

ACCA

Audit and Assurance

Paper F8 (Global)

Course Notes

ACF8CN07

F8 Audit and Assurance (Global) Study Programme

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Don't forget to plan your revision phase!

- Revision of syllabus
- Testing of knowledge
- Question practice
- Exam technique practice

BPP provides revision courses, question days, mock days and specific material to assist you in this important phase of your studies.

Introduction to Paper F8 *Audit and Assurance*

Overall aim of the syllabus

To develop knowledge and understanding of the process of carrying out the assurance engagement and its application in the context of the professional regulatory framework.

The syllabus

The broad syllabus headings are:

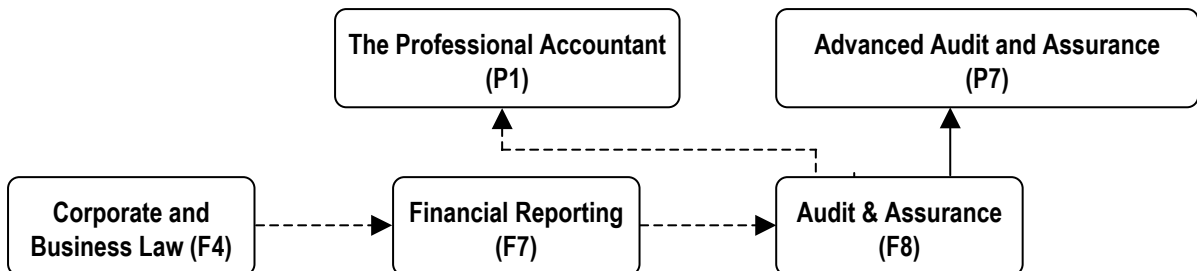
A	Audit framework and regulation
B	Internal audit
C	Planning and risk assessment
D	Internal control
E	Audit evidence
F	Review
G	Reporting

Main capabilities

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

- Explain the nature, purpose and scope of assurance engagements including the role of the external audit and its regulatory and ethical framework.
- Explain the nature of internal audit and describe its role as part of overall performance management and its relationship with the external audit
- Demonstrate how the auditor obtains an understanding of the entity and its environment, assesses the risk of material misstatement (whether arising from fraud or other irregularities) and plans an audit of financial statements
- Describe and evaluate information systems and internal controls to identify and communicate control risks and their potential consequences, making appropriate recommendations
- Identify and describe the work and evidence required to meet the objectives of audit engagements and the application of the International Standards on Auditing
- Evaluate findings and modify the audit plan as necessary
- Explain how the conclusions from audit work are reflected in different types of audit report, explain the elements of each type of report

Links with other papers



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

Although ACCA's diagram shows Paper F7 feeding into Paper F8, the accounting knowledge assumed in the F8 exam will only be that covered within Paper F3 *Financial Accounting*.

Assessment methods and format of the exam

Examiner: Alan Lewin

The examination is a three hour paper with 15 minutes reading and planning time. All questions are compulsory. Some questions will adopt a scenario/case study approach. All questions will require some form of written response although questions on planning or review may require the calculation and interpretation of some basic ratios.

Format of the Exam		Marks
Question 1	This will always be a question on audit procedures, and the application of these procedures to a specific scenario	30
Question 2	Short factual questions based on International Standards on Auditing (ISAs) and other knowledge-based areas of the Study Guide	10
Question 3	These questions are likely to involve short practical scenarios and will cover topics such as: internal audit, risk assessment, planning, controls, evidence, conclusions and reporting	20
Question 4		20
Question 5		20
		100

Course Aims

Achieving ACCA's Study Guide Outcomes

A Audit framework and regulation

A1	The concept of audit and other assurance engagements	Chapter 1
A2	Statutory audits	Chapter 2
A3	The regulatory environment and corporate governance	Chapter 3
A4	Professional ethics and ACCA's Code of Ethics and Conduct	Chapter 4

B Internal audit

B1	Internal audit and corporate governance	Chapter 5
B2	Differences between external and internal audit	Chapter 5
B3	The scope of the internal audit department	Chapter 5
B4	Outsourcing the internal audit department	Chapter 5
B5	Internal audit assignments	Chapter 5

C Planning and risk assessment

C1	Objective and general principles	Chapter 6
C2	Understanding the entity and knowledge of the business	Chapter 6
C3	Assessing the risks of material misstatement and fraud	Chapter 6
C4	Analytical procedures	Chapter 6
C5	Planning an audit	Chapter 7
C6	Audit documentation	Chapter 7
C7	The work of others	Chapter 11

D Internal control

D1	Internal control systems	Chapter 9
D2	The use of internal control systems by auditors	Chapter 9
D3	Transaction cycles	Chapter 9
D4	Tests of control	Chapter 10
D5	The evaluation of internal control components	Chapter 10
D6	Communication on internal control	Chapter 10

E Audit evidence

E1	The use of assertions by auditors	Chapter 8
E2	Audit procedures	Chapter 11
E3	The audit of specific items	Chapters 12-16
E4	Audit sampling and other means of testing	Chapter 11
E5	Computer-assisted audit techniques	Chapter 11
E6	Not-for-profit organisations	Chapter 17

F Review

F1	Subsequent events	Chapter 18
F2	Going concern	Chapter 18
F3	Management representations	Chapter 18
F4	Audit finalisation and the final review	Chapter 18

G Reporting

G1	Audit reports	Chapter 19
G2	Reports to management	Chapter 10
G3	Internal audit reports	Chapter 5

Classroom tuition and Home study

Your studies for BPP consist of two elements, classroom tuition and home study.

Classroom tuition

In class we aim to cover the key areas of the syllabus. To ensure examination success you will need to spend private study time reinforcing your classroom course with question practice and reviewing areas of the Course Notes and Study Text.

Home study

To support you with your private study BPP provides you with a Course Companion which helps you to work at home and aims to ensure your private study time is effectively used. The Course Companion includes a Home Study section which breaks down your home study by days, one to be covered at the end of each day of the course. You will find clear guidance as to the time to spend on various activities and their importance.

You are also provided with progress tests and two course exams which should be submitted for marking as they become due.

These may include questions on topics covered in class and home study.

BPP Learn Online

Come and visit the BPP Learn Online free at www.bpp.com/acca/learnonline for exam tips, FAQs and syllabus health check.

ACCA Forum

We have thriving ACCA bulletin boards at www.bpp.com/accaforum. Register and discuss your studies with tutors and students.

Helpline

If you have any queries during your private study simply contact your class tutor on the telephone number or e-mail address that they will supply. Alternatively, call +44 (0)20 8740 2222 (or your local training centre if outside the London area) and ask for a tutor for this paper to speak to you or to call you back within 24 hours.

Feedback

The success of BPP's courses has been built on what **you**, the students tell us. At the end of the course for each subject, you will be given a feedback form to complete and return.

If you have any issues or ideas before you are given the form to complete, please raise them with the course tutor or relevant head of centre.

If this is not possible, please email ACCACoursesFeedback@bpp.com.

Key to icons



Question practice from the Study Text

This is a question we recommend you attempt for home study.



Real world examples

These can be found in the Course Companion.



Section reference in the Study Text

Further reading is needed on this area to consolidate your knowledge.



Formula to learn



Formula given in exam

INTRODUCTION

The concept of audit and other assurance engagements

1

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Identify and describe the objective and general principles of external audit engagements.
- Explain the nature and development of audit and other assurance engagements.
- Discuss the concepts of accountability, stewardship and agency.
- Discuss the concepts of materiality, true and fair presentation and reasonable assurance.
- Explain reporting as a means of communication to different stakeholders.
- Explain the level of assurance provided by audit and other review assignments.

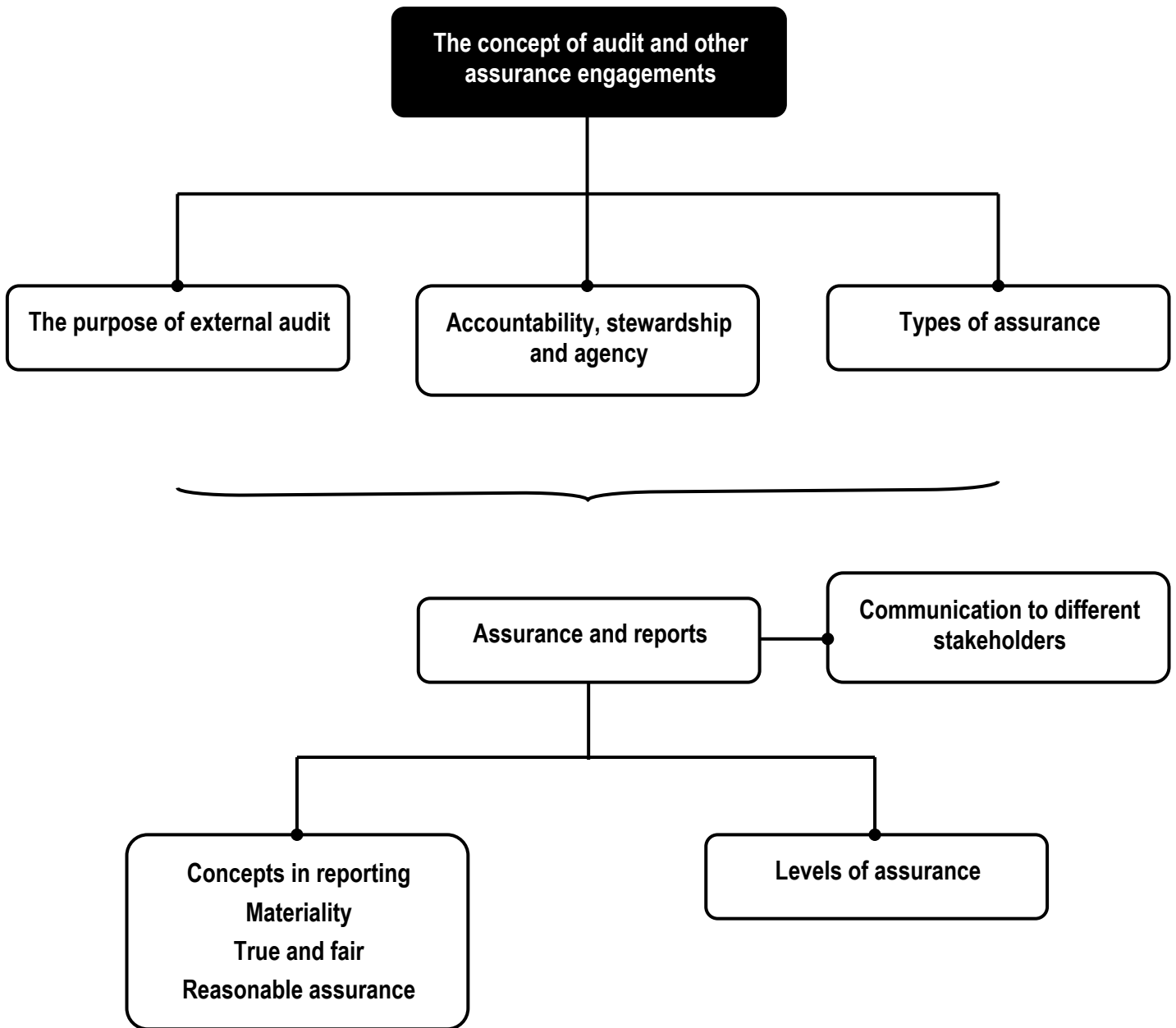
Exam Context

This chapter contains essential underlying knowledge about audit and assurance. It is unlikely that this chapter would form the basis of a full question but definitions of key terms and concepts could form parts of questions, perhaps for about 4 or 5 marks.

Qualification Context

These areas also form the basis of the professional level Advanced Audit and Assurance paper (P7) which places greater emphasis on the other non-audit assurance assignments.

Overview



1 The purpose of external audit

1.1 The purpose of external audit is to promote confidence and trust in financial information.

1.2 Definition

External audit has been defined as

'the independent examination and expression of opinion on the financial statements of an entity'.

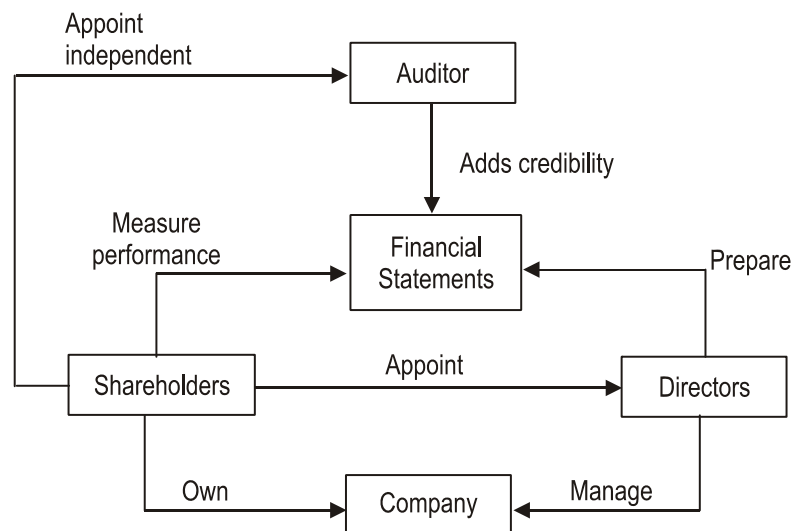
The primary role of an external audit is to report on the truth and fairness of the financial statements of an entity on behalf of its owners, the shareholders.

The auditor gives an opinion on whether the financial statements:

- Have been prepared in accordance with an acceptable financial reporting framework, e.g. IFRSs; and
- Comply with any specific statutory requirements, e.g. to keep adequate accounting records.

1.3 Most national legislation requires the directors of all companies to produce financial statements for presentation to their shareholders. This is a recognition of the division between those who own the company – the shareholders – and those who run it on a day-to-day basis – the directors.

1.4



1.5 The directors are required to account for the **stewardship** of the assets placed under their control. They achieve this by preparing financial statements which are presented to the shareholders.

1.6 An external audit is another legal requirement for incorporated entities, although many smaller entities are exempt from the requirement. The directors' statements have to be examined by an independent expert, the auditor, who is required to give an opinion on their truth and fairness.

1: THE CONCEPT OF AUDIT AND OTHER ASSURANCE ENGAGEMENTS

- 1.7 The auditor's opinion enhances the credibility of the financial statements by providing **reasonable assurance** from an independent source that the financial statements taken as a whole are free from material misstatement.



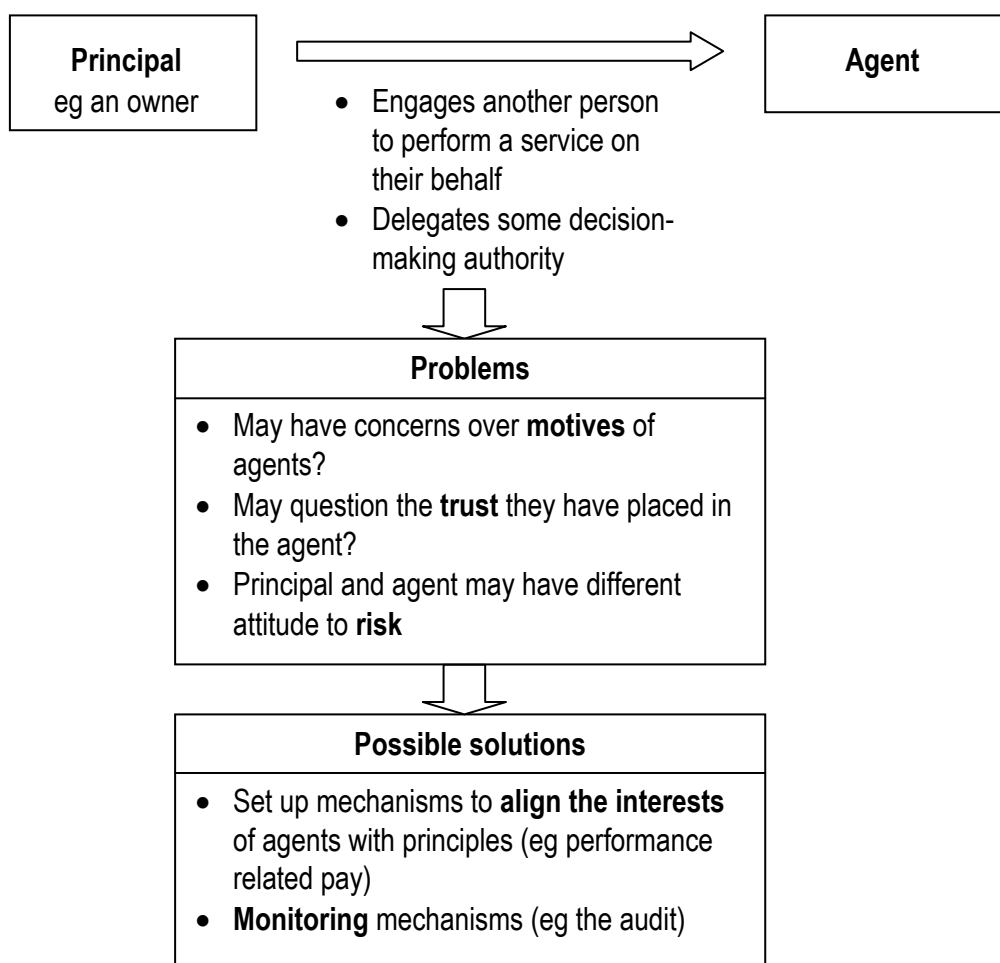
Section 2

2 Accountability, stewardship and agency

2.1 Agency theory

The role of external audit is often explained in relation to the economic model of **agency theory**.

2.2 An agency relationship



The agency relationship in audit

- 2.3 In the case of a company, the board of directors acts as the **agents** of the body of shareholders, the **principals**. The directors are **accountable** for their **stewardship** of the company.

The shareholders have limited access to information about the operations of the company. They may lack trust in the directors and may believe that the information in the financial statements is biased.

The external auditor, therefore, performs a statutory audit to address a simple agency conflict between shareholders and directors.

- 2.4 In addition, the auditor can be seen as an **agent** of the shareholders. Under law, they report to and are appointed by the shareholders (see Chapter 2).

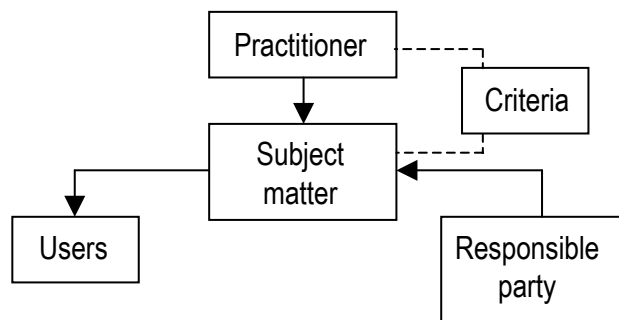
This raises more concerns with regard to trust and confidence. One key factor here is the importance that shareholders place on the auditors' **independence** from the directors. Auditors have an important incentive to maintain independence and protect their reputation in order to keep and win more audit work. The profession also imposes guidance in relation to independence (see Chapter 4).

3 Types of assurance

The F8 syllabus extends beyond audit to the wider context of assurance.

- 3.1 'An assurance engagement is an engagement in which a **practitioner** expresses a conclusion designed to enhance the degree of confidence of the **intended users** other than the **responsible party** about the outcome of the evaluation or measurement of a **subject matter** against **criteria**.' *[International Framework for Assurance Engagements]*

3.2



- 3.3 Assurance engagements are generally voluntary but may be a requirement imposed on the entity by another party.

3.4 Examples of assurance engagements include:

- Annual external audit of financial statements ('statutory' assurance)
- Half-year review of results
- Going concern review
- Review of effectiveness of an entity's IT system
- Review of compliance with corporate governance requirements

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

- Independent opinion from an external source that enhances the credibility of the information
- Management bias is reduced
- Modified opinion draws attention to risk
- The relevance of the information may be improved by the expertise and knowledge of the assurance firm.

1: THE CONCEPT OF AUDIT AND OTHER ASSURANCE ENGAGEMENTS

3.6 All assurance engagements, whether subjected to legal regulation such as statutory audit or a contractual arrangement should be performed in a similar manner:

- Agree the scope of work to be performed
- Formalise all of the terms of the engagement in a contract (engagement letter)
- Plan the work. The level of work should be based on the risk and level of assurance desired
- Obtain sufficient appropriate evidence on which to base the conclusion
- Perform overall review and form opinion
- Issue report to the client.

4 Assurance and reports

4.1 The objective of any assurance assignment is to produce a conclusion in the form of a report.

Communication to different stakeholders

4.2 The report issued after a statutory audit is addressed to the **shareholders**. The addressees of other assurance reports will vary from one assignment to another, depending on the nature of the subject matter and the purpose of the report.

Lecture example 1

Idea generation

Excluding shareholders, list other users of financial statements who may benefit from the increased confidence provided by the auditors report.

Solution

Concepts in reporting

- 4.3 In Chapter 19 we will look at auditor's reports in detail but there are a number of key concepts that underlie the nature of the audit opinion. We will introduce these at this stage because they are essential to your understanding of the nature of audit.

INDEPENDENT AUDITOR'S REPORT

(Example from ISA 700 *The Auditor's report on financial statements*)

(APPROPRIATE ADDRESSEE)

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of the significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain **reasonable** assurance whether the financial statements are free from **material** misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risk of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

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

1: THE CONCEPT OF AUDIT AND OTHER ASSURANCE ENGAGEMENTS

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

True and fair/ fair presentation

- 4.4 (a) The auditor is required to report that the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position, results and cash flows of the company concerned.
- (b) The International Federation of Accountants (IFAC) does not, however, define true and fair as it depends on the financial reporting framework used.

For example, under IFRSs, it is defined in IAS 1 *Presentation of Financial Statements*:

'Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework for the Preparation and Presentation of Financial Statements. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.'

- (c) Ultimately true and fair may need to be decided by a court where there is contention. The courts will treat compliance with the identified financial reporting framework as prima facie evidence that the financial statements are true and fair.

Reasonable assurance

- 4.5 No auditor can give 100% assurance. The highest level of assurance given, as in the case of statutory audit, is described as 'reasonable assurance'.

'Reasonable assurance' is less than absolute assurance. Reducing assurance engagement risk to zero is very rarely attainable or cost beneficial as a result of factors such as the following:

- (a) The use of selective testing.
- (b) The inherent limitations of internal control.
- (c) The fact that much of the evidence available to the practitioner is persuasive rather than conclusive.
- (d) The use of judgement in gathering and evaluating evidence and forming conclusions based on that evidence.
- (e) In some case, the characteristics of the subject matter when evaluated or measured against the identified criteria.

Materiality

- 4.6 The objective of an audit of financial statements is to enable the auditor to express an opinion on whether the financial statements are prepared in all *material* respects, with an identified financial reporting framework.
- 4.7 What is materiality?
- Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.
 - The auditor must be concerned with identifying 'material' errors, omissions and misstatements. Both the amount (quantity) and nature (quality) of misstatements need to be considered.
 - To put this into practice the auditor therefore has to set his own materiality levels – this will always be a matter of judgement. (Chapter 6 covers this area in more detail).

5 Levels of assurance

- 5.1 Differences between reasonable assurance engagements and limited assurance engagements

Type of engagement	Evidence-gathering procedures	The assurance report
Reasonable assurance engagement eg statutory audit	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes: <ul style="list-style-type: none"> • Obtaining an understanding of the engagement circumstances • Assessing risks • Responding to assessed risks • Performing further procedures using a combination of inspection, observation, confirmation, re-calculation, re-performance, analytical procedures and inquiry. 	Description of the engagement circumstances, and a positive expression of the conclusion (see section 4.3)

1: THE CONCEPT OF AUDIT AND OTHER ASSURANCE ENGAGEMENTS

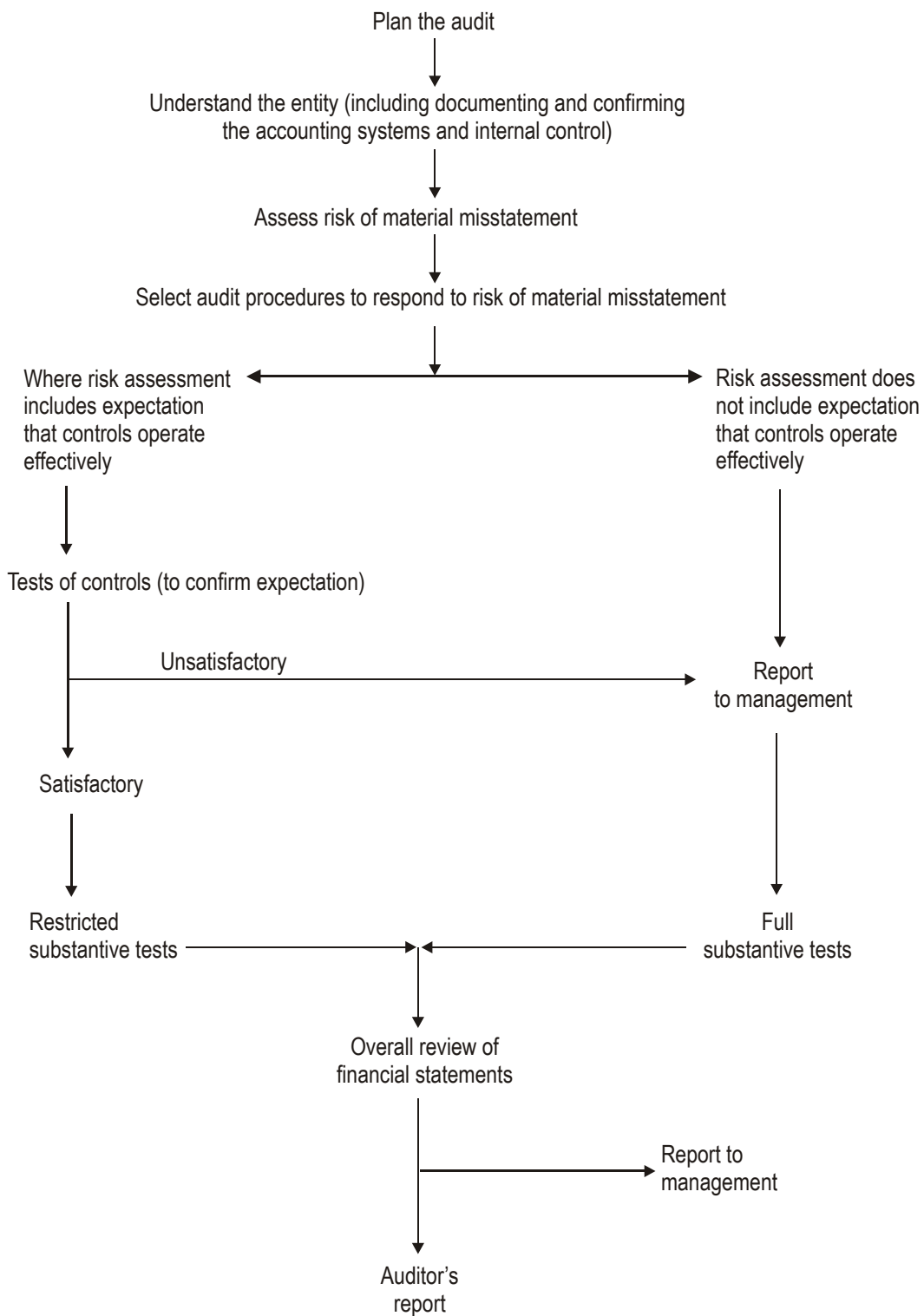
Type of engagement	Evidence-gathering procedures	The assurance report
Limited assurance engagement eg review of half-year accounts	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances, but in which procedures are deliberately limited relative to a reasonable assurance engagement. The procedures may include only inquiry and analytical procedures.	Description of the engagement circumstances, and a negative form of expression of the conclusion (see section 5.2)

5.2 Reporting different levels of assurance

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

6 Stages of an external audit

6.1 The following diagram illustrates the main steps in the conduct of an external audit. The following chapters expand each of these steps.



7 Chapter summary

- The purpose of **external audit** is to promote **confidence and trust** in financial information.
- Audit can be explained in relation to **agency theory**.
- Audit is only one type of **assurance engagement**.
- The objective of any audit or assurance engagement is to produce an **opinion** in the form of a **report**.
- **Reasonable assurance** is usually reported in terms of **positive expression**.
- **Limited assurance** is usually reported in terms of **negative expression**.

END OF CHAPTER

Statutory audits

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Describe the regulatory environment within which statutory audits take place.
- Discuss the reasons and mechanisms for the regulation of auditors.
- Explain the statutory regulations governing the appointment, removal and resignation of auditors.
- Discuss the types of opinion provided in statutory audits.
- State the objectives and principle activities of statutory audit and assess its value (eg. in assisting management to reduce risk and improve performance).
- Describe the limitations of statutory audits.

Exam Context

This chapter builds your knowledge of the regulation of statutory audit and introduces more detail on audit opinions (which will be revisited in more depth in Chapter 19). It also introduces topics which could form the basis of discussion questions on the values and limitations of statutory audit.

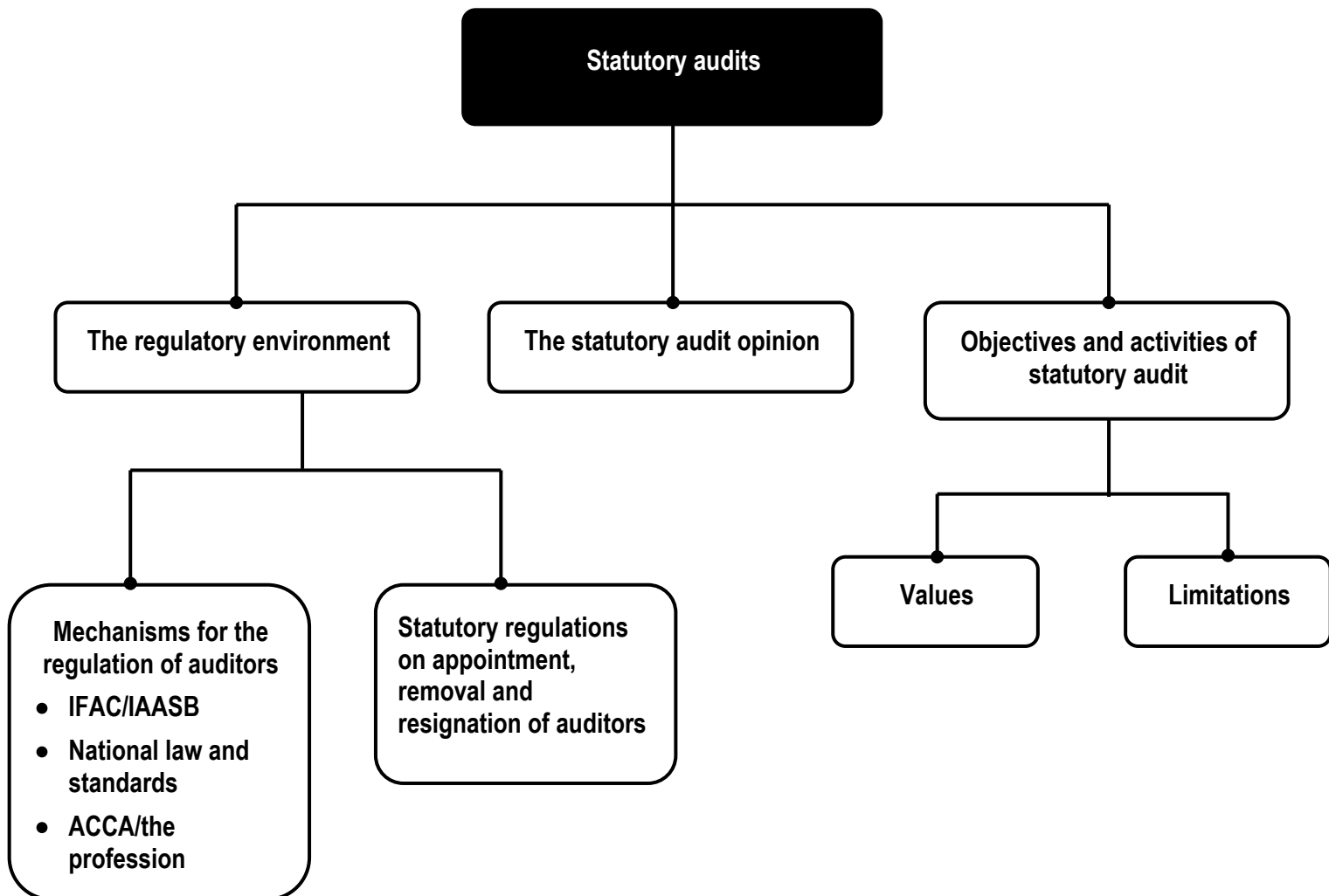
Qualification Context

The topic of audit regulation, particularly in the international context is developed further in the professional level Advanced Audit and Assurance paper (P7).

