cycle?

A Receiving orders from customers

B Marketing

C Despatching the goods and invoicing customers

D Recording sales and debtors in the accounts

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Quick quiz answers

1 A

2 C

3 C

4 C

5 B

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Skills level
Audit and Assurance

CHAPTER 9

Introduction to substantive procedures

Contents

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INTRODUCTION

Competencies

Gathering evidence

The nature of audit evidence and the selection of sufficient appropriate audit evidence (ISA 500)

C2	Evaluate the different sources and quality of evidence and the methods of obtaining evidence. *(See also chapters 6, 8,10-12)*
C3	Document appropriate procedures for gathering evidence based on a given scenario (ISA 505, ISA 520). *(See also chapters 6, 8,10-12)*

Exam context

Substantive procedures typically represent a significant element of fieldwork performed during a statutory audit engagement and are therefore a critical element of the syllabus.

Chapters 9-12 describe the various substantive procedures commonly performed on the statements of financial position and comprehensive income. Students must ensure they link substantive tests to specific assertions and risks to ensure they understand the objective of each procedure. Therefore we re-visit in greater detail the assertions that were introduced in an earlier chapter.

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

- Describe the nature of substantive procedures
- Explain the financial statement assertions
- Understand different methods of obtaining substantive evidence
- Describe directional testing
- Understand when and why analytical procedures are used
- Use common ratios

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1 THE ROLE OF SUBSTANTIVE PROCEDURES

Section overview

- The nature of substantive procedures
- Financial statement assertions
- Exam technique: devising tests of detail
- Use of audit software
- Auditing around the computer
- Methods of obtaining audit evidence for substantive testing
- Directional testing
- The significance of the audit of statement of financial position items

1.1 The nature of substantive procedures

Previous chapters have dealt with the planning stage of the audit and with the auditor's work on understanding, evaluating and testing the accounting system and control systems in place.

In accordance with ISA 330, the auditor will also do some substantive testing. He may decide, as a result of his risk assessment, to adopt a systems-based audit approach to the audit. On the other hand, his assessment may lead him to adopt a transactions-based approach (a wholly substantive approach). No matter which approach he takes, systems-based or transactions-based, he will do some substantive testing.

Substantive procedures are audit procedures performed to detect material misstatements in the figures and presentation & disclosures reported in the financial statements.

❑ They are designed to generate evidence about the **financial statement assertions** (discussed in a previous chapter, as set out in ISA 315).

❑ Theyinclude:

  - **tests of details** on transactions, account balances and disclosures, and
  - analytical procedures.

ISA 330 also **requires** that, whatever level of substantive procedures are carried out, the auditor must carry out the following procedures:

❑ Agree or reconcile the financial statements to the underlying accounting records.

❑ Examine material journal entries.

❑ Examine other adjustments made during the course of preparing the financial statements.

1.2 Financial statement assertions

Evidence is obtained by the auditor to enable him to form an opinion and prepare an audit report on the financial statements. In order to do this, the auditor has to look for evidence that supports the financial statement assertions. These are the assertions that are made in the financial statements by the directors of the company.

These assertions have been described in an earlier chapter, but it is important that you should be able to recognise and understand them. The assertions are also useful when you are asked to generate tests of detail for a particular area, as discussed later in this section.

Financial statement assertions fall into three categories:

- **classes of transactions or events** (income statement) assertions:
  - occurrence
  - completeness
  - accuracy
  - cut-off
  - classification
- **account balances** (statement of financial position) assertions:
  - existence
  - rights and obligations
  - completeness
  - valuation
- **presentation and disclosure** assertions:
  - occurrence and rights and obligations
  - completeness
  - classification and understandability
  - accuracy and valuation.

Completeness

In preparing their financial statements, the directors of a company are making the assertion that the financial statements are complete. No assets, liabilities, equity, transactions or events have been omitted that should be included.

The assertion of completeness is therefore an assertion that **there is no understatement** of amounts in the financial statements.

There is also a completeness assertion for presentation and disclosure. The directors are asserting that all disclosures that should have been included in the financial statements have been included. This would be particularly important in an area such as provisions.

Occurrence

Occurrence is the assertion that **disclosed transactions** included in the financial statements did actually occur during the financial period. The assertion of occurrence:

- relates to **transactions**, and **presentation and disclosure**, rather than assets and liabilities, and
- is an assertion that **there is no overstatement** of the amount of transactions reported in the financial statements.

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Existence

This is the equivalent to the occurrence assertion for **assets, liabilities and equity**. The directors are making the assertion that assets, liabilities and equity reported in the statement of financial position did exist at the end of the reporting period.

As with the occurrence assertion for transactions, it is an assertion that **there is no overstatement** of assets, liabilities or equity in the statement of financial position.

This assertion of existence is extremely important, and a large part of an audit is directed towards obtaining evidence that this assertion is correct.

Accuracy and Valuation

This is the assertion that transactions, events, assets, liabilities and equity are recorded at appropriate amounts in the financial statements.

"Accuracy" relates to **transactions** in the income statement/statement of comprehensive income, particularly the measurement of revenue, purchases and other expenses. "Valuation" relates to **assets, liabilities and equity** in the statement of financial position.

There is also an "accuracy and valuation" assertion for presentation and disclosure. The directors are asserting that information has been disclosed fairly and at appropriate amounts.

Rights and obligations

The assertion of rights and obligations relates to **assets, liabilities and equity** and to **presentation and disclosure**:

- The directors are asserting that the reporting entity has the rights to the assets disclosed in the statement of financial position. These are often the legal right of ownership, but they could be other rights. (Leased assets, for example, are not legally owned by the lessee, but the lessee has economic rights over the leased asset.) For example, the auditor may need to check the legal ownership of inventory that is held by a company: the company may have the legal title to the inventory; on the other hand, the legal ownership may still belong to the supplier, who has provided the inventory on a 'sale or return' basis.
- The directors also assert that the reporting entity has obligations for the liabilities disclosed in the statement of financial position.

Cut-off

The cut-off assertion relates to **transactions and events**. The directors assert that transactions have been **recorded in the correct accounting period**. This will be particularly important where revenue is received in advance or expenses are paid in advance or arrears.

Classification and Understandability

The classification assertion relates to **transactions and events**. The directors assert that transactions have been **recorded in the proper accounts.** So, for example, purchases of goods for resale have been posted to a "purchases" account, and purchases of stationery to perhaps a "stationery and postage" account.

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The classification assertion is also related to **presentation and disclosure**, along with understandability. The reporting entity asserts that financial information is appropriately presented and described and disclosures are clear. For the above examples, this would mean that purchases are categorised within “cost of sales” on the income statement/statement of comprehensive income and stationery and postage is include within, probably, “administrative expenses”. But this presentation and disclosure assertion also relates to the statement of financial position – assets, liabilities and equity also need to be appropriately classified and any necessary disclosures made.

1.3 Examtechnique: devising tests of detail

The following chapters describe a variety of substantive procedures that an auditor might carry out. In your exam, you might be asked to suggest what substantive procedures ought to be carried out in a particular situation. Each accounting system and business is different, and substantive procedures that might be appropriate in one situation would be inappropriate in another. What you need to be able to do in the examination is apply general principles of substantive testing to the particular system or business described in the question.

One possible approach to devising tests of detail is as follows (analytical procedures are considered later in this chapter):

- **What am I being asked to test?** Start by asking what it is that you should be trying to test, and obtain evidence about. Usually you will be asked to test for any misstatement, but sometimes you might be asked to test only for:

    - overstatement (occurrence of transactions or existence of assets or liabilities) or
    - understatement (completeness),or
    - one particular aspect of an item (for example, the valuation of an asset).

    To decide what you are testing for, think about the financial statement assertions. Which of these do you want to test?

- **How does the system operate and what documents exist?** You should think about the specific system described in the examination question, and write down some ideas at this stage.

- **What special tests are used for this area?** There may be some audit tests that are particularly relevant to the system described in the question. Certain statement of financial position items have specific tests, such as a year-end inventory count for inventory (that the auditor can attend) or ‘direct confirmation’ as a method of verifying receivables’ balances.

- **What tests can I think of?** To devise tests of detail, you should think about what method or methods are appropriate for gathering the evidence you are looking for. For example, in an IT system, the auditor will need to consider the use of audit software (see below).

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1.4 Use of audit software

In a previous chapter, the use of computer-assisted audit techniques (CAATs) was introduced. There are two types of CAATs: test data and audit software. Test data is primarily used in the testing of controls. **Audit software** is primarily used for **substantive testing**.

Audit software is computer programs used by the auditor to extract information from a computer-based information system, for use in the audit. The main types of audit software include:

- interrogation programs, to access the client's files and records and extract data for auditing
- interactive software, for use in interrogation of on-line IT systems
- 'resident code' or 'embedded' software, to monitor and review transactions as they are being processed by the client's programs. This type of software is called 'embedded audit facilities'.

Audit software is used to extract and analyse information in the entity's IT systems for use in the audit work. Here are some examples:

- Account analysis. Audit software may be used to interrogate the client's data files for the general ledger, and extract from the files all items above ₦5,000 in the repairs expense account.
- Calculating ratios and making comparisons. Audit software can be used to assist the auditor with analytical procedures (which are described later in this chapter).

Example: using audit software to test the receivables balance

Audit software may be used in several ways to help with testing the receivables balance, where the client operates a computerised sales and receivables accounting system.

Software can be used to total the balances on the accounts in the receivables ledger, for comparison with the balance on the receivables control account.

Software can also be used to check the balance on each account in the receivables ledger with the credit limit for that customer, to check that credit limits have not been exceeded.

There may also be a computerised reasonableness check on the balances in each customer's account in the receivables ledger. This check looks for unusually high or low balances in individual accounts, given the total volume and value of transactions in the account.

- Software can be used to prepare an aged receivables list, if these are not already produced by the client as a matter of operational routine.The audit software can interrogate the trade receivables file, and produce a list and analysis in date order of unpaid invoices. This listing can be used by the auditor to make an assessment of the receivables that may be irrecoverable.
- Software can be used to select the sample of receivables ledger balances for substantive testing in the audit.
- Software can also be used to calculate ratios (analytical procedures): for example, an analysis of 'average days to pay' and changes in this ratio over time may help the auditor with an assessment of likely irrecoverable debts and possibly also the going concern assumption for the client.

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Example: audit software

You have been put in charge of the audit of inventory at Kitchen Magic, a wholesaler of kitchen goods. Kitchen Magic keeps a permanent record of inventory on its IT system and carries out a rolling programme of inventory counts to check that the record on the system is reflected by actual goods held.The year-end inventory will be listed for you, showing for each product: date of last purchase, date of last sale, cost, selling price, quantity and year-end valuation. This schedule will be available on the last day of the year.

Required

List the tests which could be performed by audit software which will assist you in your audit of inventory.

Answer: audit software

- Cast the year-end inventory schedule.
- List out all items over a pre-set amount (at least the materiality threshold) (for subsequent physical verification).
- For each item on the schedule multiply the lower of cost and selling price~~×~~ times quantity and list out any items where this figure does not agree to the year- end valuation.
- Compare prices to those on the current sales price master file.
- List out any items where the date of the last purchase was more than, say, one month ago (as this may indicate that the product is obsolete/damaged/no longer in vogue and may need to be written off).
- List out any items where the date of the last sale was more than, say, one month ago (as, again, this may indicate that the product is obsolete/no longer in vogue and may need to be written off).
- List out any items which do not appear on the post year-end sales listing for the first, say, month of the year (again, may indicate that a provision is needed).

***Tutorialnote:** If these tests were being carried out manually then only a sample would be checked .Due to the speed of computer software it is feasible to check all items.*

Embedded audit facilities

Embedded audit facilities may also be called ‘resident audit software’ or an ‘integrated audit module’. It is audit software that is built into the client’s IT system, either temporarily or permanently.

The purpose of embedded audit facilities is to allow the auditor to carry out tests at the time that transactions are being processed, in ‘real time’.

This can be very useful for the audit of online systems where:

- data is continually processed and master files are being continually updated, and/or
- it is difficult, if not impossible, for the system to provide a satisfactory audit trail for following transactions through the system.

An embedded audit facility may also print out details of the transactions it has monitored, or copy them to a computer file, so that the auditor can study the transactions.

Problems with using audit software

Audit software may need to be written so that it is compatible with the client entity's IT system, and can therefore be expensive to use, particularly in the following circumstances.

- When it is being used for the first time for a client, so that the audit firm has set-up costs.
- The client entity changes its accounting system, so that new audit software is needed.
- There may be problems with producing suitable audit software when the client has an old purpose-written IT accounting system for which there is incomplete system documentation.

The auditor should also be aware of the possibility that if he uses copies of the client's files for carrying out tests with audit software that the client may provide a file that is not actually a copy of the current 'live' files. When using copies of client files, the auditor should insist on being present to observe the copying of the files, to make sure that they are 'genuine'.

1.5 Auditing around the computer

An alternative to using audit software to carry out checks within the client's IT system, an auditor may choose to audit 'around the computer'. With auditing around the computer, the client's internal software is not audited. Instead, inputs to the system are checked and agreed with the outputs from the system. The auditor looks at input to the system, and compares the actual output with the output that should be expected.

Auditing around the computer has greater audit risk than auditing of the client's internal software, because:

- If the actual files or programs are not tested, there will be no audit evidence that the programs are functioning properly, as documented
- Where the auditor finds discrepancies between the input to the system and the output from the system, there is no way of finding out how the discrepancy has occurred. This in turn increases the risk that the auditor will be unable to write an unqualified audit report.

1.6 Methods of obtaining audit evidence for substantive testing

The methods of obtaining audit evidence have been described in an earlier chapter. It is important that you should know what they are, and be familiar with them. They are:

- **Inspection**. Obtain evidence about an item by going to look at it. For example, an auditor can obtain evidence about the existence of tangible non-current assets by going to look at them.
- **Observation**. The auditor can obtain evidence by watching a procedure and seeing how it is carried out.
- **Inquiry**. Evidence can be obtained by asking questions. For example, evidence about the existence of trade receivables can be obtained by

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asking customers on the list of trade receivables to confirm that they do owe the amount of money that the client company asserts.

- **Confirmation.** This is a specific type of inquiry where the auditor seeks confirmation from a party outside the entity, for example, from a bank or a customer.
- **Re-calculation.** The auditor checks the arithmetical accuracy of documents or records.
- **Reperformance.** The auditor re-performs a check or control originally carried out by the client.
- **Analytical procedures**. These are described in more detail later in this chapter.

Example: year-end inventory

Continuing with the example above, concerning the audit of year-end inventory at Kitchen Goods.

Required

Describe a test using each of the above procedures (with the exception of analytical procedures).

Answer: year-end inventory

Inspection: Trace items from the year-end inventory schedule to the actual goods.

Observation: Observe counting of inventory during the year to gain evidence as to the accuracy of the inventory records.

Inquiry: Inquire of management as to the need for a year-end inventory provision.

Confirmation: Write to third parties who the client says hold goods included in the entity's year-end inventory to confirm the existence and condition of that inventory.

Recalculation: Use audit software to cast the year-end inventory schedule.

Reperformance: Use audit software to re-perform the aging of the year-end inventory schedule.

How reliable is audit evidence?

To reach an opinion about the financial statements, the auditor needs to obtain sufficient, appropriate audit evidence.

This has already been explained in the context of audit evidence and the auditor's assessment of the internal controls and their effectiveness. Where inherent risk and control risk are high, the auditor needs more evidence from substantive testing, to reduce the detection risk.

But how reliable is the evidence obtained from substantive procedures? The following general guidelines from ISA 500 may be useful:

- Evidence obtained from sources outside the client company ('external sources') is more reliable than evidence obtained from the client company's own records. For example, an auditor may receive written confirmation from a customer of the client that the customer is a trade receivable owing a stated amount of money. This is more reliable than evidence in the form of

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a copy of the invoice in the files of the client company.

- Evidence obtained from the client company's own records is more reliable when the internal control systems of the client company operate effectively.
- Evidence obtained by the auditors themselves, for example, through inspection and analytical procedures, is more reliable than evidence obtained from the client company's staff or records.
- Documentary evidence is more reliable than evidence obtained orally (for example, as answers to questions).

These are guidelines about the reliability of audit evidence, not rules. An auditor must use his judgement in deciding whether the evidence he has obtained is sufficient and appropriate, so that it can be treated as reliable. Where evidence is not sufficient or appropriate, the auditor should look for more evidence; otherwise, his eventual audit opinion will be affected.

Reliability of documentary evidence

It follows that the reliability of documentary evidence depends on its source:

- The least reliable documentary evidence is documents held within the client company that the client has created itself, such as sales invoices.
- Documentary evidence is more reliable when it is held within the client company but has been created by an external entity, such as suppliers' invoices or a bank statement.
- The most reliable documentary evidence is a document obtained from an external entity and held by the auditor. An example is a written confirmation by a customer of the client about the amount of money that it owes.

1.7 Directional testing

Introduction

With substantive testing, the auditor is normally interested in detecting two main types of misstatement:

- **errors** which may result in either **under or overstatement** of figures
- **omissions**, which result in **understatement**.

Testing for overstatement (existence or occurrence)

The auditor might be concerned that there are:

- assets or liabilities in the Statement of Financial Position that do not exist; and/or
- income or expenses in the Statement of Comprehensive Income that did not occur.

For example fictitious inventory (debits) might be recorded to enhance the Statement of Financial Position which is then offset in the system of double entry by fictitious sales (credits) recorded to boost profit in the Statement of Comprehensive Income.

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Therefore the golden rule is:

- ❑ If the auditor is carrying out tests to detect **overstatement**, the starting point should be the figures **in the accounting records**.i.e.

Illustration: Testing for overstatement (existence or occurrence)

Let's look at an example.

Example: directional testing – overstatement (existence or occurrence)

Testing trade receivables balances for overstatement (existence)

1. 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.
2. One way of doing this is to write directly to customers on the list asking them to confirm the amount that they owe the entity. Alternatively, if the auditor is checking documentation within the client entity, he can take a sample of receivables from the list of balances, and trace their existence backthrough the accounting records, from receivables ledger to sales day book (receivables day book) to invoice.

Testing for understatement (completeness)

The auditor might be concerned that there are:

- ❑ assets or liabilities missing from the Statement of Financial Position; and/or
- ❑ income or expenses not recorded in the Statement of Comprehensive Income.

For example in order to boost profits a company might not record all of its purchases. In which case purchases (debits) will be missing (understated) from the Statement of Comprehensive Income and the associated trade payables (credits) missing from the Statement of Financial Position.

The second golden rule is:

- ❑ If the auditor is carrying out tests to detect **understatement**, the starting point should be a source **outside the accounting records**.

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Illustration: Testing for understatement (completeness)

Let's look at an example.

Example: directional testing – understatement (completeness)

Testing trade payables balances for understatement (completeness)

1. To test payables for completeness there is no point in taking as a starting point the entity's list of payables balances.This may not be complete when in fact the auditor is testing for completeness (i.e. to see if any entries are missing)!

   Instead, the auditor may write to regular suppliers who they expect to be year – end creditors.

   Alternatively, the auditor might 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, supplier statements, unpaid invoices or subsequent disbursements (payments).

   In both cases this is referred to as sampling a '**reciprocal population'**.

2. The auditor would then trace either:

   - The balance advised by the regular supplier back to the detailed list of trade payables; or
   - the specific purchase from the goods received notes, supplier statement, unpaid invoice or subsequent disbursement through the system from purchase invoice to purchases day book to payables ledger.

Summary

So in summary, for directional testing to be effective, it is important that the auditor selects the correct starting point for the test.

- ❑ If the auditor is carrying out tests to detect **overstatement**, the starting point should be the figures **in the accounting records**.
- ❑ If the auditor is carrying out tests to detect **understatement**, the starting point should be a source **outside the accounting records**.

Points to consider

Understatement is much more difficult to detect than overstatement. This is because when he is looking for understatement of items in the financial statements, the auditor is trying to audit something that is not there – he is checking for **completeness**. With overstatement, he is checking that what is there is valid, and this is a check for **existence** or **occurrence**.

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Directional testing is used by the auditor to detect both over and understatements. This technique is based on double entry principles.

The basic principle of directional testing takes, as a starting point, that the trial balance of the client entity balances, and that therefore the total of debit balances in the general ledger equals the total of credit balances. Finding one error in the balances means that there must also be at least one other error somewhere else in the balances.

The following conclusions can therefore be made when the auditor finds an error with substantive testing.

- If the auditor finds, say, an overstatement of a debit entry, there must also be a corresponding understatement of another debit entry or an overstatement of a credit entry. (Otherwise, the trial balance totals of debits and credits would not be equal.)
- Similarly, if the auditor finds an understatement of a credit balance for one item, there must be either an overstatement of another credit balance or an understatement of a debit balance.

This approach also allows the auditor to work in a cost-effective and efficient way. A ‘mechanical approach’ to using directional testing would be:

- **the auditor tests debit items (assets and expenses) for overstatement only**
- **he tests credit items (liabilities, income and equity) for understatement only**.

Note however that many corporate scandals and money laundering frauds involve the overstatement of income (a credit) rather than its understatement. Therefore it is important to always remember the principles of risk-based auditing and focus resources on the higher audit-risk areas, whatever they have been judged to be, rather than simply applying a mechanical approach.

1.8 The significance of the audit of statement of financial position items

The auditor will usually pay more attention to the statement of financial position than to the income statement/statement of comprehensive income. The reason for this is that if the current statement of financial position is ‘correct’ and if the previous statement of financial position was correct, then the profit figure linking the two statements of financial position must also be correct.

The emphasis of the statement of financial position audit will be on the verification of assets and liabilities, rather than the verification of equity. If assets and liabilities are correctly stated, equity (assets minus liabilities) will also be correctly stated.

This is all a question of emphasis – the auditor will not ignore the income statement /statement of comprehensive income or equity, but these items will generally receive a lower level of audit attention (and audit time and resources) than assets and liabilities.

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The auditor will carry out tests to gain evidence on all the relevant financial statement assertions, but to make the audit as efficient as possible, the emphasis of the audit will be focused as follows:

- Assets:
  - existence
  - rights and obligations (ownership), and
  - valuation
- Liabilities:
  - completeness,
  - cut-off, and
  - accuracy.