Business Context

In response to high-profile audit failures, such as Enron, the audit profession is subject to increased regulation. At the same time there is significant debate about the value of statutory audit for smaller entities.

Overview



1 The regulatory framework

1.1 The auditing profession is subject to regulation from a range of sources.

- National legislation
- National regulation and standard-setting
- International standard-setting
- Professional bodies, eg ACCA.

1.2 Legislation will normally establish:

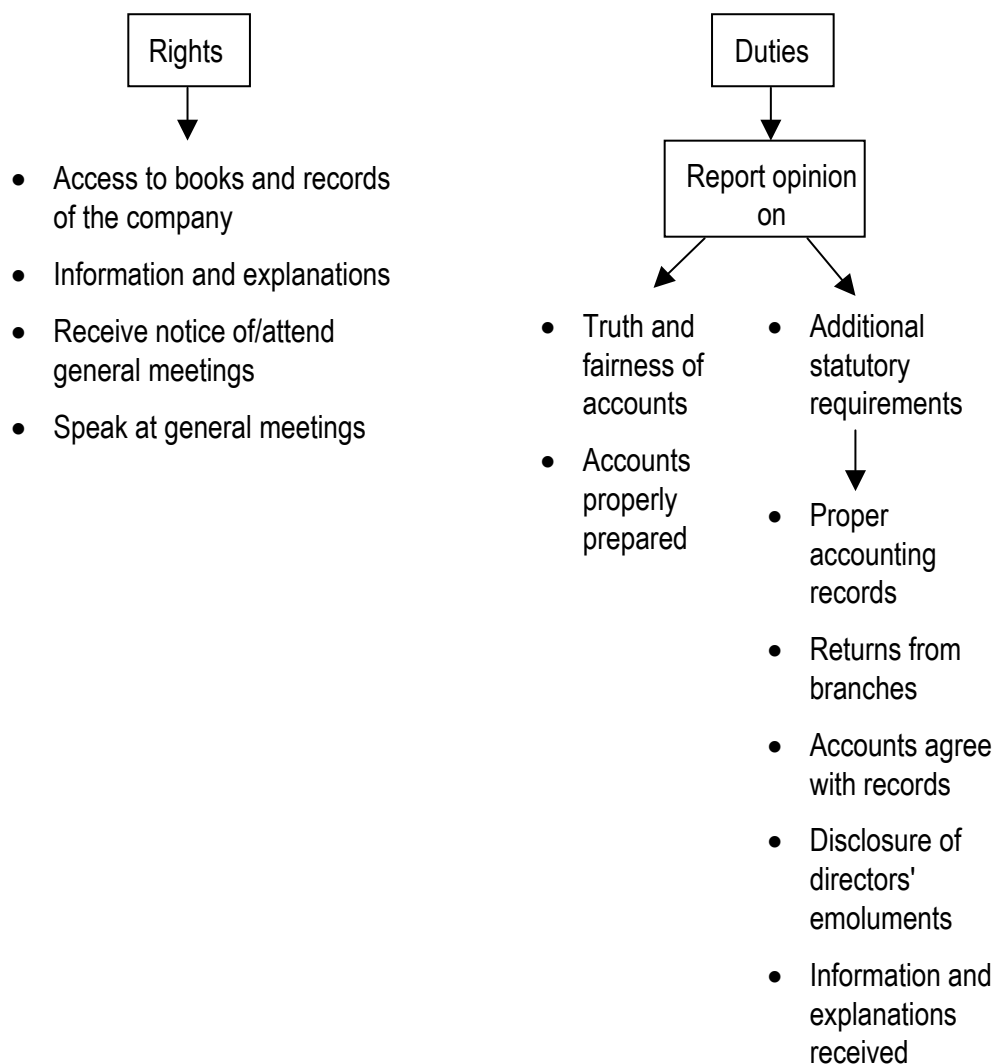
- Rights and duties of auditors
- Eligibility to act as auditor



Section 1.4

Auditors' rights and duties

1.3



Eligibility

1.4 Most legal frameworks require auditors to be members of an appropriate professional body such as ACCA.

2 International Federation of Accountants (IFAC)

2.1 IFAC came into being as a result of initiatives put forward in 1973 and formally approved at the International Congress of Accountants in Munich in 1977.

It is a non-profit, non-governmental and non-political international organisation of accountancy bodies.

Mission

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

Membership

2.3 Membership in IFAC is open to accountancy bodies recognised by law/general consensus within their countries as substantial national organisations of good standing. Through IFAC, members are automatically registered as members of the International Accounting Standards Board (IASB). There were 160 member bodies from 120 countries representing over 2.5 million accountants worldwide as at June 2006.

Council

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

Board

2.5 The Board consists of the President and representatives from 16 countries elected by the Council for three-year terms. Elections to the Board are held annually so that one third of the Board retire each year.

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

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

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

3 International Auditing and Assurance Standards Board (IAASB)

- 3.1 The IAASB was established to develop and issue standards and statements on auditing, assurance and related services on behalf of the IFAC Board.
- 3.2 The 18 members of the IAASB are nominated by the IFAC Board based on names put forward by the member bodies and Forum of Firms.
- 3.3 The objective of the IAASB, on behalf of the IFAC Board, is to serve the public interest by setting high quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The IAASB achieves this objective by:
- Establishing high quality auditing standards and guidance for financial statement audits that are generally accepted and recognised by investors, auditors, governments, banking regulators, securities regulators and other key stakeholders across the world
 - Establishing high quality standards and guidance for other types of assurance services on both financial and non-financial matters
 - Establishing high quality standards and guidance for other related services
 - Establishing high quality standards for quality control covering the scope of services addressed by the IAASB; and
 - Publishing other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of professional auditors and assurance service providers.

4 The scope and authority of IAASB pronouncements

- 4.1 The IAASB's pronouncements govern assurance and related services that are conducted in accordance with International Standards. They do not override the local laws or regulations. The pronouncements of the IAASB examinable fall into two categories:
- International Standards on Auditing (ISAs)
 - International Standards on Assurance Engagements (ISAEs)
- 4.2 The IAASB's Standards contain basic principles and essential procedures together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provide guidance for their application. It is therefore necessary to consider the whole text of a Standard to understand and apply the basic principles and essential procedures.

2: STATUTORY AUDITS

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

ISAs and national standard-setters

- 4.3 Many national standard-setters are moving towards the adoption of ISAs in place of their previous local auditing standards. By the end of 2006 over 100 countries had adopted or incorporated ISAs into their national auditing standards or are using ISAs as a basis for preparing national auditing standards.
- 4.4 ISAs are designed to be applicable globally. Auditors working in a specific country may require additional guidance in respect of issues such as national legal and regulatory requirements.

Example

- 4.5 The UK national standard-setters, the Auditing Practices Board (APB) adopted the ISAs but re-issued them as ISAs (UK and Ireland), adding in some extra requirements to meet local requirements.

Note: In BPP's study material we use the term 'ISA' to refer to both the IAASB standard and the UK and Ireland versions. For the purposes of this exam, the elements of the standards that you are required to know are identical.

5 Regulation by the profession

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

5.1 Role of the ACCA

Education and training of auditors	As a member of IFAC, ACCA must comply with IFAC's international standards and guidelines on <ul style="list-style-type: none">• Pre-qualification education and training• Continuing professional education
Implementation and enforcement of ethical requirements	IFAC member bodies such as ACCA must prepare ethical requirements based on IFAC's International Code of Ethics for Professional Accountants. Member bodies must provide high standards of professional conduct and ensure that ethical requirements are observed. Disciplinary action should normally be taken in the following instances: <ul style="list-style-type: none">• Failure to observe the required standard of professional care, skills or competence;• Non-compliance with the rules of ethics; or• Discreditable or dishonourable conduct. The power for disciplinary action may be provided by legislation or by the constitution of the professional body.

6 Appointment, removal and resignation of auditors

6.1 Chapter 1 identified the importance of the auditor being **independent** and an **agent of the shareholders**.

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

6.2 Overview of regulations

Appointment	<ul style="list-style-type: none"> • Normally appointed annually • By shareholders resolution • In particular circumstances, eg first auditors, casual vacancy, directors can appoint auditors
Removal	<ul style="list-style-type: none"> • Resolution by shareholders • Auditors entitled to: <ul style="list-style-type: none"> – Notice of resolution – Make written representation – Speak at shareholders meetings until their term of office have expired
Resignation	<ul style="list-style-type: none"> • Auditors may resign at any time • Give written notice to registered office of the company • Send statement of circumstances to everyone entitled to a copy of the accounts

7 The statutory audit opinion

7.1 As discussed in chapter 1 there are two key aspects to the opinion, that must be explicitly reported:

- Whether a **true and fair** view is given by the financial statements
- Whether the financial statements have been **properly prepared** in accordance with relevant legal requirements.

7.2 Additional areas

Other regulations, such as local law and corporate governance codes, may require the auditor to consider other aspects and report on them either positively or by exception.

2: STATUTORY AUDITS

Examples (based on UK regulatory framework)

7.3 (a) Reported by exception

- Proper accounting records kept
- Accounts in agreement with records
- Information and explanations made available
- Returns adequate for audit received from branches not visited by the auditor

(b) Specific opinions

- Whether directors report is consistent with the financial statements.

8 Objectives and activities of statutory audit

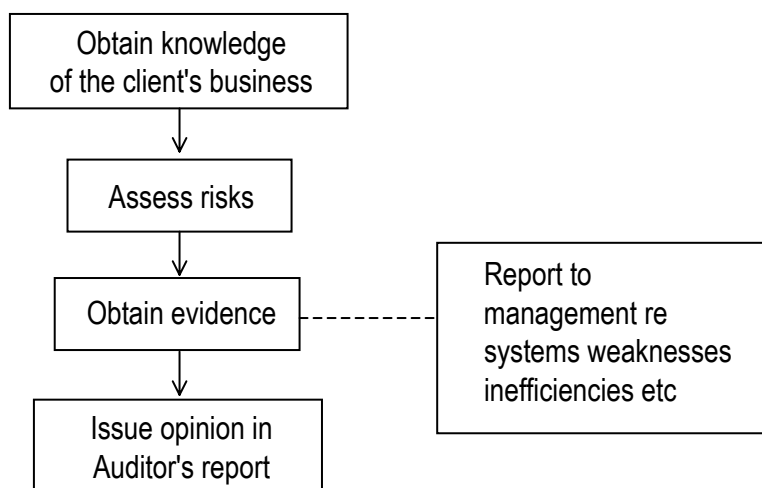
8.1 Objectives

The objective of statutory audit is to issue an opinion in line with statutory requirements, as outlined in section 7.

In more general terms, the objective could be described as 'providing assurance to the users of financial statements'.

8.2 Activities

Later chapters in these notes will cover the activities of statutory audit in detail. The following diagram summarises the main areas.



Lecture example 1

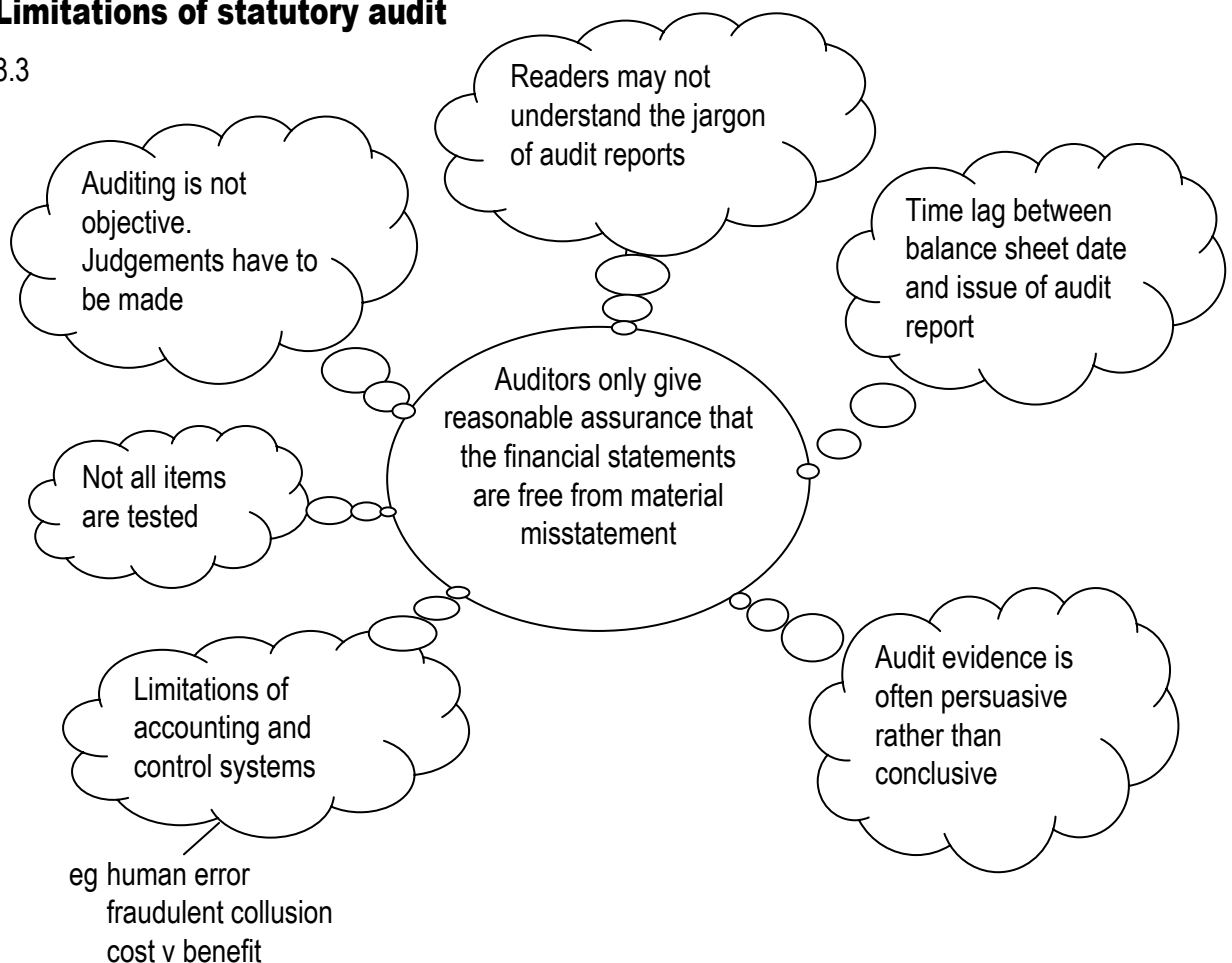
Value of external audit

Discuss the value of external audit to the following users:

- (a) Shareholders who want information about a company's performance
- (b) Management who want to reduce risk and improve performance

Solution**Limitations of statutory audit**

8.3



9 Chapter summary

- Auditors **rights and duties** are governed by **national legislation**.
- The **IAASB**, an operating board of **IFAC** produces **international standards on auditing, assurance and related services**.
- **Professional bodies**, such as ACCA, establish regulations relating to **education and training** and **ethics**.
- **National legislation** may impose **additional reporting requirements**.
- Auditors can only give **reasonable assurance** due to the inherent **limitations** of statutory audit.

END OF CHAPTER

The regulatory environment and corporate governance

3

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain the development and status of International Standards on Auditing.
- Explain the relationship between International Standards on Auditing and national standards.
- Discuss the objective, relevance and importance of corporate governance.
- Discuss the need for auditors to communicate with those charged with governance.
- Discuss the provisions of international codes of corporate governance (such as the Combined Code on Corporate Governance) that are most relevant to auditors.
- Describe good corporate governance requirements relating to directors; responsibilities (eg. for risk management and internal control) and the reporting responsibilities of auditors.
- Analyse the structure and roles of audit committees and discuss their drawbacks and limitations.
- Explain the importance of internal control and risk management.
- Compare the responsibilities of management and auditors for the design and operation of systems and controls.

Exam Context

The areas in this chapter are most likely to be tested in short factual requirements, probably carrying in the region of 5 marks. Corporate governance and its links with the role of the auditor could be a more significant part of a question, as in the pilot paper where two requirements totalling 10 marks were available.

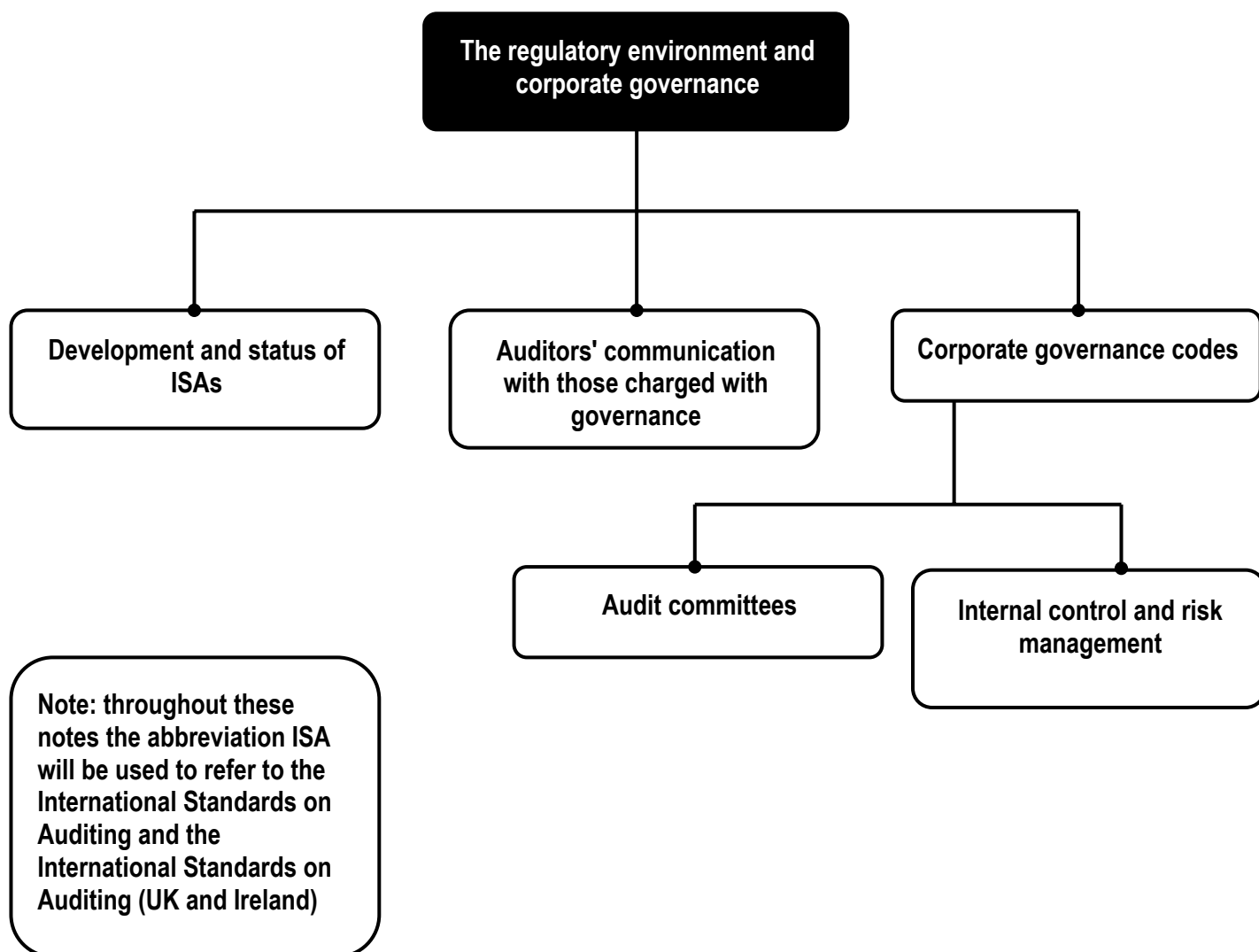
Qualification Context

The topic of corporate governance is central to the ACCA qualification and is included in the syllabus of a variety of papers, from the Accountant in Business (F1) paper through to the professional stage papers.

Business Context

The growing expectations in respect of corporate governance in the wake of the various codes are increasingly being met. A survey by Grant Thornton in the UK in 2004 showed that 96% of FTSE 100 companies had an internal audit department, compared with 81% in 2002.

Overview





Section 1

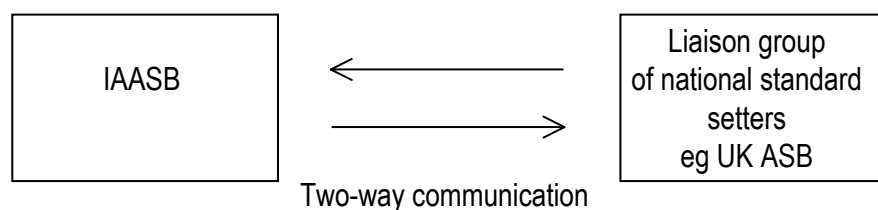
1 Development and status of International Standards on Auditing (ISAs)

1.1 The main objectives of the International Auditing and Assurance Board (IAASB), as introduced in Chapter 2, are:

- To issue high quality international standards, and
- To provide the convergence of international and national standards, in the public interest.

Liaison with national standard setters

1.2



Annual meetings with liaison group to:

- Share knowledge on international and national developments affecting the priority of topics on future standard setting agendas
- Bringing the strengths of the IAASB and national auditing standard setters to bear on standards at an early stage in their development
- Achieve close cooperation and strengthened communication eg. by closer collaboration on projects and minimising duplication
- Achieve wider involvement by national auditing standard setters in IAASB task forces or to advance research agendas

Standard setters who:

- Are significantly active in the development of national auditing standards
- Have adopted or plan to adopt ISAs, or are demonstrably committed towards the achievement of convergence of international and national standards
- Are sufficiently resourced to participate actively in collaborative efforts
- Represent the world's largest economies

Status of ISAs

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

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



Section 3

2 Corporate governance

2.1 Corporate governance relates to the internal means by which corporations are operated and controlled. While governments play a central role in shaping the legal, institutional and regulatory climate within which individual corporate governance systems are developed, the main responsibility lies with the private sector.

"A good corporate governance regime helps to assure that corporations use their capital efficiently. Good corporate governance helps, too, to ensure that corporations take into account the interests of a wide range of constituencies, as well as of the communities within which they operate, and that their boards are accountable to the company and the shareholders. This, in turn, helps to assure that corporations operate for the benefit of society as a whole." (OECD)

The OECD principles of corporate governance

2.2 The OECD (Organisation for Economic Co-operation and Development) has developed its own Principles of Corporate Governance. Their purpose is to serve as a reference point. These principles can be used by policy makers, as they examine and develop their legal and regulatory frameworks for corporate governance that reflect their own economic, social, legal and cultural circumstances, and by market participants as they develop their own practices.

2.3 The Principles are:

- I The rights of shareholders
- II The equitable treatment of shareholders
- III The role of stakeholders
- IV Disclosure and transparency
- V The responsibility of the board

2.4 The OECD document provides detailed recommendations expanding on each of the principles.



3 The UK's combined code of corporate governance

3.1 The UK's Combined Code is an example of a best practice model.

Code of best practice

3.2 The principles of good corporate governance contained in the Combined Code can be split between those applicable to directors, those applicable to relations with shareholders and those applicable to the accounts and the audit.

3.3 The recommendations applicable to **directors** are as follows.

The board main principles

Every company should be headed by an effective board, which is collectively responsible for the success of the company.

3: THE REGULATORY ENVIRONMENT AND CORPORATE GOVERNANCE

- 1 The role of chairman and chief executive officer should be separated. On retiring, a chief executive should not become a chairman.
 - 2 At least half the board, excluding the chairman, should comprise non-executive directors.
 - 3 The chairman should ensure that all directors are properly briefed on issues arising at the board meetings.
 - 4 The nomination committee should appoint all directors. Directors should be reappointed every three years and they should receive appropriate training when they are first appointed.
 - 5 Levels of remuneration should be sufficient to attract and retain directors. A significant proportion should be linked to corporate and individual performance.
 - 6 A remuneration committee should be set up. This should be comprised of non-executive directors.
- 3.4 The recommendations applicable to relations with **shareholders** are as follows.
- 1 Companies should be ready to enter into dialogue with institutional investors.
 - 2 The AGM should be used to communicate with investors and encourage their participation.
 - 3 Institutional investors have a responsibility to make considered use of their votes.
- 3.5 The recommendations applicable to the **accounts and audit** are as follows.
- 1 The board should present a balanced and understandable assessment of the company's position and prospects.
 - 2 The board should **maintain a sound system of internal control** to safeguard shareholders' investment and the company's assets. The board should, at least annually, conduct a review of the effectiveness of internal controls and should report that they have done so.
 - 3 The board should establish formal and transparent arrangements to consider how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the auditors. This will involve the establishment of an audit committee.
- 3.6 The **Combined Code** is part of the UK Stock Exchange listing rules. Listed companies must make a statement on how they apply the principles in the Code. The company is also required to confirm that it complies with the Code provisions, or where it does not, to provide an explanation. Auditors are required to review these matters.

Corporate governance and the external auditor

- 3.7 The auditor must:
- (a) Give a clear statement of responsibilities in the audit report
 - (b) Review directors compliance with 9 of the 48 Code provisions
 - (c) Read the directors' review of internal controls and assess whether it appropriately reflects the processes carried out

3: THE REGULATORY ENVIRONMENT AND CORPORATE GOVERNANCE

- (d) Liaise with the audit committee
- (e) Review the directors' remuneration disclosures
- (f) Review the directors' statement of going concern

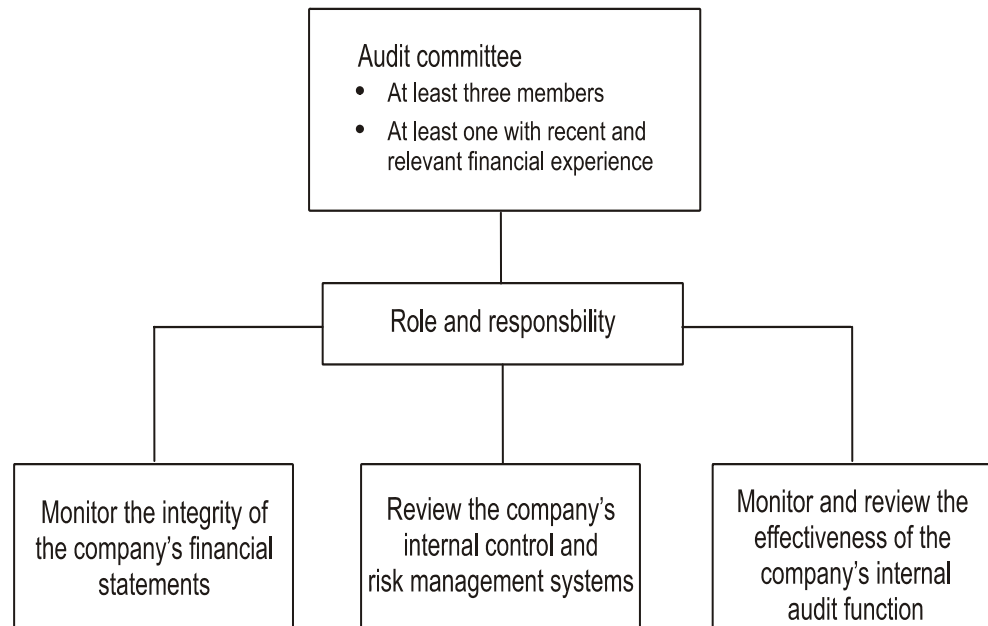
3.8 **Combined Code:** provisions that auditors are required to review

- (a) The directors should acknowledge their responsibility for preparing the accounts in the annual report.
- (b) The board should, at least annually, conduct a review of the effectiveness of the company's system of internal controls and should report to shareholders that they have done so.
- (c) The board should establish an audit committee of at least three independent non executive directors, at least one having recent and relevant financial experience.
- (d) The audit committee should have written terms of reference.
- (e) Terms of reference for the audit committee should be made available and described in the annual report.
- (f) The audit committee should review whether staff feel able to raise concerns about financial reporting or other matters.
- (g) The audit committee should monitor and review the effectiveness of the internal audit activities.
- (h) The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors.
- (i) The audit committee should describe in the annual report the safeguards adopted by external auditors to protect their independence where they provide other services.

Q3 Corporate
Governance

Audit committee and external auditors

3.9



- Make recommendations in relation to appointment, re-appointment and removal of external auditor
- Approve remuneration and terms of engagement of the external auditor
- Review and monitor external auditor's independence and objectivity and the effectiveness of the audit process
- Develop and implement policy on the engagement of the external auditor to supply non-audit services

See Chapter 15

Advantages and disadvantages of audit committees

3.10 **Advantages** that are claimed to arise from the existence of an audit committee include:

- (a) It will lead to **increased confidence** in the credibility and objectivity of financial reports.
- (b) By specialising in the problems of financial reporting and thus, to some extent, fulfilling the directors' responsibility in this area, it will allow the **executive** directors to **devote their attention to management**.
- (c) In cases where the interests of the company, the executive directors and the employees conflict, the audit committee might provide an **impartial body** for the auditors to consult.
- (d) The internal auditors will be able to report to the audit committee.
- (e) The external auditors have an independent point of reference.

3: THE REGULATORY ENVIRONMENT AND CORPORATE GOVERNANCE

3.11 Disadvantages of audit committees include:

- (a) There may be **difficulty selecting** sufficient non-executive directors with the necessary competence in auditing matters for the committee to be really effective.
- (b) The establishment of such a **formalised reporting procedure** may **dissuade** the **auditors** from raising matters of judgement and limit them to reporting only on matters of fact.
- (c) Costs may be increased.

The importance of internal control and risk management

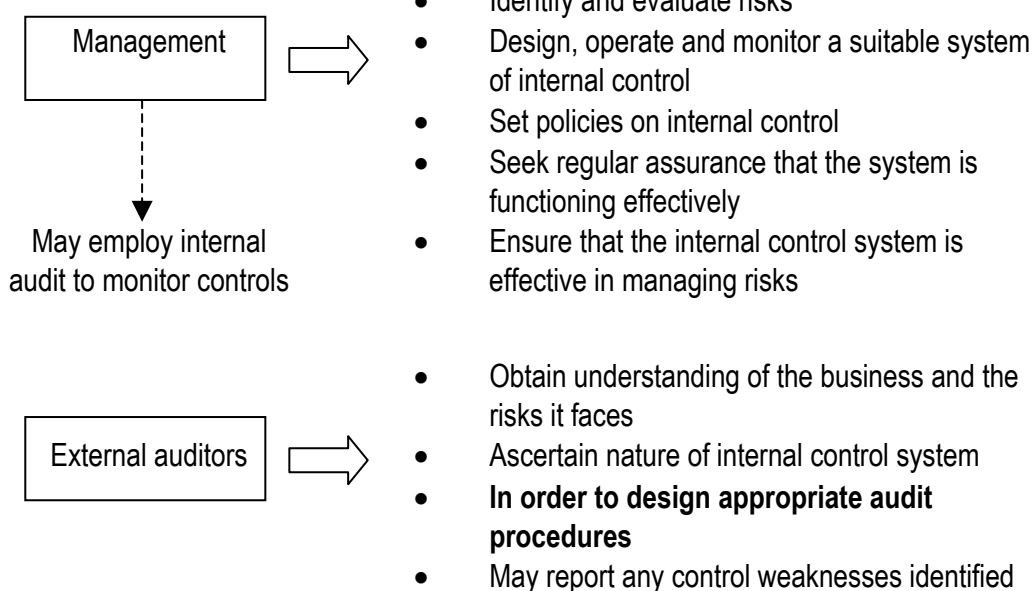
3.12 (a) A sound system of internal control contributes to safeguarding the shareholder's investment and the company's assets.

An internal control system:

- Facilitates the effectiveness and efficiency of operations
 - Helps ensure the reliability of internal and external reporting
 - Assists compliance with laws and regulations.
- (b) The risks faced by a company are continually changing. A sound system of internal control therefore depends on a thorough and regular evaluation of the nature and extent of risks to which the company is exposed. Since profits are, in part, the reward for successful risk-taking, the purpose of internal control is to help manage and control risk appropriately rather than to eliminate it.

Responsibilities of management and auditors

3.13



4 ISA 260: Communication of audit matters with those charged with governance

- 4.1 ISA 260 *requires* the external auditor to communicate 'audit matters of governance interest' to those charged with governance of the entity.

'Those charged with governance' means those entrusted with the supervision, control and direction of an entity and would therefore include the audit committee and non-executive directors. They only include management when it performs such functions.

Lecture example 1

Required

List the matters that the auditor would normally communicate to those charged with governance.

Solution

4.2 *Procedures:*

- Such communications should be on a *sufficiently prompt* basis to enable those charged with governance to take appropriate action. All communications will be before the financial statements are finalised.
- The form of communications and the addressee of communications should be established at an *early stage* in the audit process (ie planning).
- Before reporting issues to the board, auditors should first *discuss* those matters with management. This gives management an opportunity to provide further information or explanations.
- If possible, matters should be addressed to the audit committee, or to the board if there is no audit committee.

Third parties interested in communications to those charged with governance

- 4.3 Occasionally those charged with governance may wish to provide third parties, for examples bankers or certain regulatory authorities, with copies of a written communication from the auditors. It is appropriate to ensure that third parties who see the communication understand that it was not prepared with third parties in mind.
- The report has been prepared for the sole use of the entity and, where appropriate, any parent undertaking and its auditors
 - It must not be disclosed to a third party, or quoted or referred to, without the written consent of the auditors; and
 - No responsibility is assumed by the auditors to any other person.

5 Chapter summary

- **ISAs** are issued by the **IAASB** after liaison with national standard setters.
- The **OECD** has developed **Principles of Corporate Governance** as a reference point for national policy makers.
- The **Combined Code** issued by the Financial Reporting Council in the UK is an example of **best practice**.

END OF CHAPTER

Professional ethics and ACCA's Code of Ethics and Conduct

4

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Define and apply the fundamental principle of professional ethics of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.
- Define and apply the conceptual framework.
- Discuss the sources of, and enforcement mechanisms associated with, ACCA's Code of Ethics and Conduct.
- Discuss the requirements of professional ethics and other requirements in relation to the acceptance of new audit engagements.
- Discuss the process by which an auditor obtains an audit engagement.
- Explain the importance of engagement letters and state their contents.

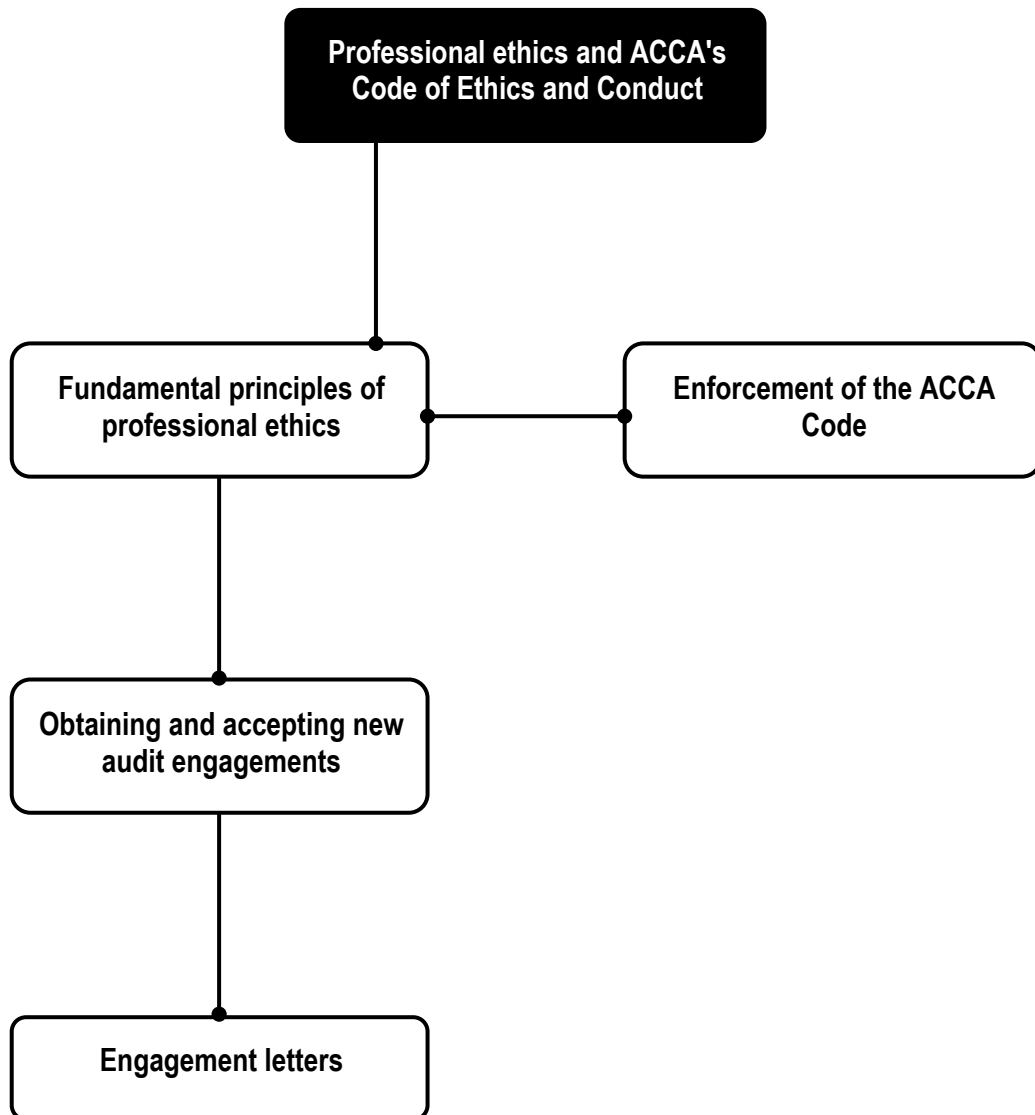
Exam Context

Ethics is likely to appear frequently in the exam, most probably in questions where you have to apply your knowledge to a specific scenario. In the pilot paper 10 marks were available for identifying threats to independence in a given scenario and explaining how the threats should be managed. Other aspects of this chapter could appear as short factual requirements. For example the pilot paper included a 3 mark requirement on the content of an engagement letter.

Qualification Context

In developing the new syllabus, ACCA increased the focus on professionalism and ethics in accounting. As well as being examined in F8 and the professional stage Advanced Audit and Assurance paper (P7), ethics appears in the syllabus of the Accountant in Business paper (F1) and the Professional Accountant (P1). In addition, the new online ethics module is being used.

Overview



1 ACCA code of ethics and conduct

- 1.1 As a member of IFAC (the International Federation of Accountants) the ACCA is required to enforce ethical standards no less stringent than those of the global body.

The ACCA rules are now fundamentally the same as those of IFAC. They give fundamental principles and specific guidance statements.

The code of ethics and conduct apply to members, affiliates and students of the ACCA.

The fundamental principles

- 1.2

Integrity	Be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.
Objectivity	Not allow bias, conflicts of interest or undue influence of others to override professional or business judgement.
Professional competence and due care	Maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service; and Act diligently in accordance with applicable technical and professional standards when providing professional services.
Confidentiality	Respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority or unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of members or third parties.
Professional behaviour	Members should ensure they comply with relevant laws and regulations and should avoid any action that discredits the profession.

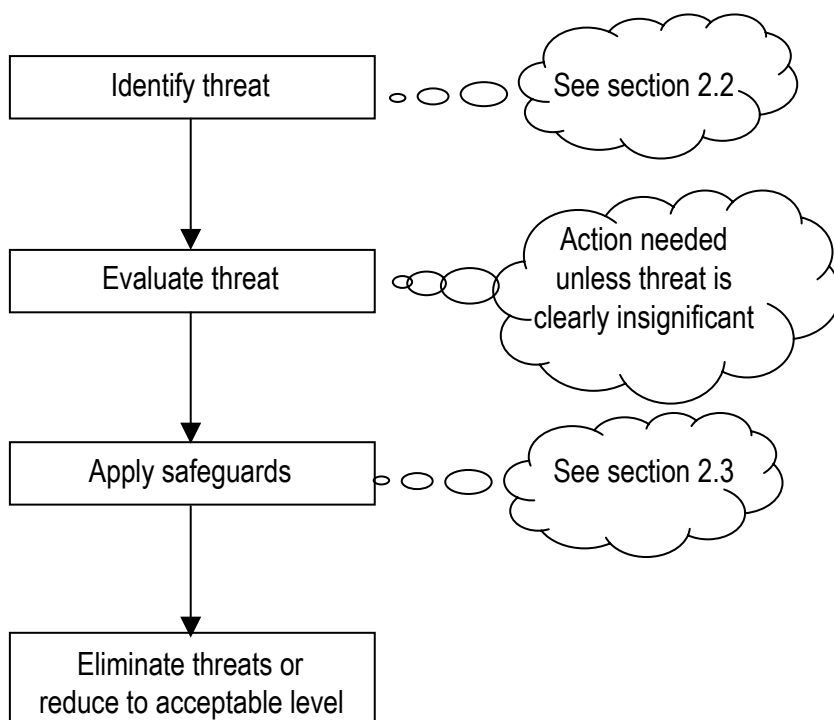
2 Conceptual framework

- 2.1 The ACCA code takes a conceptual and principles-based approach to ethics. Their view, in line with IFAC, is that it is not possible to give rules for every possible ethical dilemma.

A conceptual framework that requires members to identify, evaluate and address threats to compliance with the fundamental principles, rather than merely comply with a set of specific rules which may be arbitrary, is, therefore, in the public interest.

4: PROFESSIONAL ETHICS AND ACCA'S CODE OF ETHICS AND CONDUCT

Using the framework



2.2 Threats

(a) **Self-interest threat**

Occurs when a firm of a member of the assurance team has some financial or other interest in an assurance client.

eg Providing a loan to a client.

(b) **Self-review threat**

Occurs when a previous judgement needs to be re-evaluated by members responsible for that judgement.

eg Performing a service for a client that directly affects the subject matter of an assurance engagement.

(c) **Advocacy threat**

Occurs when members promote a position or opinion to the point that subsequent objectivity may be compromised.

eg Acting as an advocate on behalf of an assurance client in litigation or disputes with third parties.

(d) **Familiarity threat**

Occurs when, because of a close relationship, members become too sympathetic to the interests of others.

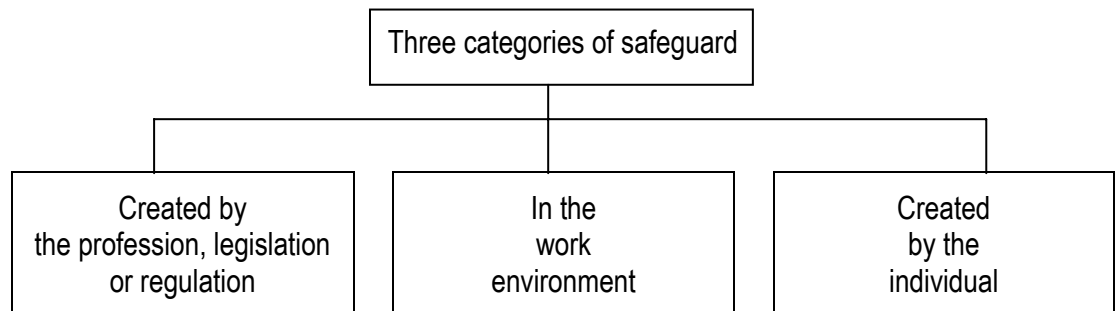
eg Long association with a client leading to over-familiarity with client management such that professional judgement could be compromised.

(e) Intimidation threat

Occurs when members are deterred from acting objectively by threats, actual or perceived.

eg Being pressured to reduce inappropriately the extent of work performed in order to reduce fees.

2.3 Safeguards to offset the threats



- Education, training and experience requirements
- CPD requirements
- Corporate governance codes
- Professional standards
- Professional or regulatory monitoring and disciplinary procedures

- Ethics and conduct programmes
- Recruitment procedures
- Strong internal controls
- Disciplinary processes
- Leadership that stresses importance of ethical behaviour
- Quality control procedures
- Training and education
- Different partners and teams for provision of non-assurance services
- Procedures to empower employees to communicate ethical concerns to senior levels without fear of retribution
- Consultation with another appropriate professional accountant

- Complying with CPD requirements
- Using an independent mentor
- Maintaining contact with legal advisors and professional bodies

Lecture example 1

Idea generation

Three situations have arisen with audit clients of your firm.

- 1 Renato Casillo has acted as engagement partner on the audit of Assynt Co, a public company, for many years.
- 2 Overdue fees from Evergreen, a private limited liability company, have built up to include all bills submitted by your firm in the last twelve months.
- 3 The partners and staff involved in the audit of Weedon, a private limited liability company, have been invited to the company's annual summer social event, a dinner dance and weekend at an exclusive spa hotel.

Required

Using the conceptual framework of ACCA's Code of Ethics and Conduct, for each of the three situations explain:

- (a) The nature of the threat faced by the audit firm, and
- (b) The appropriate safeguards that should be put in place.

Solution

3 Application of the conceptual framework to integrity, objectivity and independence



Q5 Objectivity

3.1 ACCA statement

Members should consider when providing any professional service whether there are threats to compliance with the fundamental principle of objectivity resulting from having interests in, or relationships with, a client or directors, officers or employees.

Members who provide assurance services are required to be independent of the assurance client. Independence of **mind** and **in appearance** is necessary to enable members in public practice to express a conclusion, and be seen to express a conclusion, without bias, conflict of interest or undue influence of others.

3.2 Threats arising from financial matters

(a) Financial interests

Threats	Safeguards
<p>The following parties are not allowed to own a direct financial interest or an indirect material financial interest in a client:</p> <ul style="list-style-type: none"> • The assurance firm • A member of the assurance team • An immediate family member of a member of the assurance team 	<ul style="list-style-type: none"> • Disposing of the interest • Removing the individual from the team • Keep the client's audit committee informed • Using an independent partner to review work <p>NB. If the <i>firm</i> has a direct financial interest in an audit client, disposal of the interest is the only acceptable action.</p>

Definitions from ACCA Code of Ethics and Conduct

- **Immediate family** means spouse (or equivalent) or dependent.
- **Close family** means a parent, child or sibling who is not an immediate family member.

4: PROFESSIONAL ETHICS AND ACCA's CODE OF ETHICS AND CONDUCT

(b) Loans and guarantees

Threats	Safeguards
<p>Clients that are banks or similar institutions</p> <ul style="list-style-type: none"> • Loans or guarantees to the firm <ul style="list-style-type: none"> - no threat if immaterial and on normal terms - if material, apply safeguards • Loans to members of the assurance team <ul style="list-style-type: none"> - not a threat to independence if on normal commercial terms 	<p>Review by an additional professional accountant from outside the firm</p>
<p>Clients that are not banks or similar institutions</p> <ul style="list-style-type: none"> • Loans or guarantees to/from the assurance firm or members of the assurance team. 	<p>No safeguard can reduce the threat unless the loan is immaterial to client and firm/team member</p>

(c) Fees and pricing

Threats	Safeguards									
<ul style="list-style-type: none"> • Dependence where the total fees from an assurance client represent a large portion of a firm's total fees, the dependence on that client and concern about the possibility of losing that client may create a self-interest threat. 	<ul style="list-style-type: none"> • Discussing the extent and nature of the fees with the audit committee • Taking steps to reduce the dependency • External quality control reviews • Consulting ACCA or another professional accountant 									
<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 33%;">Type of company</th> <th style="width: 33%;">Consider reasonableness of accepting or retaining a client (% of firm's total fees)</th> <th style="width: 33%;">Perception of objectivity likely to be at risk</th> </tr> </thead> <tbody> <tr> <td>Listed and other public interest</td> <td style="text-align: center;">5%</td> <td style="text-align: center;">10%</td> </tr> <tr> <td>Private</td> <td style="text-align: center;">10%</td> <td style="text-align: center;">15%</td> </tr> </tbody> </table>		Type of company	Consider reasonableness of accepting or retaining a client (% of firm's total fees)	Perception of objectivity likely to be at risk	Listed and other public interest	5%	10%	Private	10%	15%
Type of company	Consider reasonableness of accepting or retaining a client (% of firm's total fees)	Perception of objectivity likely to be at risk								
Listed and other public interest	5%	10%								
Private	10%	15%								
<ul style="list-style-type: none"> • Overdue fees Threat is similar to that of a loan (see (b) above). 	<ul style="list-style-type: none"> • discuss with the audit committee, including the possibility of resigning if overdue fees are not paid. 									
<ul style="list-style-type: none"> • Contingent fees A fee arrangement under which the amount of the fee is contingent on the result of the audit work creates self-interest and advocacy threats. 	<p>No safeguards can reduce these threats to an acceptable level.</p>									

4: PROFESSIONAL ETHICS AND ACCA'S CODE OF ETHICS AND CONDUCT

<ul style="list-style-type: none"> • Pricing If a firm has obtained an assurance engagement at a fee lower than that charged by their predecessor or quoted by other firms ('lowballing'), a self-interest threat is created. 	<p>The firm must be able to demonstrate that:</p> <ul style="list-style-type: none"> • Appropriate time and quality staff have been assigned, and • All applicable standards are being complied with
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(d) Gifts and hospitality

Threat	Safeguards
Accepting gifts or hospitality from the client may create self-interest and familiarity threats.	A firm or member of the assurance team should not accept gifts or hospitality unless the value is clearly insignificant .

3.3 Threats arising from employment and other relationships

(a) Close business relationships

Threat	Safeguards
<p>Inappropriate close business relationships between an audit firm and an audit client which create a self-interest threat include:</p> <ul style="list-style-type: none"> • Having a material financial interest in a joint venture with the assurance client • Arrangements to combine one or more services or products of the firm with one or more services or products of the assurance client and to market the package with reference to both parties • Distribution or marketing arrangements under which the firm acts as distributor or marketer of the assurance client's products or services or vice versa 	<p>Unless the interest is clearly insignificant, an assurance provider should not participate in such a venture with an assurance client.</p> <p>If an individual member of an assurance team had such an interest, he should be removed from the assurance team.</p>

4: PROFESSIONAL ETHICS AND ACCA's CODE OF ETHICS AND CONDUCT

(b) Family and personal relationships

Threat	Safeguards
<p>Family or close personal relationships between members of the assurance firm and client staff could create self-interest, familiarity or intimidation threats. Each situation has to be evaluated individually. Factors to consider are:</p> <ul style="list-style-type: none">• The individual's responsibilities on the assurance engagement• The closeness of the relationship• The role of the other party at the assurance client	<p>When an immediate family member of the assurance team is a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement, the individual should be removed from the assurance team.</p> <p>If a firm inadvertently violates the rules concerning family and personal relationships they should apply additional safeguards such as undertaking a quality control review of the audit and discussing the matter with the audit committee of the client, if there is one.</p>

(c) Employment

Threats	Safeguards
<p>Director, officer or employee of client in a position to exert direct and significant influence on the subject matter of the assurance engagement has been a member of the assurance team or partner in the firm.</p> <p>This may create self-interest, familiarity and intimidation threats.</p> <p>The significance of the threat will depend on:</p> <ul style="list-style-type: none"> • The position taken at the assurance client • The involvement the individual will have with the assurance team • The length of time that has passed since the individual was a member of the assurance team or firm • The former position of the individual within the assurance team or firm. 	<p>Safeguards might include:</p> <ul style="list-style-type: none"> • Considering the necessity of modifying the plan for the assurance engagement • Assigning an assurance team with sufficient experience in relation to the individual who has joined the client • Involving an additional professional accountant who was not a member of the assurance team to review the work done • Quality control review • The individual concerned is not entitled to any benefits or payments from the firm unless these are made in accordance with fixed pre-determined arrangements • The individual does not continue to participate or appear to participate in the firm's business or professional activities. <p>A key audit partner should not accept a key management position with their audit client unless at least two years have elapsed since the conclusion of the audit.</p>
<p>Former officer, director or employee of client has joined the assurance firm.</p> <p>This may create self-interest, self-review and familiarity threats.</p>	<p>If during the period covered by the assurance report or the preceding two years, the individual was in a position to exert influence over the financial statements, the individual should not be assigned to the audit team.</p>
<p>Serving as an officer or director on the board of an assurance client.</p> <p>If a partner or employee of the firm performs this role, the self-review and self-interest threats are so significant that no safeguards could reduce the threat to acceptable level.</p>	<p>The only course of action is to refuse to perform, or withdraw from the assurance engagement.</p>

4: PROFESSIONAL ETHICS AND ACCA's CODE OF ETHICS AND CONDUCT

(d) Long association

Threat	Safeguards
<p>Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat.</p> <p>The significance of the threat will depend on:</p> <ul style="list-style-type: none"> • Length of time the person has been a member of the team • Role of the team • Structure of the firm • Nature of the assurance engagement 	<p>Safeguards might include:</p> <ul style="list-style-type: none"> • Rotation of senior personnel • Involving another professional accountant who was not a member of the assurance team to review the work done. • Independent quality control reviews. <p>Note: for listed and other public interest entities:</p> <ul style="list-style-type: none"> • Engagement partner should be rotated after no more than 5 years and should not return until 5 years have elapsed. • Other key audit partners should be rotated after no more than 7 years and should not return until 2 years (5 years if returning as engagement partner) have elapsed.

(e) Actual and threatened litigation

Threat	Safeguards
<p>When litigation takes place or appears likely between the firm or member of the assurance team and the assurance client, a self-interest or intimidation threat may be created.</p>	<ul style="list-style-type: none"> • Disclose to the audit committee • Removal of individual involved in litigation from the assurance team • Refuse to perform the assurance engagement.

3.4 Provision of non-assurance services

Firms have traditionally provided to their assurance clients a range of non-assurance services that are consistent with their skills and expertise. Assurance clients value the benefits that derive from having these firms, who have a good understanding of the business, bring their knowledge and skill to bear in other areas. Furthermore, the provision of such non-assurance services will often result in the assurance team obtaining information regarding the assurance client's business and operations that is helpful in relation to the assurance engagement.

The following activities would generally create self-interest or self-review threats that are so significant that only avoidance of the activity or refusal to perform the assurance engagement would reduce the threats to an acceptable level:

- Authorising, executing or consummating a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so;

4: PROFESSIONAL ETHICS AND ACCA'S CODE OF ETHICS AND CONDUCT

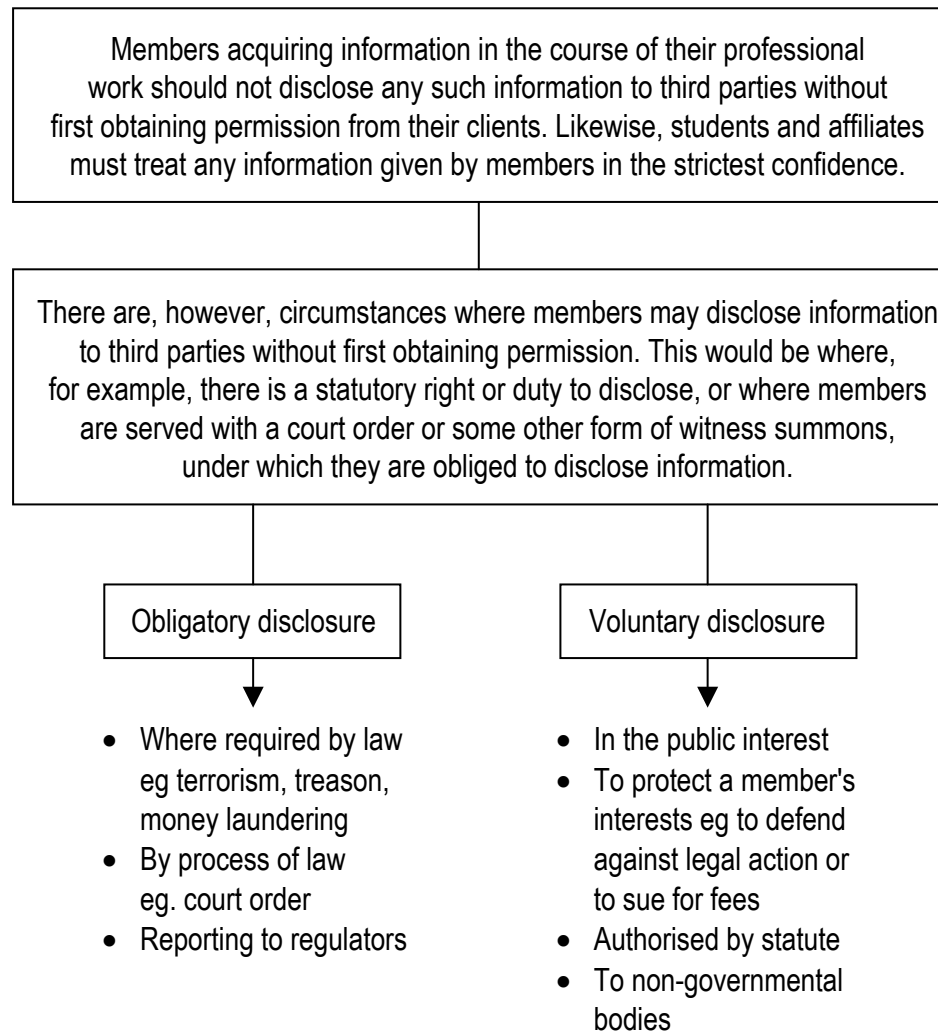
- Determining which recommendation of the firm should be implemented; and
- Reporting, in a management role, to those charged with governance.

Threats	Safeguards
<p>General</p> <p>the following activities may create self-review or self-interest threats:</p> <ul style="list-style-type: none"> • Having custody of an assurance client's assets • Supervising assurance client employees in the performance of their normal recurring activities; and • Preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction. 	<ul style="list-style-type: none"> • Making arrangements so that personnel providing such services do not participate in the assurance engagement. • Involving an additional professional accountant to advise on the potential impact of the activities on the independence of the firm and the assurance team. • Policies and procedures to prohibit professional staff from making management decisions for the assurance client. • Discussing independence issues related to the provision of non-assurance services with those charged with governance, such as the audit committee. • Disclosing to those charged with governance, such as the audit committee, the nature and extent of fees charged.
<p>Preparing accounting records and financial statements.</p> <p>This may result in a self-review threat.</p> <p>If accounting assistance amounts to making management decisions, eg</p> <ul style="list-style-type: none"> • Determining or changing journal entries without client approval • Authorising or approving transactions <p>For clients that are not listed by other public interest entities.</p>	<p>The threat created could not be reduced to an acceptable level of safeguards.</p> <p>Safeguards could include:</p> <ul style="list-style-type: none"> • Arrange that the services are not performed by a member of the assurance team • Requiring source data to be originated by the client • Obtaining client approval for any propose journal entries

4: PROFESSIONAL ETHICS AND ACCA's CODE OF ETHICS AND CONDUCT

Threats	Safeguards
For clients that are listed or other public interest entities.	No safeguard except a prohibition of such services except in emergency situations could reduce the threat to an acceptable level.
<p>Provision of tax services</p> <p>Frequently the firm may be asked to provide taxation services to an audit client. These may include compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. Such assignments are generally not seen to create threats to independence.</p>	
<p>Provision of internal audit services</p> <p>A self-review threat may be created when a firm provides internal audit services to a financial statement audit client. The level of threat will depend on the nature of service provided.</p>	<p>Appropriate safeguards include:</p> <ul style="list-style-type: none"> • The audit client is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls • The audit client designates a competent employee to be responsible for internal audit activities • The audit client is responsible for evaluating and determining which recommendations of the firm should be implemented • Such non-assurance service should be provided only by personnel not involved in the financial statement audit engagement and with different reporting lines within the firm.

4 Confidentiality



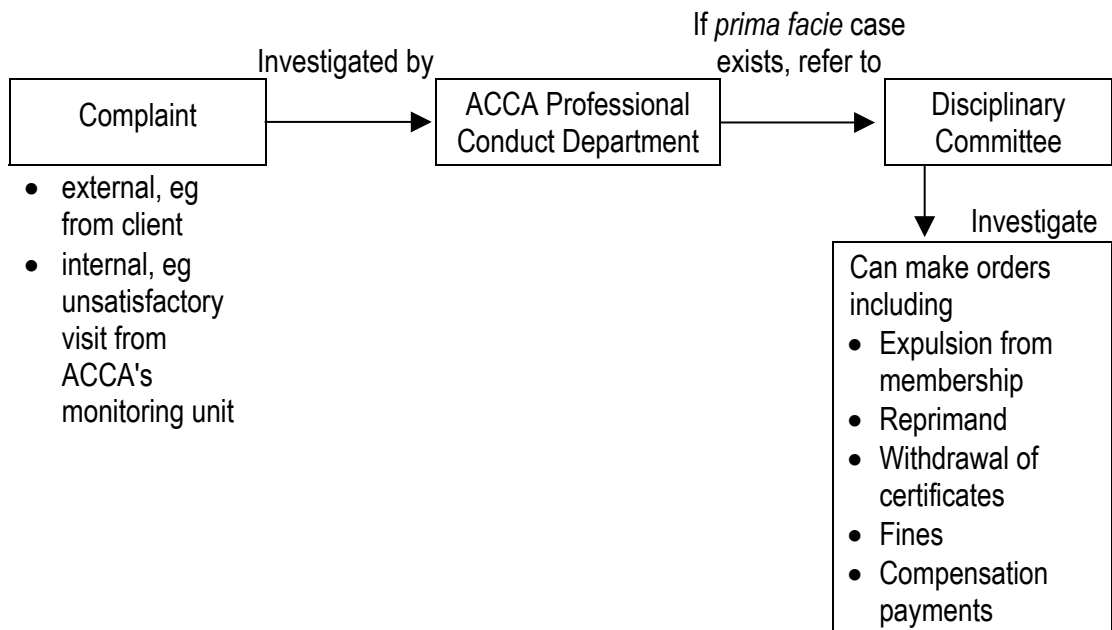
5 Enforcement mechanisms

5.1 Regulation and monitoring of audit and assurance is normally imposed by statute. In many countries this is delegated to professional bodies, such as ACCA. This places ACCA under an obligation to:

- Have systems to check that members are qualified and eligible to undertake regulated work (such as statutory audit)
- Monitor members' conduct and the standard of their regulated work
- Take regulatory action against members who do not meet requirements.

ACCA's disciplinary structures

5.2



Enforcement and statutory regulation

5.3 In many countries, the most serious complaints about auditors' conduct, especially those related to public interest entities will be dealt with by statutory regulators, not just by their own professional body.

For example, in the UK such cases are referred to the Accountancy Investigation and Discipline Board.



Section 2

6 Obtaining audit engagements

- 6.1 Subject to the rules which follow, members may seek publicity for their services and achievements and may advertise their services and products in any way they think fit.
- 6.2 Members may inform the public of the services they are capable of providing by means of advertising or other forms of promotion subject to the general requirement that the medium should not reflect adversely on the member, ACCA or the accountancy profession.
- 6.3 Advertisements and promotional material prepared or produced by members or firms should not (either in content or presentation):
 - (a) Bring ACCA into disrepute or bring discredit to the member, firm or the accountancy profession
 - (b) Discredit the services offered by others whether by claiming superiority for the member's or firm's own services or otherwise
 - (c) Be misleading, either directly or by implication

- (d) Fall short of the requirements of the UK Advertising Standards Authority's Code of Advertising and Sales Promotion, notably as to legality, decency, clarity, honesty, and truthfulness.