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2 ANALYTICAL PROCEDURES: ISA 520

Section overview

- Using analytical procedures
- The nature of analytical procedures
- Analytical procedures in substantive testing
- Investigation of fluctuations and relationships
- Common ratios

2.1 Using analytical procedures

Analytical procedures were referred to earlier as one of the procedures for generating audit evidence. The full picture is that analytical procedures **must** be used:

- **At the audit planning stage**, in order to:
  - gain a better understanding of the client entity and its business,and
  - identify areas of high audit risk: audit procedures can then be targeted at the areas of highest risk. This stage is covered by ISA 315, as discussed in a previous chapter.
- At the end of the audit, **in the overall review of the audit**, to assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with his understanding of the entity.

Analytical procedures **may also** be used:

- **as a substantive procedure** during the audit, in the audit work on the income statement and statement of financial position (to look for possible material misstatements during the audit rather than later, in the end-of-audit review).

ISA 520 *Analytical procedures* is concerned with the second two stages.

2.2 The nature of analytical procedures

"Analytical procedures" are defined by ISA 520 as "evaluations of financial information through analysis of plausible relationships among both financial and non-financial data". Analytical procedures also encompass investigation of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

ISA 520 states that analytical procedures include:

- The consideration of comparisons of the entity's financial information with, for example:
  - Comparable information for prior periods
  - Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
  - Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

- Analytical procedures also include consideration of relationships, for example:
  - Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
  - Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Illustration: Analytical procedures

Ratiosmightbeusedtomakecomparisonsandidentifytrendstoassesswhether they seem reasonable. The auditor can look for unusual features or inconsistencies. If a ratio seems unusually high or low or a trend unexpectedly changes,this might indicate that one of the two figures used to calculate the ratio is either abnormally high or abnormally low. The oddity can then be checked in more detail.

If key ratios are close to what they are expected to be, the auditor may take this as evidence that the relevant balances or transaction amounts are reliable and 'accurate'. If a ratio is very different from what is expected, the auditor should investigate the reason for the variation.There may be a good reason why a ratio differs from its expected value.On the other hand,a ratio might have an unusual value because there is a misstatement in the financial statements.

Comparisons

One essential feature of analytical procedures in auditing is 'comparison'. The auditor will calculate key relationships between figures (non-financial figures as well as financial figures) and then make comparisons.

Comparison with	
Prior accounting periods	To establish patterns and trends, and to look for unusual fluctuations in amounts in the current financial year that seem inconsistent with what has happened previously.
Expected results	Actual results can be compared with the budgeted results or with forecasts, or with results that the auditor was expecting.
Industry average results	Comparable information may be obtained for other entities in the industry or about individual entities in the same industry. Information may be obtainable for the industry as a whole from an industry body or a financial information service. Information about individual companies in the same industry may be obtainable as published financial statements.
Comparable parts of the same entity	The auditor may be able to compare the results of different branches or divisions within the same entity, where there are similar branches or divisions within the entity.

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Once the calculations have been performed, the auditor will then examine them for unexpected or unusual relationships. The auditor will then make enquiries of management in order to establish explanations for the relationships revealed.

Many of the accounting ratios used in analytical procedures may be familiar to you already from your other studies. If you have not as yet studied ratios then some common ratios are set out for you below. You should ensure you are familiar with these as you could be required to both **compute and interpret** key ratios in the exam.

Remember that ratio analysis is subject to limitations:

- Its usefulness depends on the quality of the underlying financial information. It is usual for the auditor to calculate financial ratios from the client's management accounts, which are more detailed than financial statements and can provide a source of more and better information.
- For comparison purposes, the information must be calculated on a consistent basis.
- The two figures used to calculate a ratio must be logically related.
- The auditor needs to understand the client's business, so that he is able to understand the potential significance of ratios, or reasons for differences (for example, differences between one year and the next).

Analytical procedures and the exam

An exam question may ask you to carry out analytical procedures for an entity described in a small case study. The purpose of such a question will be to test your ability to:

- identify unusual features in the draft financial statements of a client entity
- suggest what might be done to investigate the unusual figures more closely
- provide possible explanations for the unusual figures in the financial statements.

Examples of unusual items in the financial statements that analytical procedures would reveal are:

- a substantial increase in sales revenue but a substantial decrease in the cost of sales
- a significant change in the gross profit margin
- a significant increase or decrease in administrative expenses
- a significant increase or decrease in selling and distribution expenditure
- a significant increase or decrease in interest costs or investment income
- A significant change in the net profit margin.

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Example: ratios

Here are just a few more of the ratios that an auditor might use. Other common ratios are set out at the end of this section.

Payroll costs

Ratios can be used to assess whether the total recorded amount for payroll costs appears to be reasonable:

- One way of doing this is to look at the total payroll costs each month, and in each month of previous years. Changes in the total payroll cost should be reasonable, allowing for increases in wages and salaries, and for changes in the composition of the workforce, and for leavers and starters in the period. Monthly payroll costs should be consistent with each other and reasonable.
- Another way of assessing payroll costs would be to measure the average monthly or annual pay per employee, and compare this with other months or previous years. Any unexpected changes should be investigated.

Other expenses

Another simple ratio that can be useful for an auditor is the ratio of expenses to annual revenue. Unusual changes in any ratio, such as the ratio of cost of sales to sales (and so gross profit to sales) should be investigated. Similarly, ratios of distribution costs, selling costs and administration costs to revenue can also be measured and compared.

Working capital ratios

Working capital ratios, such as days' sales outstanding and the average inventory turnover period, can be used to assess whether the total balance for trade receivables or inventory is reasonable (or whether the figures for sales income and purchases appear reasonable).

2.3 Analytical procedures in substantive testing

When using **analytical procedures in substantive testing**, 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.
- Develop an expectation of recorded amounts or ratios and evaluate whether that expectation is sufficiently precise to identify a misstatement.
- Evaluate the reliability of the data from which the expectation has been developed.
- Determine what level of difference from expected amounts is acceptable without further investigation.

The auditor will normally use analytical procedures to obtain **supplementary** audit evidence. It would not normally be appropriate to base the audit conclusion on analytical procedures alone. Analytical procedures are therefore designed to provide evidence that supports (or possibly contradicts) the outcome of other, more specific, audit testing procedures.

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2.4 Investigation of fluctuations and relationships

If the auditor finds:

- fluctuations or relationships which are inconsistent with other information, or
- unacceptable levels of differences from expected amounts

then ISA 520 **requires** him to:

- make enquiries of management and verify management's responses,and
- perform other audit procedures as necessary.

The calculations performed in analytical procedures are only a part of the process. They are used to indicate areas where further audit work may be required.

If, for example, an entity's usual gross profit percentage is 20% and the auditor is not aware of any factors which would cause this to change in the current year – then no further investigation of a current year gross profit percentage of 20% should be necessary.

However, if the auditor knows that there have been significant changes in the nature of the business that should affect the gross profit percentage and yet that percentage is still 20%, he will need to make further enquiries.

These enquiries, following analytical procedures, will involve:

- using other audit evidence to help explain the ratios obtained from analytical procedures, and their unexpected and unusual value
- asking management for explanations of the unusual/unexpected ratios. Since explanations from management are being obtained as audit evidence, and oral evidence is not particularly reliable, they should be confirmed by further audit work.

Example: further investigation

You are currently planning the audit of Numero for the year ended December 31, 20X4. You are aware that revenue was budgeted to fall by 20% from last year. The following information has been made available to you:

Revenue ₦400,000 (20X3: ₦500,000)

Cost of sales ₦300,000 (20X3: ₦300,000)

Expenses ₦20,000 (20X3: ₦50,000)

Trade receivables ₦60,000 (20X3: ₦30,000)

Required

Explain which of the above amounts you believe might need further investigation and why.

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Answer: further investigation

Cost of sales has remained constant and yet revenue has fallen by the anticipated 20%. Cost of sales would generally be expected to move in line with revenue. *(Tutorial note: An alternative comment would be that the gross profit percentage has fallen from 40% to 25%.)*

Expenses have decreased by 60%.This could be due to the fall in revenue or it could indicate a misallocation between cost of sales and expenses.

Trade receivables days have increased from 22 days to 55 days. This may indicate a change in credit terms (to attract new/large customers in the light of falling sales) or that not all debts are recoverable and that a write-down is needed.

2.5 Common ratios

Profitability ratios

$$\text{ROCE} = \frac{\text{Profit before interest and taxation}}{\text{Share capital and reserves + Long - term debt capital}} \times 100\%$$

$$\text{Profit/sales ratio} = \frac{\text{Profit}}{\text{Sales}} \times 100\%$$

This could be calculated as a **net profit ratio** or a **gross profit ratio** (commonly referred to as the gross profit percentage).

$$\text{Asset turnover ratio} = \frac{\text{Sales}}{\text{Share capital and reserves + Long - term debt capital}}$$

Working capital efficiency ratios

$$\text{Average days to collect} = \frac{\text{Trade receivables}}{\text{Sales}} \times 365 \text{ days}$$

$$\text{Inventory turnover} = \frac{\text{Inventory}}{\text{Cost of sales}} \times 365\text{days}$$

$$\text{Average time to pay} = \frac{\text{Trade payables}}{\text{Cost of purchases}} \times 365 \text{ days}$$

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Liquidity ratios

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\text{Quick ratio} = \frac{\text{Current assets excluding inventory}}{\text{Current liabilities}}$$

Debt ratios

$$\text{Gearing} = \frac{\text{Long - term debt}}{\text{Share capital and reserves}} \times 100\%$$

$$\text{Interest cover} = \frac{\text{Profit before interest and tax}}{\text{Interest charges in the year}}$$

Investor ratios

$$\text{Earnings per share} = \frac{\text{Profits attributable to ordinary shareholders}}{\text{No. of shares}}$$

$$\text{P/E ratio} = \frac{\text{Current market price per share}}{\text{Earnings per share}}$$

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Current market price per share}} \times 100\%$$

$$\text{Dividend cover} = \frac{\text{Earnings per share}}{\text{Dividend per share}} \quad \text{or} \quad \frac{\text{Profit before dividends}}{\text{Dividends}}$$

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3 CHAPTER REVIEW

Chapter review

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

- Describe the nature of substantive procedures
- Explain the financial statement assertions
- Understand different methods of obtaining substantive evidence
- Describe directional testing
- Understand when and why analytical procedures are used
- Use common ratios

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Quick quiz questions

1 Which of the following is NOT a financial statement assertion?

A Completeness

B Occurrence

C Cashflow

D Existence

2 Which of the following is NOT an accepted means of obtaining audit evidence?

A Inspection

B Inquiry

C Analytical procedures

D Estimates

3 At what stage of the audit do ISAs 315 and 520 require the auditor to use analytical procedures?

A When tendering for the audit of a new client

B During the planning stage and the review stage

C At the report writing stage

D When deciding whether to rely on the evidence of an expert

4 Substantive procedures and tests of controls are used to gather audit evidence. For each of the below examples select the correct type illustrated.

Re-performing the year-end bank reconciliation

A Substantive procedure

B Test of control

Reviewing board minutes for evidence of authorisation of a 6% wage increase for the whole workforce

C Substantive procedure

D Test of control

Performing an analytical review on revenue and expenses

E Substantive procedure

F Test of control

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5 Stephen has obtained a schedule of items comprising the cash and cash equivalents balances of ₦375,000 in the balance sheet of Greens Ltd. Performance materiality has been calculated as ₦150,000. For each of the items below select whether Stephen should test it.

Petty cash float of ₦2,000

A Not test

B Test

Special directors' cash account of ₦15,000

C Not test

D Test

Current account overdraft of ₦210,000

E Not test

F Test

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Quick quiz answers

1 C

2 D

3 B

4 A, D,E

5 A, D,F

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Substantive procedures: non-current assets

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Competencies

Gathering evidence

The nature of audit evidence and the selection of sufficient appropriate audit evidence (ISA 500)

C2 Evaluate the different sources and quality of evidence and the methods of obtaining evidence. *(See also chapters 6,8-9 and11-12)*

C3 Document appropriate procedures for gathering evidence based on a given scenario (ISA 505, ISA 520). *(See also chapters 6,8-9 and11-12)*

Exam context

Substantive procedures typically represent a significant element of fieldwork performed during a statutory audit engagement and are therefore a critical element of the syllabus.

Chapters 9-12 describe the various substantive procedures commonly performed on the statements of financial position and comprehensive income. Students must ensure they link substantive tests to specific assertions and risks to ensure they understand the objective of each procedure.

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

- Explain the principal risks of misstatement for non-current assets
- Describe the key substantive procedures for auditing both tangible and intangible non-current assets

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1 TANGIBLE NON-CURRENT ASSETS

Section overview

- Tangible non-current assets: the information subject to audit
- Principal risks of misstatement
- Substantive procedures for tangible non-current assets
- Substantive procedures – additions and disposals

1.1 Tangible non-current assets: the information subject to audit

Before looking at substantive tests for tangible non-current assets, it is useful to remind yourself of the information about these assets that is presented in the financial statements.

The figures in the statement of financial position itself are supplemented by a note to the accounts, which may be presented as follows:

	Land and buildings	**Plant, equipment, fixtures and fittings and motor vehicles**	**Total**
	₦	**₦**	**₦**
Cost			
At December 31, 20X3	X	X	X
Additions	X	X	X
Acquisitions through business combinations	X	X	X
Classified as held for sale	(X)	(X)	(X)
Disposals	(X)	(X)	(X)
At 31 December 20X4	X	X	X
Accumulated depreciation and impairment losses			
At December 31, 20X3	X	X	X
Depreciation charge for the year	X	X	X
Classified as held for sale	(X)	(X)	(X)
Disposals	(X)	(X)	(X)
Impairment losses	X	X	X
Reversal of impairment losses	(X)	(X)	(X)
At 31 December 20X4	X	X	X
Net carrying amount			
At 31 December 20X3	X	X	X
At 31 December 20X4	X	X	X

When tangible non-current assets are included in the statement of financial position at a valuation, a note should disclose:

- ❑ the basis used to revalue the assets
- ❑ the date when the assets were revalued
- ❑ whether an independent valuer was involved in the revaluation, and

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- the nature of any cost index that was used as a basis for calculating replacement cost
- the carrying amount of each class of assets that would have been reported if the assets had been reported using the cost method (and so if the assets had been valued at cost minus accumulated depreciation)
- the revaluation surplus, and any movements in this surplus during the financial period.

In addition, a note should disclose the basis used for the depreciation of each class of assets.

When assets are disposed of, the gain or loss on disposal is the difference between the proceeds from the disposal and the carrying amount of the asset at the date of disposal.

When non-current assets are a significant item in the statement of financial position of a company, the disclosures relating to them are therefore both extensive and of some significance in terms of obtaining audit evidence.

1.2 Principal risks of misstatement

The principal risks of tangible non-current asset balances in the financial statements being misstated relate to the following assertions:

- **Completeness assertion**. There is a risk that assets owned by the reporting entity have not been included in the financial statements.
- **Existence assertion**. There is a risk that assets reported in the financial statements do not actually exist (for example, they may have been sold or scrapped).
- **Valuation assertion**. There is a risk that the assets have been incorrectly valued (which could be due to incorrect recording, inappropriate valuations, or incorrect depreciation calculations).
- **Rights and obligations assertion**. There is a risk that the reporting entity does not actually own assets that are included in the financial statements.
- **Presentation and disclosure assertion**. There is also a risk that the assets have not been correctly presented and disclosed in the financial statements.

The auditor can use substantive testing to obtain evidence that the various assertions relating to tangible non-current assets are valid.

1.3 Substantive procedures for tangible non-current assets

The substantive procedures used by an auditor for tangible non-current assets will therefore be designed to obtain sufficient and appropriate evidence about the above assertions. The tests will therefore be directed to:

- completeness (no understatement)
- existence (no overstatement)
- valuation,
- rights and obligations, and
- presentation and disclosure.

Possible substantive procedures to obtain this evidence are listed below.

Completeness

- Obtain or prepare a schedule of tangible non-current assets, showing cost or valuation, depreciation and carrying amount.
- Reconcile this list with the corresponding opening balances (see the notes below on substantive tests for additions and disposals).
- Select a sample of assets that physically exist (and whose existence has been verified, possibly by means of inspection by the auditor) and trace these assets to the asset register.
- Obtain or prepare a reconciliation of ledger balances for tangible non-current assets with the asset register and investigate any differences.

Existence

- Select a sample of assets from the non-current asset register and physically inspect them. During the inspection, note whether the asset is in use and the condition that it is in. For an asset register held on an IT system, audit software could be used to assist in the selection of a sample.
- Establish and investigate the reasons for any assets in the sample that are not found by the auditor.

Valuation

At cost

- **Land and buildings**: Confirm the figures for cost with the purchase contract for the asset and the invoices for associated costs (such as professional fees). Check that the purchase expenditure is analysed reasonably between land, buildings and equipment.
- **Equipment and vehicles**: Check the cost in the financial statements against the purchase invoices for the assets.
- Review the allocation of total expenditure on non-current assets between capital and revenue amounts.

At valuation

- Verify amounts in the financial statements with the valuer’s report.
- Consider the reasonableness of the valuation.
- Check that valuations are regularly updated.
- Check the accounting for the rise or fall in value on revaluation.

Depreciation and impairment

- Review depreciation rates for reasonableness in the light of the nature of the asset, its estimated useful life and residual value.
- Ensure that consistent depreciation methods are in use.
- Review gains or losses on sale disposal (and the accumulated depreciation and impairment at the time of disposal).
- Consider the possibility that assets are obsolete or suffering impairment. This matter may have to be discussed with the directors of the client company.

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- Check the depreciation calculations for accuracy, using the entity's stated policy. Again, in an IT system, audit software could be used to check these calculations.
- Ensure that fully-depreciated assets are not subject to further depreciation.
- Perform analytical procedures to verify the total charge for depreciation (for example, by taking the ratio of depreciation to total asset value, and comparing this with the ratio in previous years).
- Confirm that the entity has adequate insurance for its assets.

Rights and obligations (ownership)

- **Land and buildings**: Verify legal title to the assets by inspecting appropriate documents (such as legal documents of ownership, or lease agreements).
- **Vehicles**: Examine vehicle registration documents or similar documentation giving evidence of title.
- **Other assets**: Examine invoices or other documents transferring title.
- Ensure that documents are in the name of the entity (the client company).
- Review legal documents, bank documents and other documents for evidence of any loans that are secured by charges on assets.

Presentation and disclosure

- Review the disclosures in the financial statements and ensure they are correct and clear.
- Ensure the schedule of tangible non-current assets agrees to the figures in the financial statements.

1.4 Substantive procedures – additions and disposals

In the interests of audit efficiency, auditors will pay particular attention to substantive testing of additions and disposals of tangible non-current assets. These transactions, together with the depreciation charge for the year, will normally account for most of the changes between the valuations in the opening and closing statements of financial position. Typical substantive procedures in these areas are listed below.

Additions

- Obtain/prepare a schedule of additions for the period.
- Check the authorisation of the expenditure to purchase these additions.
- Confirm that the total additions reconcile with the movement between the opening and closing balances in the note to the financial statements.
- Inspect a purchase invoice or other document as evidence of the cost of any addition, and confirm that these documents are in the company name.
- Verify the existence of the acquired non-current assets, by means of physical inspection where appropriate.
- Check that the entries in the accounting records are correct, confirming the allocation of total expenditure between capital and revenue expenditure.

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Disposals

- ❑ Obtain/prepare a schedule of disposals for the period.
- ❑ Check the authorisation of the disposals.
- ❑ Verify that the cost and related accumulated depreciation have been removed from the accounting records.
- ❑ Verify the calculation of the figure for the gain or loss on disposal, and verify that this figure has been correctly recorded in the ledger.
- ❑ Discuss with management (including non-financial management) the possibility of unrecorded disposals of assets.

As always, the precise nature of substantive procedures performed by the auditor must reflect the circumstances involved. This is mirrored in the exam by the particular scenarios set. For example, an entity may construct its own non-current assets rather than buy them from an outside supplier. In this event, the substantive procedures will focus on confirming that internal costs (materials, labour, other direct expenses and overheads) have been properly accounted for as capital expenditure.

Example:

During the year ended 30 June Year 6, Constructico acquired free hold land at a cost of ₦500,000 and built a distribution centre on it, using a mixture of sub-contract and own labour. The distribution centre cost a total of ₦200,000 to construct.The construction was completed by the end of April.

Required

Set out the audit objectives in respect of the above and the substantive procedures you would carry out to achieve those objectives.

Answer

The land and the distribution centre exist at 30 June Year 6

- ❑ Visit site and confirm that the distribution centre has been built and is in use.

Constructico owns the land and the distribution centre at 30 June Year 6

- ❑ Inspect the land registry certificate or write to thirdparty for confirmation (e.g. bank or solicitor).
- ❑ Inspect correspondence confirming that local planning permission was granted and ensure any conditions were met.

Expenditure capitalised in respect of the distribution centre is complete

- ❑ Discuss with management their policy for capitalising expenditure incurred in building the distribution centre.
- ❑ If a formal system is in place for the identification and capitalisation of construction expenses, test that system.
- ❑ Review a sample of invoices not capitalized during the period and ensure treatment was correct.

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The land and the distribution centre are appropriately <u>valued</u> at cost

- ❑ Inspect completion statement for purchase of land.
- ❑ Obtain an analysis of costs of building the distribution centre. Inspect:
  - Purchase invoices for a sample of raw material and sub-contract costs
  - Time records for a sample of internal labour costs
  - Evidence in respect of any overheads capitalised.
- ❑ Recalculate the depreciation charge for the year, taking into account that the distribution centre was not completed until the end of April.

The land and the distribution centre are appropriately <u>disclosed</u> in the financial statements

- ❑ Review the disclosures in the financial statements and ensure they are correct and clear.

Ensure the schedule of costs agrees to the figures in the financial statements.

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2 INTANGIBLE NON-CURRENT ASSETS

Section overview

- Substantive procedures for intangible assets
- Tests of detail for purchased goodwill
- Tests of detail for other intangibles (excluding development costs)
- Tests of detail for development costs

2.1 Substantive procedures for intangible assets

The risks of misstatement and substantive procedures relating to intangible assets such as goodwill and brands should be similar to those set out above in respect of tangible assets. The emphasis of the substantive procedures will be on:

- existence and
- valuation.

Remember that the only intangible assets that can be recognised in the statement of financial position are:

- purchased goodwill
- intangibles having a readily ascertainable market value, and
- development costs, subject to the conditions set out in IAS 38.

There should therefore be adequate audit evidence available to enable a conclusion to be reached on these assets.

The main substantive procedures are listed below.