6.4 An advertisement should be clearly distinguishable as such.

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

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

Commissions, fees or rewards in return for the introduction of a client are not permitted.

7 Acceptance

7.1 The first audit for a new client means there are additional audit considerations.

(a) **Before accepting nomination the auditor must**

- Ensure the firm is independent
- Ensure the firm is competent
- Ensure firm's resources are adequate to service client's needs i.e. adequate staff, expertise and time
- Obtain references in respect of new client
- Assess the risk attaching to the client
- Communicate with present auditor (see below)

(b) **Rules of Professional Conduct Statement 'Changes in a professional appointment'**

- Obtain client's permission to communicate with present auditor
- If refused decline nomination
- If permission granted, write to auditor requesting information which may help decision whether to accept nomination

(c) **Present auditor receiving request should**

- request client's permission to freely discuss affairs
- if refused inform proposed new auditor (who should decline nomination)
- discuss freely all relevant matters if permission granted by client.

(d) **After accepting nomination**

- Ensure outgoing auditor's removal/resignation properly conducted in accordance with national regulations
- Ensure new appointment properly conducted
- Send out an Engagement Letter to the directors

ISA 210 – Terms of audit engagements

- 7.2 The auditor and the client should agree on the terms of the engagement, which need to be recorded in an audit engagement letter or other suitable form of contract. This contract should be in writing.
- 7.3 The engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit, the extent of the auditor's responsibilities to the client and the form of any reports.
- 7.4 When other services such as tax, accounting or management advisory services are to be provided, separate letters may be appropriate.
- 7.5 The auditor should regularly review the terms of engagement and if appropriate issue a new engagement letter or agree any updates in writing (if a change in management, professional standards or services provided).
- 7.6 Principal contents:
- (a) Objective of the audit of financial statements
 - (b) Management's responsibility for the financial statements
 - (c) The scope of the audit, including reference to applicable legislation, regulations, or pronouncements of professional bodies to which the auditor adheres
 - (d) The form of any reports or other communication of results of the engagement
 - (e) The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that even some material misstatement may remain undiscovered
 - (f) Unrestricted access to whatever records, documentation and other information requested in connection with the audit.
- Can also include:
- Arrangements regarding the planning and performance of the audit
 - Expectation of receiving a management representation letter
 - Request to confirm terms by acknowledging receipt of engagement letter
 - Description of any other letter or reports the auditor expects to issue to the client
 - The basis on which fees are computed and any billing arrangements.
- 7.7 An example of an engagement letter has been included in the Additional Notes to this chapter (section 9).

Additional Notes



Section 1.8

8 APB ethical standards

Introduction

8.1 The standards are:

- ES 1 *Integrity, objectivity and independence*
- ES 2 *Financial, business, employment and personal relationships*
- ES 3 *Long association with the audit engagement*
- ES 4 *Fees, remuneration and evaluation policies, litigation, gifts and hospitality*
- ES 5 *Non-audit services provided to audit clients*
- ES *Provisions available for small entities*

Authority

- 8.2 The standards are to be applied by auditors for audits of financial statements of UK companies for periods commencing on or after 15 December 2004. They are in addition to the *ACCA Code of Ethics and Conduct*.
- 8.3 For ACCA members conducting UK audits, where there is a difference between the APB Ethical Standards and the ACCA Code of Ethics, members are required to apply the more stringent requirements.

Standards summary

8.4 In substance, the ethical requirements are very similar to both the ACCA and IFAC Codes. Summarised below are the key points you should be aware of.

ES 1: Integrity, objectivity and independence

8.5 Responsibility lies with the leadership of the audit firm, i.e. a designated partner.

'Management threat' is added to the IFAC threats to independence (i.e. when the audit firm undertakes work that involves making judgements and taking decisions which are the responsibility of management).

An ethical review by an independent partner is required for audits of listed entities.

ES 2: Financial, business, employment and personal relationships

8.6 Key points:

- *Direct and indirect financial interests* - not permitted for audit firm, audit firm partner, person in a position to influence the conduct and outcome of the audit or immediate family members
- *Loans and guarantees* - not permitted unless bank etc, normal business terms and immaterial to the audit client
- *Business relationships* - not permitted unless immaterial and at arm's length
- The firm should resign as auditors when a partner who has acted as audit engagement partner in any two years prior to his appointment leaves the firm and is appointed director or key management personnel at a client

- A former director or employee of an audit client who was in a position to exert significant influence over the financial statements and joins the audit firm cannot be involved with the audit until two years have elapsed.

ES 3: Long association with the audit engagement

- 8.7 For listed companies, the audit engagement partner should not act for a continuous period longer than *five* years.

For other audits, careful consideration should be given to whether objectivity would have the appearance of being impaired if the engagement partner has held the role for a continuous period of ten years.

ES 4: Fees, remuneration and evaluation policies, litigation, gifts and hospitality

- 8.8 Fees on a contingent fee basis are not allowed.

- 8.9 Where it is expected that the fees for both audit and non-audit services receivable from an audit client and its subsidiaries will regularly exceed 10% (15% for non-listed clients) of the annual fee income of the audit firm, the firm should not act as the auditors and should either resign or not stand for reappointment.

Where the same total exceeds 5% (10% for non-listed clients) of the annual fee income, the audit engagement partner should disclose this to the ethics partner and those charged with governance and consider whether safeguards should be applied. This will include an *external* independent quality control review in the case of non-listed clients.

- 8.10 New firms should not undertake any audits of listed companies where fees would represent 10% or more of the annual fee income of the firm. In addition, for a period not exceeding two years, external independent quality control reviews should be performed on audits of unlisted entities that represent more than 15% of the annual fee income.

ES 5: Non-audit services provided to audit clients

- 8.11 The audit firm should not provide:

- | | |
|--|--|
| <i>Internal audit services</i> | <ul style="list-style-type: none">• Where the auditor will place significant reliance on internal audit as part of the audit of the financial statements |
| <i>Services to design, provide or implement IT systems</i> | <ul style="list-style-type: none">• Where it would be important to any significant part of the accounting system/ production of the financial statements and the auditor would place significant reliance upon them |
| <i>Valuation services</i> | <ul style="list-style-type: none">• Where the valuation would involve a significant degree of subjective judgement and have a material effect on the financial statements |
| <i>Tax services</i> | <ul style="list-style-type: none">• Where the fee for tax work is calculated on a contingent fee basis and the engagement fees are material to the audit firm, or• Where it would involve acting as an advocate for the client on a matter material to the financial statements |

4: PROFESSIONAL ETHICS AND ACCA's CODE OF ETHICS AND CONDUCT

Recruitment and remuneration services

- Where it would involve the firm taking responsibility for the appointment of any director or employee of the audit client

Corporate finance

- Where the engagement would involve the audit firm taking responsibility for dealing in, underwriting or promoting shares
- Where the partner doubts the appropriateness of an accounting treatment related to the advice provided, or
- The corporate finance fee is calculated on a contingent basis and is material to the audit firm.

ES: Provisions available for small entities

8.12 Certain exemptions to the Ethical Standards are permitted when auditing small entities (as defined by the Companies Act). These are:

- Independent quality control reviews where fees are expected to regularly exceed 10% fee income
- Safeguards for self-review threats for non-audit services (providing management are unformed)
- Management roles in non-audit services (providing discussed with those charged with governance)
- Acting as advocate for the client in tax services
- The two year rule for a partner to work as a director or in a key management position with a client.

9 Specimen engagement letter (for information purposes)

9.1 To the Board of Directors or the appropriate representative of senior management:

You have requested that we audit the financial statements of....., which comprise the balance sheet as at....., and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

We will conduct our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. 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.

4: PROFESSIONAL ETHICS AND ACCA's CODE OF ETHICS AND CONDUCT

Because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements may remain undiscovered.

In making our risk assessments, we consider internal control relevant to the entity's preparation 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. However, we expect to provide you with a separate letter concerning any material weaknesses in the design or implementation of internal control over financial reporting that come to our attention during the audit of the financial statements.

We remind you that the responsibility for the preparation of financial statements that present fairly the financial position, financial performance and cash flows of the company in accordance with International financial Reporting Standards is that of the management of the company. Our auditors' report will explain the management is responsible for the preparation and the fair presentation of the financial statements in accordance with the applicable financial reporting framework and this responsibility includes:

- Designing, implementing and maintaining internal control relevant to the preparation of financial statements that are free from misstatement, whether due to fraud or error
- Selecting and applying appropriate accounting policies; and
- Making accounting estimates that are appropriate in the circumstances.

As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation from your staff and we trust that they will make available to us whatever records, documentation and other information are requested in connection with our audit.

[Insert additional information here regarding fee arrangements and billings, as appropriate].

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

XYZ & Co.

Acknowledged on behalf of
ABC Company by (signed)

.....

Name and Title

Date

10 Chapter summary

- The IFAC and ACCA codes take a **conceptual** and **principles-based** approach to ethics.
- The fundamental principles are **integrity, objectivity, competence, confidentiality** and **professional behaviour**.
- The framework is based on identifying **threats** and applying appropriate **safeguards**.
- ACCA has **disciplinary processes** to enforce the Code.
- Specific rules exist in the Code in relation to obtaining and accepting **new engagements**.
- An **engagement letter** is issued to confirm acceptance and agree terms.

END OF CHAPTER

Internal audit

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Discuss the factors to be taken into account when assessing the need for internal audit.
- Discuss the elements of best practice in the structure and operations of internal audit with reference to the Combined Code on Corporate Governance/appropriate international codes of corporate governance.
- Compare and contrast the role of external and internal audit regarding audit planning and the collection of audit evidence.
- Compare and contrast the types of report provided by internal and external audit.
- Discuss the scope of internal audit and the limitations of the internal audit function.
- Explain the types of audit report provided in internal audit assignments.
- Discuss the responsibilities of internal and external auditors for the prevention of detection of fraud and error.
- Explain the advantages and disadvantages of outsourcing internal audit.
- Discuss the nature and purpose of internal audit assignments including value for money, IT, best value and financial.
- Discuss the nature and purpose of operational internal audit assignments including procurement, marketing, treasury and human resources management.
- Explain the process for producing an internal audit report.

Exam Context

Practical questions on internal controls may be set from an internal audit perspective; this was done in an 8 mark requirement in the pilot paper. A further 6 mark part of the same question required a comparison of the responsibilities of external and internal auditors in respect of fraud.

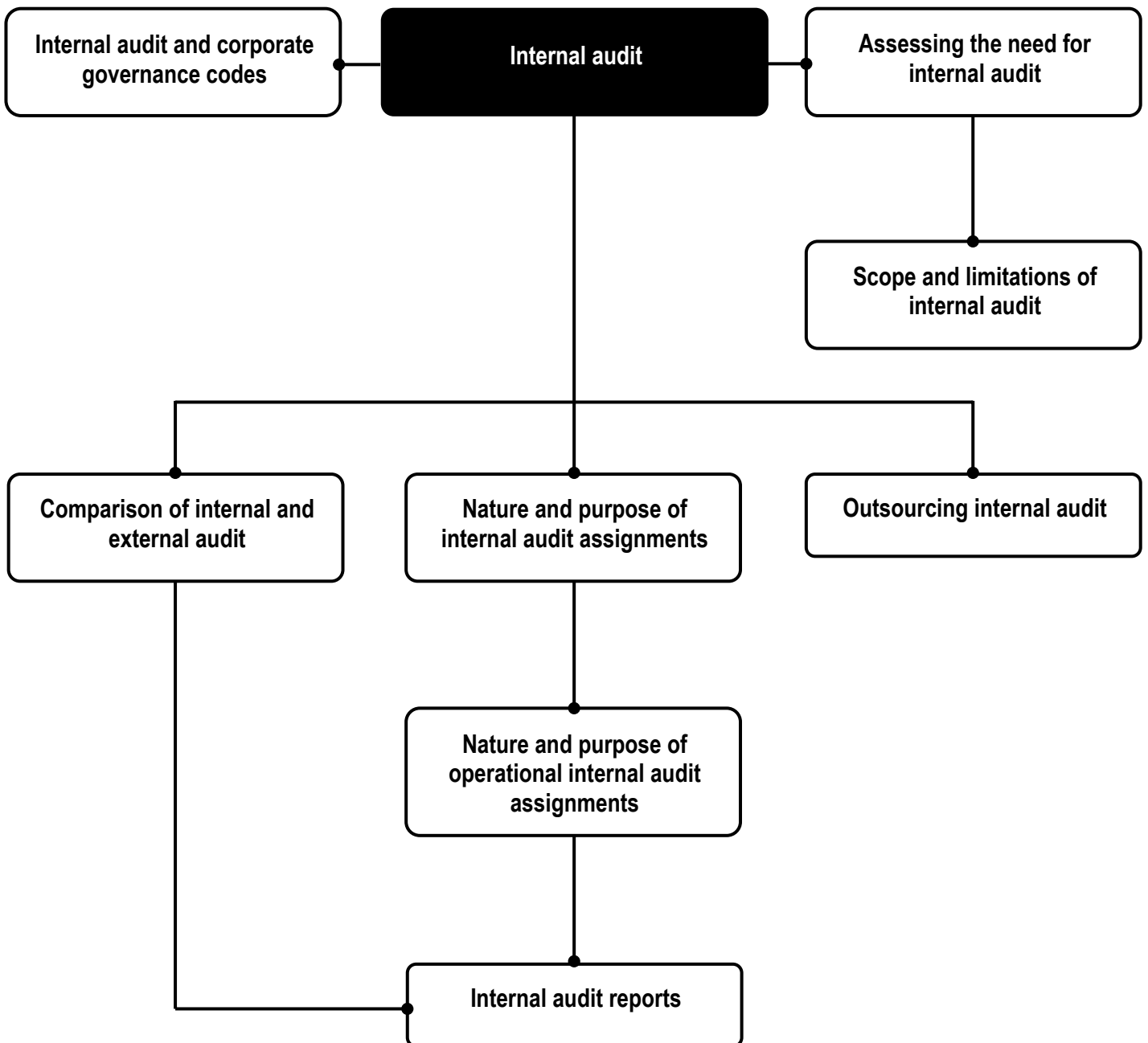
Qualification Context

All of the issues covered in this chapter are included in greater depth in the professional stage paper Advanced Audit and Assurance (P7).

Business Context

The number of major companies that have an internal audit function or equivalent has increased as corporate governance requirements have been implemented. In the UK a survey published by Grant Thornton in 2006 showed that 97% of FTSE 100 companies have an internal audit department (compared with 82% in 2002).

Overview





Q7 Role of internal audit

1 Internal audit and corporate governance

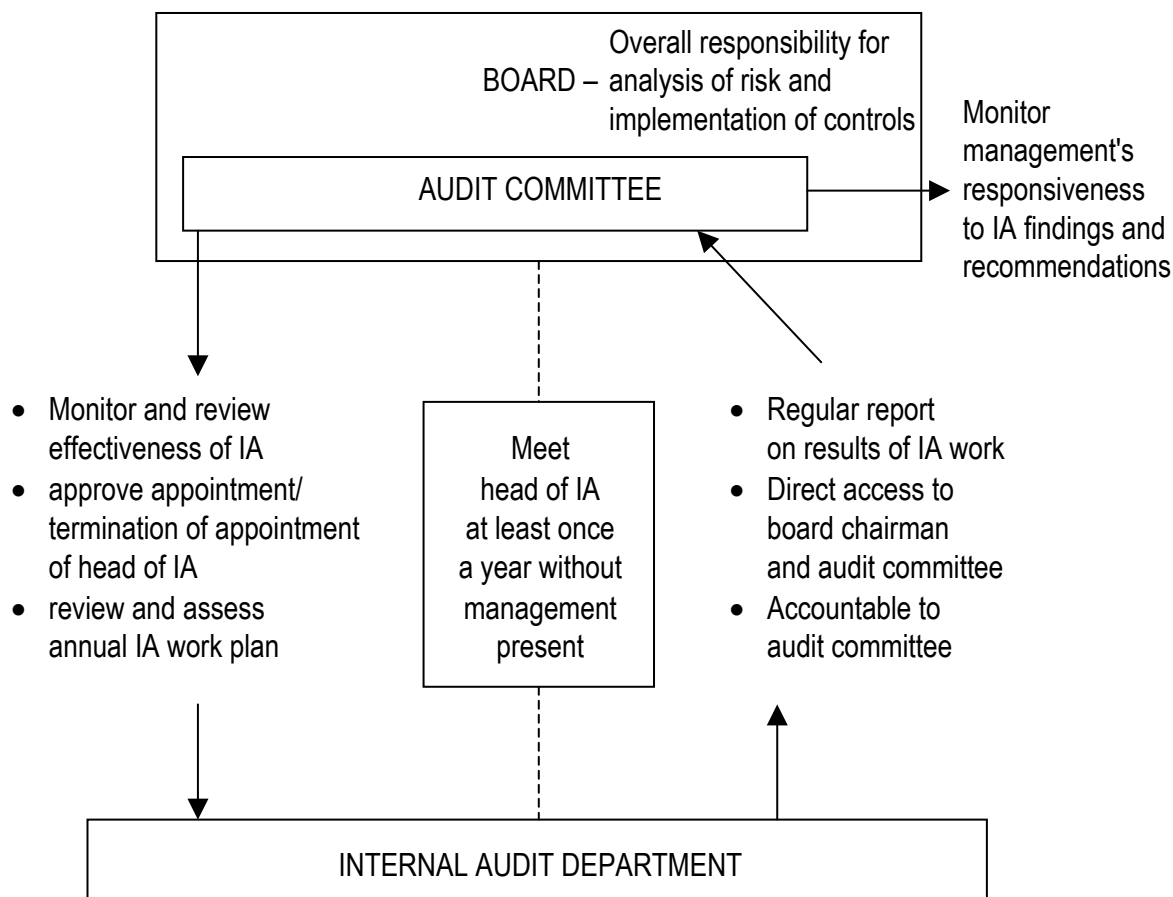
- 1.1 Codes of corporate governance, such as the IFAC Code or the UK's Combined Code (see Chapter 3) highlight the need for businesses to maintain good systems of internal control to manage the risks the company faces.

It is seen as part of good corporate governance to have an internal audit function to assess and monitor internal control policies and procedures.



Best practice guidance from corporate governance codes

1.2



Factors to be considered when assessing the need for internal audit

1.3 The board should consider:

- Any trends or current factors relevant to the company's activities, markets or other aspects of its external environment that have increased risks.
- Internal factors such as organisational restructuring or changes in reporting processes or underlying information systems
- Adverse trends evident from the monitoring of internal control systems
- Increased incidence of unexpected occurrences.

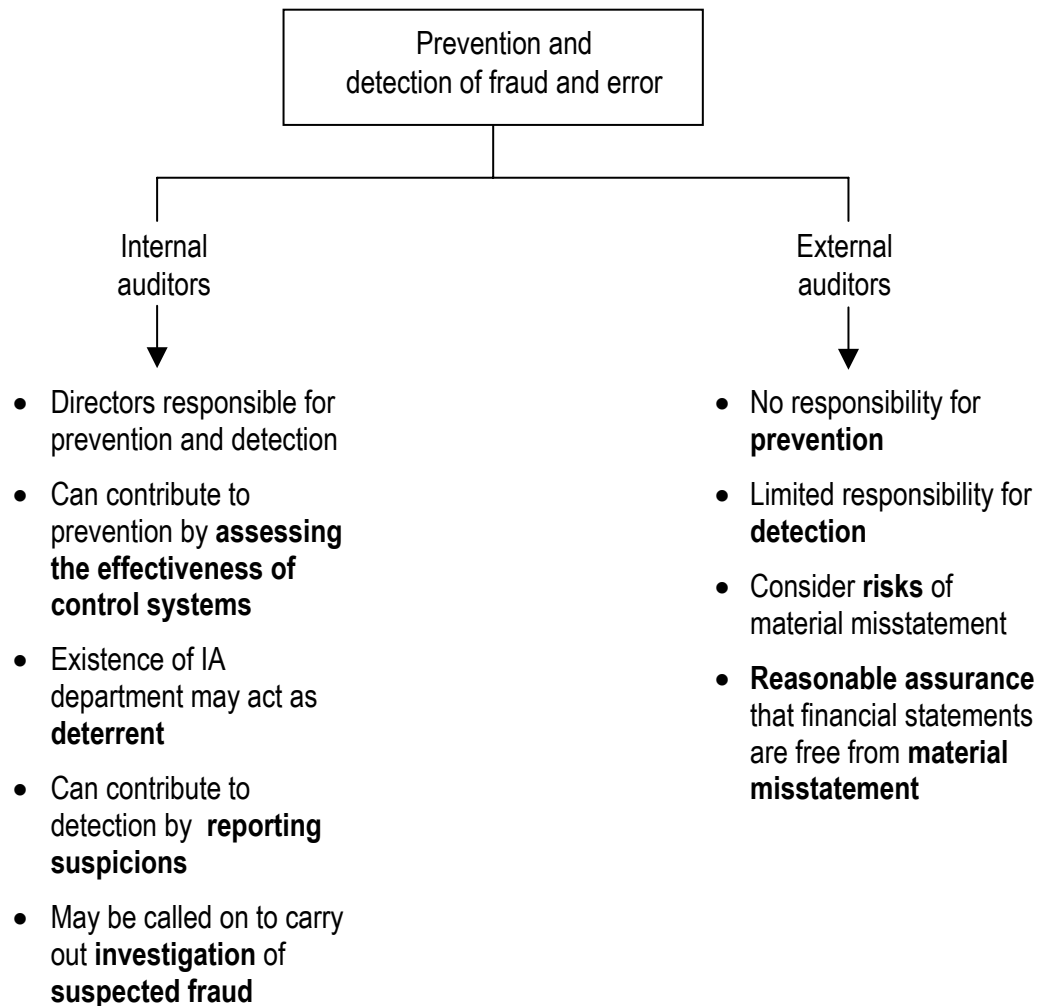
2 Comparison of internal audit and external audit

- 2.1 When undertaking an *external audit* the auditor is carrying out a statutory duty to report on the truth and fairness of the financial statements.
- 2.2 The external audit will be undertaken in accordance with the International Standards on Auditing and local legislation.
- 2.3 **Internal audit** is a review of the accounting and internal control systems within a company, as an aid to management.

	External auditor	Internal auditor
Objectives	<ul style="list-style-type: none"> Opinion on accounts in true and fair terms Proper accounting records kept 	<ul style="list-style-type: none"> Wide ranging, up to employers but may include: Review of accounting and internal control systems Examination of financial/ operating information Value for money (VFM) reviews Review of implementation of corporate policies, laws and regulations Special investigations, eg suspected fraud Procurement, marketing, treasury and HR reviews
Reports to	<ul style="list-style-type: none"> Shareholders / members 	<ul style="list-style-type: none"> Management / directors
Status	<ul style="list-style-type: none"> Independent / external to company 	<ul style="list-style-type: none"> Employee of company / contracted by company (outsourcing)
Qualification	<ul style="list-style-type: none"> Qualified / member of a recognised supervisory body 	<ul style="list-style-type: none"> No formal qualifications required

Fraud and error

2.4



Section 3

3 Nature and purpose of internal audit assignments

3.1 Definition of internal auditing

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

3.2 Scope

The scope of internal audit will vary from business to business as it will be decided by the directors of each company. The following sections give an indication as to the type of assignments they may be involved with.

5: INTERNAL AUDIT

Value for money audits

3.3 (a) Value for money (VFM) audits are concerned with evaluating the three 'Es':

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

(b) Reviews concerned with solely the 'Economy' objective are often termed 'Best Value' reviews.

Lecture example 1

Pharma is a pharmaceuticals company supplying hospitals and drugstores globally with a head office in Vienna and its main manufacturing base and distribution centre located in nearby Bratislava in Slovakia.

Required

Identify relevant objectives for each of the three 'Es' and controls you would expect to find to ensure they are achieved.

Solution

Objective

ECONOMY

Control

Objective
EFFICIENCY

Control

EFFECTIVENESS

3.4 Information technology audit

This involves testing controls within the computer systems of the business. Areas which might be the subject of audit include:

- Systems development process
- Asset management
- Database management systems
- e-business
- Networks
- Access controls

5: INTERNAL AUDIT

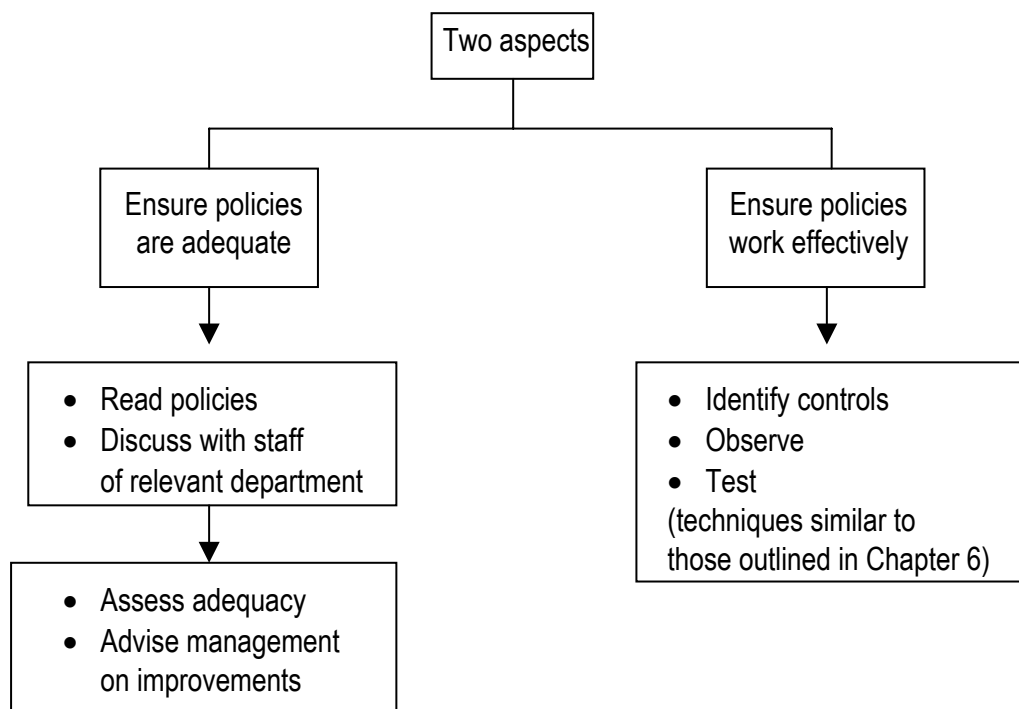
3.5 Financial internal audit

This was the traditional role of internal audit. It involved gathering evidence (mainly within the company's records) to substantiate the information in the management accounts and financial statements.

3.6 Operational internal audit

Operational audits are audits of the operational process of the organisation. Their prime objective is the monitoring of management's performance, ensuring company policy is adhered to. They can also be called management or efficiency audits.

3.7 Approach to operational internal audit assignments



3.8 Examples of operational internal audit assignments

Procurement	<ul style="list-style-type: none"> • Audit will concentrate on purchasing department systems • Checking that the system achieves key objectives and follows company guidelines
Marketing (could involve research, advertising, promotions and after-sales)	<ul style="list-style-type: none"> • Audit will focus on marketing process to ensure: <ul style="list-style-type: none"> – process managed efficiently – information freely available to managers – risks managed correctly
Treasury	<ul style="list-style-type: none"> • Key risks are interest rate risk and foreign currency risk • Audit must ensure that risks are managed in line with company procedures

Human resources	<ul style="list-style-type: none"> • Audit will focus on processes to ensure that: <ul style="list-style-type: none"> – people are available to work as required by the business – overall development of the business is planned and controlled
------------------------	--

4 Duties and limitations of internal audit

4.1 Internal auditors are not normally subject to any regulatory authority.

4.2 Key elements of the responsibilities of internal auditors include independence, objectivity and due skill / care

4.3 *Independence*

- Internal auditors should be independent of the activities they audit.
- Internal audit departments should be granted sufficient status to achieve independence from the various company functions.
- Internal audit reports should be considered appropriately by directors and recommendations acted upon.
- Internal auditors must have a reporting line that is independent of the function they are auditing – highest level of management/ audit committee

4.4 *Objectivity*

- Objectivity is an independent mental attitude. Consider the facts in front of you and nothing else.
- Drafting procedures for systems, designing systems, installing systems and operating systems are not in the remit of internal audit work. Performance of such tasks likely to hinder objectivity.

4.5 *Due skill and care*

- Wide ranging skills: accounting, auditing, business and management skills.
- Multi-disciplinary internal audit team
- Ongoing training
- Internal audit quality control manuals / procedures
- Supervised, reviewed and documented.

4.6 Potential **limitations** in the effectiveness of internal audit will result from failures in respect of any of these elements.

5 Outsourcing internal audit

5.1 Increasingly, companies are outsourcing their internal audit function to accountancy firms. Outsourcing has various advantages and disadvantages:

- Advantages*
- Increased independence of internal auditors
 - Relevant accounting and auditing skills
 - Increased reliability

- Disadvantages*
- Cost to company
 - Limited knowledge of specific entity
 - Independence issues if external auditor provides internal audit function

Additional Notes

6 Example of an internal audit report

- 6.1 Review reports can take many formats depending on the nature of the assignment.
- 6.2 The following is an example of a systems review report following an assignment carried out by internal audit or outsourced to an audit firm. Bear in mind though, that usually this is an internal report and can therefore be of any format. This is a brief example. More complicated assignments are likely to summarise the main findings and include a number of appendices containing detailed information.

REPORT

To: Directors of Robinson Co

From: Internal audit department

Subject: Review of sales system

Period of fieldwork: May 200X

Terms of Reference

The scope of the assignment was to carry out a thorough review of the sales system. This involved carrying out tests of controls on the existing controls to determine whether the controls were operating effectively. In addition, we considered the key risks surrounding the sales function and identified any risks for which we found no related controls. Thus, we have been able to give recommendations regarding existing controls as well as suggest new controls where we believe they are needed.

Executive Summary

The main findings from our review are:

- the sales system, on the whole, comprises adequate controls
- some specific control weaknesses were identified and recommendations are given in the Appendix to the report.

Follow-up

Responsibilities have been allocated for introducing/improving control procedures which we found to be deficient.

We propose a follow-up review in six months' time.

Dated.....

Signed.....

Head Internal Auditor

APPENDIX**Detailed identification of weaknesses, risks and recommendations**

Weakness	Risk	Recommendation	Responsibility	Timescale
There is no credit check of new customers prior to taking an order.	These new customers could represent an increased risk of bad debts.	All new customers should be subject to this check and the computer system should have a compulsory check before a sales order can be accepted.	To be implemented by the head of the credit control department.	September 200X
There is no follow up of sales orders unmatched to GDNs.	If customers do not receive their goods as ordered, they are unlikely to use Robinson Co for further purchases.	There should be a monthly reconciliation between the month's sales orders and the related GDNs. Any unmatched orders should be followed up with queries being directed to head of sales.	To be implemented and managed by the head of the sales department.	September 200X
Customers are not asked to sign a proof of delivery.	This could lead to disputes, loss of customer goodwill and increased bad debts.	The P.O.D should be signed and retained within the sales department along with the order and invoice.	To be implemented by head of the sales department.	September 200X

7 Chapter summary

- Internal audit contributes towards **good corporate governance**.
- The role of the **external auditor** is clearly defined in **statute**, the role of **internal audit** is decided by the **management** of a specific company.
- Internal audit assignments can include **financial, value for money, IT and operational** objectives.
- Some companies **outsource** internal audit to accountancy firms.

END OF CHAPTER

Risk assessment

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Identify and describe the need to plan and perform audits with an attitude of professional scepticism.
- Identify and describe engagement risks affecting the audit of an entity.
- Explain the components of audit risk.
- Compare and contrast risk based, procedural and other approaches to audit work.
- Discuss the importance of risk analysis.
- Describe the use of information technology in risk analysis.
- Explain how auditors obtain an initial understanding of the entity and knowledge of its business environment.
- Define and explain the concepts of materiality and tolerable error.
- Compute indicative materiality levels from financial information.
- Discuss the effect of fraud and misstatements on the audit strategy and extent of audit work.
- Describe and explain the nature and purpose of analytical procedures in planning.
- Compute and interpret key ratios used in analytical procedures.

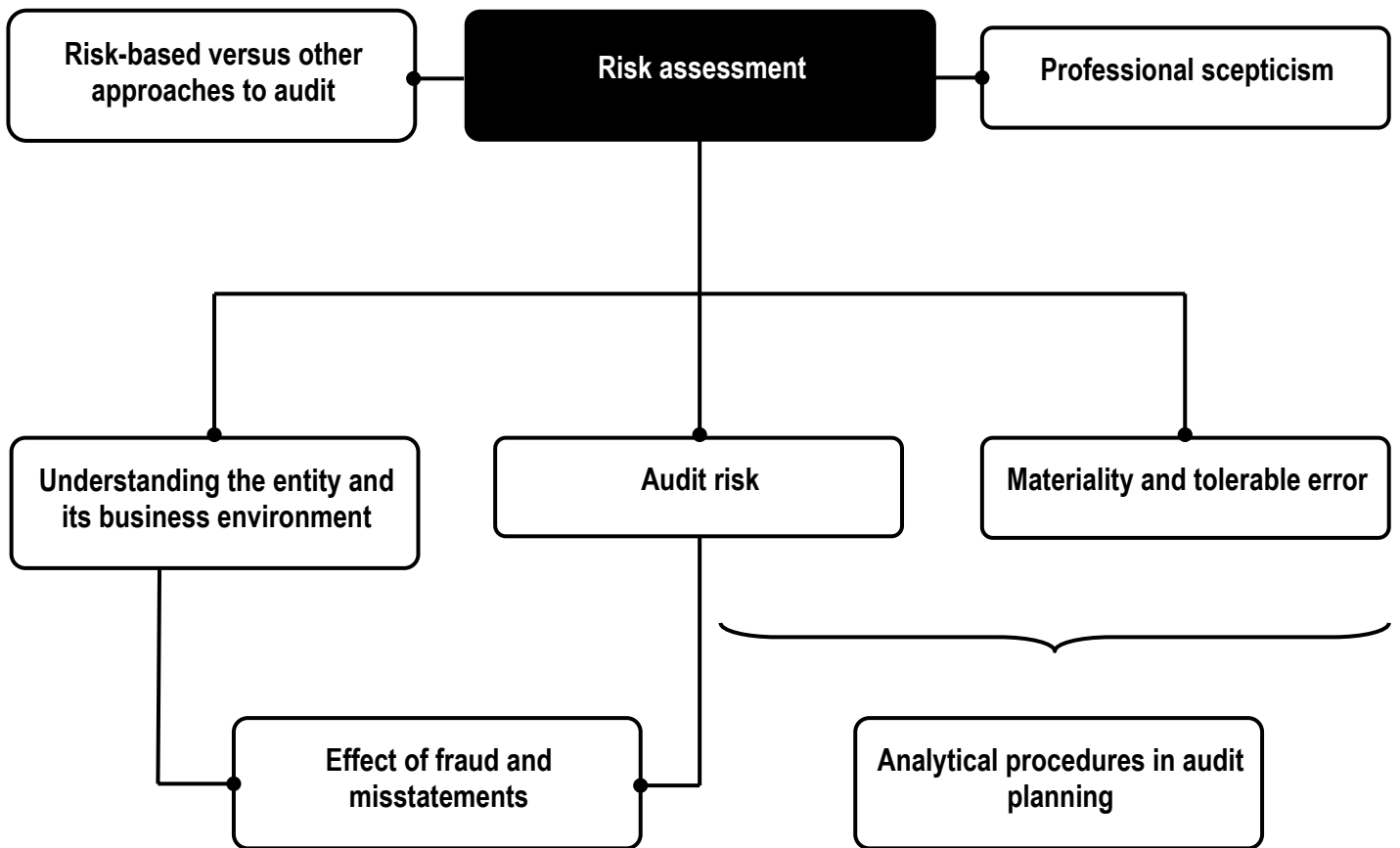
Exam Context

Risk assessment is at the heart of the audit approach set out in the ISAs. In the exam you could be asked to identify risks in a practical scenario, or in shorter factual requirements to explain the risk model or concepts such as materiality and tolerable error.

Qualification Context

Risk assessment is a key topic in the professional stage Advanced Audit and Assurance Paper (P7) where you are likely to have to apply the same basic knowledge to more complex scenarios.

Overview



1 General principles

Professional scepticism

1.1 The auditor should plan and perform an audit with an attitude of **professional scepticism** recognising that circumstances may exist that cause the financial statements to be materially misstated.

This requires:

- Critical assessment, with a questioning mind, of the validity of evidence obtained
- Alertness to contradictory evidence
- Neither the assumption that management is dishonest nor the assumption of unquestioned honesty.

Risk-based versus other approaches

1.2

Risk-based approach	Other approaches
Required under ISAs	Do not comply with ISAs
Auditor must: <ul style="list-style-type: none"> • Perform procedures to assess risk of material misstatement • Perform further procedures based on that assessment 	Auditor would: <ul style="list-style-type: none"> • Use 'procedural' approach, ie. perform audit according to: <ul style="list-style-type: none"> - a set schedule, using - fixed procedures



Section 1

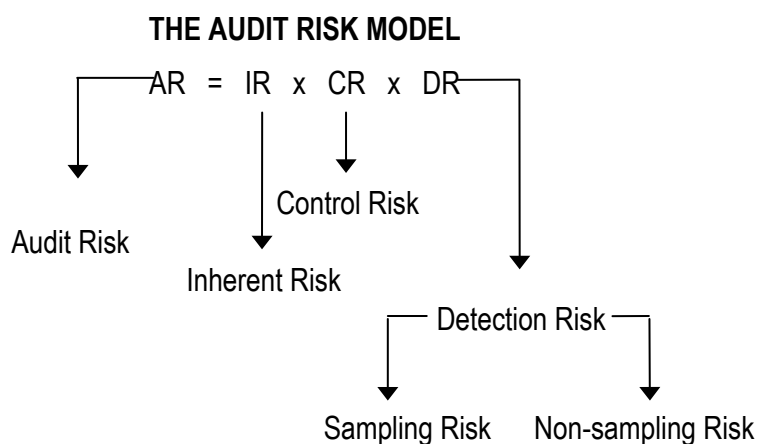
2 Audit risk

2.1 Under ISA 200 *Objective and General Principles Governing an Audit of Financial Statements*, the auditor should plan and perform the audit to reduce audit risk to an acceptably low level.

2.2 Audit risk is the 'risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated'.

6: RISK ASSESSMENT

It is made up of 3 component parts, *inherent risk*, *control risk* and *detection risk*:



Inherent risk and control risk together form the 'risk of material misstatement'.

Inherent risk

- 2.3 This is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there were no related internal controls.
- 2.4 The risk of such misstatement is greater for some assertions and related classes of transactions, account balances, and disclosures than for others. For example,
- Complex calculations are more likely to be misstated than simple calculations
 - Accounts consisting of amounts derived from accounting estimates that are subject to significant measurement uncertainty pose greater risks than accounts consisting of relatively routine, factual data.

External circumstances giving rise to business risks may also influence inherent risk.

Control risk

- 2.5 This is the risk that a misstatement could occur in an assertion 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.
- 2.6 Control risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's financial statements.

Some control risk will always exist because of the inherent limitations of internal control.

Detection risk

- 2.7 This is the risk that the auditor's procedures will not detect a misstatement that exists in an assertion that could be material either individually or when aggregated with other misstatements.

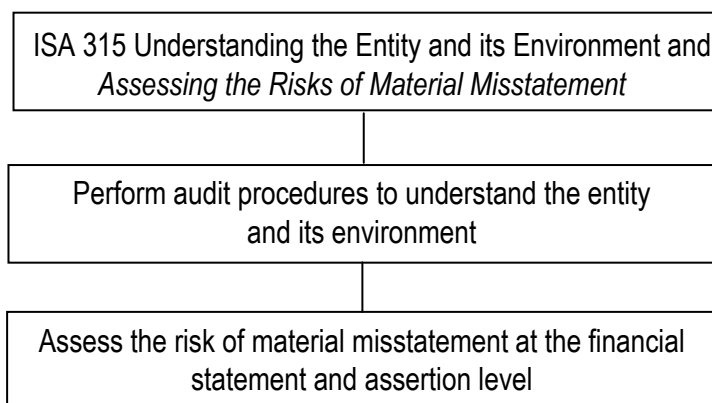
Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. It is primarily the consequence of the fact that the auditor does not, and cannot, examine all available evidence (sampling risk).

2.8 Factors affecting non-sampling risk are

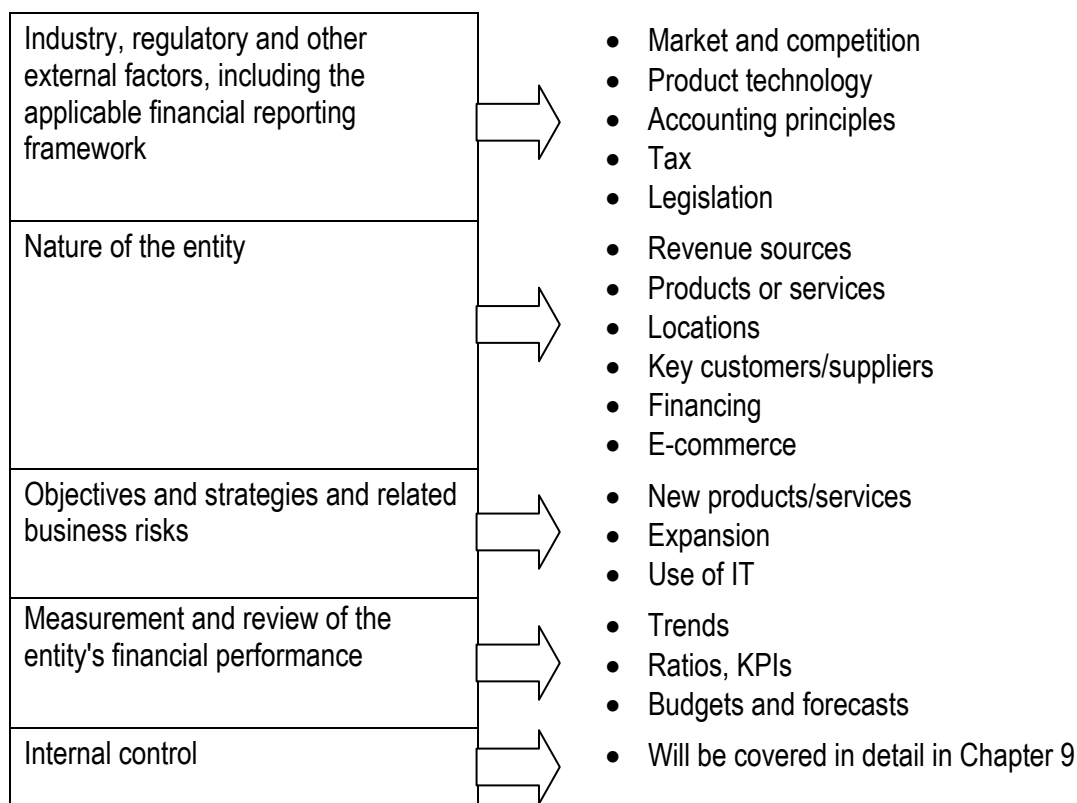
- Auditor's experience
- Time pressure
- Financial constraints
- Poor planning
- New client
- Industry knowledge

3 Understanding the entity and its business environment

3.1



3.2 Matters to consider when obtaining an understanding of the entity.



6: RISK ASSESSMENT

Assessing risk

3.3 This includes:

- (a) Identifying risks by considering the entity and its environment, including its internal control
- (b) Relating the identified risks to what can go wrong at the assertion level
- (c) Considering the significance and likelihood of the risks
- (d) Establishing materiality and evaluating whether the original level set remains appropriate as the audit progresses
- (e) Developing expectations for use when performing analytical procedure
- (f) Designing and performing further audit procedures to reduce audit risk to an acceptably low level
- (g) Evaluating the sufficiency and appropriateness of audit evidence

3.4 Risk assessment includes both an assessment of:

- **Business risk** resulting from the entity's objectives and strategies that may result in material misstatement of the financial statements
- **Audit risk** and its component parts.

Business risk

3.5 Business risks 'result from significant conditions, events, circumstances or actions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies' [ISA 315].

3.6 It is usually split into financial risk, operational risk and compliance risk.

3.7 The auditor should obtain an understanding of the entity's process for identifying business risks relating to financial reporting objectives and deciding about actions to address those risks, and the results thereof.

Lecture example 1

Introductory example

You are employed by Ticker and Co, a firm of certified accountants. Giffnock Corp is a new audit client recently taken on by the firm. Giffnock Corp is an importer and wholesaler of specialist computer hardware.

During the year the company's chief accountant resigned and in the three months leading up to the appointment of her replacement, no checking had been performed on the monthly reconciliations of the bank account and the receivables and payables ledgers.

Required

- (a) From the scenario, identify examples of inherent risk and control risk, clearly explaining the nature of any misstatements that might arise in the financial statements.
- (b) From the scenario, identify any potential detection risk, and explain how the firm could minimise this risk.

Solution

4 Risk assessment procedures

4.1 ISA 315 requires auditors to perform the following procedures to obtain an understanding of the entity and its environment, including its internal control:

- Enquiries of management and other within the entity
- Analytical procedures
- Observation and inspection.

The members of the audit team should also **discuss** the susceptibility of the entity's financial statements to material misstatements.

Effect of fraud and misstatements

4.2 ISA 240 *The auditor's responsibility to consider fraud in an audit of financial statements* contains very similar requirements to those listed in paragraph 4.1 above. It has a particular emphasis on:

- Obtaining an understanding of how those charged with governance exercise oversight over the identification of the fraud risks and the implementation of controls.

4.3 Where the risk assessment suggests there may be material misstatements arising from fraud the main effects on the audit strategy will relate to:

- Assignment and supervision of personnel
- Consideration of accounting policies
- Unpredictability in nature, timing and extent of audit procedures.

ISA 520 Analytical procedures

4.4 'Analytical procedures' means the analysis of relationships to identify inconsistencies and unexpected relationships.

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

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

4.6 Analytical procedures include the following type of comparisons:

- (a) Prior periods
- (b) Budgets and forecasts
- (c) Industry information
- (d) Predictive estimates
- (e) Relationships between elements of financial information, ie ratio analysis
- (f) Relationships between financial and non-financial information, eg payroll costs to the number of employees.

Analytical procedures as risk assessment procedures

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

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



Common ratios for use in analytical review

4.8 (a) Profitability

$$(i) \quad \text{Return on Capital Employed (ROCE)} = \frac{\text{Profit before interest and tax (PBIT)}}{\text{Share capital + reserves + NC liabilities}}$$

$$(ii) \quad \text{Net profit margin} = \frac{\text{PBIT}}{\text{Revenue}}$$

$$(iii) \quad \text{Asset turnover} = \frac{\text{Revenue}}{\text{Share capital + reserves + NC liabilities}}$$

$$(iv) \quad \text{Gross margin} = \frac{\text{Gross profit}}{\text{Revenue}}$$

(b) Liquidity

$$(i) \quad \text{Current ratio} = \frac{\text{CA}}{\text{CL}}$$

$$(ii) \quad \text{Quick ratio (Acid Test)} = \frac{\text{CA} - \text{Inventories}}{\text{CL}}$$

$$(iii) \quad \text{Inventory turnover} = \frac{\text{Inventories}}{\text{COS}} \times 365 \text{ days}$$

$$\text{or } \frac{\text{COS}}{\text{Inventories}} = \text{No. of times turnover}$$

$$(iv) \quad \text{Trade receivables days} = \frac{\text{Trade receivables}}{\text{Credit sales}} \times 365 \text{ days}$$

$$(v) \quad \text{Trade payables days} = \frac{\text{Trade payables}}{\text{Credit purchases}} \times 365 \text{ days}$$

(c) Gearing

$$(i) \quad \text{Debt/equity} = \frac{\text{Interest bearing debt}}{\text{Share capital and reserves}}$$

Lecture example 2

Lime Ltd is a long established manufacturing company with a year end of 30 September. The senior in charge of the audit has been provided with extracts from the draft accounts for the year ended 30 September 20X7 prior to the final audit planning meeting with the financial accountant of Lime Ltd.

Extracts from the draft balance sheet as on 30 September 20X7

	<i>Draft 20X7 \$'000</i>	<i>Actual 20X6 \$'000</i>
Property, plant and equipment	32,560	31,850
Receivables: trade	3,600	2,150
other	250	200
Inventory: raw materials	1,200	870
work in progress	350	450
finished goods	1,860	1,610
Payables: trade	2,060	1,470
other	500	450

Extracts from the draft income statement for the year ended 30 September 20X7

	<i>Draft 20X7 \$'000</i>	<i>Actual 20X6 \$'000</i>
Revenue	43,150	40,750
Cost of sales	<u>(29,180)</u>	<u>(29,040)</u>
	13,970	11,710
Depreciation and loss on sale of fixed assets	(3,450)	(2,010)
Other expenses	(2,340)	(2,280)
Profit before taxation	<u>8,180</u>	<u>7,420</u>

Required

- (a) Calculate each of the following ratios for 20X6 and 20X7:
- (i) Gross profit margin
 - (ii) Net profit margin
 - (iii) Inventory turnover
 - (iv) Trade receivables days
 - (v) Trade payables days

- (b) Explain any risks of misstatement that might be significant in planning the audit of Lime Co.

Solution

5 Audit materiality (ISA 320)

- 5.1 The auditor should consider **materiality** and its relationship with **audit risk** when conducting an audit.
- 5.2 The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared in all **material** respects, with an identified financial reporting framework.
- 5.3 What is materiality?
- (a) Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.
 - (b) The auditor must be concerned with identifying 'material' errors, omissions and misstatements. Both the amount (quantity) and nature (quality) of misstatements need to be considered.
 - (c) To put this into practice the auditor therefore has to set his own materiality levels – this will always be a matter of judgement.

6: RISK ASSESSMENT

- (d) The level set has a critical impact on two key areas:
 - (i) The nature, timing and extent of audit procedures; and
 - (ii) Evaluating the effect of misstatements:
 - Whether to seek adjustments; or
 - The degree of any auditor's report modification.

The calculation of materiality

- 5.4 (a) It is a matter of professional judgement
- (b) Most firms set criteria for guidance

For example:

- between ½ and 1% of revenue
- between 1 and 2% of total assets; or
- between 5 and 10% of profit before tax.

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

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

Tolerable error

- 5.6 Tolerable error is the maximum error in the population (eg. a specific balance in the financial statements) that auditors are willing to accept and still conclude that the audit objective has been achieved.
- 5.7 Tolerable error is normally set as a percentage of planning materiality.
- 5.8 It is also used to help determine the size of samples (covered in detail in Chapter 11).

6 Chapter summary

- Audits must be planned with an attitude of **professional scepticism**.
- The auditor must obtain a knowledge of the business, including an understanding of **business risk**.
- The auditor must plan to minimise **audit risk**.
- **Audit risk** is a combination of **inherent risk**, **control risk** and **detection risk**.
- **Analytical procedures** should be used as part of risk assessment.
- **Materiality** must be assessed during audit planning.

END OF CHAPTER

Audit planning and documentation

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Identify and explain the need for planning an audit.
- Identify and describe the contents of the overall audit strategy and audit plan.
- Explain and describe the relationship between the overall audit strategy and the audit plan.
- Develop and document an audit plan.
- Explain the difference between interim and final audit.
- Explain the need for and the importance of audit documentation.
- Describe and prepare working papers and supporting documentation.
- Explain the procedures to ensure safe custody and retention of working papers.

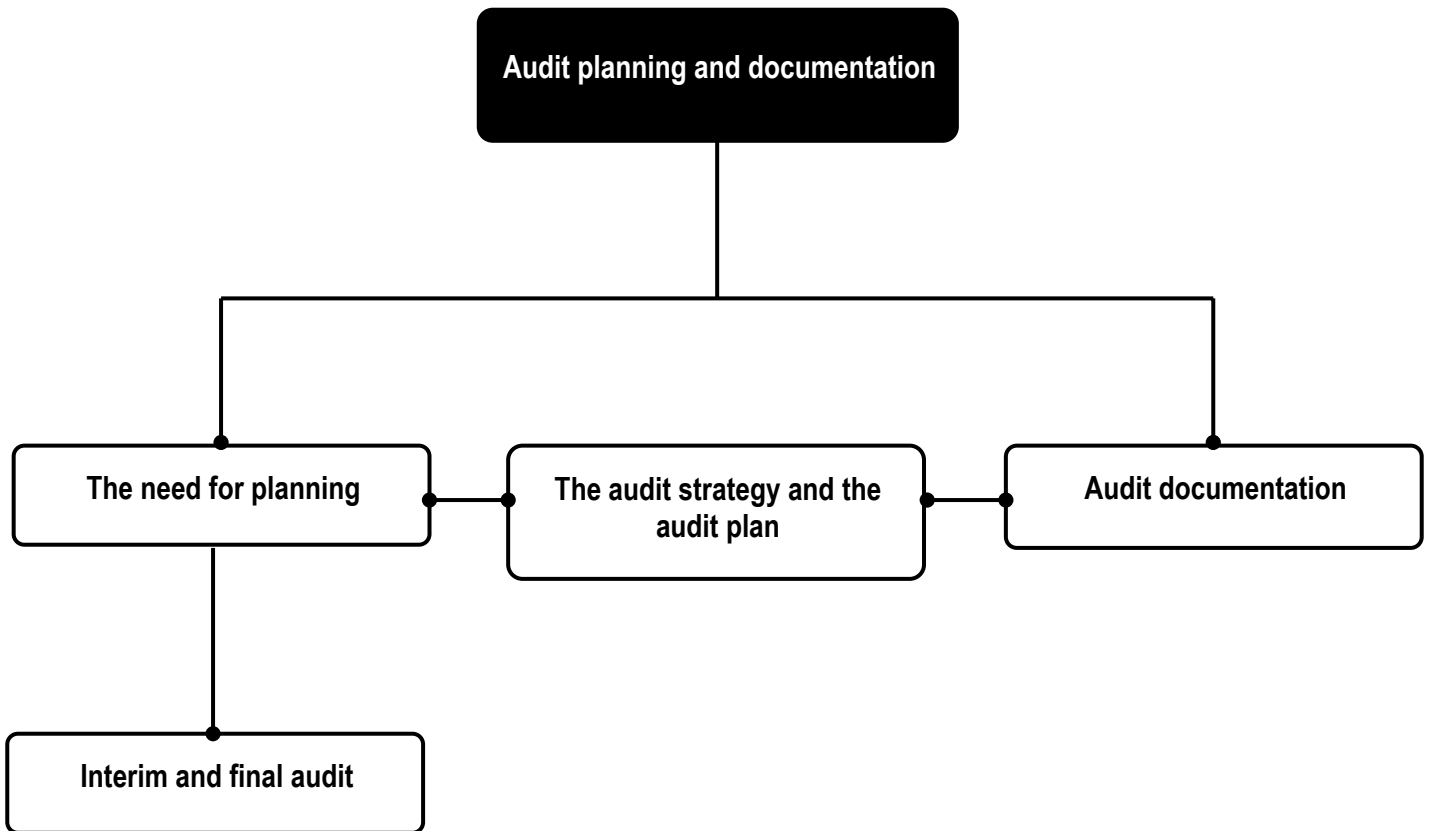
Exam Context

The main principles of the auditing standards featured in this chapter could be tested in short, factual parts of questions. Scenario questions could link these topics with the risk assessment topics covered in Chapter 6.

Qualification Context

These topics again will be assumed knowledge in the professional stage Advanced Audit and Assurance paper (P7).

Overview



1 The need for planning

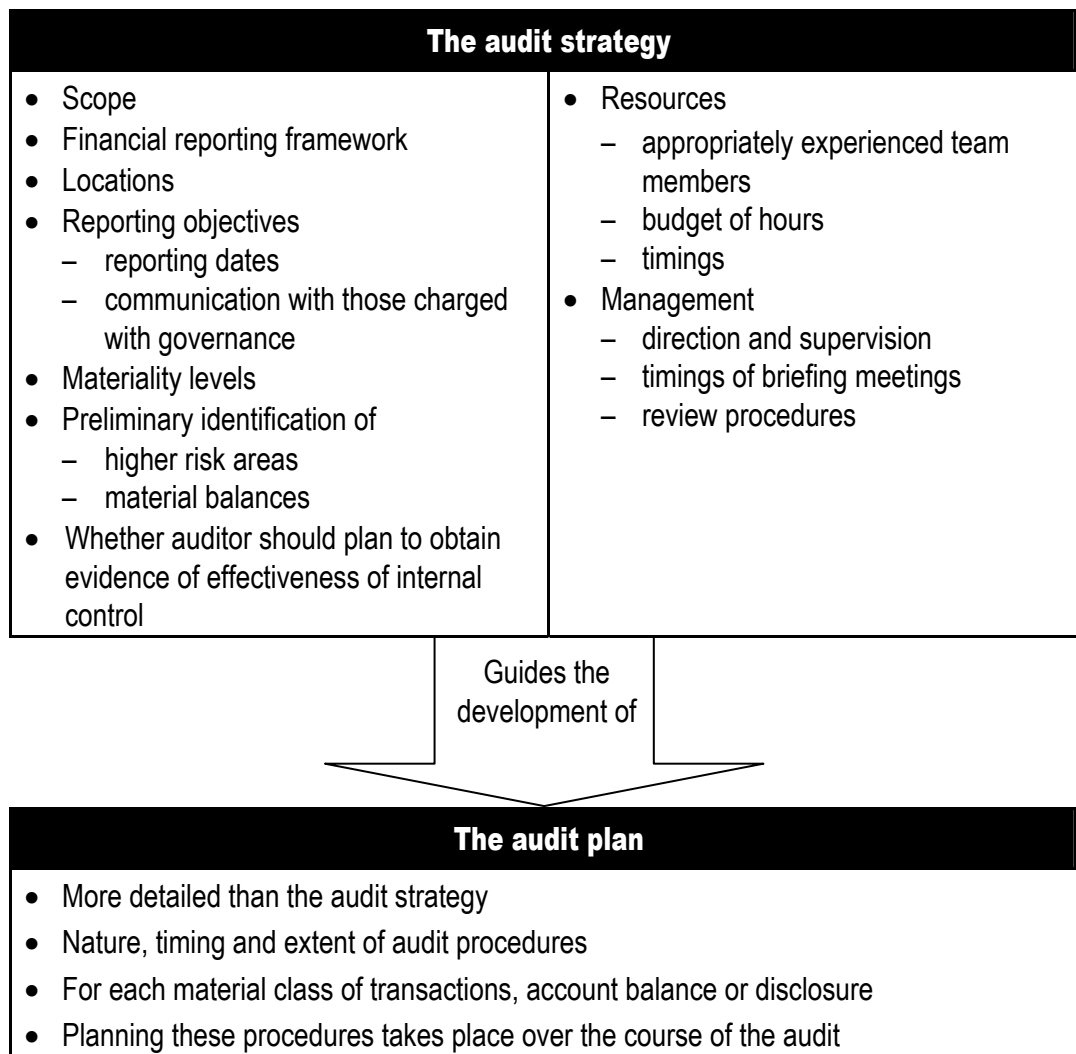
- 1.1 ISA 300 (revised) *Planning an audit of financial statements* sets out the basic reasoning for audit planning: the auditor should plan the audit work so that the audit will be performed in an effective manner.
- 1.2 'Planning' entails developing a general strategy and a detailed approach for the expected nature, timing and extent of the audit. The auditor plans to perform the audit in an efficient and timely manner.
- 1.3 The form and nature of planning is affected by
 - Size of the entity
 - Complexity of the audit
 - Auditor's experience with the entity
 - Knowledge of the business
 - Commercial environment
 - Method of processing transactions
 - Reporting requirements
- 1.4 Objectives of planning
 - Ensuring that appropriate attention is devoted to important areas of the audit
 - Ensuring that potential problems are identified
 - Ensuring that the work is completed expeditiously
 - Proper assignment of work to assistants
 - Coordination of work done by other auditors and experts; and
 - Facilitating review.



Section 1.2

2 The audit strategy and the audit plan

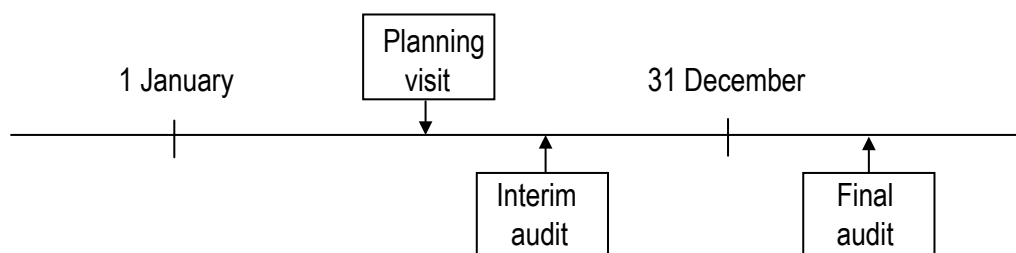
2.1 Overview



3 Interim and final audit

3.1 The main audit procedures are likely to be carried out in two phases, the interim and final audit.

A typical timeframe for a client with a 31 December year end might be:



3.2 Interim audit

Procedures are likely to include:

- Analytical procedures
- Tests of controls
- Updating risk assessments
- Review of relevant internal audit reports
- Substantive testing (of transactions in first part of year)

3.3 Final audit

At this stage a set of draft financial statements or at least a trial balance will be available.

Procedures are likely to include:

- Completion of tests of controls and substantive tests of transactions started at interim
- Analytical procedures on financial statements
- Substantive testing of financial statements.



Section 2

4 Audit documentation

- 4.1 ISA 230: (revised) *Documentation* states that the auditor should document matters which are important in providing audit evidence to support the auditor's opinion and evidence that the audit was carried out in accordance with ISAs.

Working papers:

- Assist in the planning and performance of the audit
- Assist in the supervision and review of audit work
- Enable the audit team to be accountable for its work
- Retain a record of matters of continuing significance to future audits; and
- Enable quality control reviews to be performed.

4.2 Contents

- Sufficiently complete and detailed to enable an experienced auditor with no previous connection with the audit subsequently to ascertain from them what work was performed and to support the conclusions reached
- Should record information on the auditor's planning the audit, the nature, timing and extent of the audit procedures performed, and the results thereof, and the conclusions drawn from the audit evidence obtained
- Auditor's reasoning on all significant matters requiring exercise of judgement, with auditor's conclusions thereon



Q9 Audit planning
and
documentation

Types of documentation

4.3

Permanent file
(information of continuing importance)

- Engagement letters
- Legal documents such as prospectuses, leases, sales agreement
- Details of the history of the client's business
- Previous years' signed accounts, analytical review and management letters
- Accounting systems notes, previous years' control questionnaires

Current file
(information of relevance to current year's audit)

- Financial statements
- Accounts checklists
- A summary of unadjusted errors
- Review notes
- Audit planning memorandum
- Time budgets and summaries
- Letter of representation
- Management letter
- Notes of board minutes
- Communications with third parties
- A lead schedule including details of the figures to be included in the accounts
- Problems encountered and conclusions drawn
- Audit programmes
- Analytical review
- Details of substantive tests and tests of control

4.4 Custody and retention

The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of documentation, for example:

- Passwords to restrict access to electronic documentation to authorised users
- Back-up routines
- Confidential storage of hard copy documentation.

Local laws are likely to specify retention periods. These are unlikely to be shorter than five years.