2.2 Tests of detail for purchased goodwill

The tests listed below relate mainly to the valuation of purchased goodwill:

- Confirm that a business was acquired and confirm the consideration paid for the business acquired. (This is a measure required to check the existence of purchased goodwill as well as to confirm its valuation.)
- Review the reasonableness of the valuation placed on the net assets acquired.
- Check the calculation of the purchased goodwill (as the difference between the consideration paid and the fair value of the net assets acquired).
- Review for the possibility of an impairment having arisen.
- Ensure that any impairment loss has been correctly calculated and recorded in the ledger.

2.3 Tests of detail for other intangibles (excluding development costs)

The tests for other intangible assets, other than development costs, are similar to those that may be applied to tangible non-current assets.

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- The auditor should confirm the existence, the cost and the client entity's legal rights to the acquired assets, by looking at the purchase documentation.
- Check the amortisation calculations for accuracy, using the entity's stated policy.
- Consider the possibility that the assets are suffering impairment. This matter may have to be discussed with the directors of the client company.
- Ensure that any impairment has been correctly dealt with in the ledger.

2.4 Tests of details for development costs

The tests for development costs must enable the auditor to conclude whether or not the provisions of IAS 38 for the recognition of development costs have been met.

IAS 38 states that an intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

- the technical feasibility of completing the intangible asset so that it will be available for use or sale.
- its intention to complete the intangible asset and use or sell it.
- its ability to use or sell the intangibleasset.
- how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
- the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
- its ability to measure reliably the expenditure attributable to the intangible asset during its development.

Audit tests might include the following:

- discuss the development project with management, other relevant senior personnel and other key stakeholders to assess the feasibility of the project and product:
  - review projections and forecasts for using resources and generating future economic benefits.
  - assess production and marketing plans and whether a market (or use) actually exists.
  - consider funding requirements to completion.
  - whether the entity will actually be able to use or sell the asset.
  - discuss management's intention to complete the asset and either use or sell it.

- ❑ inspect development contracts and records supporting and safeguarding patents.
- ❑ test controls around the documentation and safekeeping of scientists' notes, discoveries and conclusions.
- ❑ test a sample of development costs for appropriate capitalisation.
- ❑ obtain written representation from management as to their commitment to complete the project and either use or sell the asset(s).

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3 CHAPTER REVIEW

Chapter review

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

- Explain the principal risks of misstatement for non-current assets
- Describe the key substantive procedures for auditing both tangible and intangible non-current assets

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Quick quiz questions

1 Which tangible non-current assets are normally not depreciated?

A Land andbuildings

B Landonly

C Buildingsonly

D All tangible non-current assets are depreciated

2 Which of the following should not be shown as an intangible non-current asset?

A Purchased goodwill

B Non-purchased goodwill

C Development costs meeting the criteria in IAS 38

D Other intangible assets having a readily ascertainable market value

3 A non-current asset register holds details of non-current assets.

These details will include:

A Cost, depreciation, service details, location, disposal proceeds

B Service details, serial number, capital allowances, net book value

C Capital allowances, disposal proceeds, supplier, location

D Cost, depreciation, asset number, serial number, location

4 Which of the following is NOT a substantive test for the audit of non-current assets?

A Reconcile the non-current assets register to the receivables ledger control account

B Consider the reasonableness of are valuation

C Physically check a sample of non-current asset additions

D Vouch disposal proceeds to the bank statement

5 Which term would you NOT normally associate with non-current assets?

A Net realizable value

B Goodwill

C Investments

D Net book value

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Quick quiz answers

1 B

2 B

3 D

4 A

5 A

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CHAPTER 11

Substantive procedures: Current assets

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The nature of audit evidence and the selection of sufficient appropriate audit evidence (ISA 500)

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C3	Document appropriate procedures for gathering evidence based on a given scenario (ISA 505, ISA 520). *(See also chapters 6,8-10 and12)*

Exam context

Substantive procedures typically represent a significant element of fieldwork performed during a statutory audit engagement and are therefore a critical element of the syllabus.

Chapters 9-12 describe the various substantive procedures commonly performed on the statements of financial position and comprehensive income. Students must ensure they link substantive tests to specific assertions and risks to ensure they understand the objective of each procedure.

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

- Explain the principle risks of misstatement for current assets
- Describe the key substantive procedures for auditing
  - Inventory
  - Trade receivables
  - Bank and cash

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1 INTRODUCTION TO SUBSTANTIVE PROCEDURES FOR INVENTORY

Section overview

- The importance of closing inventory for audit testing
- Principal risks of misstatement
- Substantive procedures for inventory

1.1 The importanceofclosing inventory for audit testing

For many businesses (although service organisations are often an exception) inventory is one of the areas needing most attention from the auditor. The reasons for the importance of closing inventory for the auditor include the following:

- Inventory is often a material item in the financial statements.
- Inventory may be a high-risk area, involving a high degree of judgement in areas such as valuation. For example, judgement may be needed to estimate the stage of completion of work in progress.
- Inventory may suffer from deterioration, loss or theft that may not be recognised in the client company's financial statements.
- Inventory may be highly technical in nature. Where inventory is complex, the auditor may need to consider whether to rely on the work of an expert.
- Establishing a closing inventory figure may be a lengthy and complex process for the client, with a high risk of error.
- Closing inventory is often not part of the double entry system, so directional testing (tests on other areas and other balances) may not reveal misstatements in inventory.

Audit work on inventory is often given to more experienced members of the audit team. The work will typically be subject to a process of rigorous review and quality control. In addition, analytical procedures are widely used to obtain evidence to supplement the detailed substantive testing on inventory in the audit.

1.2 Principal risks of misstatement

The principal risks of inventory being misstated are due to the following:

- Not all inventory that is owned by the reporting entity being included in the financial statements (the **completeness** assertion).
- Inventory in the financial statements not actually existing (the **existence** assertion).
- Inventory being incorrectly valued (which could be due to incorrect recording of costs, or failing to value at net realisable value, if lower) (the **valuation** assertion).
- Inventory being included in the financial statements which actually belongs to third parties (the **rights and obligations** assertion).
- Inventory being incorrectly disclosed in the financial statements (the **presentation and disclosure** assertion).

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1.3 Substantive procedures for inventory

The figure for inventory in the financial statements reflects:

- the **quantity** of inventory on hand at the end of the reporting period,and
- the **value** of each item of that inventory.

Substantive procedures for inventory will therefore focus largely on the **existence** and **valuation** assertions and these are covered in the following sections. However, by carrying out test counts in both directions (see section on the physical inventory count below) the **completeness** assertion will also be covered.

In order to satisfy the **rights and obligations** assertion the auditor will need to check, when he attends the year-end physical inventory count (see below), that inventory belonging to third parties is separated and not included in the count.

To satisfy the **presentation and disclosure** assertion the auditor will need to ensure that:

- the schedule of year-end inventory (on which he bases his substantive procedures below) agrees to the financial statements
- inventory is correctly disclosed and classified (e.g. between raw materials, work in progress and finished goods) in the financial statements.

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2 VALUATION OF INVENTORY

Section overview

- IAS 2: Inventories
- Substantive procedures
- Cost or net realizable value?

2.1 IAS 2: Inventories

IAS 2 requires that inventory should be valued at the lower of cost or net realisable value, on an item-by-item basis:

- **Cost** includes the costs of purchase and all other costs incurred in bringing inventories to their present location and condition. In the case of work-in-progress and manufactured finished goods, this includes an amount for production overheads. (The absorption rate for production overheads should be based on normal levels of activity). Cost can be estimated by using a number of methods (such as first-in-first-out or average cost). The method chosen should provide a close approximation to the actual cost of the inventory.
- **Net realisable value** (NRV) is the estimated selling price of the inventory in the ordinary course of business, minus (1) any estimated costs to complete the items (and make them available for sale) and (2) the estimated costs of making the sale.

2.2 Substantive procedures

Substantive procedures on inventory should be designed to allow for the nature of the inventory and the nature of the situation that the auditor is facing.

- If the entity is a retailing organisation, the only major component of the cost of inventory is likely to be the purchase cost of the goods for resale.
- If the entity is involved in manufacturing or processing, the cost of inventory will include an amount for direct labour and production overhead, in addition to the cost of the raw materials and components.

Substantive procedures for the valuation of inventory items are suggested below. In the exam, which procedures are the most appropriate will depend on the particular scenario given.

Cost of raw materials or the cost of goods purchased for resale

For raw materials and goods held for resale, the cost of inventory will be the actual purchase cost of the items (plus any costs of delivery that the entity may have had to pay). The auditor should carry out the following tests for valuation:

- Confirm the approach adopted by the client company to estimate the cost of materials or goods used/sold (for example first-in-first-out, or weighted average cost).
- Check the figures for the cost of inventory by comparing them with prices in purchase invoices or official supplier price lists.

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Cost of manufactured goods and work in progress

For work-in-progress and items of finished (manufactured) goods, the auditor needs to check each of the elements in the cost: direct materials, direct labour and production overheads. He should therefore carry out the following tests:

- Obtain schedules showing the make-up of the cost figures for each item of work-in-progress and finished goods.
- Check the accuracy of the calculations.
- Materials
  - Perform the same substantive tests as for raw materials, shown above.
  - Check that the correct **quantity** of materials has been used in the valuation.
- Labour
  - Check pay rates for direct labour cost against payroll/personnel records for the employees who produced the work-in-progress or finished goods items.
  - Check the hours worked (and used to calculate labour costs in the inventory) with the time records for the employees concerned.
- Production overheads
  - Confirm that only production overheads (as opposed to selling and administration overheads) are included in the valuation.
  - Confirm that overhead absorption rates are based on **normal levels of output**.
- Work in progress: in addition to the above tests, the auditor may also need to check the stage of completion of the work in progress, in respect of both materials and conversion costs (labour and overheads).

2.3 Cost or net realisable value?

In his substantive testing of inventory, the auditor should also look at the procedures of the client entity for deciding whether each item of inventory should be valued at cost or at net realisable value (NRV). The auditor may therefore carry out the following tests:

- Review and test the procedures in place for comparing NRV with cost for each item of inventory.
- Follow up any information obtained from other audit work suggesting that for certain items of inventory, NRV may be lower than cost. Information may be obtained from the physical inventory count (where the auditor has observed evidence of deterioration of the inventory) or from the amount of returns and allowances granted to customers.
- Review inventory records and order books for evidence of slow-moving items, whose selling price might need to be reduced and whose NRV may therefore be less than cost.
- Review prices at which goods have been sold after the reporting period, for evidence that NRV is higher than cost

- In the case of work in progress, compare costs incurred to date with selling price minus costs to complete (NRV). Estimated costs to complete may be assessed by the auditor from the client's management accounts.

As discussed in a previous chapter, where the client has an IT system in place over inventory, audit software may be used to improve the efficiency and accuracy of audit testing in this area.

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3 INVENTORY QUANTITY: THE PHYSICAL INVENTORY COUNT AND ISA 501

Section overview

- Physical inventory counts: purpose and responsibilities
- Timing of the count
- Counting procedures
- Cut-off
- Audit work relating to the inventory count
- Audit work before the count:planning
- Audit work during the count: observing and recording
- Audit work after the count: followup
- Possible control weaknesses in an inventory count

3.1 Physical inventory counts: purpose and responsibilities

Many organisations rely on a physical inventory count at the end of their financial year in order to arrive at a figure for inventory in their financial statements. Even if an entity maintains 'sophisticated' inventory records, with continuous accounting records for inventory, the accuracy of these records should be checked by means of regular physical counts of inventory.

There are several reasons for physical counts of inventory:

- Physical counts may be fairly easy to arrange, particularly where most items of inventory are held in a limited number of physical locations.
- Physical counts provide evidence of the actual existence of the inventory. This evidence is important to the client company (for preparing the financial statements) as well as for the auditor (for checking the reliability of those statements).
- Physical counts can be used by the entity to check the accuracy of its inventory records, where it maintains continuous inventory records.
- Where the entity does not have continuous inventory records, a physical count of inventory is probably the only way of establishing the quantity of inventory at the year-end.
- Discrepancies between the physical count of inventory and the entity's inventory records may indicate weaknesses in physical controls over inventory, and losses due to theft or for losses from other causes.
- A physical count of inventory can also be used to check the physical condition of inventory, and whether there has been any deterioration in condition.

It is important to appreciate the relative responsibilities of management and auditors with respect to inventory counts.

- It is the responsibility of management to arrange for physical counts to be made and to establish appropriate procedures for counting, to ensure that a complete and accurate count is taken. (It is the responsibility of the company's directors to ensure that the valuation of inventory in the financial statements is reliable.)

- It is the responsibility of the auditor to gather evidence from which he can reach a conclusion on the figure for inventory in the financial statements. Observation and other audit procedures performed by the auditor at the inventory count will provide some of this audit evidence.

The auditor's attendance at the physical inventory count is covered by ISA 501 *Audit evidence – Additional considerations for specific items*. The **requirements** of ISA 501 in respect of inventory state that if inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding the **existence** and **condition** of inventory by **attendance at physical inventory counting** unless impracticable. The purpose of such attendance is given as being to:

- Evaluate management's instructions and procedures for recording and controlling the results of the count.
- Observe the performance of management's count procedures.
- Inspect the inventory.
- Perform tests counts.
- Perform audit procedures over the final inventory records to determine whether they accurately reflect the results of the count.

Each of these areas, along with other issues, are considered below.

3.2 Timing of the count

An entity can take any of three different approaches to the **timing** of the physical inventory count: These are:

- an annual count at the end of the reporting period (periodical counting)
- an annual count shortly before or after the end of the reporting period (periodical counting)
- 'continuous counts' at a variety of dates during the period (perpetual counting).

Annual count at the end of the reporting period

An annual count at the end of the reporting period is the 'traditional' approach to the physical inventory count. As the term suggests, all inventory is counted at the end of the reporting period.

The annual inventory count may be a lengthy process, involving many staff. In order to count all of the inventory at the end of the reporting period, it may therefore be necessary for the entity to close down its production facility. This will ensure an accurate physical count, by making sure that no items of inventory are produced or used, from the end of the reporting period until the physical count has ended.

Annual count shortly before or after the end of the reporting period

Companies often hold their 'year-end' counts shortly before or shortly after the end of the reporting period. There are usually practical reasons for this:

- The count may be held early to allow extra time for management to process the information from the inventory count (and put their valuation to closing inventory) before the audit begins.

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- The end of the reporting period may fall at an inconvenient time. In the UK, for example, the financial year end for many companies is 31st December, which is a time when many staff are on holiday.
- It may be convenient to hold the count on a Saturday or Sunday when business activity is at a lower level, and when the count can therefore be completed more quickly. The chosen Saturday or Sunday may be just before or just after the end of the financial year.

Timing the annual count to take place just before or just after the end of the reporting period is acceptable for audit purposes, provided that the accounting records are sufficiently adequate to allow the auditor to check the changes in inventory between the date the count took place and the end of the reporting period.

Continuous counting: counts take place at a variety of dates during the financial period

An entity may decide to hold several physical counts of inventory throughout the financial year, in order to avoid the potential disruption of an annual count at the end of the reporting period. This involves counting certain items of inventory at different dates during the financial year.

This system is acceptable for audit purposes, provided that certain conditions are satisfied. The main conditions are as follows:

- The entity should have a system for maintaining accurate and up-to-date inventory records. This is because the figure in financial statements for inventory at the end of the reporting period will be based on these records. Only a portion of the entity's inventory will be physically counted at the end of the reporting period.
- Every item should be counted at least once a year.
- Counting should be systematic, and properly organised and controlled.
- Counts must be fully documented and reviewed by management. Any differences between inventory records and the figures from the physical inventory counts must be investigated.

3.3 Counting procedures

It is the responsibility of management to arrange the inventory count and to establish effective procedures to ensure that a complete and accurate count is taken. The auditor attends the count as a means of obtaining audit evidence. This evidence will be used, together with other appropriate evidence, to reach a conclusion on the value of inventory in the financial statements.

It is important that the auditor should be confident that the inventory counting procedures organised by the client's management will ensure a complete and accurate count.

The following procedures should therefore be in place:

- The directors of the client entity should issue written instructions for the inventory count, well in advance of the count.
- The instructions should be reviewed by the auditor before the count takes place.

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- The auditor needs to be satisfied that the instructions for the count are such that a complete and accurate count will be taken.
- If the auditor is not confident in the instructions, the matter should be brought to the attention of management, and suitable amendments to the counting procedures should be requested.

The instructions issued by management for the inventory count should cover the following areas:

	Area	Comments
(1)	Adequate planning of the count.	Planning must be sufficient to ensure that the work will be carried out precisely and systematically. The planning should provide for the following: ■ The early issue of counting instructions to the staff who will do the counting. There should be arrangements for the staff to comment on the instructions and discuss them with management, and for suitable amendments to be made to the instructions if appropriate. ■ Deciding the date of the count. ■ Identifying the locations at which inventory is held. ■ Ensuring that sufficient staff are available to conduct thecount. ■ There should be procedures for identifying high-value items (for which accurate counting is essential). ■ There should be procedures to control or stop production and the movement of inventory during the count, in order to make sure that all inventory is counted. ■ There should be procedures for ensuring a clean inventory **cut-off** (see below).
(2)	The inventory should be divided into manageable sections for the purpose of controlling the count.	
(3)	There should be proper instructions for counting, weighing, measuring, and checking.	The instructions should give clear guidance about the units of measurement that should be used for the count; for example, single units, units of 100, units of 1,000 etc., measurement by weight, and so on. Counting should be carried out by teams of two (one person to act as counter and the other person to act as a checker).

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	Area	Comments
(4)	There should be procedures for identifying inventory on the entity's premises that is owned by third parties.	This inventory should be excluded from the inventory valuation for the statement of financial position. For example, inventory may be supplied to the entity on a sale or return basis; this is legally owned by the supplier.
(5)	There should be procedures for identification of defective, damaged, obsolete and slow-moving inventory.	These procedures are necessary in order to identify inventory whose NRV may be below cost.
(6)	There must be appropriate documentation for recording the count.	Pre-numbered documents should be used. Typically, these are tags for attaching to counted inventory items (containing details of the counted items) and sequentially-numbered sheets on which details from the tags are summarised, with the tags listed in numerical order. Controls over documentation should include keeping records of the tags and sheets that have been used, and accounting for all these documents at the end of the count. Records should be kept of the documentation issued.
(7)	There should be procedures for identifying and quantifying inventory belonging to the client but held by other entities.	For example, the entity may supply goods to customers on a sale or return basis. The auditor will probably seek to verify the quantity and value of these items of inventory by writing to the other entities concerned and asking them for written confirmation of the amount of the client's inventory that they are holding.

3.4 Cut-off

Cut-off is the process of ensuring that all transactions are **fully recorded in the correct accounting period**. Unless a correct ('clean') cut-off is achieved, there can be significant distortions in the figures reported for **two** consecutive financial periods.

Cut-off affects many areas of the financial statements:

- inventory
- sales revenue recognition
- cost of sales
- receivables
- payables.

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Sales cut-off

Cut-off is concerned with making sure that sales are recorded in the correct accounting period. For example, sales that occur around the end of the financial year should be recognised in the appropriate year. This in turn affects the recording of receivables and inventory at the year-end.

For example, if a sale is recorded in the year to 31 December Year 4, the following should also be recorded in that period:

- a receivables balance
- the goods must be removed from inventory
- a cost of sales entry.

This is an example of **sales cut-off**. In particular, it is important to ensure that the same item is not reflected as both a receivable balance and an inventory item.

Purchases cut-off

Similarly, all purchases that occur around the end of the year should be recorded in the correct financial year. This in turn will affect the recording of payables and inventory in the year-end statement of financial position.

For **purchases cut-off**, if goods are received in the year ended 31 December Year 4 and included in closing inventory, the following entries should also be recorded in that period:

- an inventory purchase
- a payables balance.

It is important to ensure that if an asset (inventory) is recorded, a corresponding liability (a trade payable) must also be recorded.

The auditor's work should include substantive testing on cut-off. This is described below.

3.5 Audit work relating to the inventory count

The main financial statement assertion addressed by the auditor's attendance at the inventory count is **existence**. However, the audit work at the count (and after the count) will also generate evidence relating to:

- valuation, and
- ownership (rights and obligations).

It is convenient to deal with the auditor's work on the inventory count under three headings:

- before the count: **planning**
- during the count: observing and recording
- after the count: '**followup**'.

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3.6 Audit work before the count: planning

The auditor should carry out the following planning tasks before the inventory count:

- Review the audit files for previous years, to find out whether problems were encountered with the inventory count on previous audits. If so, the auditor should plan to make sure that similar problems do not occur again this year.
- Review (for adequacy) the instructions for the count that have been prepared by the client entity's management: suggest appropriate changes if necessary.
- Establish the date, time and location of the count.
- Decide which counts at which locations will be observed by members of the audit team.
- Establish whether any inventory is held by third parties. If so, decide whether written confirmation is needed in respect of inventory held by third parties.
- Make arrangements with a local firm of auditors to attend a physical count location if the audit firm's own auditors are unable to do so.
- Consider the possible use of the client's internal audit department, which may be involved in checking inventory counts.
- The auditor in charge should make a requisition for the appropriate number and grade of audit staff to observe the inventory counts.
- He may also circulate these instructions to members of the audit team and invite their comments.

The auditor in charge should also plan the audit for the inventory count.

- He should become familiar with the client's inventory. He should give particular attention to high value or complex inventory items.
- He should decide the scope of the audit testing to be performed during the count, based on materiality and risk considerations.
- He should consider whether there is a need to use an expert to assist with the count of complex items.

3.7 Audit work during the count: observing and recording

What is the purpose of attending an inventory count?

The auditor should attend inventory counts by the client for the following reasons.

- **Tests of control**. To ensure that the inventory count is carried out by the client entity's employees in accordance with their instructions. Also to look for any control weaknesses in the inventory counting system.
- **Substantive tests**. To ensure that there is no material misstatement at the assertion level in the client's financial statements. This means not just checking that the inventory does exist, but also that the method of valuation is appropriate. For example if some inventory appears to the auditor to be in dilapidated condition, or if there is evidence of slow-moving items (from dates on the inventory containers) the auditor should consider whether inventory should be valued at net realisable value (NRV) rather than cost.

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Procedures at the count

The inventory count should be a fairly straightforward procedure. The client will appoint employees to carry out the count and will give instructions about how the count should be performed. The counters are given count sheets to record the quantities for each inventory item. These count sheets are handed out at the beginning of the counting process (although additional sheets may be handed out later).

When inventory has been counted, it should be marked or tagged. This is to prevent the same inventory from being counted twice. It also helps with identifying inventory items that have not yet been counted.

On completion of the count, each count sheet should be signed by the counter responsible for filling it in. All the sheets are handed in for recording and summarising.

The work of the auditor during the inventory count

During the physical inventory count, the auditor should observe the count and make his own records.

Observe

During the count, the auditor should:

- Observe whether or not the count is being conducted in accordance with the written instructions of the client's management
- Observe the condition of the inventory, in order to identify items where NRV might be below cost (and in particular, inventory that seems to have deteriorated in condition)
- Observe whether or not inventory not owned by the client entity is properly identified and labelled (for example, inventory owned by customers but held on the entity's premises)
- Observe whether or not, during the count, production of new inventory and the movement of inventory are controlled and properly documented, in accordance with management's instructions for the count
- At the end of the count, observe whether or not all inventory items have been counted and tagged accordingly.

It is normal practice for the auditor to prepare an **inventory count memorandum** recording his observations in the audit files. The memorandum should include a conclusion on the effectiveness of the count procedures.

Record

The auditor should also prepare some records relating to the inventory count:

- The auditor should carry out a sample of **test counts**. Audit staff will count items of inventory selected for the sample and compare the quantity they have counted with the quantity recorded by the client's staff. This will test that recorded inventory is **complete**. They should also select a sample of items from the client's count records and count those items themselves. This will test that recorded inventory **exists**.

  Any differences should be discussed with the client and resolved. The results of the test counts should be recorded.

- The auditor should make a record of the sequence numbers of the last tags and summary sheets used during the count. This record will be used after the count to confirm that all inventory items are included in the client's inventory list.
- The auditor should also record cut-off information. Typically he will record details of the last few goods received notes issued before the count and the first few goods received notes issued after the count. Similar information should be recorded relating to despatch notes. This helps to establish the financial year in which inventory items were physically received or physically despatched so that the auditor can subsequently check the **cut-off** assertion for sales and purchases.
- The auditor should record details of slow-moving or obsolete inventory, or inventory in poor condition, observed during the count. This will provide evidence to subsequently support the **valuation** assertion.

3.8 Audit work after the count: followup

The final audit work on inventory may take place several weeks after the inventory count itself. In the intervening period the client should have calculated a final inventory figure for the financial statements.

One of the main objectives of the audit work on inventory quantity at this stage is to ensure that the inventory quantities that existed at the count date are properly reflected in the final inventory figure in the financial statements (the **completeness** and **presentation and disclosure** assertions). (Note: At this stage, the auditor should also carry out his checks on the valuation of inventory items, as described earlier.)

The audit work involved in verifying inventory **quantities** will include the following:

- Obtaining the final inventory sheets that were prepared by the client's staff during their inventory count.
- Check the numerical sequence of the sheets and the auditor's record of the last sheet number, to confirm that no sheets are missing.
- Check the numerical sequence of tag numbers listed on the sheets and the auditor's record of the final tag number, to confirm that no inventory items are missing from the sheets.
- Check the arithmetical accuracy of the calculations on the sheets.
- Confirm that inventory records have been amended as appropriate. For some inventory items, there is likely to be a difference between the physical count numbers and the quantity of inventory shown in the client's inventory records (where a continuous recording system is used). In these situations, the client's inventory records will be incorrect. The auditor should therefore check that the inventory records were amended.
- Confirm that inventory belonging to the client, but held by third parties, is included on the inventory sheets.
- Confirm that inventory belonging to third parties, but on the client's premises at the date of the count, is not included on the inventory sheets.
- Check that cut-off is correct. This is done by reference to the cut-off information recorded at the time of the count.

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Having done all this work, the auditor should be able to reach a final conclusion on the quantity of inventory held at the end of the reporting period.

Example:

You are the senior in charge of the audit of inventory at Spares R Us. Inventory is comprised of large quantities of spare parts for the car industry. Spares R Us operates a perpetual inventory recording system, backed up by a rolling programme of physical counts throughout the year. There is no year-end physical inventory count and the amount for inventory in the year-end financial statements is based on the computer records.

Required

Briefly summarise the audit procedures that you would undertake to obtain evidence on the amount for inventory in the year-end financial statements.

Answer

- ❑ Carry out spot checks during the year.
- ❑ Conduct sample counts at the year end, compare to perpetual records and investigate any differences.
- ❑ Review the results of the rolling counts and ensure any differences from book to actual are investigated and adjusted for.
- ❑ Check a sample of cost prices to purchase invoices.
- ❑ Assess obsolesce.
- ❑ Consider the use of audit software on the year-end inventory file.

3.9 Possible control weaknesses in an inventory count

Control weaknesses in the client's inventory counting procedures may be observed by the auditor. These might include:

- ❑ **Failure to pre-number the count sheets**. All count sheets should be pre-numbered, so that they can all be accounted for at the end of the count and none are 'lost' (and none are counted twice).
- ❑ Including on the count sheet for each inventory item the quantity of the inventory as recorded in the entity's inventory records. The counters should not be told what quantity of inventory to 'expect' for each item, because this may influence them to expect in advance how much inventory to 'look for'.
- ❑ **Entering the quantities counted on the count sheets in pencil**. Entries in pencil can be erased and altered later, fraudulently, without leaving trace of the alteration.
- ❑ Stores staff are commonly used to do the counting. However if all the counters are from the stores staff, there is a risk that they may collaborate to hide errors or missing inventory. The client should therefore use some other non-stores staff to assist in the count, such as some employees from the accounts department.
- ❑ **Inventory may not be marked when it is counted**. This gives rise to a risk that items of inventory will be counted twice, and possibly that some items will not be counted at all.

- **Count sheets may not be signed** by the individual counter who prepared them. If there is no signature on the count sheet, it may be difficult to refer queries back to the counter if a problem arises.
- **Lack of precise instructions to the counting team**. The counting team must be given precise and specific instructions about how to perform the count. If the counting team is left to decide itself how the count should be conducted, this will increase the risk of mistakes in counting – such as missing out some items and double counting others.

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4 SUBSTANTIVE PROCEDURES: TRADE RECEIVABLES AND PREPAYMENTS

Section overview

- Principal risks
- Confirmation of receivables balances
- ISA 505: External confirmations
- Planning the confirmation exercise
- Positive or negative confirmation?
- Sample selection and performing the confirmation exercise
- Audit procedures following the receipt of replies (with positive confirmation requests)
- Preparing a summary and reaching a conclusion
- Other audit procedures for receivables
- The audit of prepayments

4.1 Principal risks

The balance for trade receivables is usually a material amount in a company's statement of financial position. A significant amount of audit work on trade receivables is therefore likely to be needed to check the reliability of this amount.

The **principal risks of misstatement** of the trade receivables balance are due to:

- ❑ receivables being irrecoverable (the **valuation** assertion)
- ❑ receivables being contested by customers (the **existence** and **rights and obligations** assertions)
- ❑ cut-off between goods outwards and receivables recording being incorrect (the **cut-off** assertion – an **income statement** assertion that has a knock-on effect to the audit of trade receivables (see below)).

Because assets are typically tested for overstatement, the **completeness** assertion is less relevant.

An important audit technique for trade receivables is **direct confirmation of balances** with customers. This is sometimes known as '**circularisation**'.

4.2 Confirmation of receivables balances

Direct confirmation involves asking customers to provide written confirmation, direct to the auditors, of their account balance with the client entity. Written confirmation by customers can normally be taken as high-quality audit evidence because it is a strong source of written, external audit evidence.

However, the reliability of this evidence depends on two factors that are not entirely within the auditor's control:

- ❑ A large proportion of the customers who are asked to provide written confirmation should do so. Customers are not obliged to provide confirmation, and some time and effort may be required to get some customers to provide the information required.

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- Some customers may provide written confirmation without properly checking the details.

As discussed above, the auditor will be concerned to check that the balance for trade receivables is not overstated. The confirmation process is therefore based on the company's own list of receivables ledger balances (customer account balances). This is the main accounting record used in this part of the audit.

A direct confirmation of receivables is intended to check the following assertions:

- **Existence** assertion. That the receivables do in fact exist, and there is no over-statement of receivables in the financial statements.
- **Rights and obligations** assertion. That the client entity has the legal right to the amounts receivable.
- **Valuation** assertion. That the receivables are stated at their appropriate amount.
- **Cut-off** assertion. That transactions have been recorded in the correct accounting period.

4.3 ISA 505: External confirmations

The confirmation process is covered by ISA 505 *External confirmations*. In line with the generalisations about the reliability of audit evidence in ISA 500, audit evidence in the form of external confirmations received directly by the auditor are likely to be **more reliable** than evidence generated within the client entity.

It is therefore likely that, where it is reasonable to expect customers to respond to requests for confirmation of their balance, direct confirmation of balances **will be a part of the substantive testing process** for trade receivables.

The requirements of ISA 505

The **auditor should maintain control over external confirmation requests**, including:

- deciding on the information to be confirmed/requested
- selecting the "confirming party" (e.g. the financial director/controller at the entity contacted)
- designing the confirmation requests (including an instruction for responses to be sent **directly to the auditor**)
- sending the requests himself.

Although the letter to customers is sent out by the auditor, it must contain authorisation from the client's management for the customer to provide the required information direct to the auditor. (An example of the form that this letter might take is shown later.)

If **management refuse to allow the auditor to send a confirmation request** the auditor should:

- enquire into and validate the reasons for such refusal
- consider the implications of the refusal on risk assessment and other audit procedures
- perform alternative audit procedures.

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Possible alternative audit procedures are considered in a later section.

Various requirements are set out in relation to the **results of the external confirmation procedures:**

- If there are doubts about the reliability of any response the auditor should obtain further evidence to resolve those doubts.
- If a response is determined not to be reliable, the auditor should consider the implications of this on risk assessment and other audit procedures.
- For any non-response, the auditor should perform alternative audit procedures (though for a non-response to a vital positive confirmation request (see below) the auditor will need to consider the implications for his audit report).
- The auditor should investigate all exceptions to determine whether they indicate misstatements. They could indicate fraud or a breakdown in internal control or might just be due to timing differences and therefore not indicative of misstatements.
- The auditor should evaluate the results as a whole to decide whether they provide relevant and reliable audit evidence or whether further evidence is needed.

Audit procedures

Audit procedures relating to confirmation of receivables balances are summarised below, under the following headings:

- Planning the confirmation exercise
- Positive or negative confirmation?
- Sample selection and performing the confirmation exercise
- Audit procedures following the receipt of replies (with positive confirmation requests)
- Preparing a summary and reaching a conclusion

4.4 Planning the confirmation exercise

The auditor needs to plan the exercise for the confirmation of balances:

- **Decide on the timing of the confirmation**. Ideally, the confirmation of balances should take place after the reporting period, and should be based on customers' account balances as at the end of the reporting period. However, to reduce the time pressure at the final audit stage, the confirmation process is often based on balances at an interim date before the end of the financial year (normally no more than three months before the end of the reporting period). In this case, the auditor will need to check the changes in the receivables balances between the confirmation date and the end of the reporting period. This check will consist mainly of checking entries in the receivables control account with the transactions entered in the books of prime entry during the same period.
- **Decide on the number of customer balances to be confirmed**. The confirmation process is normally based on a sampling approach. There are often many customers and the time and effort required to obtain a confirmation from all of them is not worth the benefit obtained. The auditor

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should be able to reach a reasonable conclusion from a representative sample of accounts.

- **Decide on the confirmation method to be used**. This will be a**positive** or **negative** confirmation request. These methods are explained below.

4.5 Positive or negative confirmation?

The confirmation will be either positive or negative. The auditor should decide which type of confirmation to obtain.

Positive confirmation

A **positive confirmation request** asks the customer to reply to the auditor **whether or not he agrees with the balance** on his account that is in the client company's accounting records (receivables ledger) as at the date selected for the confirmation. Positive confirmation can be obtained in either of two ways:

- **Method 1**. By providing the customer with details of the balance on his account, and asking him to indicate his agreement that this information is correct, or to indicate that it is wrong.
- **Method 2**. By asking the respondent to provide details of his balance at the selected date, but not providing any details of the balance in the client company's receivables ledger.

This should provide reliable audit evidence. However, there is a risk with Method 1 that a customer may reply to a confirmation request without checking that the information is correct. This risk can be reduced by using Method 2. However, with Method 2 there may be a lower response rate from customers, because they are being asked to do more work to provide the confirmation.

Negative confirmation

A **negative confirmation request** asks the customer to reply to the auditor **only where he disagrees** with the balance recorded by the company. If no reply is received, there is no explicit audit evidence in respect of the customer's balance. The absence of a reply could mean that the customer agrees with the balance, but is not required to provide written evidence. On the other hand, the absence of a reply could mean that the customer has not carried out any check of the balance at all.

The use of negative confirmation requests therefore provides audit evidence that is **less reliable** than evidence obtained with positive confirmation requests.

ISA 505 only permits the sole use of negative confirmation **where all of the following conditions are met**:

- The risk of material misstatement has been assessed as low and controls have been tested.
- The population is comprised of a large number of small account balances or transactions.
- A very low exception rate is expected.
- The auditor is not aware of circumstances which would case the respondent to ignore his request for confirmation.

Example: request for a confirmation of balance (positive confirmation)

A sample letter to a customer asking for confirmation of the outstanding balance, using the positive confirmation method, is shown below.

Note that it appears to be written by the management of the client company. In practice, this provides authorisation for the customer to provide the required information direct to the auditor. As discussed above, the letter will also be sent out to customers by the auditor (to make sure that the letters are actually sent to the customers in the selected sample). Replies should go directly to the auditor.

A COMPANY

25 South Street

Anytown

Customer's name and address

Date ……….………

Dear ……………..…

In accordance with the request of our auditors, Arthur Dailey and Co we ask that you kindly confirm to them directly your indebtedness to us at (*insert date*) which, according to our records, amounted to ₦…………..… as shown by the enclosed statement.

If the above amount is in agreement with your records, please sign in the space provided below and return this letter **direct to our auditors** in the enclosed stamped addressed envelope.

If the amount is not in agreement with your records, please notify our auditors**directly** of the amount shown by your records, and if possible detail on the reverse of this letter full particulars of the difference.

Yours faithfully,

A COMPANY

Confirmation No ……………

The amount shown above is/is not* in agreement with our records as at ………………….

AccountNo... Signature ……………………………………………….

Date …………………………………………….

Title or position …………………….……….

* the position according to our records is attached

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4.6 Sample selection and performing the confirmation exercise

The auditor will normally select a sample of customers who will be asked to provide a confirmation of the balance on their account with the client company. The audit procedures for selecting the sample and for the confirmation process are as follows:

- Obtain or prepare an aged listing of receivables ledger balances at the chosen date.
- If the list is prepared by the client, check the completeness and accuracy of the list of balances and the total of the balances in the list. This can be done by checking the list against (1) the total balance for trade receivables in the receivables control account in the main ledger and (2) a sample of customers' account balances in the receivables ledger.
- A suitable sampling method should be chosen. As with all sampling, the sample selection process should as far as possible ensure that the sample is representative of the 'population' of receivables.
- If the 'population' of receivables ledger balances is not homogeneous, stratified sampling might be used. (Stratified sampling was explained in an earlier chapter.)
- In selecting the sample, certain types of account should be considered for inclusion:
  - Over due accounts
  - Credit balances or 'negative balances' (accounts where the client entity owes money to its customer, having issued credit notes to the customer)
  - Accounts on which round sum payments are received (for example, where the customer makes payments of ₦500, or ₦1,000 or₦3,000, instead of paying specific invoices)
  - Nil balances. (A check on nil balances provides a check on the completeness of trade receivables.)
  - Any individual balances that are considered 'material'.

  In an IT system, with many year-end receivables balances audit software can be used to help select the main sample (for by selecting every 500th ₦or sampling or selecting all balances over a certain amount, as well as nil and credit balances).
- Having selected items for circularisation, details should be extracted from the receivables ledger, and letters to the customer should be prepared.
- In the case of an external audit, the confirmation requests are issued **by the auditor**, not by the client, and replies are sent directly to the auditor. However, the request will need to contain **management's authorisation** to the customer to disclose the necessary information. Should the client refuse to give permission for a confirmation letter to be sent to a particular customer, the auditor should look for a reason for the refusal. As that customer has been included in the sample selection, the auditor will need to carry out alternative audit work (see below) to verify that customer balance.
- The letters should be sent out by post or emailed directly to the parties selected.

- With positive confirmation requests, if the auditor does not receive a reply from a customer within a reasonable period of time, follow-up procedures should be initiated. For example, second request and third request letters could be sent, or the client could be asked to contact the customer and ask for a reply.

4.7 Audit procedures following the receipt of replies (with positive confirmation requests)

On receipt of the replies from customers, the auditor should check that the letters are signed by a responsible official. The replies are filed in the receivables section of the current audit file. The current audit file should classify the customers in the sample as follows:

- **Balance agreed**. The customer has replied and agrees with the balance in the client entity's accounting records (or has provided a balance that corresponds with the entity's accounting records – depending on whether Method 1 or Method 2 of positive confirmation is used). No further audit work is required.
- **Balance not agreed**. The customer has replied but does not agree with the balance in the client entity's accounting records. The auditor should ask the client to review the replies and try to reconcile the balance in their records with the balance confirmed by the customer. The auditor should then check the reconciliation, looking for evidence of errors in the client company's figures which may represent misstatements of their accounts receivable balances. However, many of the reconciling items will often be '**timing differences**' – invoices, credit notes or cash may be recorded in the accounts of one party (the customer or the client entity), but not yet recorded by the other. Provided that the auditor is confident that the difference in the balances is due to timing differences, they should not be seen as evidence of errors in receivables balances.
- **No reply received**. No reply has been received from the customer. The auditor cannot ignore these customer accounts. They have been chosen as part of a representative sample and the auditor needs to reach a conclusion on the accuracy of the balances on **all** the accounts included in the sample for the confirmation process.

Further checking where no reply is received

Where no reply has been received, the auditor should therefore perform **alternative procedures** in order to obtain evidence to confirm the customer's balance.

- If the customer has subsequently paid all of the amount due at the confirmation date, this is strong evidence of the validity of the receivable.
- If no payment (or only part-payment) has been received, all the relevant documentation supporting the amount still due should be examined. For each invoice outstanding at the confirmation date, the auditor should examine:
  - a signed customer purchase order
  - signed delivery documentation (the customer's signature on the delivery note)
  - a sales invoice addressed to the customer.

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4.8 Preparing a summary and reaching a conclusion

On completion of the confirmation exercise, the auditor should produce a **summary** of the responses. This should clearly indicate the amounts of the balances subject to confirmation for which the auditor has not been able to establish supporting evidence. These amounts indicate misstatement of receivables balances. In particular, they may indicate the existence of irrecoverable receivables.

As always with a sampling exercise, the auditor should draw a **conclusion** on the likely level of misstatement in the total population of receivables balances based on the result of the sample, and whether this is material.

Such a summary might be prepared as follows:

	Value of balances	**% of total**
	₦	
Replies received and agreed	465,600	80.3
Replies received and reconciled	56,400	9.7
Non-replies agreed using alternative procedures	43,200	7.5
Balances still unresolved	14,300	2.5
	579,500	100

Total value of receivables = ₦1,248,900.

Extrapolation of potential error = ₦1,248,900 × 2.5% = ₦31,222 – Transferred to the cumulative errors schedule

Note: The cumulative errors schedule is a list of items where the auditor's view of the amount of the item differs from the amount in the client company's accounting records/draft financial statements. The auditor builds up this schedule as the audit progresses, and will use it when reaching his final audit opinion.

4.9 Other audit procedures for trade receivables

In addition to the confirmation process, the auditor should consider the following additional audit procedures in respect of trade receivables:

Irrecoverable receivables

The auditor needs to be satisfied that the amount of irrecoverable receivables written off and any allowance made for receivables are reliable. These will affect the amount included in the statement of financial position for trade receivables. The following substantive procedures should therefore be performed:

- ❑ Review the company's procedures for identifying irrecoverable and doubtful receivables.
- ❑ Review aged listings of receivables balances ('aged receivables lists'). Irrecoverable receivables and allowances for doubtful receivables should only relate to overdue accounts. The auditor should enquire as to whether the overdue receivables are collectable.
- ❑ Review any correspondence of the client company with customers, lawyers and collection agencies that deal with unpaid or disputed debts.
- ❑ Review the calculation of any allowances against doubtful receivables.
- ❑ Examine credit notes issued after the year-end, as evidence that some balances were overstated at the year-end. (The customer and the client

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company may have been in dispute about an invoice at the end of the financial year, and the dispute may subsequently have been resolved by the issue of a credit note and a reduction in the amount receivable.)

- Review the replies from customers for the confirmation of balances exercise, for evidence of receivables that may not be collectable.

Cut-off

The audit work after the physical inventory count will also give evidence of the accuracy of sales cut-off. The **cut-off assertion** was explained in an earlier chapter. It is concerned with ensuring that revenue (and therefore receivables) is properly recorded **in the correct accounting period**. Sales that occur just before or after the year-end need to be allocated to the correct financial year.

Additional work on this area might include the following:

- The use of analytical procedures to confirm that inventory levels, cost of sales and gross margins can be explained in terms of known business facts.
- Checking that sales invoices and credit notes dated shortly before and after the year end are recorded in the correct financial year.
- Review of the control account entries shortly before and after the year end for unusual items, which the client should then be asked to explain.

Presentation and disclosure

To satisfy the **presentation and disclosure** assertion the auditor will need to ensure that:

- the list of receivables ledger balances (on which he bases his substantive procedures below) agrees to the financial statements
- receivables are correctly disclosed and classified in the financial statements.

Example:

The following is a summary of the year-end receivables balances at Mike's Manufacturing and the equivalent figures for the previous year. Performance materiality has been set at ₦5,000.

Customer	**20X4**	**20X3**
	₦	**₦**
Jones	2,500	2,400
Smith	6,000	3,000
Brown	2,000	2,000
White	1,000	1,100
Crane	20,500	18,900
Other customers, all with balances under ₦1,000	16,600	7,400
	48,600	34,800

Brown went into liquidation during the year.

Required

Set out which of the above balances, as a minimum, the auditor should select for testing and explain why.