5 Chapter summary

- **Planning** is carried out so that the audit is performed in an **effective** manner.
- The overall approach to the audit is documented in the **audit strategy**.
- The **audit plan** documents specific procedures for each class of transactions, balance or disclosure.
- The audit is usually carried out in two phases, the **interim audit** and the **final audit**.
- All audit evidence that supports the auditor's opinion must be **documented**.

7: AUDIT PLANNING AND DOCUMENTATION

END OF CHAPTER

Introduction to audit evidence

8

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain the assertions contained in the financial statements.
- Explain the principles and objectives of transaction testing, account balance testing and disclosure testing.
- Explain the use of assertions in obtaining audit evidence.
- Discuss the sources and relative merits of the different types of evidence available.
- Discuss the quality of evidence obtained.

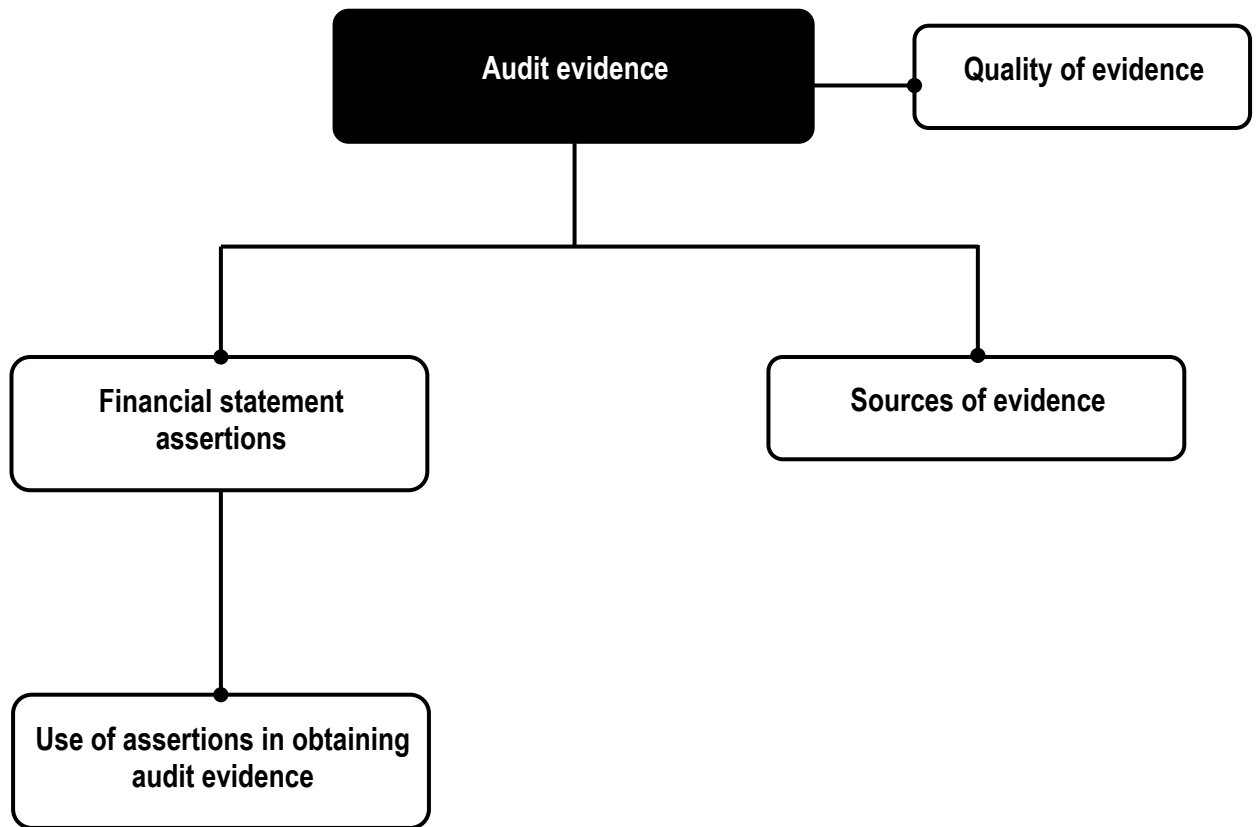
Exam Context

Audit evidence is a core area of this syllabus. It can be tested in straightforward factual questions, as in the pilot paper where 4 marks were available for explaining 4 types of audit evidence. It is essential to have a thorough understanding of the financial statement assertions. These could also be tested in factual questions or you could be asked to apply them in practical questions, as illustrated in a 12 mark requirement in the pilot paper.

Qualification Context

Your knowledge from the Financial Accounting paper (F3) will help you understand the assertions. Again the topics of assertions and evidence are also key in the professional stage Advanced Audit and Assurance paper (P7) where you will have to apply your knowledge in more complicated scenarios that will include the more complex accounting issues that you will study in the professional stage Corporate Reporting paper (P2).

Overview



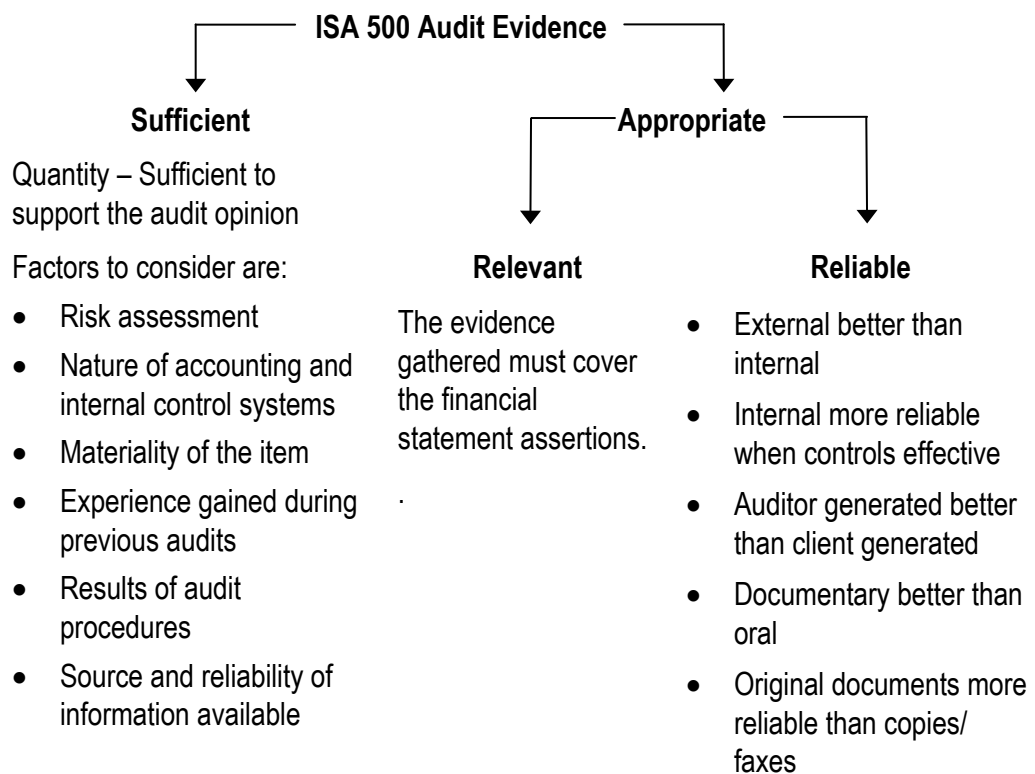
1 Introduction

- 1.1 When undertaking an audit or a review assignment, the accountant needs to find evidence through testing of processes, transactions, account balances and data to support the findings of his report.

ISA 500 *Audit Evidence* outlines the requirements when conducting an external audit under International Standards on Auditing.

2 Quality of evidence

- 2.1 The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. (ISA 500)
- 2.2 Audit evidence is information obtained by the auditor in arriving at the conclusions on which the audit opinion is based.



- 2.3 If the auditor is unable to obtain sufficient appropriate evidence, then he should consider the implications for the auditor's report.

3 Sources of evidence

Types of procedures

3.1 Audit evidence is obtained from an appropriate mix of the following types of procedure:

(a) **Risk assessment procedures**

- Procedures to obtain an understanding of the entity and its environment, including its internal control, to assess risks of material misstatement at the financial statement and assertion levels.

(b) **Tests of controls**

- Procedures to test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level (when necessary or when the auditor has determined to do so).

(c) **Substantive procedures**

- Procedures to detect material misstatements at the assertion level and include *tests of details* of classes of transactions, account balances and disclosures and *substantive analytical procedures*.



Section 1.2

Procedures for obtaining evidence

- 3.2
- | | |
|---|--|
| (a) Analytical procedures | – Evaluations of financial information made by a study of plausible relationships among financial and non-financial data and the investigation of identified fluctuations and relationships inconsistent with other information. |
| (b) Enquiry and the confirmation directly | – Seeking information of knowledgeable persons throughout entity or outside the entity and obtaining representation from a third party. |
| (c) Inspection | – Examining records, documents and tangible assets. |
| (d) Observation | – Looking at a process or procedure being performed by others. |
| (e) recalculatUlation | – Checking the arithmetical accuracy of documents or records and the auditor's independent execution of procedures and reperformance of controls. |



Section 2

4 The use of assertions in obtaining audit evidence

4.1 Assertions are the representations of the directors which are embodied in the financial statements.

The auditor should use assertions for classes of transactions, account balances and disclosure as a basis for:

- Assessing the risks of material misstatement, and
- Designing and performing further audit procedures.

These are the assertions used by auditors ('ACCA COVER'):

A ccuracy

Amounts and other data relating to recorded transactions and events have been recorded appropriately.

C ompleteness

All transactions, events, assets, liabilities, equity interests and disclosures that should have been recorded have been recorded.

C ut off

Transactions and events have been recorded in the correct accounting period.

A llocation

Assets liabilities and equity interests are recorded in the correct class of account

C lassification/understandability

Transactions and events have been recorded in the proper accounts.

O ccurrence

Transactions and events that have been recorded have occurred and relate to the entity.

V aluation

Assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation is appropriately recorded.

E xistence

Assets, liabilities and equity interests exist.

R ights and obligations

The entity holds or controls the rights to assets and liabilities of the entity.

4.2 Occurrence, completeness, accuracy, cut-off and classification typically relate to transactions and events for the period under review. (Income statement)

Existence, rights and obligations, completeness, valuation and allocation typically relate to account balances at the year end. (Balance sheet)

Lecture example 1

Exam standard for 8 marks

Required

For each of the following assertions, discuss the relative merits of the different sources of evidence suggested.

Solution

<i>Assertion</i>	<i>Evidence</i>	<i>Discussion</i>
(a) Valuation of inventory	<ul style="list-style-type: none"> • Year end line-by-line listing from clients inventory system • Agreeing a sample of items to purchase invoices • Tracing items to their post year end sales value 	
(b) Existence of inventory	<ul style="list-style-type: none"> • Enquiry of client management • Observation of year end inventory count 	
(c) Completeness of recording of purchases	<ul style="list-style-type: none"> • Enquiry of client management • Reperformance of sequence check of posting of purchase invoices 	

5 Chapter summary

- ISA 500 requires the auditor to obtain evidence that is **sufficient, relevant and reliable**.
- Evidence is obtained through **risk assessment procedures, tests of controls and substantive procedures**.
- When selecting audit procedures, the **financial statement assertions** ('ACCA COVER') must be considered.

END OF CHAPTER

Internal control

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain why an auditor needs to obtain an understanding of internal control activities relevant to the audit.
- Describe and explain the key components of an internal control system.
- Identify and describe the important elements of internal control including the control environment and management control activities.
- Discuss the difference between tests of control and substantive procedures.
- Explain the importance of internal control to auditors.
- Explain how auditors identify weaknesses in internal control systems and how those weaknesses limit the extent of auditors' reliance on those systems.
- Explain, analyse and provide examples of internal control procedures and control activities.
- Provide examples of computer system controls.
- List examples of application controls and general IT controls.
- Analyse the limitations of internal control components in the context of fraud and error.
- Explain the need to modify the audit strategy and audit plan following the results of tests of control.
- Identify and explain management's risk assessment process with reference to internal control components.
- Discuss and provide examples of how the reporting of internal control weaknesses and recommendations to overcome those weaknesses are provided to management.

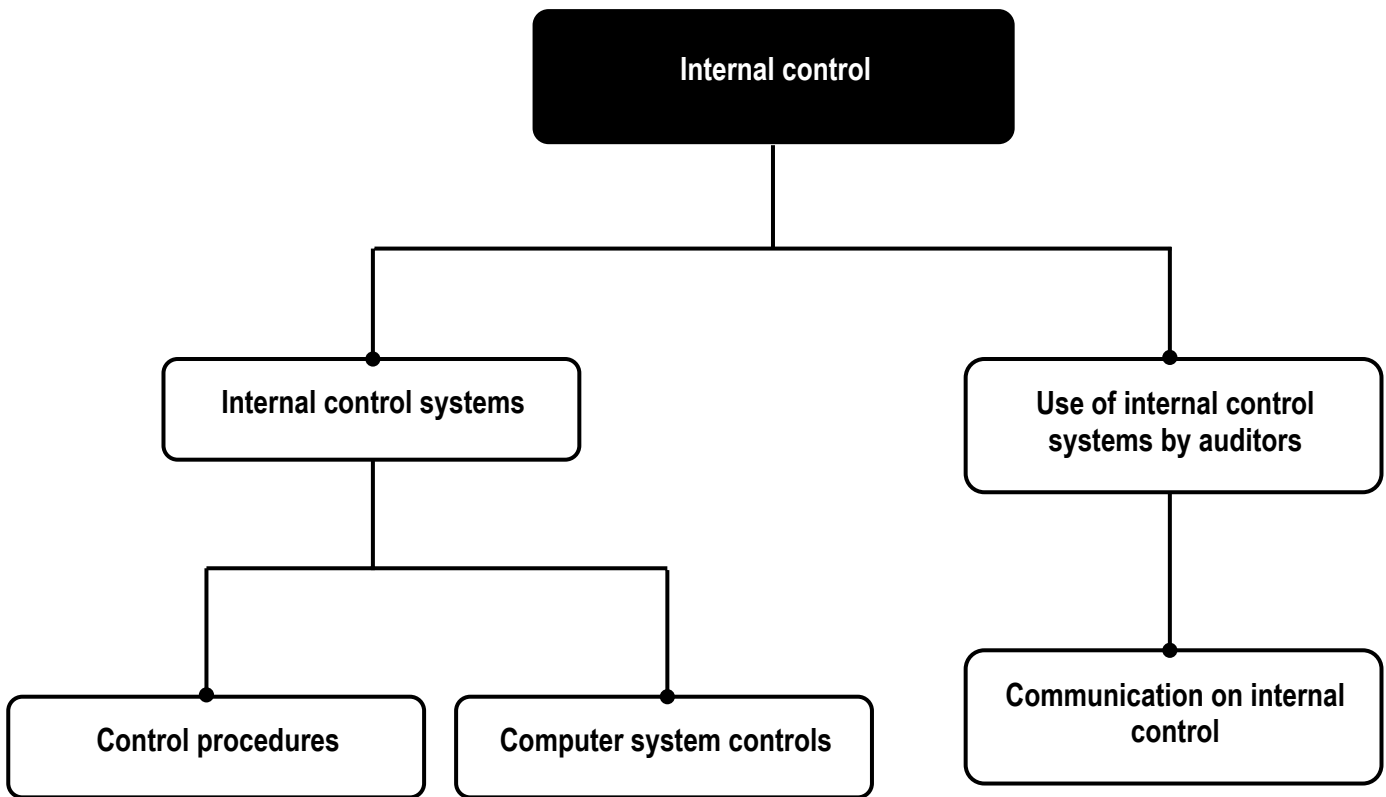
Exam Context

Internal control is another core topic in this syllabus. In the pilot paper it featured in two questions. There was a 5 mark requirement on computer system controls, as well as a 14 mark practical requirement where weaknesses had to be identified within a wages system and appropriate control procedures suggested.

Qualification Context

This syllabus builds upon the principles of accounting and internal financial control that were introduced in the Accountant in Business paper (F1). The same principles are also relevant in the professional stage Advanced Audit and Assurance paper (P7).

Overview





Section 1

1 Internal control systems

1.1 Definition

"**Internal control** is the process designed and effected by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations."

1.2 Components of an internal control system

<p>The control environment</p>	<ul style="list-style-type: none"> • Governance and management functions • Attitudes and awareness and actions of management • "Sets the tone" • Communication and enforcement of integrity and ethical values
<p>The entity's risk assessment process</p>	<ul style="list-style-type: none"> • How management identifies risks and decides upon actions to manage them
<p>The information system</p>	<ul style="list-style-type: none"> • Consists of infrastructure, software, people, procedures and data • For financial reporting objectives, the procedures and records that initiate, record, process and report transactions and maintain accountability for assets, liabilities and equity
<p>Control activities</p>	<ul style="list-style-type: none"> • The policies and procedures that help ensure that management directives are carried out. <p>The categories most relevant to an audit:</p> <ul style="list-style-type: none"> • Performance reviews • Information processing • Physical controls • Segregation of duties
<p>Monitoring of controls</p>	<ul style="list-style-type: none"> • Assessing the design and operation of controls over time • Ongoing is monitoring is part of regular management activity • Separate monitoring may be performed by internal auditors

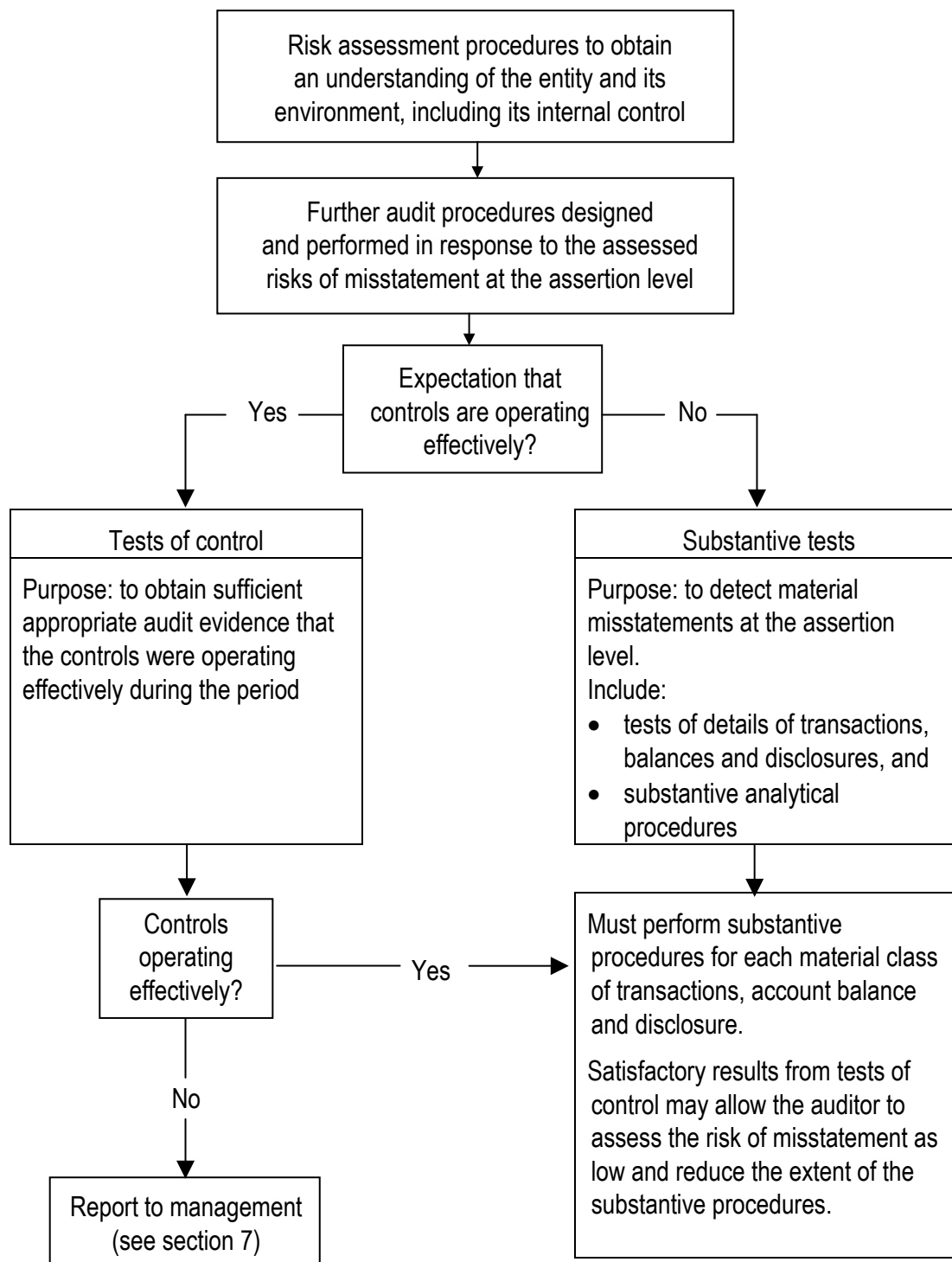
2 Use of internal control systems by auditors

2.1 ISA 315 *Understanding the entity and its environment* states that 'the auditor should obtain an understanding of internal control relevant to the audit'. This is used to:

- Identify types of potential misstatements
- Consider factors that affect the risks of material misstatement
- Design the nature, timing and extent of further audit procedures.

Responses to assessed risks

2.2



Limitations of internal control

- 2.3 The auditor can never rely solely on tests of controls because of the inherent limitations in any system of internal control, ie
- Poor judgement in decision making
 - Human error
 - Processes being deliberately circumvented by employees and others
 - Management overriding controls, and
 - The occurrence of unforeseen circumstances.

3 Control activities

Overview

- 3.1 **Management** design and implement control activities to address **risks** that threaten the achievement of the entity's objectives.

The **auditor** needs to obtain an understanding of the control activities relevant to assessing risks of material misstatement at the **assertion** level.




In this section we will look at several of the transaction cycles that are within the scope of the syllabus. Some will be approached from a management perspective, by analysing the relevant cycle and considering how to respond to the main risks. Others will be approached from the audit perspective, considering controls that relate to specific financial statement assertions.

4 Transaction cycles: sales

Lecture example 1

Idea generation

Credit sales and receipts controls

Stage	Risk	Controls
Customer places order/ Written order form raised 	<ul style="list-style-type: none"> • Order could be accepted and goods despatched to a customer who is not credit worthy • Risk of irrecoverable debts 	
Written order passed for packing and delivery Delivery note raised when items are despatched 	<ul style="list-style-type: none"> • Risk that order is not fulfilled, loss of future business from dissatisfied customer • Risk that incorrect items, wrong quantity or damaged goods are despatched 	
Goods sent to customer 	<ul style="list-style-type: none"> • Risk that goods do not reach the proper destination • Risk that invoice is not raised for goods despatched 	

Stage	Controls	
Customer invoiced Warehouse will send copy of sales order, delivery note and invoice raised ↓	<ul style="list-style-type: none"> Risk of errors in accounting, eg incorrect amounts, posted to wrong account 	
Customer accounts Monitored ↓	<ul style="list-style-type: none"> Risk that cash is not received 	
Payment received from customer ↓	<ul style="list-style-type: none"> Risk that cash/cheques are misappropriated 	
Statements sent to customer ↓	<ul style="list-style-type: none"> See above – risks of accounting errors and fraud 	

Stage		Controls
Monthly management accounts and reconciliations	<ul style="list-style-type: none"> • See above – risks of accounting errors and fraud 	

5 Transaction cycles: inventories

Overview




5.1 The main risks to be considered by management in designing controls over inventories are:

- Acceptance of goods and the related liabilities for
 - goods not genuinely required by the entity
 - under-deliveries, or damaged goods
- Disruption to business through stockouts
- Losses arising from theft of inventory
- Losses arising from damage to inventory

Lecture example 2

Preparation

INVENTORIES

Stage	Controls
Receipt and recording of inventories 	<ul style="list-style-type: none"> • Segregation of duties; custody and recording of inventories • Reception, checking and recording of goods inwards • Maintenance of inventory records • Password control over amendments to stock records
Protection of inventories 	<ul style="list-style-type: none"> • Precautions against theft, misuse and deterioration • Restriction of access to stores • Inventory issues supported by appropriate documentation • Controls on stores environment (right temperature, precautions against damp etc)
Inventory holding 	<ul style="list-style-type: none"> • Control of inventory levels • Maximum inventory levels • Minimum inventory levels • Reorder quantities and levels • Regular monitoring of inventory levels
Inventory counting	<ul style="list-style-type: none"> • Regular inventory counts • Fair coverage so that all inventories are counted at least once a year • Counts by independent persons • Cut off for goods in transit and time differences • Reconciliation of inventory count to book records and control accounts

9: INTERNAL CONTROL

Required

Identify controls from the above table that relate to specific financial statement assertions on the following list:

Accuracy

Completeness

Cut off

Allocation

Classification/understandability

Occurrence

Valuation

Existence

Rights and obligations

6 Transaction cycles: payroll

Overview

- 6.1 There are many inherent risks within a payroll system, including:
- Errors arising from complexities relating to tax and other deductions
 - Frauds, for example
 - Establishing fake payroll records
 - Changing pay rates
 - Claiming payment for more hours than genuinely worked
 - Cash theft



Lecture example 3

Idea generation

Controls in the wages cycle

Requirement

Describe appropriate controls relating to the objectives listed below.

Objectives	Controls
Ensure the correct number of hours have been recorded 	
Ensure work done is paid at correct rate? 	

9: INTERNAL CONTROL

Ensure that only bonafide employees paid only ↓	
Other controls	

7 Communication on internal control

7.1 The auditor has no duty to report any weaknesses in control systems to the shareholders but ISA 260 *Communications of audit matters with those charged with governance* requires the external auditor to communicate 'audit matters of governance interest' to those charged with governance of the entity.

The matters to be communicated include:

- Approach and scope of audit
- Selection of, or changes in, accounting policies
- Audit adjustments that could have a material effect on the entity's financial statements
- Material uncertainties that may cast doubt on the entity's ability to continue as a going concern
- **Material weakness in internal control**
- Questions regarding management integrity and fraud involving management.

Procedures

- 7.2
- Such communications should be on a *sufficiently prompt* basis to enable those charged with governance to take appropriate action. All communications will be before the financial statements are finalised.
 - The form of communications and the addressee of communications should be established at an *early stage* in the audit process (ie. planning).
 - Before reporting issues to the board, auditors should first *discuss* those matters with management. This gives management an opportunity to provide further information or explanations.
 - If possible, matters should be addressed to the audit committee, or to the board if there is no audit committee.

Third parties interested in communications to those charged with governance

- 7.3
- Occasionally those charged with governance may wish to provide third parties, for examples bankers or certain regulatory authorities, with copies of a written communication from the auditors. It is appropriate to ensure that third parties who see the communication understand that it was not prepared with third parties in mind.
- The report has been prepared for the sole use of the entity and, where appropriate, any parent undertaking and its auditors
 - It must not be disclosed to a third party, or quoted or referred to, without the written consent of the auditors; and
 - No responsibility is assumed by the auditors to any other person.

Specimen paragraphs from the weaknesses section of a report to management

7.4 1 Purchases – ordering procedures

Present system

During the course of our work we discovered that it was the practice of the stores to order certain goods from X Limited without preparing either a purchase requisition or purchase order.

Implications

There is therefore the possibility of liabilities being created in relation to unauthorised items and of purchases being made at non-competitive prices.

Recommendations

We recommend that stores personnel should be informed at a department meeting that they are not permitted to place orders. The correct procedure of making a request through the buying department should be explained and training in completing a purchase requisition should be given. Spot checks should be made by the internal audit department over the next six months to monitor compliance.

9: INTERNAL CONTROL

2 **Purchase ledger reconciliation**

Present system

Although your procedures require that the purchase ledger is reconciled against the control account on the nominal ledger at the end of every month, this was not done in December or January.

Implications

The balance on the payables ledger was lower than the nominal ledger control account balance at 31 December 2003 by \$2,120 for which no explanation could be offered. This implies a serious breakdown in the purchase invoice and/or cash payment batching and posting procedures.

Recommendations

It is important in future that this reconciliation is performed regularly by a responsible official independent of the day to day purchase ledger, cashier and nominal ledger functions. We recommend that a control sheet is signed off monthly by the purchase ledger supervisor (or the finance controller in his absence) indicating that the reconciliation has been completed and reviewed.

Additional Notes

8 Bank and cash

8.1 Objectives

- All monies received are recorded
- All monies received are banked
- Cash and cheques are safeguarded against loss or theft
- All payments are authorised, made to correct payees and recorded
- Payments are not made twice for the same liability

8.2 Controls

- (a) Segregation of duties – two people open post, another individual banks
- (b) Receipts listing produced and verified to cashbook, paying in slip and bank statement
- (c) Bank reconciliations performed on a regular basis and reviewed by a responsible official
- (d) Unbanked receipts kept in a locked safe
- (e) Cheques are raised and reviewed by management against supporting documentation prior to payment
- (f) Supplier standing data regularly reviewed by management to ensure payee details correct
- (g) Supplier statement reconciliations performed and reviewed by management for unrecorded payments
- (h) Payables ledger regularly reconciled to Payables Ledger Control Account
- (i) Invoices stamped as paid
- (j) Sequentially numbered purchase invoices – computerised system identifies invoices previously recorded as paid
- (k) Cheque books kept by a responsible official and kept in a secure location



Section 4

9 Types of computer control (ISA 315)

- 9.1 As part of the risk assessment process, the auditor should obtain an understanding of how the entity has responded to the risks arising from IT.
- 9.2 The controls which the auditor would expect to find can be considered in two categories:
 - (a) **General IT-controls** : policies and procedures that *relate to many applications* and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems.
 - (b) **Application controls** : manual or automated procedures that typically operate at a *business process level*. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data.

Application controls and general controls are inter-related. Strong general controls contribute to the assurance which may be obtained by an auditor in relation to application controls. Unsatisfactory general controls may undermine strong application controls.

10 General IT-controls

10.1 General IT-controls that maintain the integrity of information and security of data commonly include the following:

Control	Examples
Controls over data centre and network operations	<p>Policies and procedures;</p> <p>Operating logs showing when users have accessed the system and the files they used;</p> <p>Standby arrangements with either the users of similar systems or a computer firm;</p> <p>Regular backup and secure storage of files;</p> <p>Virus protection/ firewalls.</p>
System software acquisition, change and maintenance	<p>Authorisation, approval, testing, implementation and documentation of new systems software;</p> <p>Change management;</p> <p>Restricted access to system software and documentation;</p> <p>Maintenance agreements.</p>
Access security	<p>Restriction of access to data and programs using passwords;</p> <p>Dedicated terminals;</p> <p>Job scheduling to allow central control over when users have access.</p>
Application system acquisition, development, and maintenance	<p>Testing of new systems;</p> <p>Authorisation, approval and testing of changes to applications systems;</p> <p>Use of standard packages;</p> <p>Regular review of unauthorised changes to/ corruption of application systems software;</p> <p>Restricted access to application systems documentation.</p>

11 Application controls

Controls over input

- 11.1 (a) **Batch controls** where data entered onto the system is first subject to manual processes to pre-determine the results and the input data will only be accepted by the system when it meets the pre-determined totals. Typically the information checked is:
- Number of documents
 - Net amount
 - Gross amount
 - Hash totals for due dates and codes
- (b) **Range/Limit checks** which specify maximum and minimum expected values (eg in a wages system an exception report may be produced for employees receiving net pay of more than \$3,000 per month to allow management to follow up and investigate before payment is made).
- (c) **Existence checks** that will only allow data to be input for valid account codes. This is useful in a sales or purchases system.
- (d) **Check digits** which give codes a mathematical pattern and data will not be accepted for codes which do not match this pattern. These are used to prevent transposition errors.
- (e) **Sequence checks** which will highlight gaps in data both within and between batches.

Controls over processing and computer data files

- 11.2 The control techniques used over input may also be used to ensure the completeness and accuracy of processing provided they are applied to the results of processing e.g. a batch reconciliation produced after processing.