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Answer

- Smith should be selected as this balance is above performance materiality. Also, the balance has doubled since the previous year.
- Brown should probably be selected. Although it is below performance materiality it would seem likely that the receivable is irrecoverable.
- Crane should be selected as individually material.
- Although the “other customers” balances all fall well within the performance materiality threshold, they are material in total, and so a sample of these should be verified. This would particularly be the case if the auditor was not expecting sales to smaller customers to have increased during the year. There could be a deliberate attempt to overstate a number of small balances (or invent fictitious customers and balances) in a deliberate attempt to boost assets and avoid audit detection.

4.10 The audit of prepayments

Prepaid expenses are often **estimated amounts** and so may not be open to precise and specific audit checking procedures. The problem of auditing accounting estimates was discussed in a previous chapter. In addition, for many business entities, prepayments are not material and so may not justify significant audit attention.

Substantive procedures on prepayments may include the following:

- Obtain or prepare a list of prepayments with supporting calculations.
- Check the calculations if the list has been prepared by the client’s staff.
- Apply analytical procedures (for example, by comparing the balances for prepayments with the balances at the end of the previous financial year).
- Review the list of prepayments for any obvious errors or omissions, based on the auditor’s knowledge of the business.

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5 SUBSTANTIVE PROCEDURES: BANK AND CASH BALANCES

Section overview

- Features of the audit of bank and cash balances
- Principal risks
- Bank balances: confirmation of balances
- Audit work on receipt of the banks' replies
- Cash balances: physical count

5.1 Features of the audit of bank and cash balances

Introduction

For the purpose of this chapter, bank balances are amounts held in a bank account, and cash balances are bank notes and coins (although coins are likely to be immaterial).

Assets held as bank balances and cash can be at risk of loss. There may be fraudulent activity, or the misappropriation of money by employees or others, particularly when many individuals have authority for dealing with receipts and payments.

However, bank balances and cash are also easily checked and verified. Bank balances can be confirmed directly in writing by the banks (third parties) and cash can be physically counted.

Bank balances and cash are also usually subject to rigorous internal controls, to prevent loss and theft. In many countries, it is regular practice for business entities to receive regular bank statements from their bank. A feature of internal control for bank balances is the reconciliation of the balance shown in a bank statement with the balance recorded in the entity's own accounting records (cash book).

The audit work on **cash** balances will be determined largely by materiality (how much cash does the entity hold and is it a material amount?) and the effectiveness of the client's internal controls for cash.

5.2 Principal risks

The **principal risks of misstatement** of the bank and cash balances in the financial statements are that:

- not all bank balances owned by the client are disclosed (the **rights and obligations** and **existence** assertions)
- reconciliation differences between bank statements and the client's cash book balances are incorrectly dealt with (the **valuation** assertion)
- material cash balances are omitted (the **completeness** assertion).

The **presentation and disclosure** assertion is low risk as the disclosures in this area are straightforward.

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5.3 Bank balances: confirmation of balances

Checking the accuracy of bank balances can be done effectively by means of **direct confirmation** to the auditor by the banks at which the entity's bank accounts are held. This is similar to written confirmation of balances from customers, in order to check trade receivables.

The bank confirmation letter

The auditor must decide, taking a risk-based approach, which banks to contact for confirmation. Typically, all banks that hold accounts for the client entity are contacted. However, the auditor may choose to omit some banks for reasons of immateriality.

The auditor can use either of two possible approaches to the confirmation of bank balances:

- **Method 1**. The auditor lists information about the bank balances from the client's accounting records and asks each bank to confirm that the balances are correct. (Note: Banks may operate several different accounts for the same customer.)
- **Method 2**. The auditor requests confirmation of the relevant bank balance(s) without providing any details to the bank. This method provides stronger audit evidence but it may be more time-consuming for the bank to provide the required confirmation.

The two methods are similar to the two methods of positive confirmation of balances from customers for trade receivables.

In the case of the external audit, permission must be given to the bank by the client to release information to the auditor. The letter should be written in a standard form that is acceptable to banks and should include the client entity's authorisation to the bank to release the information to the auditor. (The client entity may give standing authority to the bank to release the information to the auditor each year: if so, the letter should refer to this standing authority.) The letter should be sent by the auditor to the bank.

The reply should be sent by the bank direct to the auditor. (This is also the same as for the confirmation of balances from customers for trade receivables.)

Typical areas covered by the confirmation letter include the following:

- Confirmation of balances on all bank accounts at the end of the reporting period.
- Details of any unpaid bank charges.
- Details of any liens (charges) over assets of the client entity.
- Details of any assets of the client entity held by the bank as security for lending.
- Details of any other client bank accounts that are known to the bank but not listed in the request to the bank for confirmation of balances.

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5.4 Audit work on receipt of the banks' replies

The main audit work will focus on the confirmation letters from the bank (or the confirmation letter from the client's bank, if there is just one bank) and the client company's bank reconciliation statement. A statement should be provided by the bank for the end of the reporting period.

- Obtain or prepare a bank reconciliation statement for each bank account.
- If the reconciliation is prepared by the company, check it for arithmetical accuracy.
- Check the bank balance confirmed in the bank's confirmation letter against the balance used in the bank reconciliation statement.
- Relate other information contained in the confirmation letter to other areas of the audit (for example, accrued bank charges must be provided for in the financial statements).
- Check items appearing in the bank reconciliation statement against any available supporting evidence (for example, unpresented cheques in the bank reconciliation statement should be shown as having been presented in a subsequent bank statement).
- Review the cash book and bank statements for unusual items, including unusual delays between cash book and bank statement entries. Investigate the reasons for any unusual item.
- Review the confirmation letter from the bank for any other information to be disclosed in the financial statements (for example, charges on assets and security for loans).

5.5 Cash balances: physical count

The audit work performed on cash balances (as opposed to bank balances) will be largely dictated by materiality considerations. In this context, materiality should be considered not only in terms of the statement of financial position amount, but also in terms of the value of total transactions passing through the cash account during the period.

In addition, the auditor needs to appreciate that certain businesses hold cash in a large number of locations (for example, in a company that operates a chain of hotels or supermarkets). In total, these balances may be material, whereas the amount of cash held in any single location may be insignificant.

The main audit work involved in verifying cash balances is a **physical count**.

Audit procedures include the following:

- The auditor should count cash at all locations **simultaneously** and in the presence of a company official. (Simultaneous counting is necessary, to prevent the client from moving cash that has been counted at one location to another location ready for the next count.)
- After the count the auditor should obtain a signed receipt for the amount of cash returned to the official, after the count.
- The auditor should check the cash balance obtained from the count against the client's cash records and cash balance in the draft financial statements.
- Where appropriate, the auditor should also investigate the treatment of any money advances to employees (for example, against wages or salary).

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6 CHAPTER REVIEW

Chapter review

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

- Explain the principle risks of misstatement for current assets
- Describe the key substantive procedures for auditing
  - Inventory
  - Trade receivables
  - Bank and cash

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Quick quiz questions

1 The principal audit procedure at the inventory count is?

A Analytical review

B Computation

C Observation

D Delegation

2 Cut-off is most commonly associated with which IAS?

A IAS 16

B IAS 38

C IAS 2

D IAS 37

3 Which of the following is not applicable in the audit of inventory?

A The application of IAS 2

B Performing some sample counts during the inventory count

C Reviewing post year-end sales

D Checking cash after date

4 Which of the following is NOT a substantive test for the audit of receivables?

A Test cash received after the end of the reporting period

B Check there is adequate provision for doubtful debts

C Check reasons for debit balances (and ensure they are disclosed under payables)

D Check brought forward balance

5 Bank reports for audit purposes should normally be sent to the bank at what time?

A At the start of the audit

B At the period end date

C 2 weeks before the period end date

D Immediately after the inventory count has been completed

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Quick quiz answers

1 C

2 C

3 D

4 C

5 C

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Skills level
Audit and Assurance

CHAPTER 12

Substantive procedures: Other areas

Contents

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INTRODUCTION

Competencies

Gathering evidence

The nature of audit evidence and the selection of sufficient appropriate audit evidence (ISA 500)

C2	Evaluate the different sources and quality of evidence and the methods of obtaining evidence. *(See also chapters 6 and8-11)*
C3	Document appropriate procedures for gathering evidence based on a given scenario (ISA 505, ISA 520). *(See also chapters 6 and 8-11)*

Exam context

Substantive procedures typically represent a significant element of fieldwork performed during a statutory audit engagement and are therefore a critical element of the syllabus.

Chapters 9-12 describe the various substantive procedures commonly performed on the statements of financial position and comprehensive income. Students must ensure they link substantive tests to specific assertions and risks to ensure they understand the objective of each procedure.

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

- Explain the principal risks of misstatement for the areas listed below
- Describe the key substantive procedures for auditing
  - Trade payables
  - Accruals, provisions and contingencies
  - Non-current liabilities
  - Equity
  - Directors' emoluments
  - Key income statement figures

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1 SUBSTANTIVE PROCEDURES: TRADE PAYABLES

Section overview

- Principal risks of misstatement in the audit of liabilities
- The general approach to the substantive testing of trade payables
- Substantive procedures for trade payables
- Purchases cut-off

1.1 Principal risks of misstatement in the audit of liabilities

As discussed in previous chapters, **directional testing** is an approach to audit testing that an auditor may use to improve the efficiency of an audit. With directional testing, liabilities, income and equity are usually tested for **understatement** only. This is testing the financial statement assertion of **completeness**. The reason for this approach is that an auditor will consider it much more likely that an entity will understate its liabilities (in order to present a better financial position) than overstate its liabilities.

Because auditing liabilities involves testing for completeness, auditing liabilities is often more difficult than auditing assets (where the emphasis of audit testing is on overstatement/existence). The auditor is looking for something that is not recorded, rather than verifying something that has been recorded. This influences the audit approach and the type of audit work performed.

The **principal risks of misstatement** in respect of liabilities are therefore due to the following:

- ❑ Not all liabilities of the reporting entity being included in the financial statements. This is considered to be the main risk.
- ❑ Cut-off between goods inwards and liability recording being incorrect (the **cut-off** assertion – an **income statement** assertion that has a knock-on effect to the audit of trade payables (see below)).
- ❑ Non-existent liabilities being included in the financial statements (the **existence** and **rights and obligations** assertions). This risk is rarer, and will often not be considered a risk at all.
- ❑ Liabilities not being properly disclosed in the financial statements (the **presentation and disclosure** assertion).

1.2 The general approach to the substantive testing of trade payables

Trade payables are a material item in the statement of financial position of many entities. Therefore, this area is likely to receive a significant level of audit attention.

In some respects, the audit approach is similar to the approach used for the audit of trade receivables. However, a major difference lies in the fact that direct confirmation of balances with suppliers, although sometimes used, is **not** a typical audit testing procedure.

The reason why direct confirmation is not widely used is that the auditor normally has an alternative external source of written evidence. This evidence is provided in the form of supplier’s statements.

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- A supplier's statement is a printed statement, received at regular intervals from a supplier (usually each month), showing details of transactions between the supplier and its customer (purchases, purchase returns and payments) since the previous statement, and the amount owing as at the date of the statement.
- These statements and the entity's own listing of trade payables are the main records used by the auditor for testing trade payables.

Audit work performed on purchases, cash payments and inventory (including purchases cut-off) will also generate valuable audit evidence relating to trade payables.

1.3 Substantive procedures for trade payables

The following substantive procedures can be used to gather audit evidence on trade payables:

- Obtain or prepare a listing of balances on supplier accounts in the payables ledger (a listing of trade payables)
- If this listing is obtained from the client company, check it for arithmetical accuracy (perhaps by using audit software). In addition, check the payables for accuracy and existence by taking a sample of the balances and checking them against the balance on the supplier's account in the payables ledger.
- Similarly, take a sample of balances from supplier accounts in the payables ledger and confirm that they are correctly included in the listing. This is a test for valuation and completeness.
- Check that the total of the balances in the listing agrees with the balance for total trade payables in the trade payables control account in the main ledger.
- In selecting the sample of balances for testing, the auditor should consider the following points:
  - It is **not** important to select large balances, as the main audit emphasis is on completeness and understatement (not existence and overstatement).
  - For the same reason, it **is** important to select a number of accounts showing nil balances and debit balances. (When there is a debit balance, the supplier owes the client entity, presumably because goods have been returned and a credit note has been issued by the supplier, or because an invoice was over-paid or paid twice.)
  - Include major suppliers in the sample. Identification of major suppliers should be based on the auditor's knowledge of the business. This knowledge may be derived from information gained at the inventory count or from audit work on the purchases system.

  As with trade receivables, for an IT-based system, audit software can be used to assist in sample selection.

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- For each supplier account balance in the sample, compare the balance from the payables listing with the balance shown in the supplier's statement. (The first supplier's statement received after the reporting period should be used, because this will include the position as at the end of the reporting period.)
- If there is a difference between the balance in the payables listing and the balance shown in the supplier's statement, the auditor should ask the client company to prepare a reconciliation to explain the difference. The auditor should then check these reconciling items with the relevant supporting documentation.

In order to gain additional assurance about the **completeness** of trade payables balances, the auditor should also carry out the following procedures:

- Review the list of account balances for any suppliers who are not in the listing of trade payables, but who would be expected to be in the listing. These would include regular suppliers of frequently-purchased items.
- Compare the list of trade payables balances with the listing that was prepared for the previous year's audit (at the same date in the previous year). Look for explanations as to why any major balances do not appear on the current year's listing when a major balance for the same supplier is in the listing in the previous year.
- Apply other analytical procedures and obtain explanations for any significant differences identified with this method of testing. For example, the auditor might compare the ratio of trade payables to purchases in the year, and compare this with the same ratio in previous years. He might expect the ratio to remain fairly stable between one year and the next.

1.4 Purchases cut-off

Purchases cut-off was explained in an earlier chapter. It is concerned with making sure that purchases transactions just before or after the year end are allocated to the correct financial year, so that purchases (for the income statement/statement of comprehensive income) and inventory and trade payables (for the statement of financial position) are correctly recorded.

- Work performed on cut-off (and recorded at the physical inventory count) will provide evidence as to the accuracy of purchases cut-off.
- This work is based on preparing a list of the goods received notes that were prepared by the client entity immediately before and after the end of the reporting period. The auditor should confirm that goods included in closing inventory have also been recorded as a liability (trade payable) and that purchased goods not recorded in closing inventory have not generated such a liability.

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2 SUBSTANTIVE PROCEDURES: ACCRUALS, PROVISIONS AND CONTINGENCIES

Section overview

- Difficulties of obtaining evidence in this area
- Accruals
- IAS 37 Provisions, Contingent Liabilities and Contingent Assets
- Provisions and contingencies: substantive procedures

2.1 Difficulties of obtaining evidence in this area

The audit of accruals, provisions and contingencies can also be difficult areas for the auditor. Accruals are usually estimated amounts and will be subject to audit techniques which are similar to those applied to prepayments. Provisions and contingencies can be highly subjective areas where a considerable amount of judgement may be called for. Evidence may be needed from outside experts such as legal advisors.

2.2 Accruals

Principal risks of material misstatement

Accruals balances are difficult to audit as the figures reported are often based on estimates. However, the amounts involved may not be material, in which case the auditor will not devote a significant amount of time and resources to this area.

As with all liabilities, the emphasis will be on **completeness**. The nature of the items involved means that analytical procedures and the auditor's knowledge of the business are useful in reaching a conclusion on this area.

Key substantive procedures

Substantive procedures on accruals might include the following:

- ❑ Obtain or prepare a listing of accruals as at the end of the reporting period.
- ❑ If the list is prepared by the client company, check the calculations and additions for arithmetical accuracy. Check the amounts in the listing against the balances in the relevant main ledger expense accounts and ensure that the amounts are the same.
- ❑ Where invoices have been received, or payments made, after the year end, confirm that the amount accrued appears reasonable in relation to this evidence. For example, suppose that a company makes an accrual for two months of electricity charges, and receives an invoice for three months' supply of electricity one month after the year-end. If the accrual for electricity is, say, ₦6,000 (₦3,000 per month), the auditor should expect the total invoice to be for about ₦9,000.
- ❑ Compare the list of accruals with the list that was prepared at the same date in the previous financial year, and enquire about items not listed in the current year that were in the list in the previous year.
- ❑ Review the list of accruals for completeness, based on the auditor's knowledge of the business.

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- ❑ Relate items on the list of accruals to other audit areas, such as the bank confirmation letter (which might provide details of unpaid/accrued bank charges).

Accrued wages and salaries may be more material than other items and may require a higher level of audit attention:

- ❑ Consider what items should be accrued for at the end of the reporting period, such as unpaid wages, overtime, holiday pay, bonuses.
- ❑ Check the amounts for accrued wages and salaries by comparing them with personnel records and payroll records (records of time worked, records of wage rates and salaries, details of dates for the payment of wages and salaries, and so on) and to payments made after the year end.
- ❑ Confirm that any additional costs (such as employer's payroll taxes) have been accounted for.
- ❑ Perform analytical procedures on accrued wages and salaries. For example, the auditor might measure the ratio of accrued payroll expenses to total payroll costs for the year, and compare this with the similar ratio in previous years. Significant differences should be investigated.

2.3 IAS 37 Provisions, Contingent Liabilities and Contingent Assets

Accounting for provisions and contingencies can be a subjective area, which may require a high level of audit attention because the amounts involved could be material. Part of the work of the auditor will be to establish whether the provisions of IAS 37 have been complied with. You therefore need to be aware of the key points of IAS 37. The main provisions of IAS 37 are described below.

Provisions

IAS 37 gives the following definitions:

- ❑ A **provision** is a type of liability. It is a liability of **uncertain timing** and **uncertain amount**.
- ❑ A **liability** is:
  - a present obligation
  - arising from past events
  - the settlement of which is expected to result in an outflow of economic benefits.

An 'ordinary' liability is for a **known amount**. For example, an amount payable under the terms of a finance lease agreement is a liability. The obligation arises from the lease agreement. The settlement of the obligation by means of the lease payments will result in a known outflow of cash on known dates.

A provision is a liability of an **uncertain amount** or **uncertain timing**, such as:

- ❑ amounts that an entity might have to pay under a guarantee, or
- ❑ amounts that an entity might have to pay as the result of a legal claim.

An entity may know that it will have to incur expenses or will have to make a payment under guarantees it has given to customers. It therefore has a liability – an obligation that already exists arising from past events that will result in an outflow of economic benefits in the future. However, it will not know for certain when claims might be made under the guarantees and how much the claims will

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cost. The entity should therefore make a provision for expenses or payments that it expects to make under the terms of its guarantees.

Recognising a provision

IAS 37 states the criteria for recognising a provision as a liability in the financial statements. A provision should only be recognised when:

- an entity has a present obligation as a result of a past event
- it is probable that an outflow of economic benefits will be required to settle the obligation, and
- a reliable estimate can be made of the amount of theobligation.

There must be an obligation already in existence. The obligation may be legal or constructive:

- A **legal obligation** is one arising from a contract, or some other aspect of the law.
- A **constructive obligation** is one arising from the entity's actions, whereby
  - through established past practice, published policies, or a specific current statement, the entity has indicated to other parties that it will accept certain responsibilities, and
  - as a result, the entity has created a valid expectation that it will discharge those responsibilities. For example, a clothing retailer may have a policy of taking back items of clothing that customers have purchased, and refunding the purchase price, simply because the purchaser has changed his or her mind after purchase. The retailer is not under a legal obligation to take back purchased items in this way, so there is no legal obligation. However, if this is the usual practice of a particular retailer, then a constructive obligation arises.

The event leading to the obligation must be **past**, and must have occurred before the end of the reporting period when the provision is first recognised. No provision is made for costs that may be incurred in the future but where no obligation yet exists. For example, if an entity is planning a reorganisation but does not yet have an obligation (legal or constructive) to undertake the reorganisation, it cannot create a provision for reorganisation costs.

The outflow of benefits must be **probable**. 'Probable' is defined by IAS 37 as '**more likely than not**'. For example, an entity may have given a guarantee but may not expect to have to honour it. In such a situation, it cannot create a provision for the cost of expenses that it may have to incur under the terms of the guarantee. This is because a payment under the guarantee is not probable.

Measuring a provision

The amount recognised as a provision should be the best estimate of the expenditure required to settle the obligation at the end of the reporting period.

Risks and uncertainties should be considered in reaching the best estimate. Events after the reporting period will provide useful evidence. However, entities should:

- **avoid** creating **excessive provisions** (which could be used as a way of manipulating profits between financial years),or
- avoid underestimating provisions.

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Contingent liabilities

A contingent liability is **either of the following**:

A contingent liability is:

- a possible obligation;
- arising from pastevents; and
- whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events.

A contingent liability is:

- a present obligation;
- arising from pastevents; and
- which is not recognised as an actual liability because
  - an outflow of economic benefits is not probable, or
  - the amount of the obligation cannot be estimated reliably.

A contingent liability arises when some, but not all, of the criteria for recognising a provision are met. For example, a contingent liability exists, but not a provision or an actual liability if:

- a reliable estimate cannot be made, or
- no legal obligation or constructive obligation exists: there is merelya **possible** obligation.

Contingent assets

A contingent asset is:

- a possible asset;
- arising from past events; and
- whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events.

An example of a contingent asset might be a possible gain arising from an outstanding legal action against a third party. The existence of the asset (the money receivable) will only be confirmed by the outcome of the legal dispute.

Recognising contingent liabilities or contingent assets

Unlike provisions, contingent liabilities and assets:

- **are not recognised** in the financial statements and
- are not recorded in the ledger accounts of an entity. (They are not included in the double entry ledger accounting system.)

In some circumstances, the existence of a contingent asset or a contingent liability is **disclosed** in the notes to the financial statements:

- Contingent liabilities are disclosed **unless** the possibility of any outflow in settlement is remote (the meaning of ‘remote’ is not defined in IAS37).
- **Contingent assets** are **only disclosed where** an inflow in settlementis **probable**. ’Probable’ is defined by IAS 37 as ‘more likely than not’.

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Disclosures about contingent liabilities and contingent assets

Where disclosure of a contingent liability or a contingent asset is appropriate, IAS 37 requires the following disclosures in notes to the financial statements:

- ❑ A brief description of the nature of the contingent liability/asset
- ❑ Where practicable:
  - an estimate of its financial effect
  - an indication of the uncertainties.

For contingent liabilities**,** the possibility of any reimbursement.

2.4 Provisions and contingencies: substantive procedures

Principal risks of material misstatement

The auditor needs to be satisfied that the client has correctly distinguished between provisions (included in the financial statements), contingent liabilities (not included in the financial statements but disclosed in a note) and items that should not even be disclosed.

Similarly, it may be necessary to assess whether an item is an actual asset (included in the financial statements), a contingent asset (not included in the financial statements but disclosed in a note) or not likely to happen and so not disclosed.

The auditor must also be satisfied about the measurement/valuation of the items in the financial statements or disclosed by way of a note.

So, in summary the key assertions at risk are:

- ❑ Completeness and occurrence;
- ❑ Valuation, accuracy and allocation

Key substantive procedures

Substantive procedures to provide evidence on provisions should normally include the following:

- ❑ Obtain a listing of provisions that the client has included in the (draft) financial statements.
- ❑ For each item in the listing, confirm that the accounting provisions of IAS 37 have been complied with. Does the item meet the definition of provision?
- ❑ Review the changes in the provision for the period during the financial period.
- ❑ Review the measurement of the closing balance for each provision and discuss these with management if appropriate. Consider whether it might be appropriate to take expert advice on the existence or measurement of a provision.
- ❑ Review the list for possible omissions, based on the auditor's knowledge of the business and the industry in which it operates.
- ❑ Compare provisions for the current financial year with provisions in previous years, and investigate any major differences or omissions.

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- Relate the testing of provisions to other areas of the audit work, such as correspondence with lawyers (which might reveal more information about matters to which the provisions relate).

Key substantive procedures - contingencies

The audit approach to gathering evidence on contingencies may be as follows:

- Ascertain the approach taken by the client's management to identifying contingencies.
- Review the minutes of board meetings (where such matters are likely to be discussed).
- Review relevant sections of the business press and trade journals for areas in which possible industry-wide contingencies may arise.
- Review the client's correspondence with lawyers and invoices for legal services. These may help the auditor to identify contingencies that the client has not disclosed in the notes to the draft financial statements, or that provide additional information for the auditor about contingencies that have been disclosed.
- Consider direct confirmation from lawyers of matters handled on behalf of the entity under audit. Any letter should be sent by management with an instruction for the reply to be sent directly to the auditor. It is more likely that lawyers will respond if the letter lists specific areas where contingencies may exist, together with an assessment by management of the possible outcome. The lawyers should then be asked to comment on the information in the letter.
- Consider whether expert advice may be required from outside sources other than lawyers.

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3 SUBSTANTIVEPROCEDURES: NON-CURRENT LIABILITIES

Section overview

- Aspects of reporting non-current liabilities
- Substantive procedures for non-current liabilities

3.1 Aspects of reporting non-current liabilities

Non-current liabilities are liabilities repayable after more than one year from the end of the reporting period. They may include:

- debentures
- loan stock
- loan notes
- bank loans
- finance lease obligations.

It may be that loans are repayable at regular intervals throughout the term of the loan, in which case a part of the overall balance owing may be a current liability (repayable within the next 12 months) with the remaining part being a non-current liability. This is an important point for the auditor to consider, in terms of ensuring the proper disclosure of information in the financial statements (and the classification of liabilities as non-current or current).

The agreements under which these non-current liabilities are taken out may impose conditions on the company which, if broken, may give the lender the right to impose penalties or possibly withdraw the finance. This is another significant consideration for the auditor.

3.2 Substantive procedures for non-current liabilities

Substantive procedures in respect of non-current liabilities may be as follows:

- Obtain or prepare a listing of long-term borrowings/non-current liabilities. The listing should include, for each item, details of the lender and the movement on the borrowing in the financial period. (Opening balance plus interest charges minus payments on the loan equals closing balance.)
- If the list is obtained from the client entity, check it for accuracy.
- Agree the opening balances on the listing with the amount for non-current liabilities in last year's statement of financial position.
- Check that any new borrowings during the year have been authorised in accordance with the correct company procedures.
- Agree the details of each loan with the loan agreement/documentation.
- Check whether any restrictions contained in the lending agreements have been complied with. For example, check that the client entity has not been in breach of any covenant in a borrowing agreement.
- Confirm loan repayments in the listing with payments recorded in the cash book, entries in bank statements and also with any correspondence or receipts or statements from lenders.

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- ❑ Check the interest calculations and confirm that the correct accounting entries for interest have been made, recognising any opening and closing accruals for interest expenses.
- ❑ Obtain direct confirmation from lenders of amounts outstanding.
- ❑ Confirm that any relevant statutory requirements have been complied with (such as whether charges on assets have been properly registered, if there is a legal obligation to register charges).
- ❑ Confirm the correct allocation of the total amounts outstanding between current liabilities (repayable within 12 months) and non-current.
- ❑ Review cash book entries for unusual cash receipts that may represent new loans taken out during the period. Where unusual cash book entries are found, obtain an explanation.

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4 THE AUDIT OF EQUITY

Section overview

- Introduction
- Substantive procedures: share capital
- Substantive procedures: reserves
- The audit of statutory books

4.1 Introduction

To some extent, the nature of the specific audit work performed on equity in the statement of financial position will be dictated by the requirements of local company law. The procedures described here cover general audit principles which are likely to be relevant in most countries.

The amount of audit work performed on this area is usually not significant. If the auditor is confident that assets and liabilities are correctly stated, the total of equity (capital and reserves = assets minus liabilities) must also be correct.

4.2 Substantive procedures: share capital

The auditor will usually carry out the following substantive procedures on share capital:

- Where local law requires that companies should have an authorised share capital, the auditor should check that the total authorised capital in the draft financial statements is consistent with the company's constitution.
- The auditor should check the nominal value of shares issued during the year, by reading the supporting documentation, and should ensure terms of issue were properly complied with.
- If new shares were issued during the year, check that cash received for them has been properly recorded in the main ledger.
- Check that the amount reported as issued share capital agrees with the amount recorded in the register of members/shareholders, if the company has such a register. (In some countries there is a legal requirement to maintain a register of members.)

4.3 Substantive procedures: reserves

The auditor will usually carry out the following substantive procedures on reserves:

- Obtain an analysis of movements on all reserves during theperiod.
- Check the accuracy of these movements by checking supporting documentation.
- Ensure that any specific legal requirements relating to reserves have been complied with. (For example, check that the entity has not breached legal restrictions on use of the share premium account.)
- Confirm that dividends have been deducted only from those reserves that are legally distributable (usually the accumulated profits reserve/retained earnings).

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- ❑ Check the authorisation for the amount of dividendspaid.
- ❑ Check the dividend calculations and check that the total dividends paid are consistent with the amount of issued share capital at the relevant date.

4.4 The audit of statutory books

Most countries require companies to maintain certain 'books' or records containing defined information, in addition to their normal accounting records. The nature of these '**statutory books**' varies from country to country, but they may include the following:

- ❑ Minutes of board meetings and minutes of general meetings of the company.
- ❑ Register ofmembers/shareholders.
- ❑ Register of directors and their interests in the shares and loan capital of the company.
- ❑ Register of charges on the company's assets.
- ❑ Copies of directors' service contracts and details of directors' remuneration packages. (Audit work on this area can be included in payroll testing procedures. The auditor should confirm that national company law disclosure requirements are complied with.)

The auditor should confirm that the required statutory records are maintained by the client company and are up-to-date.

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5 DIRECTORS' EMOLUMENTS

Section overview

- Directors' emoluments
- IAS 24 Related party disclosures
- Audit procedures for Directors' emoluments

5.1 Directors' emoluments

Whilst payments (emoluments) to directors may be immaterial in size relative to revenue or net assets, shareholders and other users of the financial statements are normally very interested in the amount of the company's wealth that is being paid to directors. Therefore directors' emoluments are **material by nature** and must be carefully considered by the auditor.

Listed companies in many countries must disclose details of directors' emoluments as part of their Directors' Remuneration report, typically detailing salaries, bonuses, pension contributions, retirement benefits, non-cash benefits and other fees.

5.2 IAS 24 Related party disclosures

IAS 24 requires various disclosures relating to Directors' emoluments. IAS 24 states:

An entity shall disclose key management personnel compensation in total and for each of the following categories:

- ❑ Short-term employee benefits
- ❑ Post-employment benefits
- ❑ Other long-term benefits
- ❑ Termination benefits; and
- ❑ Share-based payment

Note that *ISA 550 Related Parties* is not examinable in this exam, so you will not be tested on the audit procedures relating to related party disclosures. These are covered in Advanced Audit and Assurance.

5.3 Audit procedures for Directors' emoluments

- ❑ Obtain a detailed schedule of emoluments for the year for each director.
- ❑ Check the casting (addition) in the schedule and agree the totals to the relevant disclosures in the financial statements.
- ❑ Seek confirmation from each director that the emoluments are complete.
- ❑ Review the minutes of board meetings and the remuneration committee (if it exists) for evidence of any undisclosed emoluments. This will assist in testing for completeness of disclosure. A review of the cash book for unusual transactions may also uncover undisclosed (incomplete) emoluments.

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- ❑ Agree figures from the emoluments schedule to payroll records and check that the amounts paid per the bank statements agree with those payroll records.
- ❑ Inspect and review any returns to tax authorities relating to directors' emoluments that have been made by the company on behalf of the directors. Ensure details are consistent with relevant disclosures in the financial statements.
- ❑ Perform an analytical review by comparing the emoluments against prior year emoluments and current year expectations based on your knowledge of the business and each director's performance. Inquire as to reasons for any significant variations.
- ❑ Inspect and review the directors' contracts to ensure emoluments are in line with their contracts.
- ❑ In light of the above procedures and your understanding of the entity consider the adequacy of disclosure of directors' emoluments.

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6 KEY INCOME STATEMENT FIGURES

Section overview

- Introduction
- Revenue
- Purchases
- Payroll costs
- Interest paid and received
- Expenses

6.1 Introduction

Tests of controls on key income statement figures were covered in a previous chapter. Whatever the results of those tests, some degree of substantive procedures will need to be performed. For some clients, with strong internal controls, this could be limited to analytical procedures. These and other possible substantive procedures are considered below.

6.2 Revenue

As you saw in an earlier chapter, revenue is often tested by testing controls.

It should also be possible to obtain strong evidence from analytical procedures especially as there is a strong relationship between revenue and other key figures in the financial statements (such as receivables, where the auditor should be able to obtain strong third-party evidence as described in a previous chapter).

Revenue can also be substantively tested by vouching transactions. If the major risk is one of **overstatement**, then the auditor will select a sample of entries from the revenue account in the nominal ledger and trace them back via sales invoices to despatch notes, to provide evidence that recorded sales did **occur.**

6.3 Purchases

Similar to revenue, purchases is also often tested through controls testing.

It should also be possible to obtain strong evidence about purchases from analytical procedures due to the strong relationships that normally exist between purchases and other key figures in the financial statements (such as revenue (via the gross profit percentage) and trade payables).

As with revenue, purchases can also be substantively tested by vouching transactions. If the major risk is one of **understatement**, then the auditor will wish to test for **completeness**. He may therefore wish to check that:

- ❑ all purchase orders are recorded and that the order details are correct
- ❑ for every purchase order the goods were actuallyreceived
- ❑ all goods received were properly recorded in the inventory accounting system.

Substantive procedures on purchases (other than analytical procedures) include the following.

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- ❑ Obtain a sample of copies of purchase orders and trace these to the purchasing IT system. Check the accuracy of the recorded order details in the system.
- ❑ Obtain a sample of purchase orders in the purchasing IT system and trace these to the signed copies of the goods received notes in the stores department (goods inward department).
- ❑ For this same sample of purchase orders, check that the details of the goods received were properly recorded in the inventory accounting system.

Substantive tests can also be carried out on **purchase invoices**, in order to ensure that:

- ❑ details in the purchase invoices have been correctly entered in the payables ledger
- ❑ entries are made in the purchase ledger only for goods that have actually been received
- ❑ the liability was recorded in the correct supplier account.

Methods of performing these tests include:

- ❑ Obtain a sample of purchase invoices recorded in the purchases day book and agree the details (of supplier and price) with the entry in the purchase ledger.
- ❑ For a sample of purchase invoices in the purchases day book, agree the invoice details by checking with the corresponding goods received note.
- ❑ Carry out arithmetical checks on a sample of suppler invoices (quantities delivered multiplied by price and total invoice amounts; also check prices against the original purchase orders).

6.4 Payroll costs

As with other income statement expense items the key risk of material misstatement for payroll is that it has been **understated**. The auditor will therefore focus on testing for **completeness**.

Substantive analytical procedures are often carried out on payroll costs as there is a strong relationship between rates of pay and numbers of employees (for gross pay) and between gross pay and deductions (such as employer’s national insurance and pension deductions).

An example of analytical procedures for payroll costs is as follows. For a department where employees all receive fixed salaries, compare salary costs in the current year with salary costs in the preceding year. Unless there has been a significant change in staff numbers, the two totals should be similar, except for any inflationary increase in salaries during the year.

Another check would be to compare total salary payments for the same department between one month and the next. Except for a month in which a salary increase is applied, total salary costs for the department should be constant from one month to the next.

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Other substantive procedures to verify payroll costs might include selecting a sample of payroll records and checking that:

- the employee exists (by reference to personnel records)
- gross pay has been correctly calculated (by reference to personnel records for salaries or time worked multiplied by documented rates of pay)
- deductions have been correctly calculated (by re-performance on a sample of payroll payments).

6.5 Interest paid and received

Interest paid and received will usually be verified via:

- Bank statements
- "proof in total" (average interest rates for the period multiplied by average balance outstanding).

6.6 Expenses

Other expenses can be tested via analytical procedures, or by vouching transactions to purchase invoices.

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7 CHAPTER REVIEW

Chapter review

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

- Explain the principal risks of misstatement for the areas listed below
- Describe the key substantive procedures for auditing
  - Trade payables
  - Accruals, provisions and contingencies
  - Non-current liabilities
  - Equity
  - Directors' emoluments
  - Key income statement figures

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Quick quiz questions

1 A good way to authenticate sales is to view the authorisation of?

A Goods received notes

B Sales orders

C Goods despatch notes

D Supplier statements

2 Why is the circularisation of payables not a typical audit testing procedure?

A Because they are less likely to be misstated than receivables

B Because they are usually a smaller amount than receivables

C Because they are less likely to reply than receivables

D Because the auditor normally has an alternative external source of evidence

3 Which of the following is NOT normally a non-current liability?

A Corporation taxpayable

B Debentures

C Bankloans

D Finance lease obligations

4 IAS 37 states that provisions are liabilities of uncertain timing or amount. Where do they appear in the financial statements?

A Current liabilities

B Non-current liabilities

C Either of the above depending on when payment is expected

D Provisions are a separate heading

5 Suppliers' statements are reconciled in order to:

A verify the completeness of payables

B ensure cut-off is correct

C vouch the authorisation of purchase orders

D verify the existence of payables

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Quick quiz answers

1 C

2 D

3 A

4 C

5 A

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Skills level
Audit and Assurance

CHAPTER 13

Contents

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INTRODUCTION

Competencies

Objectives, need for and process of audit and assurance

A1 (f) Discuss audit expectation gap.

A3 (a) Explain the basic steps of audit and assurance process in relation to:

(v) Performance

- Evaluating results (ISA450);

(vi) Conclusion; and

(vii) Reporting (ISA 700).

A3 (e) Explain opinion and assurance report.

Gathering evidence

The nature of audit evidence and the selection of sufficient and appropriate audit evidence (ISA 500)

C4 Identify the circumstances where written representations may be required (ISA 580).

C5 Evaluate the circumstances requiring discussion with senior assurance team members (ISA 450) and advise on how this should be communicated and documented.

Exam context

The auditor's report is the key deliverable from an external audit engagement. In summary the auditor's report is what the client is buying!

This chapter addresses the main processes involved in finalising the audit fieldwork and drawing a conclusion. The student is introduced to the core structure of a basic auditor's report prepared in accordance with ISAs and CAMA 2020

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

- Explain what a written representation is and discuss the instances when they would be used
- Summarise the requirements of ISA 450 with respect to misstatements identified
- Describe what is involved in the final review prior to signing the auditor's report
- Explain the contents of an unmodified auditor’s report both in terms of the requirements of ISA 700 and Companies and Allied Matters Act 2020

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1 WRITTEN REPRESENTATIONS: ISA 580

Section overview

- Definition and objectives
- Written representations as audit evidence
- Written representations about management's responsibilities
- Form and contents of the letter of representation
- Refusal to provide requested written representations

1.1 Definition and objectives

Definition: Written representation

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 appropriate written representations from management (often referred to as "**management representations**") to be in the form of a **letter of representation**, addressed to the auditor.

These written representations may be an important source of audit evidence.

1.2 Written representations as audit evidence

If the auditor considers that written representations are needed **to support other audit evidence** he is **required** to request such other written representations.

During the course of the audit, management will make many representations to the auditor. Some of these will be unsolicited but some will be given in response to specific enquiries from the auditor. The auditor will have recorded such verbal discussions with management in the audit working papers. However, verbal evidence is not strong audit evidence. In order to improve the quality of this evidence, the auditor will ask for any significant discussions to be confirmed in writing.

Such representations are likely to be needed:

- to support the auditor's understanding of management's intention or judgment (for example, in respect of future plans for the business or a specific matter such as the net realisable value of inventory), or
- in respect of the completeness of a specific item (for example, that all liabilities have been provided for).

However, although such written representations provide necessary audit evidence, **they do not provide sufficient appropriate evidence on their own**.

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If a representation by management is contradicted by other audit evidence, the auditor should:

- ❑ consider whether his risk assessment of that area is still appropriate
- ❑ consider whether additional audit procedures are needed
- ❑ if he has concerns about the integrity of management, document those concerns and consider withdrawing from the audit.

The auditor is also **required by specific other ISAs** to request certain other written representations. These requirements are illustrated in the example letter set out below.

1.3 Written representations about management's responsibilities

The auditor is also **required** by ISA 580 to obtain certain other specific written representations from management. In these representations management acknowledges that:

- ❑ it has fulfilled its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
- ❑ it has provided the auditor with all relevant information
- ❑ all transactions have been recorded and are reflected in the financial statements.

Again, these points are illustrated in the example letter set out below.

1.4 Form and contents of the letter of representation

The letter of representation is:

- ❑ usually drafted by the auditor (since he knows the areas on which he requires written representations)
- ❑ addressed to the auditor
- ❑ dated as near as practicable (but not after) the date of the auditor's report.

A written representation letter may include the followings tatements.

- ❑ The written representation letter relates to the audit of the client company.
- ❑ The management of the entity have fulfilled their responsibilities for the preparation of the financial statements, and the financial statements give a true and fair view and are free from material misstatement.
- ❑ The assumptions made by management to make accounting estimates and reach fair values are reasonable.
- ❑ Related party relationships and transactions have been disclosed.
- ❑ All events after the reporting period have been either adjusted or disclosed.
- ❑ The effect of any uncorrected misstatements (a list of which should be attached to the letter) is immaterial.
- ❑ The auditors have been provided with all relevant material, including the books of account, and unrestricted access to individuals within the entity.
- ❑ All transactions have been recorded and are included in the financial statements.

- Management have disclosed to the auditors all information that is relevant to fraud or suspected fraud.
- Management have disclosed all known instances of non-compliance with laws or regulations that are relevant to the preparation of the financial statements.
- Representations may also be included that refer to specific assertions in the financial statements, if the auditors require that such assertions should be made.

Examples

The following example of a letter of representation shows the minimum contents of such a letter. However, remember that the auditor may also need to request management to provide written representations about specific assertions in the financial statements.

Example of a letter of representation

ABC Ltd

To XYZ Auditor

(Chartered Accountants)

22nd February 20X5

This representation letter is provided in connection with your audit of the financial statements of ABC Ltd for the year ended 31 December 31 20X4 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)

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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 theentity.

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)

1.5 Refusal to provide requested written representations

If management refuse to provide requested written representations the auditor is **required** to:

- ❑ discuss the matter with management
- ❑ re-evaluate the integrity of management and reconsider the impact on other representations and audit evidence
- ❑ take appropriate action, including considering the effect on the auditor's report.

Example:

The following points have arisen during the audit for the year ended 30 June 20X4 of Compo, a nationwide dealer in used cars.

1. During the year, five of Compo's properties were revalued by an independent surveyor.
2. One property was sold during the year to the marketing director.
3. The directors have refused to make provision against a bad debt.

Required

Explain whether or not each of the above would be referred to in the letter of representation for the year ended 30 June 20X6.

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Answer

1. No – other evidence should be available (the independent surveyor's report).
2. Yes – to support the completeness of disclosure of loans and other transactions with directors.
3. No – the impact on the auditor's report will need to be considered. (And if the directors have refused, and the auditor is sure the debt is bad, the directors are not going to provide evidence to support this view in the letter of representation.)

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2 EVALUATION OF MISSTATEMENTS: ISA 450

Section overview

- Objective of ISA 450
- Requirements of ISA 450

2.1 Objective of ISA 450

As illustrated above, ISA 450 *Evaluation of misstatements identified during the audit* requires a **list of the uncorrected misstatements** to be attached to the letter of representation. Such a list is often referred to as a **summary of unadjusted audit differences**.

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.

2.2 Requirements of ISA 450

ISA 450 **requires** the auditor to do the following:

- 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 reassess 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 auditor's 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 letter of representation above).

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- Document:
  - the amount below which misstatements would be regarded as clearly trivial
  - all misstatements accumulated during the audit and whether they have been corrected
  - his conclusion as to whether uncorrected misstatements are material, individually, or in total.

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3 OVERALL REVIEW OF THE FINANCIAL STATEMENTS

Section overview

- General review
- Specific review

After the detailed audit work has been completed, the auditor will carry out an overall review of the financial statements. By this stage of the audit, the financial statements should be in their final draft form.

This review will normally be carried out by a senior member of the audit team, often the manager or partner.

3.1 General review

At a general level, the review will check that a clear conclusion has been reached and documented on each of the financial statement areas. Analytical procedures may be used as a final check that the information contained in the draft financial statements 'makes sense'.

3.2 Specific review

More specifically, the overall review will cover the following matters:

- Compliance by the client with the relevant accounting framework (national legislation and relevant accounting standards).
- A review of the accounting policies adopted by the entity, to assess whether they are acceptable (and comply with accounting standards and industry practice).
- A review of the financial statements for adequate disclosure of relevant information.
- An assessment of whether the information contained in the financial statements is consistent with known business facts.

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4 PURPOSE OF THE AUDITOR'S REPORT

Section overview

- Introduction
- The expectation gap

4.1 Introduction

The auditor's report is the end-product of the external audit process. It is the document in which the auditor expresses his professional judgement on whether the financial statements present a ‘true and fair view’.