Controls over output

- 11.3 These are designed to provide reasonable assurance that processing is accurate, output is restricted to authorised personnel and provided on a timely basis. Examples include:
- Test checks on outputs
 - Approval of computer-generated payments
 - Reconciliation of report totals to general ledger accounts
 - Use of programmed control procedures.

Controls over standing data (master files)

- 11.4
- Amendments to standing data should only be made by authorised persons.
 - This can be achieved either through passwords or prenumbered forms.
 - Regular printouts of data should be obtained and reviewed by someone in authority.
 - The computer could be programmed to provide a list of all amendments, additions and deletions on a daily or weekly basis. These could then be reviewed to ensure that all changes have been properly authorised.

12 Chapter summary

- An **internal control system** comprises:
 - The control environment
 - The entity's risk assessment process
 - The information system
 - Control activities, and
 - Monitoring of controls
- The auditor must **obtain an understanding** of internal control to:
 - Identify types of potential **misstatement**
 - Assess **risks**
 - Design appropriate **audit procedures**
- Any system of internal control has **inherent limitations**.
- ISA 260 requires the auditor to **communicate material weaknesses** in internal control to those charged with governance.

END OF CHAPTER

Tests of controls

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain and tabulate tests of control suitable for inclusion in audit working papers.

The following transaction cycles and account balances are relevant to this capability:

- Sales
- Purchases
- Stock
- Revenue and capital expenditure
- Payroll
- Bank and cash

Exam Context

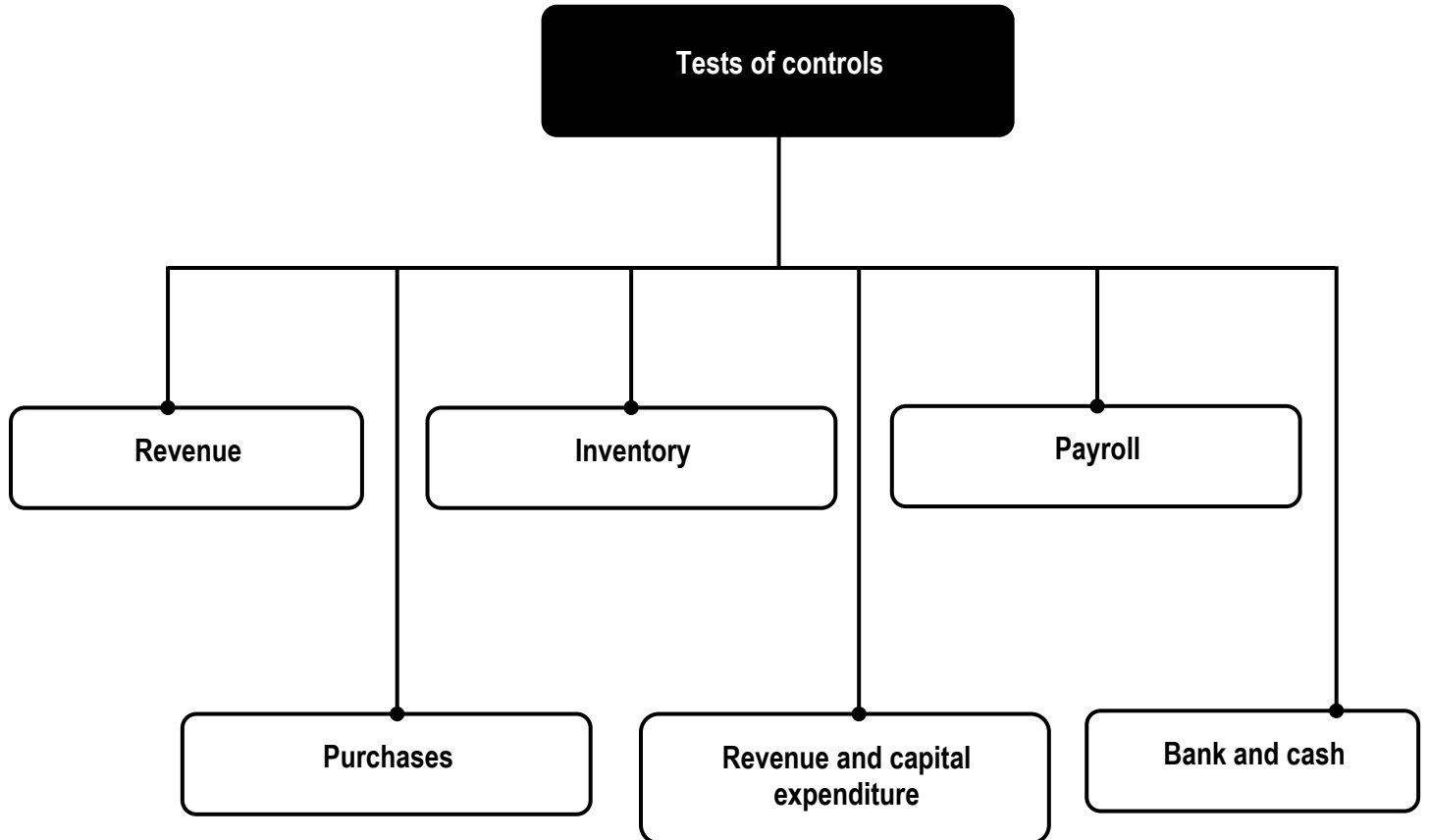
Tests of controls are likely to appear regularly in the exam. You could be asked to explain the tests of control that an auditor would use in a specific area of an audit, perhaps related to one of the transaction cycles mentioned above. There will also be marks available for including tests of controls in answers to requirements asking about 'audit work' more generally.

Qualification Context

This area again draws on the principles of accounting and internal financial control that were introduced in the Accountant in Business paper (F1).

The same issues continue to be relevant in the professional stage Advanced Audit and Assurance paper (P7).

Overview



1 Tests of controls

- 1.1 When the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls are operating effectively, the auditor should obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit.

[ISA 330].

This will involve conducting tests of controls.

- 1.2 Where the auditor's assessment of risk of material misstatement does not include an expectation that controls are operating effectively, the auditor will move directly to designing and performing substantive procedures on classes of transactions and account balances and report the weaknesses to management.
- 1.3 Tests of controls are performed to obtain audit evidence about the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

They test that the control:

- Is properly designed
- Exists, and
- Has operated throughout the period.

Deviations should be recorded and investigated regardless of the amount involved.

The auditor assesses whether deviations are isolated departures or indicate existence of errors in accounting records.

If results are unsatisfactory then the preliminary assessment of control risk is not supported. The auditor must modify the nature, timing and extent of his planned substantive procedures.

- 1.4 Tests of controls include **enquiry** in combination with other audit procedures, for example:
- **Observation** of the entity's procedures
 - **Inspection** of documents supporting controls or events to gain audit evidence that controls have operated effectively
 - **Examination of evidence of management reviews** e.g. minutes of board meetings
 - **Reperformance** of the application of a control to ensure it was performed correctly
 - **Testing of the control activities performed by a computer**, possibly using CAATs (computer-assisted audit techniques).



Q12 Internal controls

2 Tests of controls: transaction cycles

Payables and purchases

2.1 In order to identify the relevant tests of control, it is necessary to understand the main stages of the transaction cycle.

Lecture example 1

Idea generation

Stage	Controls
Employee requires goods to be purchased and raises purchase requisition ↓	Approval by department manager Standard purchase requisition detailing exact requirements raised
Suppliers identified and chosen ↓	For standard items – review standard supplier catalogues and identify most appropriate For non-standard items or for orders in excess of pre-set limit obtain separate quotations and select the most appropriate
Raise order ↓	Match order to requisition and quotations Raise sequentially numbered order form
Receipt of goods ↓	Match receipts to purchase order Check quantity, condition and contents of each receipt Raise sequentially numbered Goods Received Notes (GRN) and pass copy to accounts Pass copy GRN to purchasing department Purchasing department matched GRN to order and perform a regular review of unmatched orders and remind suppliers of unfulfilled orders

Stage	Controls
Supplier sends invoice ↓	Match invoice to GRN and order Sequentially number invoices received Arithmetical checks on invoice calculations
Invoices recorded ↓	Invoices posted to Purchase Day Book (PDB) and Purchase Ledger Supervisor performs sequence checks and analysis checks in PDB
Payment to supplier made ↓	Supplier accounts are regularly monitored and beneficial discounts taken Cheques signed by one or more responsible officials Cheques signed only upon sight of invoice Invoices stamped paid Supplier accounts promptly updated
Statements received from suppliers ↓	A person other than the purchase ledger staff performs supplier statement reconciliations and differences are promptly and correctly followed up
Monthly management accounts and reconciliations	Reconcile <ul style="list-style-type: none"> • purchase ledger to purchase ledger control account • cash book to bank statement Perform detailed variance analysis and investigate adverse and favourable variances Compare cash flow to forecast

Required

Tabulate the main risks of misstatement related to accounting for purchases and payables and describe relevant tests of control.

Solution

2.2 Revenue and capital expenditure

Many of the processes and controls in this area will be covered within the purchase ledger system.

Lecture example 2

Exam standard for 4 marks

There is a risk of misclassification between revenue and capital expenditure.

Required

Describe the tests of controls that an auditor could perform in order to assess the above risk as low.

Solution

Sections 1.3, 2.3,
3.3, 4.3, 5.3, 6.3

3 Chapter summary

- This is a very practical chapter. You must be able to outline appropriate **tests of controls** relating to all the main areas of accounting within the F8 syllabus.

END OF CHAPTER

Audit procedures and sampling

11

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Discuss and provide examples of how analytical procedures are used as substantive procedures.
- Discuss the problems associated with the audit and review of accounting estimates.
- Describe why smaller entities may have different control environments and describe the types of evidence likely to be available in smaller entities.
- Define audit sampling and explain the need for sampling.
- Identify and discuss the differences between statistical and non-statistical sampling.
- Discuss and provide relevant examples of, the application of the basic principles of statistical sampling and other selective testing procedures.
- Discuss the results of statistical sampling, including consideration of whether additional testing is required.
- Explain the use of computer-assisted audit techniques in the context of an audit.
- Discuss and provide relevant examples of the use of test data and audit software for the transaction cycles and balances included in the syllabus.
- Discuss the use of computers in relation to the administration of the audit.
- Discuss the extent to which auditors are able to rely on the work of experts.
- Discuss the extent to which external auditors are able to rely on the work of internal audit.
- Discuss the audit considerations relating to entities using service organisations.
- Discuss why auditors rely on the work of others.
- Explain the extent to which reference to the work of others can be made in audit reports.

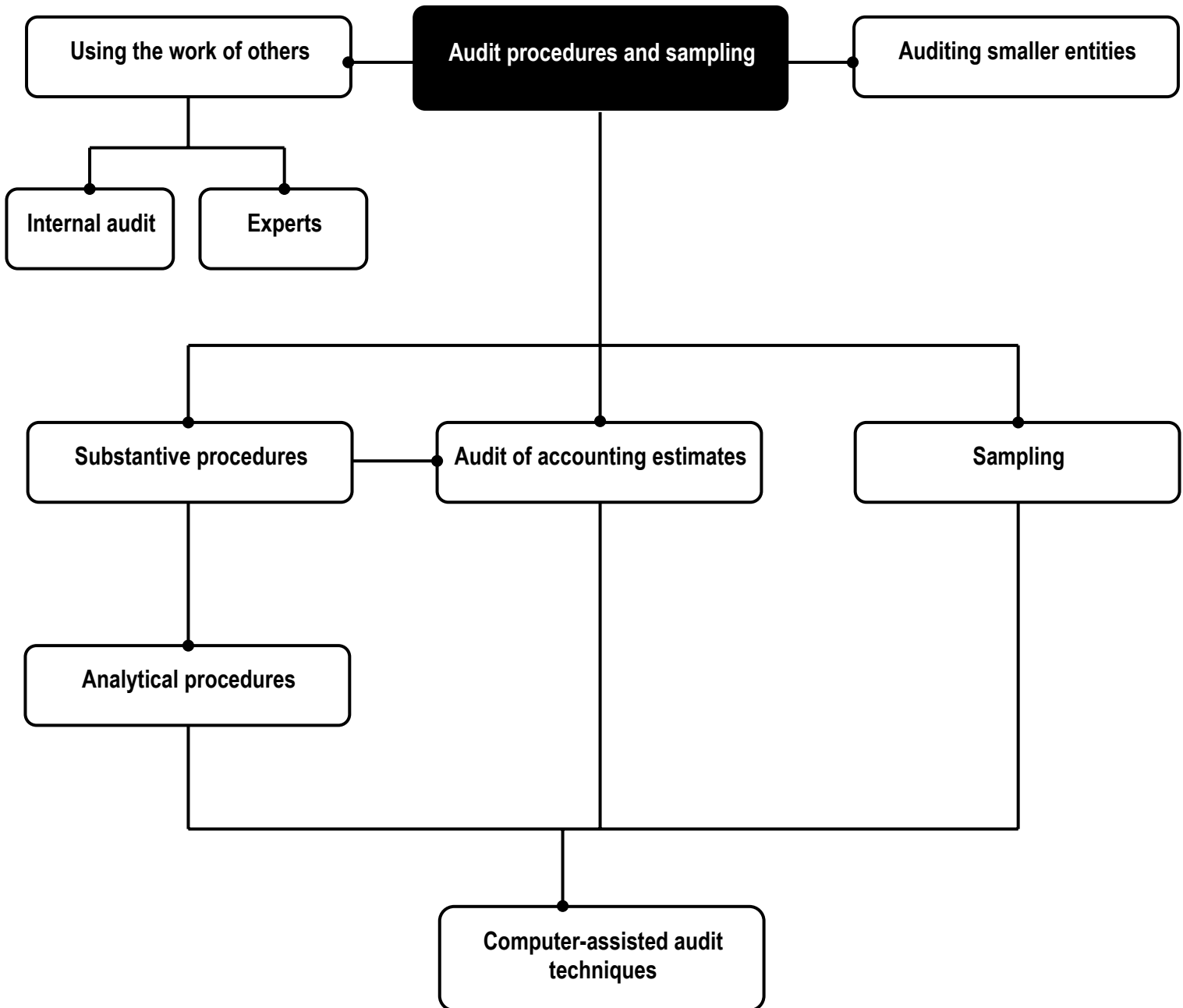
Exam Context

The topics covered in this chapter are likely to appear in several questions in the exam. In the pilot paper these areas would have provided a few marks in the parts of question 1 that asked for lists of procedures, as well as a separate 5 mark requirement in that question about computer-assisted audit techniques. They would also have provided some points relevant to an 8 mark part of the audit report question.

Qualification Context

These topics continue as a core part of the syllabus of the professional stage Advanced Audit and Assurance paper (P7).

Overview

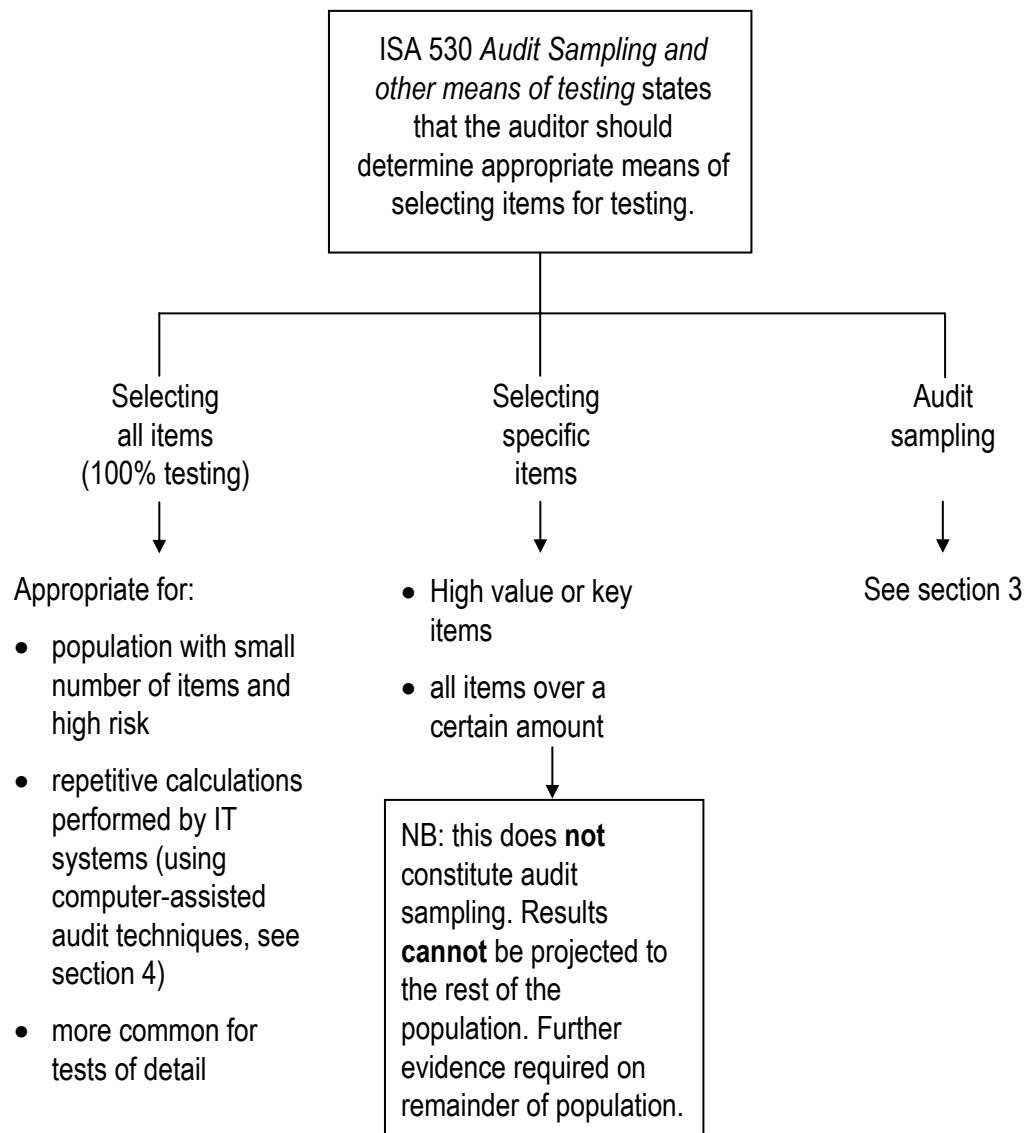


11: AUDIT PROCEDURES AND SAMPLING

(3) Accuracy of wages expense

(4) Cut-off of sales revenue

2 Selecting items for testing



3 Sampling

3.1 Definition

Audit sampling means the application of audit procedures to less than 100% of the items within a class of transactions or account balance such that all sampling units have an equal chance of selection, in order to assist in forming a conclusion concerning the population from which the sample is drawn [ISA 530].

3.2 Statistical vs non-statistical sampling

Statistical sampling is any approach to sampling that has the following characteristics:

- (a) random selection of a sample, and
- (b) use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (a) and (b) is considered non-statistical sampling.

3.3 Design of the sample: factors to consider

- (a) **Objectives of the test** – nature of audit evidence sought and possible error conditions need to be considered, e.g. Is it a test of control? Is there evidence a control has not been operating properly? – or is it a substantive test more concerned with verifying completeness and accuracy?
- (b) **Population** – this is the entire set of data from which the auditor will select his sample.

It is important to ensure that the population tested is *appropriate* (e.g. the accounts payable listing to test overstatement of accounts payable, but subsequent payments, suppliers' statements etc to test for understatement of accounts payable) and *complete*.

- (c) **What constitutes an error** – for example, in a test of details on the existence of trade receivables by confirmation, payments made by the customer before confirmation date but received after the confirmation date do not constitute an error.

Sample size and sampling risk

- 3.4 (a) In determining the sample size, the auditor should consider whether sampling risk is reduced to an acceptably low level. Sampling risk arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.
- (b) The sample size can be calculated by the application of a statistically-based formula or through professional judgement objectively applied to the circumstances.

11: AUDIT PROCEDURES AND SAMPLING

(c) Examples of factors affecting sample size:

Factor	Effect on sample size
<i>Required confidence level</i>	The greater the degree of confidence the auditor requires, the larger the sample size needs to be.
<i>Risk of material misstatement</i>	The higher the auditor's assessment of inherent risk and control risk the larger the sample size needs to be.
<i>Tolerable error</i>	The lower the total error the auditor is willing to accept*, the larger the sample size needs to be.
<i>Expected error</i>	The greater the amount of error the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of the error in the population.
<i>Population size</i>	For large populations, little, if any, effect. For small populations, audit sampling is often not as efficient as alternative methods.
<i>Stratification</i>	When a population can be appropriately stratified (by dividing it into discrete sub-populations which have an identifying characteristic), the aggregate of the sample sizes will generally be lower for the same sampling risk than if one sample had been drawn from the whole population.

* For tests of detail the tolerable error is the tolerable misstatement and will be less than or equal to auditor's materiality used for the class of transactions or account balances being audited.

For tests of controls the tolerable error is the maximum number of times a control has not operated properly whilst allowing the auditor to conclude that the control risk assessment is still valid.

3.5 Selection of the sample

The auditor should select items for the sample with the expectation that **all sampling units in the population have a chance of selection**. [ISA 530]. While there are a number of selection methods, four methods commonly used are

- (a) **Random selection**, using a computerised random number generator or random number tables.
- (b) **Systematic selection**, in which the number of sampling units in the population is divided by the sample size, to give a sampling interval, e.g. 50, and having determined a starting point within the first 50 (preferably randomly), each 50th sampling unit thereafter is selected. When using systematic selection, the auditor needs to ensure that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population;
- (c) **Haphazard selection**, in which the auditor selects the sample without following a structured technique, but which avoids any conscious bias or predictability (e.g. avoiding difficult to locate items, or always choosing or avoiding the first or last entries

on a page). This may be an acceptable alternative to random selection provided the auditor is satisfied that the sample is not unrepresentative of the entire population; and

- (d) **Value weighted selection**, where items are selected for testing by weighting the items in proportion to their value. It can often be efficient in substantive testing, particularly when testing for overstatement. It is also known as 'monetary unit sampling' (MUS). This is a technique which, when applied correctly ensures that every \$1 in a population will have an equal likelihood of being selected for testing. Under MUS, material balances will be automatically selected.

Lecture example 2

Preparation

You are the auditor of XYZ Co and wish to audit receivables by circularising a sample of the year end balances. Total receivables at the year end amount to \$1 million and materiality is \$100,000.

Required

State which customer balances you will select for sampling when using MUS.

Solution

DEBTOR	BALANCE	CUMULATIVE TOTAL	SELECTED (Y/N)
1	60,000		
2	70,000		
3	90,000		
4	105,000		
5	28,000		
6	100,000		
7	46,000		
8	1,000		
9	84,000		
10	94,000		
11	108,000		
12	34,000		
13	160,000		
14	20,000		
	<u>1,000,000</u>		

3.6 MUS has the following advantages and disadvantages.

Advantages

- (a) The auditor can design and evaluate the sample with little difficulty, especially when using CAATS.
- (b) All items exceeding materiality will be selected, thus ensuring all material items are tested.

11: AUDIT PROCEDURES AND SAMPLING

Disadvantages

- (a) Where the auditor cannot use computers to calculate sample selection, the procedure can be time consuming.
- (b) MUS does not cope easily with errors of understatement or where there are negatively valued items in the population.
- (c) If the population is not randomly tabulated (for example by customer name or customer account number) then there is a likelihood that only the larger items will be selected, resulting in a non representative sample.

3.7 Evaluation of sample results

Having carried out, on each sample item, those audit procedures which are appropriate to the particular audit objective, the auditor should evaluate the sample results to determine whether the preliminary assessment is confirmed or needs to be revised.

3.8 Analysis of errors in the sample

- What is the nature and cause of the error?
- Is there a possible effect on other areas of the audit?
- Is it an anomalous error?

Anomalous error – arises from an isolated event that has not recurred other than on specifically identifiable occasions and is therefore not representative of similar errors in the population.

Example - an error arises from a computer breakdown known to have occurred on only one day in the period.

3.9 Tests of detail

For tests of detail, the auditor should project monetary errors found in the sample to the population and compare this to the tolerable error.

Where an error has been established as an anomalous error, it may be excluded when projecting sample errors to the population (but still need to be considered overall in addition to the projection of the non-anomalous errors).

Where a class of transactions or account balance has been divided into strata, the error is projected for each stratum separately.

3.10 Tests of controls

For tests of controls, no explicit projection of errors is necessary since the sample error rate is also the projected rate of error for the population as a whole.

For example, if the auditor has performed tests of controls on a sample of 20 items and has found 2 deviations, this represents an error rate of 10% ($2/20 \times 100$). The auditor must then decide if this error rate is acceptable.

- 3.11 If the evaluation of sample results indicates that the assessment of the relevant characteristic needs to be revised, the auditor may:
- (a) request management to investigate identified errors and the potential for further errors and make any necessary adjustments; and/or
 - (b) modify the nature, timing and extent of further audit procedures; and/or
 - (c) consider the effect on the auditor's report.

Lecture example 3

Preparation

You are auditing trade receivables and have obtained the following results based on your sample:

- Total value of the population \$1,000,000
- Number of items in the population 400
- Number of items tested 20
- Sample value \$200,000
- Error in sample \$9,000

Required

- (a) Assuming the errors are not anomalous ones, calculate the expected error in the population.
- (b) Assuming that tolerable error was set at \$40,000, explain what action should be taken.

Solution

- *Ratio method extrapolation*
Error rate in sample x total value in population

4 CAATs

- 4.1 Computer-assisted audit techniques (CAATs) involve using a computer to perform audit work. Computers can be used to perform either substantive tests or tests of controls.

Audit software (used for substantive testing)

- 4.2 Audit software consists of computer programs used by the auditor, as part of his auditing procedures, to process data of audit significance from the entity's accounting system. It may consist of:

Package programs: used to read computer files, select information, perform calculations, create data files and print reports in specified formats.

Purpose-written programs: used to perform audit tasks in specific circumstances. May be written by the auditor, entity or third-party

Utility programs: used to by the entity to sort, create and print files.

- 4.3 Data may be down-loaded from the client's system to the auditor's in order to perform tests on it.

Typical tests

- (a) Reperformance of calculations e.g. ageing of receivables, adds/casts of day book, ledger listings or inventory reports.

Additional comfort is gained as the auditor's own software is being used to generate evidence.

- (b) Extraction of samples
(c) Analytical review, e.g. calculation of ratios

Test data (used for tests of controls)

- 4.4 Test data techniques are used in conducting audit procedures by entering data into an entity's computer system, and comparing the results obtained with pre-determined results.

This will require significant co-operation from the client, especially in terms of computer access time.

Typical uses

- (a) *Test data used to test specific controls in computer programs*

e.g. online password and data access controls.

- (b) *Test transactions*

Either selected from previously processed transactions or created by the auditor to ensure they are processed correctly.

This can be conducted 'live' or 'dead' i.e. as part of normal processing or at times when the computer is not in business use. Test transactions normally involve submitting both valid and invalid data for processing. The auditor would expect the valid data to be processed properly and the invalid data to be rejected.

(c) *Test transactions using an integrated (embedded) test facility*

These aim to extend testing more fully throughout the period.

- (i) A dummy unit (e.g. a department or employee) is established, and to which test transactions are posted during the normal processing cycle. Exception reports could be produced where output differs from that expected. This is especially useful for clients with strong internal audit.
- (ii) SCARF: Systems Control and Review File. Taking real transactions at random and replicating their output in a separate file for later investigation. This file is set up by the auditor and can only be accessed by him. The auditor decides on the type of data which he wishes to have recorded in the file.

5 Using the work of others

- 5.1 Whilst auditors are highly trained individuals, it is possible that when conducting an audit they encounter issues which are outside the scope of their expertise, for example, valuation of buildings.
- 5.2 Additionally, it is increasingly common for companies to outsource specific functions, for example payroll, to service organisations who have more expertise than the entity.
- 5.3 As such, the auditor must consider the availability and reliability of the evidence provided by such experts and by the work of service organisations.
- 5.4 Also, in some cases, external auditors may want to rely on work done by internal audit.

6 ISA 620 – Using the work of an expert

- 6.1 Expert means a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing. When using the work performed by an expert, the auditor should obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit.
- 6.2 When planning to use the work of an expert the auditor should evaluate the objectivity and professional competence of the expert by considering the expert's:
 - (a) Professional certification or licensing by, or membership in, an appropriate professional body.
 - (b) Experience and reputation in the field in which the auditor is seeking evidence.
- 6.3 The auditor should evaluate the appropriateness of the expert's work as audit evidence. This will involve evaluation of whether the substance of the expert's findings is properly reflected in the financial statements or supports the assertions, and consideration of:
 - Source data.
 - Assumptions and methods used and their consistency with prior periods.
 - Results of the expert's work in the light of the auditor's overall knowledge of the business and the results of other audit procedures.

11: AUDIT PROCEDURES AND SAMPLING

- 6.4 Audit evidence from an expert may be obtained in the form of:
- (i) Valuations of land and buildings;
 - (ii) Determination of inventory quantities or physical condition;
 - (iii) Legal opinions concerning interpretations of agreements, statutes and regulations, or on the outcome of litigation or disputes.
- 6.5 When issuing an unmodified audit report, the auditor should not refer to the work of an expert.

7 ISA 420: Audit considerations relating to entities using service organisations

- 7.1 Service organisations provide a wide variety of services to businesses. Examples include:
- maintenance of accounting records
 - payroll
 - credit control
 - data entry/ information processing.
- 7.2 The auditor should:
- assess the significance of the service organisation's activities to the entity and audit
 - assess the risk of material misstatement relating to the transactions, assets and liabilities dealt with by the service organisation
 - assess the extent of control risk associated with the service organisation (controls exerted by the entity and controls present at the service organisation)
(reports from the service organisation's internal/external auditors or by regulatory agencies may provide useful evidence as to the operation and effectiveness of the accounting and internal control systems)
 - consider whether information held by the entity is sufficient to provide the auditor with adequate audit evidence and if necessary design further audit procedures in response to the assessed risk
 - if necessary, request the service organisation's auditor to perform additional procedures or visit the service organisation to perform tests of controls
 - consider any implications for the auditor's report.

8 Use of the internal auditor's work for the external audit

- 8.1 During the course of their planning, the external auditors should perform an assessment of the internal audit function if they consider that it may be possible, and desirable, to rely on some of internal audit's work. If the external auditor can rely on the work conducted by the internal auditor, the volume of detailed work undertaken by the external auditor may be reduced.

- 8.2 ISA 610 *Considering the Work of Internal Auditing* sets out the criteria that auditors should use when obtaining an understanding, and subsequent assessment of, the internal audit function.

General assessment includes:

- (a) Organisational status i.e. degree of independence
- (b) Scope of function
- (c) Technical competence
- (d) Due professional care.

Evaluation of internal audit work

- 8.3 When the external auditor intends to use the specific work of internal auditing, the external auditor should evaluate and perform audit procedures on that work to confirm its adequacy for the external auditor's purposes.

Factors to consider include:

- (a) adequacy of technical training and proficiency
- (b) whether work of assistants is properly supervised, reviewed and documented
- (c) sufficiency and appropriateness of audit evidence to be able to draw reasonable conclusions
- (d) whether conclusions are appropriate and reports are consistent with work performed
- (e) whether any exceptions or unusual matters disclosed are properly resolved

Planning, controlling & recording

- 8.4 The external auditor should liaise closely with the internal auditor at all stages.

He should compare results obtained by internal audit with those produced by his own staff and if necessary, re-examine transactions and balances.

Report to management

- 8.5 External auditor should consider whether he should report separately to management any weaknesses / irregularities discovered by internal audit.

Auditor's report

- 8.6 The external auditor cannot make reference to work done by the internal auditor in his auditor's report.

9 ISA 540 – Audit of accounting estimates

9.1 Examples of accounting estimates are:

- allowances to reduce inventory and accounts receivable to their estimated realisable value
- depreciation
- provisions
- accrued revenue

Management often make these estimates in conditions of uncertainty over outcomes and with the use of judgement. The risk of misstatement is increased, and the evidence available to detect a material misstatement will often be more difficult to obtain and less persuasive than that relating to other items in the financial statements.