The contents of the auditor's report are likely to be regulated by national legislation. In addition, the external auditor is governed by:

- ISA 700 *The auditor’s report on financial statements*
- ISA 701 *Key audit matters in the independent auditor’s report*
- ISA 705 *Modifications to the opinion in the independent auditor’s report*
- ISA 706 *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor’s report*

Note that ISAs 705 and 706 are outside the scope of this syllabus

4.2 The expectation gap

The auditor's report is the only direct means of communication between the auditor and the users of the financial statements (who are mainly, but not exclusively, the shareholders). In recent years, auditing has suffered from an ‘expectation gap’ as the role of the auditor in law does not match what the users of financial statements expect from an auditor.

The term ‘expectation gap’ refers to the fact that the public perception of the role and responsibilities of the external auditor is different from his statutory role and professional 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 auditor's report amounts to a ‘certificate’ that the financial statements are correct and can be relied upon for all decision-making purposes, including decisions about takeovers.
- The public also believes that the auditor has a duty to prevent and detect fraud and that this is one reason for an audit.
- The public assumes that, in carrying out his audit work, the auditor tests 100% of the transactions undertaken during the accounting period.

One consequence of these misunderstandings has been an increasing tendency in some countries to undertake legal action against the auditors, sometimes on a ‘frivolous’ basis, in the belief that the auditor should have prevented misstatements in the financial statements or should have prevented fraud.

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Elements of expectation gap

There are three main elements of expectation gap:

- A standards gap - This occurs because of a perception that auditing standards are more prescriptive than they actually are, and that the 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 expectation. In addition, there is a perception that auditors have a responsibility for detecting fraud, whenever this occurs; and
- A liability gap - This arises from lack of understanding about the auditor's liability and who the auditor may be liable to.

Responses to the problem of the expectation gap have varied between countries. In some countries, corporate governance codes have been changed to strengthen the role and responsibilities of directors for good internal control and accounting systems.

In addition, the standard format of the auditor's report has been expanded in recent years in an attempt to clarify what is involved in an audit and the relative responsibilities of the directors and the auditors.

Critics argue that these moves are not likely to be effective as those groups in society who are promoting the expectation gap may not understand these attempts that have been made to remedy the problem.

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5 THE UNMODIFIED AUDITOR'S REPORT: ISA 700

Section overview

- Definition of an unmodified auditor's report
- Reaching the audit opinion
- Basic elements of the auditor's report
- Key audit matters
- Auditor's report prescribed by law or regulation
- Unaudited supplementary information presented with the audited financial statements

5.1 Definition of an unmodified auditor's report

An **unmodified auditor's report** is an auditor's report containing an audit opinion not modified in any way – either by changing the unmodified opinion (to a qualified opinion, an adverse opinion or a disclaimer of opinion) or by adding an extra paragraph such as an 'emphasis of matter' or 'other matters' paragraph after the opinion paragraph.

ISA 700 **requires** the auditor to give an unmodified opinion when he concludes that the financial statements have been prepared, in all material respects, **in accordance with the applicable financial reporting framework**.

If that framework is a "fair presentation framework" then the report will give an opinion stating whether or not the financial statements "give a true and fair view" or "present fairly" the position and results of the entity.

An unmodified opinion provides a high level of assurance that a professional, independent examination of the financial statements has not revealed any material misstatements in those financial statements.

5.2 Reaching the audit opinion

In reaching his audit opinion, the auditor is **required** to evaluate whether:

- ❑ he has obtained sufficient appropriate audit evidence as to whether the financial statements are free from material misstatement
- ❑ uncorrected misstatements are material, individually or in aggregate
- ❑ the financial statements have been prepared in accordance with the requirements of the applicable financial reporting framework (which for a "fair presentation framework" will include evaluating whether the financial statements give a true and fair view)

and, in particular, whether:

- ❑ the financial statements adequately refer to or describe the applicable financial reporting framework
- ❑ the financial statements adequately disclose the entity's significant accounting policies
- ❑ the significant accounting policies are appropriate and consistent with the applicable financial reporting framework
- ❑ accounting estimates are reasonable

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- the information in the financial statements is relevant, reliable, comparable and understandable
- the financial statements provide adequate disclosures
- the terminology used in the financial statements is appropriate.

5.3 Basic elements of the auditor's report

The basic elements of an unmodified auditor's report, as given in ISA 700, are as follows:

1. Title
2. Addressee
3. Auditor’s opinion
4. Basis for opinion
5. Going concern - material uncertainty (if applicable)
6. Key audit matters (if applicable)
7. Other information (if applicable)
8. Responsibilities for the financial statements
9. Auditor’s responsibilities for the audit of the financial statements
10. Other reporting responsibilities (if applicable)
11. Name of the engagement partner (if applicable)
12. Auditor’s signature
13. Auditor’s address
14. Date of the auditor's report

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 evaluation of the conclusions drawn from the audit evidence obtained; and
- Express that opinion clearly through a written report that also describes the basis for that opinion.

Title

The auditor’s report shall 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 shall 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.

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Auditor's opinion

The first section of the auditor's report shall include the auditor's opinion and have the heading "**Opinion**". The opinion section shall:

- Identify the entity whose financial statements have been audited;
- State that the financial statements have been audited;
- Identify the title of each statement comprising the financial statements;
- Refer to the notes, including the summary of significant accounting policies; and
- Specify the date of, or period covered by, each financial statement comprising the financial statements.

When the financial statements have been prepared in accordance with a **"fair presentation" framework** an unmodified opinion shall 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 shall 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 shall identify the jurisdiction of the financial reporting framework.

Basis for opinion

The '**Basis for Opinion**' paragraph shall:

- State that the audit was conducted in accordance with International Standards on Auditing;
- Refer to the section of the auditor's report that describes the auditor's responsibilities under the ISAs;
- Include a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall identify the jurisdiction or origin of the relevant ethical requirements or refer to the IFAC *Code of Ethics for Professional Accountants*; and
- State whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Going concern – material uncertainty (if applicable)

If:

- The use of the going concern basis of accounting **is appropriate** but a material uncertainty exists; and
- The auditor considers that **adequate disclosure** about the material uncertainty has been made in the financial statements...

…then the auditor shall express an unmodified opinion and include an extra paragraph in the auditor's report entitled '**Material Uncertainty Related to Going Concern**'. This paragraph shall:

- Draw attention to the note in the financial statements that describes the material uncertainty;
- State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern; and
- State that the auditor's opinion is not modified in respect of the matter.

This paragraph was introduced by the 2015 revision to ISA 700. Prior to that, adequately disclosed material uncertainty of going concern would have been referenced in an emphasis of matter (EOM) paragraph. The new 'Material Uncertainty Related to Going Concern' paragraph replaces the former EOM approach.

Key audit matters (if applicable)

For audits of:

- listed entities; and
- any other audits where the auditor is otherwise required by law or regulation, or decides voluntarily to communicate key audit matters,…

…the auditor shall communicate key audit matters in accordance with ISA 701.

Other information (if applicable)

Where the auditor has obtained (and/or additionally, in the case of listed entities, also expects to obtain subsequent) 'other information' (as defined by ISA 720 *The Auditor's Responsibilities Relating to Other Information*) as at the date of the auditor's report, the auditor shall include an '**Other Information**' paragraph.

Responsibilities for the financial statements

This section of the report shall describe the responsibilities of those responsible for the preparation and presentation of the financial statements. It shall include an explanation that management is responsible for:

- preparing the financial statements in accordance with the applicable financial reporting framework;
- such internal controls as deemed necessary to enable the preparation of financial statements which are free from material misstatement; and
- assessing the entity's ability to continue as a going concern, whether the use of the going concern basis of accounting is appropriate and the adequacy of any related disclosures.

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Auditor's responsibilities for the audit of the financial statements

This section of the report shall:

- State that the objectives of the auditor are to:
  - Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
  - Issue an auditor's report that includes the auditor's opinion.
- State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists;
- State that misstatements can arise from fraud or error;
- Describe materiality;
- State that the auditor exercises professional judgment and maintains professional scepticism throughout the audit;
- Describe the auditor's responsibilities in an audit. This description shall be located:
  - Within the body of the auditor's report;
  - Within an appendix to the auditor's report; or
  - By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority (where permitted by law, regulation or national auditing standards).

Other reporting responsibilities

In some countries, the auditor may have additional reporting responsibilities. For example, he may be required by local legislation to report certain matters if they come to his attention during the course of the audit, or he may be required to report on specific matters such as the adequacy of accounting records.

Such other reporting responsibilities shall be addressed in a separate section of the report, following the opinion paragraph, sub-titled "Report on Other Legal and Regulatory Requirements.

Name of the engagement partner (if applicable)

The auditor's report for listed companies shall state the name of the engagement partner unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat.

Auditor's signature

The report shall be signed:

- in the name of the audit firm,or
- in the personal name of the auditor, or
- both.

The report is usually signed in the name of the firm because the firm assumes responsibility for the audit.

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Auditor's address

The report shall give a specific location for the auditor. This will usually be the city where the office responsible for the audit is located.

Date of the auditor's report

The report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base his opinion on the financial statements.

This will not be earlier than the date on which the financial statements are signed or approved by the directors/management of the client company.

The date of the report informs the reader that the auditor has considered the effect on the financial statements (and on his auditor's report) of subsequent events which occurred after the reporting period and up to that date.

Example:

An example of an unmodified auditor's report taken from ISA 700 is set out below.

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company (*or other appropriate addressee*)

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at 31 December 20X6, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended,and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements give a true and fair view (or present fairly, in all material respects,) of the financial position of ABC Company as at 31 December 20X6, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Opinion

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

Key Audit Matters *(if applicable)*

Key audit matters are those that, in our professional judgment, were of most significance in our audit of the financial statements of the current period.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

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

Other information *(if applicable*)

[Reporting in accordance with the reporting requirements in ISA 720 (Revised)].

Responsibilities for the financial statements

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

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

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

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

[*The subsequent explanations of the auditor's responsibilities listed below can either be presented here, in an appendix to the auditor's report, or (if allowed by law, regulation or national auditing standards) through reference to a website of an appropriate authority.]*

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

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsible 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 auditin order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

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

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

[The following paragraph would be included where key audit matters have been presented.]

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Other reporting responsibilities *(if applicable)*

[The form and content of this section would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation, or national auditing standards.]

(Name of the engagement partner) *(if applicable)*

(Auditor's signature) (Auditor's address)

(Date of the auditor's report)

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5.4 Key audit matters

ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report* is a new ISA introduced in 2015 as part of the IAASB's extensive revisions to ISAs relating to audit reporting. The objective of the IAASB's revisions was to make the auditor's report more informative and useful for the intended users.

Key audit matters (KAMs) must be communicated:

- in the auditor's report of all listed companies; and
- when the auditor is required by law or regulation to communicate key audit matters in the auditor's report.

Determining key audit matters

KAMs are defined by ISA 701 as:

"Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance."

Note:

- KAMs are defined with reference to the auditor, NOT the user – i.e. the areas that required significant auditor attention in **performing the audit**.
- KAMs are a standard element of all unmodified auditor's reports for listed companies (and other entities where required to be presented by law or regulation). KAMs therefore DO NOT represent a modification to the auditor's report and must not be confused with modified audit opinion, emphasis of matter or other matters, all of which are determined with reference to the USER, not the auditor.

ISA 701 explains that in determining KAMs, the auditor shall take into account:

- Areas of higher assessed risk of material misstatement, or **significant risks**;
- **Significant auditor judgments** relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty; and
- The effect of **significant events or transactions** that occurred during the period.

The auditor determines which of the above matters were **most significant** in the audit, and hence are the key audit matters.

Communicating key audit matters

KAMs are described in a separate section in the auditor's report under the heading '**key audit matters**'. For each KAM the description must explain:

- Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter; and
- How the matter was addressed in the audit.

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Example:

The IAASB's '*Auditor Reporting Implementation Work Group*' issued a paper entitled '*Auditor Reporting – Illustrative Key Audit Matters*' which included the following:

Key Audit Matters

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

Goodwill

Under IFRSs, the Group is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the balance of XX as of December 31, 20X6 is material to the financial statements. In addition, management's assessment process is complex and highly judgmental and is based on assumptions, specifically [describe certain assumptions], which are affected by expected future market or economic conditions, particularly those in [name of country or geographic area].

Our audit procedures included, among others, using a valuation expert to assist us in evaluating the assumptions and methodologies used by the Group, in particular those relating to the forecasted revenue growth and profit margins for [name of business line]. We also focused on the adequacy of the Group's disclosures about those assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill.

Revenue recognition

The amount of revenue and profit recognised in the year on the sale of [name of product] and aftermarket services is dependent on the appropriate assessment of whether or not each long-term aftermarket contract for services is linked to or separate from the contract for sale of [name of product]. As the commercial arrangements can be complex, significant judgment is applied in selecting the accounting basis in each case. In our view, revenue recognition is significant to our audit as the Group might inappropriately account for sales of [name of product] and long-term service agreements as a single arrangement for accounting purposes and this would usually lead to revenue and profit being recognised too early because the margin in the long-term service agreement is usually higher than the margin in the [name of product] sale agreement.

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> Our audit procedures to address the risk of material misstatement relating to revenue recognition, which was considered to be a significant risk, included:
>
> - Testing of controls, assisted by our own IT specialists, including, among others, those over: input of individual advertising campaigns' terms and pricing; comparison of those terms and pricing data against the related overarching contracts with advertising agencies; and linkage to viewer data; and
>
> Detailed analysis of revenue and the timing of its recognition based on expectations derived from our industry knowledge and external market data, following up variances from our expectations.

5.5 Auditor's 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 auditor's report, rather than the wording in ISA 700, then the auditor's report shall only refer to ISAs if it includes, as a minimum, the following elements:

- ❑ Title
- ❑ Addressee
- ❑ An opinion section containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used.
- ❑ An identification of the entity's financial statements that have been audited.
- ❑ A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall identify the jurisdiction of origin of the relevant ethical requirements or refer to the IFAC Code.
- ❑ Where applicable, a section addressing a material uncertainty of going concern (in compliance with ISA 570).
- ❑ Where applicable, a key audit matters section (in compliance with ISA 701).
- ❑ Where applicable, a section addressing 'other information' (in compliance with ISA 720(Revised)).
- ❑ A description of management's responsibility for the preparation of the financial statements and an identification of those responsible for the oversight of the financial reporting process.
- ❑ A reference to ISAs and the law or regulation, and a description of the auditor's responsibilities for an audit of the financial statements.
- ❑ For listed entities, the name of the engagement partner unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat.
- ❑ Auditor's signature.
- ❑ Auditor's address.
- ❑ Date of the auditor's report.

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These headings correspond with those specified by ISA 700 (Revised) as headings to be included in an unmodified auditor's report.

5.6 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 shall be satisfied that any unaudited supplementary information that is presented together with the audited financial statements is clearly differentiated from the audited financial statements. This is because unaudited items are not covered by the auditor's opinion.

If the auditor concludes that the unaudited information is **not** clearly differentiated, then he shall ask management to change how that information is presented. If management refuse to do so then the auditor shall explain in his report that the supplementary information has not been audited.

The auditor's responsibilities in respect of unaudited supplementary information are covered by ISA 720 (*which is outside the scope of this syllabus*).

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6 AUDIT REPORTING AND THE COMPANIES AND ALLIED MATTERS ACT 1990

Section overview

- Reporting requirements of the Companies and Allied Matters Act 1990 (s359)
- The audit committee

6.1 Reporting requirements of the Companies and Allied Matters Act1990 (s359)

The auditors of a company shall make a report to its members on the accounts examined by them, and on every statement of financial position and profit or loss account, and on all group financial statements, copies of which are to be laid before the company in a general meeting during the auditors' tenure of office.

The auditor's report shall state the matters set out in the Fifth Schedule as follows:

Fifth Schedule – s.404 (2) of CAMA2020 – Matters to be expressly stated in the auditor's report

1. Whether the directors have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purpose of their audit.

2. Whether, in the auditor's opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.

3. Whether the company's balance sheet and (unless it is framed as a consolidated profit and loss account) profit and loss account dealt with by the report are in agreement with the books of account and returns.

4. Whether, in the auditor's opinion and to the best of their information and according to the explanations given them, the said statements give the information required by this Act in the manner so required and give a true and fair view in the case of the:

   (a) Balance sheet, of the state of the company's affairs as at the end of its year; and

   (b) profit and loss account, of the profit and loss for its year; or as the case may be, give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which, by virtue of Part I of the First Schedule of this Act, are not required to be disclosed.

5. In the case of a holding company submitting group financial statements whether, in their opinion, the group financial statements have been properly prepared in accordance with the provisions of this Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries and associates dealt with where it, so far as it concerns members of the company, or the case may show as to give a true and fair view thereof subject to the non-disclosure of any matter to be indicated in the report which by virtue of Part 1 of the First Schedule to this Act are not required to be disclosed.

6.2 The audit committee

In addition to the report to the members, the auditor shall in the case of a public company also make a report to an audit committee which shall be established by the public company.

The audit committee shall consist of an equal number of directors and representatives of the shareholders of the company (subject to a maximum number of six members) and shall examine the auditor's report and make recommendations thereon to the annual general meeting as it may think fit.

The audit committee member presenting to the members shall not be entitled to remuneration and shall be subject to re-election annually.

Any member may nominate a shareholder as a member of the audit committee by giving notice in writing of such nomination to the secretary of the company at least 21 days before the annual general meeting.

Subject to such other additional functions and powers that the company's articles of association may stipulate, the objectives and functions of the audit committee shall be to-

- ascertain whether the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices;
- review the scope and planning of audit requirements;
- review the findings on management matters in conjunction with the external auditor and departmental responses thereon;
- keep under review the effectiveness of the company's system of accounting and internal control;
- make recommendations to the Board in regard to the appointment, removal and remuneration of the external auditors of the company; and
- authorise the internal auditor to carry out investigations into any activities of the company which may be of interest or concern to the committee.

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7 CHAPTER REVIEW

Chapter review

Before continuing with your studies, check that you now know how to:

- Explain what a written representation is and discuss the instances when they would beused
- Summarise the requirements of ISA 450 with respect to misstatements identified
- Describe what is involved in the final review prior to signing the auditor's report
- Explain the contents of an unmodified auditor's report both in terms of the requirements of ISA 700 and Companies and Allied Matters Act 1990

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Quick quiz questions

1 The auditor is required to:

A accumulate all misstatements found during the audit, unless they are immaterial.

B communicate to the credit controller the effect that uncorrected misstatements may have on the auditor's report.

C reassess materiality after evaluating the effect of uncorrected misstatements.

D Accumulate all misstatements found during the audit, unless they are clearly trivial.

2 Which of the following is true about written representations?

A They are the best source of audit evidence

B They should be used only when there is a lack of other substantive audit evidence

C They should be used only when there is other substantive audit evidence to complement it

D Shareholders receive a copy of all material written representations

3 What is meant by the expression ‘expectation gap’?

A The gap between how the directors of a company perform their duties and how the shareholders expect them to perform

B The gap between how the directors of a company perform their duties and how the general public expects them to perform

C The gap between the public perception of the role of company auditors and their statutory role and responsibilities

D The gap between the auditors’ own perception of their duties and how they are set out in the Companies Act

4 Which of the following does NOT belong in the auditor's report?

A Auditor's address

B Basis for the opinion

C Involvement of any specialist

D Statement of responsibilities of auditors

5 The audit committee should be comprised of?

A an equal number of directors and shareholder representatives subject to a maximum of ten members

B an equal number of shareholder representatives and directors subject to a maximum of six members

C directors and shareholder representatives with the directors forming the majority

D directors and shareholder representatives with the shareholder representatives forming the majority

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Quick quiz answers

1 D

2 B

3 C

4 C

5 B

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Skills level
Audit and

CHAPTER 14

Business Systems and Associated Information Technology Risks

Contents

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Business systems and associated information technology risks

14.0 Introduction

A business system refers to the interrelated components of activities driving exchange of value between interacting parties and arising from the exchange of good and services. A business system may cut across a number of component parts namely, sales and marketing, human resources, finance and administration, product development, corporate services, data centre operations, etc. Increasingly, organisations with large interacting business systems deploy a great deal of information technology applications to improve business speed and value to customers. Often, these systems are prone to information technology (IT) risks which if unchecked, can cause devastating damages to business entities and even related parties.

Automating the auditing sector is not really about making auditors redundant but enhancing their skills and capacities with the right tools in the technological domain. Consequently, eliminating monotonous workflows enables speedy strategic decision-making associated with the audit process. It is important to note that this is only possible if technology is adequately and properly adopted to aid audit and assurance activities.

Some of the new technologies that have potentials to disrupt the auditing process include:

(a) Cloud-based accounting systems;
(b) Big data and analytics;
(c) Social media;
(d) Blockchain technology; and
(e) Artificial intelligence and robotics.

With these digital technologies, it is estimated that some professions will disappear completely, some will experience growth, and new branches of professions that were never known will emerge. As a result, it is inevitable that these systems will affect the auditing profession.

Some areas of audit and assurance that are likely to be affected by the emerging technologies are as follows:

i. **Audit engagement planning**

Audit planning involves:

- Identifying the areas to be audited;
- Audit team set up;
- Assigning responsibilities to each audit staff;
- Time allocation; and
- Establishing the materiality threshold.

There are many aspects of these activities that could be automated and made more efficient with the use of technology. Most available off-the-shelve audit software have capabilities and inbuilt tools to enhance audit planning activities.

ii. **Audit risk assessment**: Modern audit software and advanced data analytic solutions can be used to conduct audit risk assessment – both qualitative and quantitative risk assessments. For instance, in conducting quantitative risk assessment, all that is required is to upload the financial information of the client into the audit software and use existing functions to select and compute the relevant ratio, percentages and proportions for the auditor to interpret. In some cases, the results from the computations are given interpretation by the software and made available for the auditor to review and exercise human judgement.

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iii. **Evaluation of internal controls**: After planning and risk assessment, the external auditor is expected to evaluate the operating effectiveness of internal controls which would most likely include computer controls. The only viable means to evaluate computer or IT controls is through the use of Computer Assisted Audit Tools (CAATs). Many audit software are built with the capability to test IT controls to ascertain their level of adequacy and operating effectiveness.

iv. **Audit substantive testing**: Substantive testing involves the use of analytical procedures and test of details to confirm the completeness, accuracy and validity of financial statements amounts and disclosures. Ratios and trend analysis can easily be carried out by the auditor using a software. Also, automated audit solutions could be used to prepare and serve circularisation letters to obtain third party confirmations.

v. **Audit reporting**: Over the years, auditors have been using word processors and spreadsheets to compile their reports at the end of the exercise. Most modern audit software have embedded reporting modules that could be used by the auditor to put together all kinds of relevant report to users. With the help of the reporting modules of these applications, the auditor could convert certain aspects of his findings into diagrams and pictures which are easier to understand by the clients' executives.

14.1 Vulnerability of business systems and associated information technology (IT) to risks

There is hardly any business outfit today that does not use one form of information system or the other. This is due to the critical role of information technology (IT) in facilitating and simplifying many aspects of business operations. Business owners that make use of IT systems (such as microcomputers and network system) in their businesses, have responsibility to identify and manage the various risks to their IT systems and data. Some aspects of information processing system with potential risk exposures are discussed below.

14.2 Types of information systems

a) Management information systems (MIS)

Prior to the era of computerisation, the activity associated with organisation, movement and management of information, such as records and files creation, storage, retrieval and archiving were achieved through manual processes. This process required the use of paper files, rings for holding documents on these files and storage cabinets (see illustration below).

Source: Shutterstock.com

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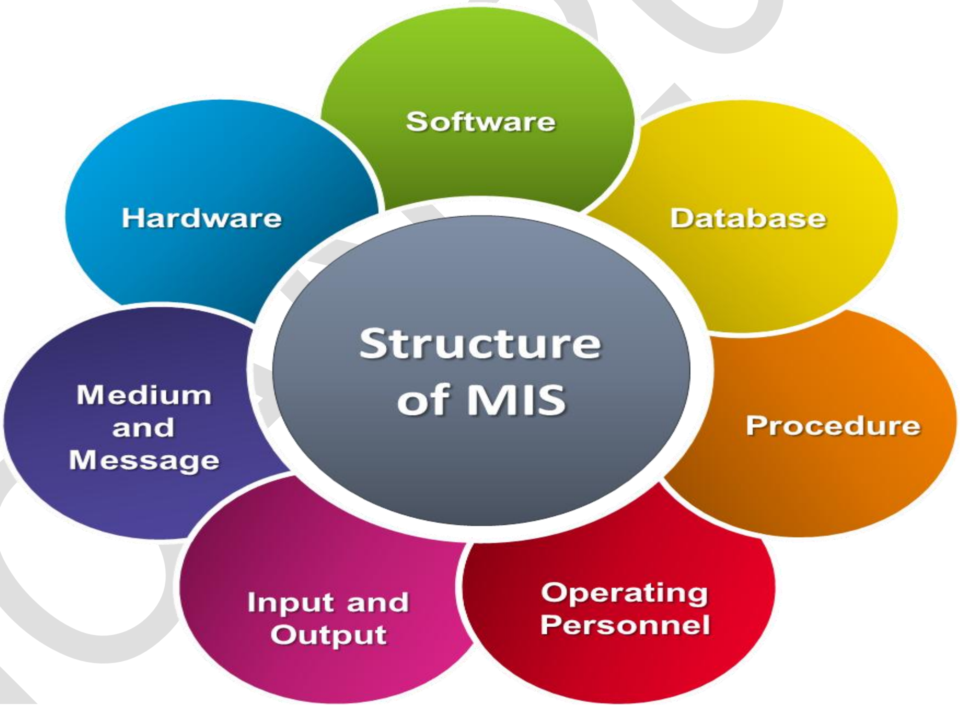
This process often presents a great deal of difficulties especially with searching and retrieving information or records which could be very cumbersome for the most part. In the event of fire outbreak, in addition to fueling greater combustion, losses of information may become totally irretrievable.

However, with the advent of the computer, information creation, storage, movement and management take the form of electronic codes aided by computer digital process or codes called computer language. Such language includes BASIC, Fortran, COBOL, AGOL, PL/1, C, C++, Java, etc. Some user applications derived from these languages are further made simpler by the application of graphic-user interfaces which enabled most functional illiterate computer users to use computer machines effortlessly. In a nutshell, the computerisation of the hitherto manually-driven information movement and management using computer electronics is described as management information system (MIS).

No doubt, MIS has eased a greater part, if not all the difficulties experienced with the use of manual system to run offices and businesses. The main purpose of MIS is to provide management with feedback mechanism about their own performance and to monitor the company as a whole. MIS specialists assist firms take optimal advantage of investment in personnel, equipment, and organisational processes.

The MIS architecture is fused around a number of component parts namely, hardware, software, databases, medium and messages, procedures, input and output channels and operating personnel. The figure below illustrates a typical component parts of an MIS environment.



Source: https://shopinverse.com

b) Transaction processing systems (TPS)

This typically represents application software designed to process daily business transactions. TPS is a derivative of the management information system. Examples of TPS include applications used for processing payroll, sales orders, purchase and payment procedures. Other applications include airline reservations, hotel bookings, manufacturing and inventory scheduling processes.

c) Executive information systems

This is a tool utilised for reporting enterprise-wide data to executive management. To this end, it is a brand of MIS that is a decision support system in organisations. These systems provide quick and easy to use reports that exist in visual screens that are easy to compare.

d) Decision assistance systems

This class of MIS also known as decision support system (DSS) are used to aiding decision-making processes in organisation. Applicable areas of DSS include medical diagnosis and treatment of ailments in clinics, project planning and support, manufacturing scheduling and inventory planning processes.

14.3 Information technology (IT) risks

Generally speaking, risks are events that have potentials for compromising the objectives of a business or a business entity. These risks are derived from internal or external environments and could be man-made or arising from nature's hazards.

IT risks involves threats to IT systems including:

(a) **Hackers**

These are people who illegally break into computer systems for various reasons which could include extortion of money or just for pride;

(b) **Insider fraud**

A member of staff could use the employer's computer systems to alter sensitive data for unlawful benefit;

(c) **Passwords theft**

This could be the target of a malicious hacker or disgruntled employee;

(d) **Denial-of-service attack**

This is an online attack that prevents the company's authorised users from having access to their website or other IT resources;

(e) **Hardware and software failures**

A computer hardware or software may fail as a result of targeted attacks including loss of power and corrupted data. A simple internet downtime could lead to loss of purchase orders;

(f) **Malware threat**

Malware is a malicious software designed to disrupt computer operation. An infected computer system could cripple the entire operations of an organisation;

(g) **Virus threat**

Viruses represent computer program that, when executed can copy itself and spread from one computer to another, often disrupting computer operations;

(h) **Spams and phishing attack**

This is an unsolicited email that seeks to fool unsuspecting people into revealing personal details or buying fraudulent goods online;

(i) **Natural disaster**

Natural disasters such as flood and fire outbreak could lead to huge disruptions of computer operations; and

(j) **Human error**

This is a major threat to most organisations. An employee might accidentally delete important data, or fail to follow security procedures properly.

Managing information technology (IT) risks should be a deliberate and structured process that involves a series of activities designed to:

i. Identify the risks;
ii. Assess the risks;
iii. Mitigate the risks;
iv. Develop response plans; and
v. Review risk management procedures.

For IT risk assessment to be effective, it should be made to identify key risks, based on the probability that the risk will occur, and its costs of business impacts and recovery.

14.4 Ways to protect information systems

An organisation can adopt the following general and practical ways to protect their information systems:

(a) Regular software updates to the latest versions are critical;

(b) Train staff in IT policies and procedures regularly;

(c) Secure computers, servers and wireless networks with both physical and logical access controls;

(d) Use anti-virus and anti-malware protection such as firewalls and intrusion prevention solutions;

(e) Periodic and regular backup of data to off-site or remote storage locations;

(f) Implement password protection policy;

(g) Constant review of the legal and operating environment for online business; and

(h) Take insurance policy to cover those risks that would eventually crystallise.

14.5 Application systems audit process

As information technology has become pervasive and indispensable across many organisations, business owners and other stakeholders seeking assurances on the use of systems have resorted to information systems (IS) audit. Auditing business applications and system has become a common type of audit for medium and large companies, especially when some of the applications are developed in-house.

Information systems (IS) audit is an examination of internal controls within the business applications and IT environment to determine if the information systems are operating effectively to achieve the objectives of an organisation. An IS auditor carries out his work with the aim of giving assurance on the confidentiality, integrity and availability of the entity's information systems.

This type of audit usually covers the audit of:

(a) IT governance;
(b) Networks and telecom services;
(c) Systems development;
(d) Information processing facility and infrastructure; and
(e) IT service management.

Information system audit is only effective if it is carried out by professionals who are not only well versed with the complex information system issues but also know how to relate them to the business.

14.6 Systems audit process

There are some basic principles of auditing applications that IS auditors need to know and understand. An IS auditor would follow the steps below while performing the audit:

(a) **Planning the audit** - This involves understanding the purpose of the audit, risk identification and allocation of resources to achieve the set objectives.

(b) **Map systems and data flow** - In auditing applications, it is important to properly scope other systems that either affect or is affected by the application. Systems mapping can assist the IS auditor in gaining an in-depth understanding of the relevant technologies, the process, the data, the controls and how they all fit together. It also empowers him to best perform the steps from planning to reporting and follow-up which would impact positively on the quality of the IS audit.

(c) **Controls identification** - The IS auditor should identify and document the computer controls that exist within the IT infrastructure. This would enable him assess the level of adequacy of the existing controls in addressing the risk of computer abuse and other related risks.

(d) **Controls testing and evaluation** - After documenting existing IT controls, the IS auditor will conduct a detailed evaluation of those controls to determine if they are operating effectively. A good knowledge of the system and associated vulnerabilities is required to carry out the work at this stage.

(e) **Report writing** - At the end of his work, the IS auditor is required to write a formal report stating his findings. This report is meant to draw the attention of management or other relevant stakeholders to the key issues discovered and offer a reasonable level of assurance on the design and effectiveness of the entity's information systems.

(f) **Follow-up** - Once the audit report is approved by management, the expectation is that the recommendations contained in the IS auditor's report will be implemented. A follow-up audit should be conducted after some time to determine if those approved recommendations were implemented and operating as intended.

14.7 Audit of business continuity plan (BCP) or contingency plan

A contingency or business continuity plan (BCP) is a document that outlines how a business entity would continue to operate in the event of operational disruptions from unplanned incident. Having a contingency and business continuity plan is only half of the battle. A key issue is how would the organisation know that the contingency and business continuity plan is sound and adequate for your needs?

The answer is that the organisation should conduct an audit of the BCP. This should be preferably done by a different party other than the one that was instrumental in conceiving and developing the plan on the grounds of objectivity. It is a simple fact of business that it is almost impossible for the team that developed the plan to find deficiencies in the plan.

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The audit of a BCP can be broken into the following three (3) major components:

i. Validating the BCP;
ii. Verifying the preventive measures for ensuring continuity; and
iii. Examining evidence about the performance of activities that can ensure continuity and recovery.

14.8 Audit steps

BCP audit involves the following steps:

(a) Obtain and review a copy of the contingency plan or BCP to determine if it is complete and approved by management;
(b) Review the organisational chart and business process analysis;
(c) Enquire from the management to ascertain their level of involvement and knowledge about the plan;
(d) Review the assumptions made to determine if they are reasonable and consistent with the type of business;
(e) Review the business impact analysis (BIA) and enquire if the recovery time objective (RTO) and recovery point objective (RPO) have been identified;
(f) Compare the recovery strategies with the result of the BIA to determine if they align;
(g) Enquire from management to confirm if an Emergency Coordinator has been appointed and discuss with him on his roles;
(h) Identify personnel with critical roles to perform in the plan and discuss with them to confirm their level of awareness and readiness;
(i) Identify third party links and test the viability of their contacts;
(j) Verify the backup tapes with respect to backup logs and labelling of the tapes;
(k) Verify the maintenance and testing logs for all key equipment, such as power generators; UPS; fire control equipment; air conditioners, etc.;
(l) Verify if the BCP has been tested; and
(m) Review the BCP documentation to ascertain if it has been reviewed and updated in recent time.

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The nature, complexity and cost of a business continuity plan (BCP) are related to the level of business' dependence on information technology. While the testing of BCP using various testing techniques and drills remains the best possible way to give assurance on a BCP, an effective audit conducted by an IS auditor would be very helpful in uncovering any weaknesses or lapses in the plan that might not be revealed during such drills.

14.9 Systems vulnerability audit

Every corporate information system holds sensitive and valuable information about the organisation, its employees, customers, suppliers and other stakeholders. Responsible organisations would do everything possible to ensure that such information do not get into the hands of unauthorised persons within and outside the organisation.

There is no information system that is perfect, which implies that hackers and other disgruntled people might make moves to exploit the system vulnerabilities and hurt the organisation. All organisations must, therefore, take steps to discover the hidden threats with a view to immediately addressing these risks and enhance security.

A vulnerability audit identifies security risks on an enterprise information system and network. At the end of the audit, the IS auditor provides a comprehensive threat analysis report which includes all the security incidents detected during the audit and will recommend how to protect against these threats.

A vulnerability audit uncovers flaws in the company's security procedures, design, implementation or internal controls. It identifies weaknesses that could be triggered or exploited to cause a security breach. During a vulnerability test, the IS audit team will examine and determine which system flaws are in danger of being exploited. They might run specific software to scan for vulnerabilities, test from inside the network or use approved remote access to determine what needs to be corrected to meet security standards.

14.10 Procedures for a vulnerability audit

a. Most IS auditors would conduct an on-site vulnerability audit that includes the followingg procedures:
b. Identify the information systems components to be covered;
c. Appliance set up and configuration;
d. Scanning the applications; servers; websites; networks and inspection of the traffic;
e. Analysis of the results of the scan;
f. Generation of a report; and
g. Presentation of the finding and solutions to address the identified weaknesses.

14.11 - Data centre audit

The data centre is an integral part of an organisation's ICT infrastructure as it hosts all critical ICT infrastructures, such as servers; routers; switches; software; and supporting equipment. To ensure the security, effectiveness and efficiency of an ICT data centre, periodic audit is required to provide reasonable assurance to stakeholders and management that their investment in physical ICT hardware, software and supporting equipment such as power, cooling, environmental, safety and security equipment/devices are reasonably protected and functioning optimally.

It is the responsibility of the internal audit team (made up IS auditors) to routinely perform audit of data centre as required. In doing so, the scope of such audit should reasonably cover all aspects of data centre operations, infrastructures, administration, human capacity, relevance to the business, among others and should be part of the audit work program for the data centre.

Some of the key areas of the data centre to be covered during the audit include the following:

(a) Data centre administration;
(b) Environmental monitoring controls;
(c) Safety and emergency procedures;
(d) IT service delivery management;
(e) IT infrastructure maintenance and support;
(f) Physical and logical access controls;
(g) Power supply management;
(h) Redundancy and operational resilience;
(i) Networking and telecommunication controls;
(j) Human capacity management; and
(k) Third party services and support.

14.12 Auditing banking transactions

A financial entity such as bank requires a concurrent audit which ensured a continuous and robust review and monitoring of their transactions outside the statutory audits and routine internal audit. Unlike most other audits, a concurrent audit is simply the examination of banking transactions as they occur. It offers the bank an early warning signal to ensure timely detection of all forms of irregularities and lapses.

Lending of money to customers is a major function of the banks and this generates a lot of the day-to-day transactions of each bank. A concurrent audit can be focused on reviewing the transactions relating to loans and advances.

14.13 Big data analytics and audit of electronic transactions

Big data analytics refers to the strategy of analysing large volumes of data, or big data. This big data is gathered from a wide variety of sources, including social networks, videos, digital images, sensors, and sales transaction records. The aim in analysing all this data is to uncover patterns and connections that might otherwise be invisible, and that might provide valuable insights about the users who created it.

Through this insight, businesses may be able to gain an edge over their rivals and make superior business decisions. On a broad scale, data analytics technologies and techniques provide a means to analyse data sets and draw conclusions about them to help organisations make informed business decisions.
This offers accountants/auditors some advantages, such as:

(a) Testing transactions at source;

(b) Testing complete set of data (100% check) ;

(c) Predictive analytics (assist in risk assessment);

(d) Evaluation of programmed controls; and

(e) Avoidance of analysis paralysis.

Big Data analytics helps in transforming the traditional sample-based audit approach to centralised and data driven audit approach such as 100 percent data population testing by automated analytical algorithms instead of sample-based testing, thus improving audit quality.

14.14 Artificial intelligence (AI) and machine learning in the audit process

Artificial intelligence and robotic process automation (RPA) are no longer limited to science fiction and Hollywood movies. Robots that have more sensory capacities than humans are being developed today, to assist in performing many human tasks, through artificial intelligence (AI).

RPA and AI are expected to yield the following benefits:

(a) Significant cost reduction;

(b) Task performance time reduction;

(c) Increase in output quality by eliminating human error;

(d) Scalable solutions, unlike human-based teams;

(e) Integration to existing accounting ERP systems; and

(f) Allowing for local competency and control.

It is almost certain that AI systems will lead to a reduction in the demand for repetitive roles of accountants in the future, while more creative roles, such as business advisory roles would emerge. AI will increase audit quality, as it begins to allow auditors to ask a lot more questions. It will improve efficiency in audit work by providing more insight.

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Robotics and artificial intelligence (AI) are changing business operations and these developments are also opening up new opportunities for the audit process itself. A key question that arises is: to what extent do robots and artificial intelligence at the client's side impact the audit approach? In the case of clients using software robots in key processes, the auditors will have to gain a certain level of comfort over the reliability of the data processing carried out by the robot. This means that the auditors will need to boost their technology understanding in order to assess the reliability of robot software.

In the future, both internal and external auditors will use software to interview client's personnel and would be able to collect more information for further analysis.

14.15 Reporting IT audit activities

At the end of the work of the IS auditor, he is expected to produce a report of his activities and submit to the management of the organisation. However, there is no generally accepted template or format for reporting the work of the IS auditor.

Meanwhile, a typical report issued by an IS auditor would include:

(a) The cover page;
(b) The terms of reference;
(c) The background information;
(d) The executive summary (should be kept below five pages unless where it is impracticable);
(e) The body of the report (contains the findings, their implications and recommendations – usually in a tabular form); and
(f) The appendices.

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14.16 Chapter review

At the end of this chapter, readers should be able to understand:

(a) Business systems and associated information technology (IT) risks;

(b) Types of Information Systems;

(c) Information technology (IT) risks;

(d) Ways to protect information systems;

(e) Systems audit process;
(f) Audit of business continuity plan (BCP) or contingency plan;
(g) Audit steps;
(h) Systems vulnerability audit;
(i) Procedures for a vulnerability audit;
(j) Data centre audit;
(k) Auditing banking transactions;
(l) Big data analytics and audit of electronic transactions;
(m) Artificial intelligence (AI) and machine learning in the audit process; and
(n) Reporting IT audit activities.

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14.17 Worked examples

14.17.1 Open-ended questions

1) Briefly discuss how emerging technologies could affect the work of external auditors.

2) Describe the audit procedures an information systems auditor would carry out when auditing a data centre.

14.17.2 Solutions to open-ended questions

1. Emerging technologies that have potentials to disrupt the auditing process include:
   (a) Cloud-based accounting systems;
   (b) Big data and analytics;
   (c) Social media;
   (d) Blockchain technology; and
   (e) Artificial intelligence and robotics.

With these digital technologies, it is estimated that some professions will disappear completely, some will experience growth, and new branches of professions that were never known will emerge. As a result, it is inevitable that these systems will affect the auditing profession.

Some areas of audit and assurance that are likely to be affected by the emerging technologies are as follows:

(i) **Audit engagement planning**

Audit planning involves:

- Identifying the areas to be audited;
- Audit team set up;
- Assigning responsibilities to each audit staff;
- Time allocation; and
- Establishing the materiality threshold.

There are many aspects of these activities that could be automated and made more efficient with the use of technology. Most available off-the-shelve audit software have capabilities and inbuilt tools to enhance audit planning activities.

(ii) Audit risk assessment: Modern audit software and advanced data analytic solutions can be used to conduct audit risk assessment – both qualitative and quantitative risk assessments. For instance, in conducting quantitative risk assessment, all that is required is to upload the financial information of the client into the audit software and use existing functions to select and compute the relevant ratio, percentages and proportions for the auditor to interpret. In some cases, the results from the computations are given interpretation by the software and made available for the auditor to review and exercise human judgement.

(iii) Evaluation of internal controls: After planning and risk assessment, the external auditor is expected to evaluate the operating effectiveness of internal controls which would most likely include computer controls. The only viable means to evaluate computer or IT controls is through the use of Computer Assisted Audit Tools (CAATs). Many audit software are built with the capability to test IT controls to ascertain their level of adequacy and operating effectiveness.

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(iv) Audit substantive testing: Substantive testing involves the use of analytical procedures and test of details to confirm the completeness, accuracy and validity of financial statements amounts and disclosures. Ratios and trend analysis can easily be carried out by the auditor using a software. Also, automated audit solutions could be used to prepare and serve circularisation letters to obtain third party confirmations.

(v) **Audit reporting**

Auditors have been using word processors and spreadsheets to compile their reports at the end of the exercise. Most modern audit software have embedded reporting modules that could be used by the auditor to put together all kinds of relevant report to users. With the help of the reporting modules of these applications, the auditor could convert certain aspects of his findings into diagrams and pictures which are easier to understand by the clients' executives.

The data centre is an integral part of an organisation's ICT infrastructure as it hosts all critical ICT infrastructures, such as servers; routers; switches; software; and supporting equipment. To ensure the security, effectiveness and efficiency of an ICT data centre, periodic audit is required to provide reasonable assurance to stakeholders and management that their investment in physical ICT hardware, software and supporting equipment such as power, cooling, environmental, safety and security equipment/devices are reasonably protected and functioning optimally.

It is the responsibility of the internal audit team (made up IS auditors) to routinely perform audit of data centre as required. In doing so, the scope of such audit should reasonably cover all aspects of data centre operations, infrastructures, administration, human capacity, relevance to the business, among others and should be part of the audit work program for the data centre.

Some of the key areas of the data centre to be covered during the audit include the following:

(a) Data centre administration;
(b) Environmental monitoring controls;
(c) Safety and emergency procedures;
(d) IT service delivery management;
(e) IT infrastructure maintenance and support;
(f) Physical and logical access controls;
(g) Power supply management;
(h) Redundancy and operational resilience;
(i) Networking and telecommunication controls;
(j) Human capacity management; and
(k) Third party services and support.

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