9.2 Three approaches are available to the auditor:

- (a) review and test the process used by management to develop the estimate;
- (b) use an independent estimate for comparison with that prepared by management; or
- (c) review of subsequent events which provide audit evidence of the reasonableness of the estimate made.

9.3 Where the auditor reviews and tests the process used by management, the following steps would normally be appropriate:

- (a) evaluation of the data and consideration of the assumptions on which the estimate is based;
- (b) testing of the calculations involved in the estimate;
- (c) comparison, where possible, of estimates made for prior periods with actual results of those periods;
- (d) consideration of management's approval process.

10 Auditing smaller entities

- 10.1 As detailed in chapter 1, most limited liability companies are generally required by statute to have their financial statements audited with the exception of dormant companies and companies which meet the small company exemption criteria.
- 10.2 **The problem of control**
- (a) Many of the controls which would be relevant to a large enterprise are neither practical nor appropriate for the smaller entity.
 - (b) In particular, small enterprises are likely to have poor segregation of duties due to limited numbers of staff.
 - (c) Additionally, management override of controls is likely to be an issue as a result of the close involvement of directors and/or proprietors
 - (d) To compensate for these weaknesses, management should instigate additional physical authorisation, arithmetical, accounting and supervisory procedures.
- 10.3 **Substantive or Systems based auditing?**
- (a) It is important to appreciate that such additional controls will not, and can not, be relied upon by the auditor as in a “systems” based approach. However, such controls within smaller entities do provide overall comfort to the auditor, particularly when determining whether to seek to rely on management assurances and representations.
 - (b) As a result, the audit of smaller entities will focus on substantive procedures in order to provide an opinion on the Financial Statements.
 - (c) IAPS 1005 *The Special Considerations in the Audit of Small Entities* provides additional guidance to auditors when auditing such smaller entities.

11 Chapter summary

- **Analytical procedures** can be used as **substantive procedures**.
- Auditors may select items for testing using:
 - 100% testing
 - selecting specific items, or
 - **sampling**
- Sample sizes are affected by **risk** and **materiality**.
- Sample **results must be extrapolated** to the population.
- **CAATs** can be used to perform audit work.
- Auditors may need to place reliance on the work of others, namely **experts, service organisations** or **internal audit**.

11: AUDIT PROCEDURES AND SAMPLING

END OF CHAPTER

Receivables

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain the purpose of substantive procedures in relation to financial statement assertions.
- Explain the substantive procedures used in auditing each balance, and
- Tabulate those substantive procedures in a work program for:

Receivables

- (i) direct confirmation of debtors
- (ii) other evidence in relation to debtors and prepayments, and
- (iii) the related income statement entries.

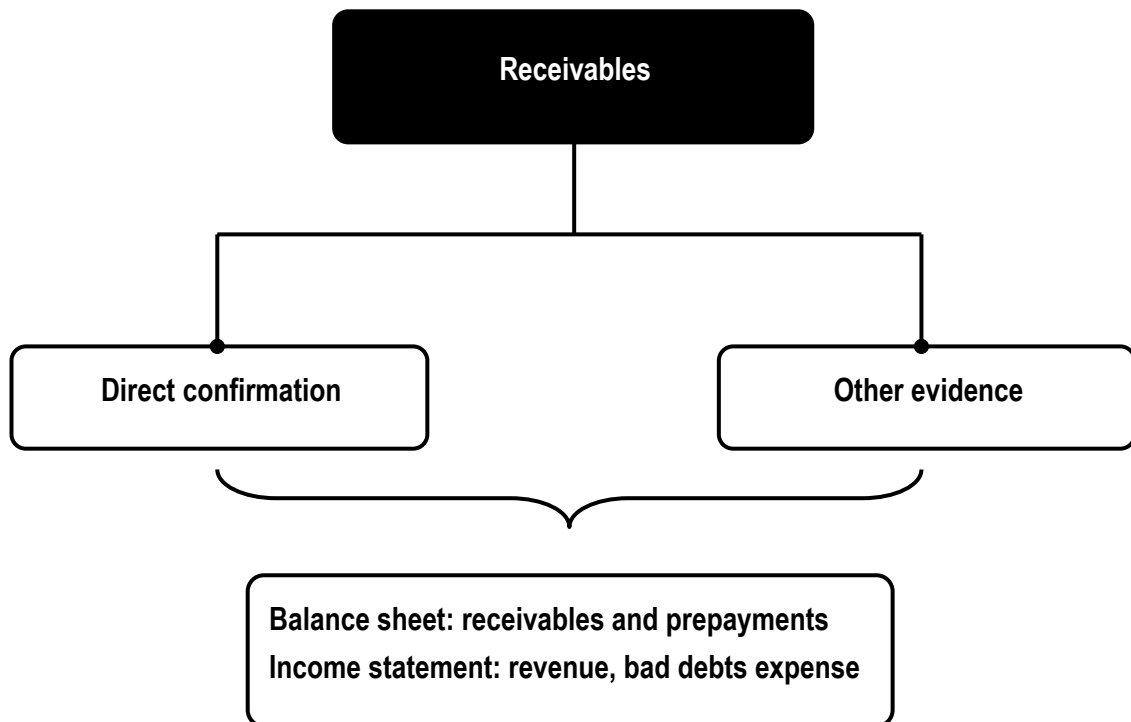
Exam Context

The examiner is very keen on testing your *understanding* of audit procedures. The link between financial statements assertions and relevant procedures is critical here. In the 30 mark case study question in the pilot paper, a 12 mark requirement asked for procedures to confirm specific assertions relating to purchases, then a further 8 mark requirement asked for audit procedures relevant to trade payables, along with an explanation of the purpose of each procedure.

Qualification Context

This area draws on your knowledge of accounting for receivables from the Financial Accounting paper (F3).

Overview



1 Receivables

1.1 A specific technique used to test for the existence and obligation/rights of receivables is a direct circularisation. This is conducted as follows:

- (a) Obtain listing of trade receivables as at the confirmation date.
- (b) Agree total to Nominal Ledger.
- (c) Review for any obvious omissions/mis-statements by comparing this year's list with last year's.
- (d) Select a sample of accounts for confirmation.

Select the sample from the following balances:

- Old, unpaid amounts
- Credit balances
- Nil balances
- Material balances

Letter should be on the client's paper, signed by the client with a copy of the current statement attached. It should request that the reply be sent direct to the auditor and reply paid envelopes should be sent.

- (e) After reasonable period, send 'follow-up' request.
- (f) Follow up by telephone or fax if there is no reply.
- (g) No reply:
 - Confirmation of individual outstanding invoices
 - Alternative procedures.
 - Agree opening balance on account with last year's closing balance.
 - Test casts.
 - Verify outstanding items to back up documentation.
 - Review cash received after year end.
 - Discuss with responsible company official.

Lecture example 1

You have obtained the following results from 3 receivables balances circularised during the audit of Chewy Co.

	Balance per sales ledger \$	Balance per circularisation response \$	Reason for difference
Darth Co	25,000	20,000	Cash in transit
Skywalker Co	55,000	45,000	Goods not received at year end
Yoda Co	68,000	57,000	Disputed invoice

Required

Detail the tests you would perform on each of these responses.

Solution

Other standard audit tests for receivables

1.2 (a) *Completeness/existence*

- (i) Cutoff work – This is concerned with ensuring that the sales invoice and the dispatch have been recorded in the same period.

Tests

- select a sample of GDNs before the year end and a sample in the following period.
- ensure invoices recorded in the same period as the GDN

- posted to NL/SL in correct period
- review receipts from receivables recorded after the year end to ensure these shouldn't have been recorded before year end
- review sales ledger control account around the year end for any unusual items
- review material post-year end invoices to ensure these are properly treated as next year's sales
- (ii) Review receivables analytically
 - Ratios e.g. payment period
 - Compare with previous years/budgets
- (b) *Rights and obligations*
 - Perform a receivables circularisation.
 - Trace a sample to cash received post year end.
 - Discuss with management/ review board minutes to establish whether any debts have been factored.
- (c) *Allocation and valuation*
 - Obtain listing of overdue debts and check its extraction.
 - Discuss significant overdue debts with the credit controller.
 - Review correspondence with customers to assess recoverability.
 - Ensure all debts written off were properly authorised.
 - Review payments received after the year end.

2 Chapter summary

- **Direct circularisation** of receivables is a key procedure but does not give evidence on all the relevant assertions
- Other important procedures are:
 - **Cut-off tests**
 - Tests to determine **recoverability**

END OF CHAPTER

Inventory

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain the purpose of substantive procedures in relation to financial statement assertions.
- Explain the substantive procedures used in auditing each balance, and
- Tabulate those substantive procedures in a work program for:

Inventory:

- (i) Inventory counting procedures in relation to year-end and continuous inventory systems
- (ii) Cut-off
- (iii) Auditor's attendance at inventory counting
- (iv) Direct confirmation of inventory held by third parties
- (v) Other evidence in relation to inventory.

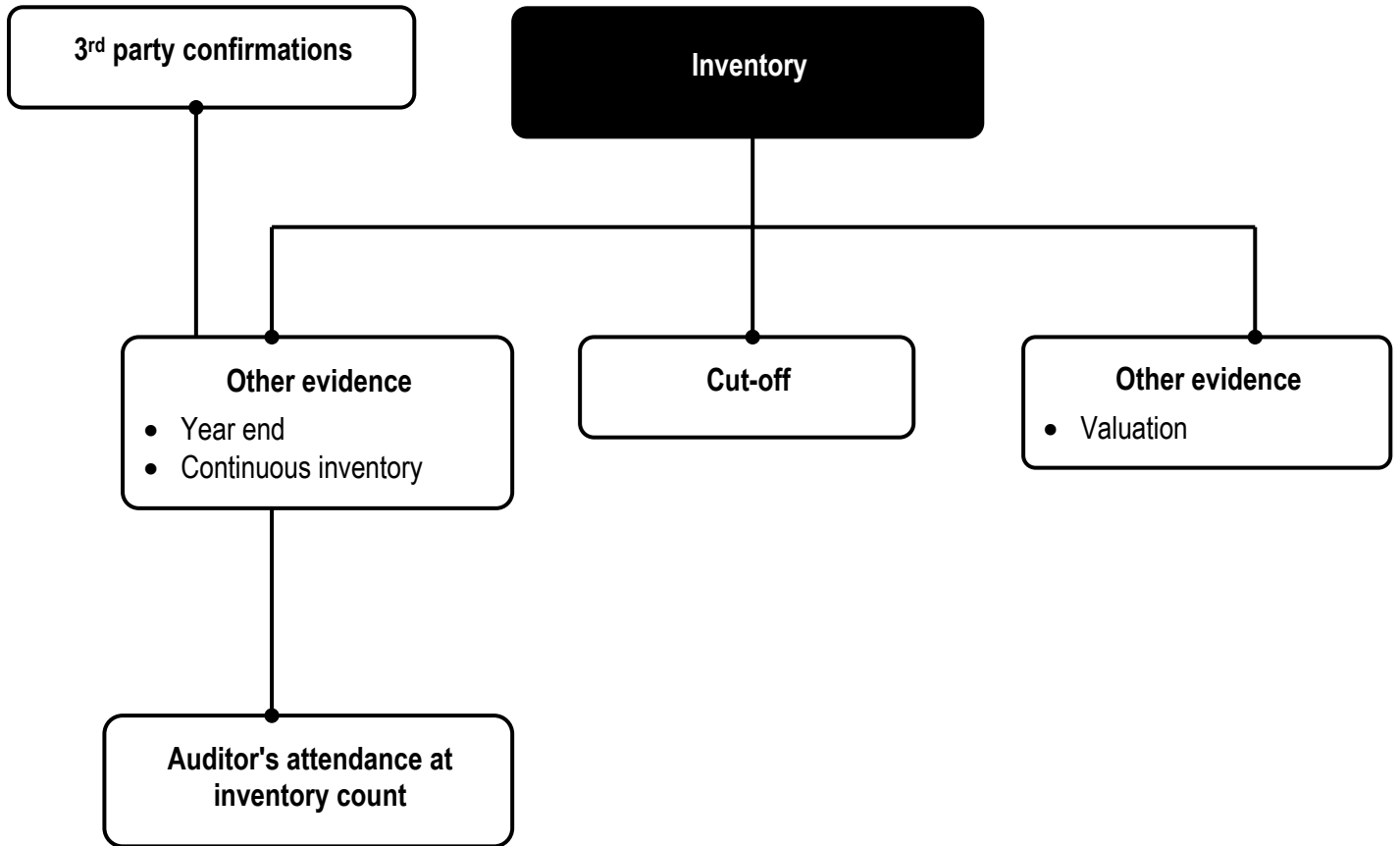
Exam Context

As in the previous chapter, this is a topic that could carry a large number of marks in a case study question.

Qualification Context

Again this area draws on your knowledge of accounting for inventory from the Financial Accounting paper (F3). More complex areas of accounting for inventory will be developed in the professional stage paper Advanced Audit and Assurance (P7).

Overview



1 Inventories

1.1 The audit/review approach must consider

- Quantity – normally arrived at by a year end count
- Valuation – must apply IAS 2/SSAP 9
- Disclosure

A particular technique to verify quantity of inventories is for the auditor to attend the client's inventory count.

Attendance at the inventory count

1.2 (a) **Before**

(i) *Planning*

- Review working papers for previous year to identify risks and familiarise yourself with the inventories
- Determine arrangements with management in advance
- Inventories held by/for third parties – what arrangements have been made?
- Review client's inventory count instructions
- Investigation of differences (where inventory records exist)
- Consider the need for an expert

(ii) Determine procedures to cover a representative selection of inventories

(b) **During**

- Ensure staff are following the inventory counting instructions
- Test counts from the inventories to the inventory sheets and from the inventory sheets to the inventories.
- Note damaged, old or obsolete inventories.
- Review WIP for stage of completion
- Inventories held by client for third parties: ensure excluded from count
- Record the number of the last GRN and the last GDN
- Form an overall impression of inventory levels
- Photocopy inventory sheets

(c) **After**

- Check sequence of inventory sheets
- Check client's computation of final figure
- Trace own test count items through to final inventory sheets
- Check replies from third parties

13: INVENTORY

- Inform management of any problems
- Follow up cut-off details
- Ensure necessary adjustments to book inventories have been made (where records are maintained).

Lecture example 1

Exam standard for 10 marks

Required

You have been provided with the following inventory count instructions by your client. Identify five matters that you believe will require action by management if the inventory count is to be effective. Explain how the matters could be rectified.

- (a) Mrs Ishbel Curbar, assistant chief accountant, has overall responsibility for the inventory count but she is to be assisted by Mr Jack Farditch, the warehouse manager, to whom the inventory counting teams are to report, and who will be responsible for the detailed organisation of the count.
- (b) Five inventory count teams are to carry out the actual count, each team to be responsible for a predetermined section of the warehouse. Each team comprises 2 persons, one from the accounting department and the other from the warehouse.
- (c) Each inventory count team is to meet Mr Farditch at 07.30 hours on 29 March 20X1 and will be provided with pre-numbered and pre-printed inventory sheets for the section of the warehouse for which they are responsible. These inventory sheets have been prepared by the inventory control department and show the balance of each inventory item on hand as shown on the inventory records held independently of the warehouse.
- (d) During the count both members of the inventory count team are to count the inventories independently of each other. In the event of differences arising between inventories counted and the quantity shown on the inventory sheets, the quantity counted is to be entered alongside the original quantity and must be initialled by the senior member of the count team.
- (e) Each inventory count sheet is to be signed by the senior member of the count team and the bin or rack cards held in the warehouse are to be adjusted, if necessary, to actual quantities counted. All cards are to be initialled to show that the count has been made.
- (f) Any goods that appear to be in poor condition are to be deducted from the quantity appearing on the inventory sheets, such action again to be supported by initials of the senior member of the count team.
- (g) Any queries during the count are to be referred to Mr Farditch to whom inventory sheets are to be returned at the conclusion of the count. Mr Farditch is responsible for ensuring that all inventory count sheets have been returned and for forwarding them to Mrs Curbar for valuation.

Solution

2 Continuous inventory counting/Perpetual inventory

- 2.1 Some businesses keep inventory records and if these are reliable a year end count is not required. To determine the reliability of the records, it is necessary for the business to count inventories on a regular basis. This is called continuous inventory counting or perpetual inventory.
- 2.2 (a) Review company's procedures
- Independence of counters
 - Frequency of counts
 - Ensure all lines covered at least once per year
 - Investigation of discrepancies
 - Updating of records
- (b) Attend at least one of the company's counts (to observe)
- (c) Review whole year's results
- Extent of counting
 - Accuracy of records
 - Reasons for discrepancies
 - Perform test counts at the year end

13: INVENTORY

Inventory valuation

- 2.3 (a) Record basis of valuation used
- (b) Test material costs
- Check to individual invoices
 - Ensure FIFO or appropriate basis being used
 - Check quantities used in WIP/FG
- (c) Test labour costs
- Check calculations to supporting documentation
 - Review costing against actual labour and production
- (d) Test application of overheads
- Ensure only production overheads included
 - Ensure based on normal levels of activity

Lecture example 2

Idea generation

Required

Can you think of any instances where NRV is likely to be lower than cost?

Solution

- 2.4 Tests to determine whether NRV is lower than cost .
- Check the selling prices of goods sold after the year end against their purchase invoices
 - Review order book to determine at what price the goods are ordered at
 - Background knowledge
 - Write downs last year – are these items still in inventory?

Inventories disclosure

- 2.5 (a) Accounting policies used in calculating
- Carrying value
 - Net realisable value

(b) Inventories should normally be sub-classified as

- Merchandise
- Production supplies
- Materials
- Work in progress
- Finished goods



Section 3

3 Cutoff

3.1 Cutoff is a test used to ensure that all of the company's transactions have been included in the correct period.



Q19 Sitting Pretty

3.2 *Purchases cutoff*

All purchases for which goods have been received before the year end must be included in the financial statements as a liability, expense and closing inventories.

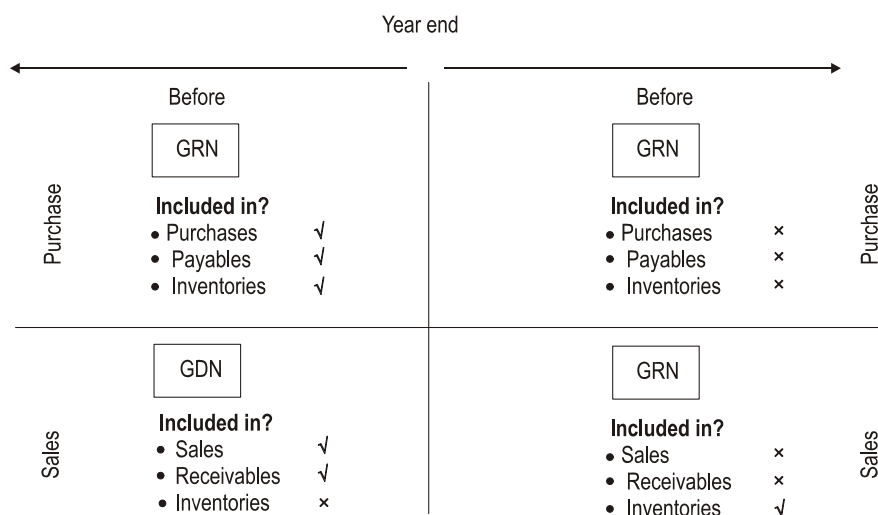
Goods received after the year end should not be included in the financial statements.

3.3 *Sales cutoff*

Sales for which the goods have left the warehouse should be included within the sales and trade receivables at the year end, but not in closing inventories.

Sales made after the year end must not be included in the financial statements but should be included in closing inventories.

3.4 Cutoff is usually tested by obtaining a sample of GRN and GDN either side of the year end and then matching them to purchase/ sales invoices to ensure they have been included in the correct account balance(s).



4 Chapter summary

- Procedures to verify the **quantity** of inventory will depend on whether the client uses a **year-end stock count** or a **continuous inventory** .
- The auditor will **attend the inventory count** to:
 - Perform tests of controls (observation)
 - Obtain substantive evidence of quantity (test counts, cut-off details)
 - Obtain preliminary evidence of valuation (note damaged or obsolete inventories)
- Procedures to audit the valuation of inventory must cover both **cost** and **valuation**.
- **Cut-off** tests are used to ensure that transactions have been recorded in the correct accounting period.

END OF CHAPTER

Liabilities and capital

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain the purpose of substantive procedures in relation to financial statement assertions.
- Explain the substantive procedures used in auditing each balance, and
- Tabulate those substantive procedures in a work program for:

Payables and accruals:

- (i) Supplier statement reconciliations and direct confirmation of accounts payable,
- (ii) Obtain evidence in relation to payables and accruals and long-term liabilities and
- (iii) The related income statement entries.

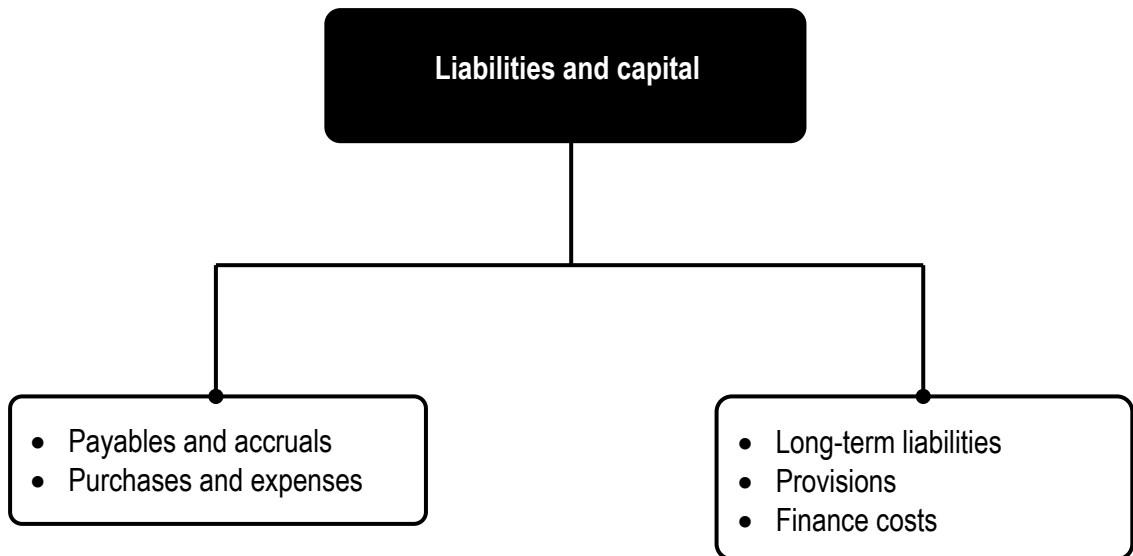
Exam Context

This is likely to be another major topic in practical questions on audit procedures. In the pilot paper, a total of 20 marks in the 30 mark case study question related to the audit of purchases and trade payables.

Qualification Context

This is another area where your accounting knowledge from the Financial Accounting paper (F3) will play a part. In the professional stage Advanced Audit and Assurance paper (P7) questions are likely to focus more on long-term liabilities and more complex financial instruments.

Overview



1 Payables and accruals

1.1 When testing payables, the auditor must focus on understatement.

1.2	Objective	Example tests
	(a) Existence	<ul style="list-style-type: none"> • Circularise/suppliers statements. • Cut-off tests – purchases/credit
	(b) Rights and obligations	<ul style="list-style-type: none"> • Circularise trade payables (the procedure is similar to that used for trade receivables). • Reconcile balance at year end to a supplier's statement. The reconciling items must be verified. <p>Both these tests also provide evidence of completeness and valuation.</p>
	(c) Completeness	<ul style="list-style-type: none"> • Review payables analytically comparing to previous year end or budgets. • Review goods received notes around the year end to ensure purchases correctly treated. • Review unpaid invoice files for liabilities not provided. • Review after date payments for liabilities not recorded. • Check the supplier statement reconciliations to ensure that all outstanding invoices are accrued.
	(d) Allocation and valuation	<ul style="list-style-type: none"> • Check closing accruals calculated in accordance with accounting policies and are consistent. • Check any provisions have been recognised in accordance with IAS37/FRS 12.

2 Non-current liabilities

2.1 This will include bank loans, debentures, and other loans repayable more than one year after the balance sheet date.

2.2	Objective	Example tests
	(a) Existence	<ul style="list-style-type: none"> • Obtain confirmation from banks and other lenders
	(b) Rights and obligations	<ul style="list-style-type: none"> • Review confirmation letters from lenders

14: LIABILITIES AND CAPITAL

- (c) **Completeness**
 - Obtain breakdown of liabilities, compare to prior year audit working papers and for any items no longer included agree to
 - Repayment amount in cashbook
 - Inclusion as current liability if reclassified
 - Review board minutes for evidence of any new borrowings which might not be recorded
- (d) **Accuracy**
 - Perform proof in total of finance charges
 - Agree capital and interest amounts to confirmation letters
 - Recalculate finance charges agreeing interest rates to loan agreements
- (e) **Classification and understandability**
 - Check that liabilities are correctly classified as current/non-current by reference to the repayment dates in the loan agreements



Section 4

3 Tests on provisions and contingencies

- 3.1 Obtain a detailed analysis of all provisions showing opening balances, movements and the closing balance. Also obtain details of all contingencies which have been disclosed.
- 3.2 For each material provision:
 - (a) Determine whether the company has a present obligation as a result of a past event by:
 - (i) Review of correspondence and other documentation relating to the item.
 - (ii) Discussion with the directors. Have they created a valid expectation in other parties that they will discharge the obligation? Review evidence of past practices, published policies and statements made.
 - (b) Determine whether it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation by:
 - (i) Checking whether any payments have been made in the post balance sheet period in respect of the item.
 - (ii) Review of correspondence with solicitors, banks, customers, insurance company and suppliers both pre and post year end.
 - (iii) Sending a letter to the solicitor to obtain their views (where relevant).
 - (iv) Discussing the position with similar past provisions with the directors. Were these provisions eventually settled?

- (c) Determine whether provisions represent the best estimate of liability by:
- (i) Recalculating all provisions made.
 - (ii) Comparing the amount provided with any post year end payments and with any amount paid in the past for similar items and considering opinions given by independent experts.
 - (iii) In the event that it is not possible to estimate the amount of the provision, check that this contingent liability is disclosed in the accounts.
- 3.3 Consider the nature of the client's business. Would you expect to see provisions e.g. warranties ?
- 3.4 For all material provisions and contingencies obtain a management representation.
- 3.5 Check that appropriate disclosures have been made in accordance with IAS 37/FRS 12.

4 Chapter summary

- The audit of liabilities will cover **payables and accruals**, and the related purchases and expenses in the income statement, as well as **long-term liabilities, provisions and finance costs**.
- Substantive tests on liabilities will cover all the financial statement assertions but with an emphasis on testing for **understatement**.
- A circularisation of trade payables may be carried out but is often not necessary as supplier statements will provide documentary evidence from third parties.
- **Bank letters** and **loan agreements** will be key evidence in respect of loans.
- Procedures on **provisions and contingencies** will focus on the criteria established in accounting standards for their recognition, ie
 - Is there a **present obligation** as a result of past events?
 - Is an outflow of benefits **probable**?
 - Has the amount been **estimated reasonably**?

END OF CHAPTER

Bank and cash

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain the purpose of substantive procedures in relation to financial statement assertions.
- Explain the substantive procedures used in auditing each balance, and
- Tabulate those substantive procedures in a work program for:

Bank and cash:

- (i) Bank confirmation reports used in obtaining evidence in relation to bank and cash
- (ii) Other evidence in relation to bank and cash, and
- (iii) The related income statement entries.

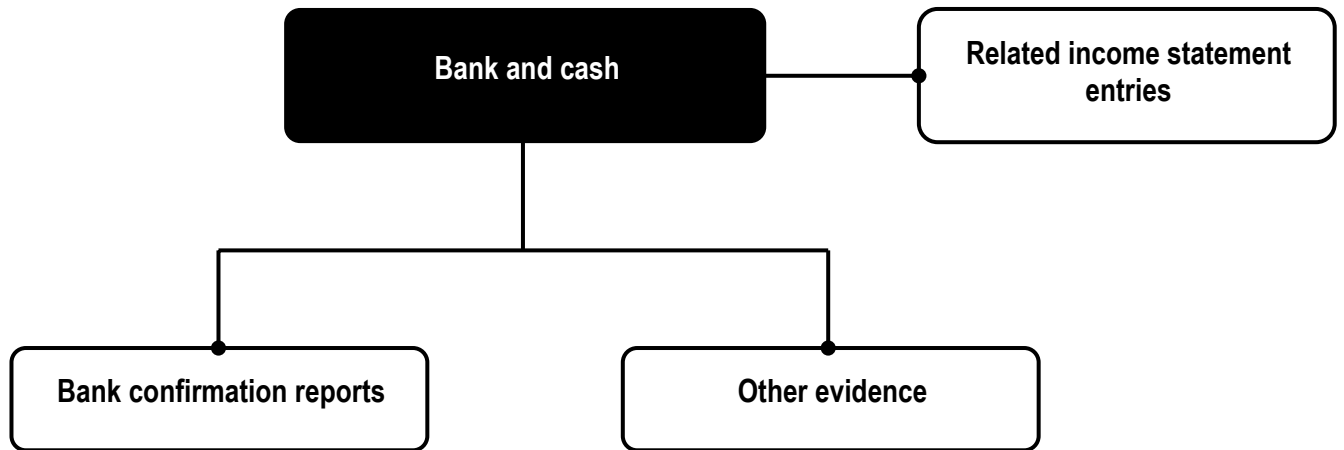
Exam Context

The audit of bank and cash is likely to appear in case study questions. Factual questions on the main contents of bank confirmation reports could appear in shorter requirements.

Qualification Context

In this area of the syllabus, your knowledge of accounting for bank and cash, including reconciliations as studied in the earlier accounting papers, will be relevant.

Overview



1 Bank and cash

1.1 Objective	<i>Example tests</i>
Existence	<ul style="list-style-type: none"> • Trace recorded assets and liabilities to bank confirmation of balances.
Rights and obligations	<ul style="list-style-type: none"> • Review bank letter to ensure valid title to accounts held.
Completeness/ Allocation and valuation	<ul style="list-style-type: none"> • Review bank confirmation letter for details of all accounts held. • Count petty cash balance. • Check casts of bank reconciliations. • Trace outstanding items to after date bank statements and ensure all subsequently cleared. • Review cashbook for unusual items.

Bank confirmations for audit purposes

Introduction

- 1.2 ISA 505 *External Confirmations* requires the auditor to determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. This includes bank balances.

A commonly adopted procedure in the audit of an entity's financial statements is for the auditor to obtain direct confirmation from the entity's banker(s) of balances and other amounts which appear in the balance sheet and other information which may be disclosed in the notes to the financial statements, for example off-balance sheet items such as guarantees and foreign exchange transactions. Bank confirmations are a valuable source of audit evidence because they provide independent evidence regarding the reliability of an entity's records.

Authority to disclose

- 1.3 Banks require the explicit written authority of their customers to disclose the information requested. This often takes the form of an ongoing standing authority rather than as a separate authority each time information is requested.

Bank confirmation process

- 1.4 The key steps to be taken by an auditor in initiating the process are as follows:
- (a) A request for a bank confirmation is to be issued on the auditors' own headed paper and sent to the bank branch with which the client has the prime business arrangement.

15: BANK AND CASH

- (b) The bank confirmation request should specify:
 - (i) The names of all entities covered by the request
 - (ii) Whether the auditor is requesting 'standard information'; and, where appropriate, the nature of supplementary information required
 - (iii) Details of 'additional information' if so required
 - (iv) The date for which the auditor is requesting confirmation (the audit confirmation date);
 - (v) A statement that the bank's response will not create a contractual relationship between the bank and the auditor
 - (vi) A statement requesting the bank to advise the auditor if the Authority is insufficient to allow the bank to provide full disclosure of the information requested; and
 - (vii) A contact name and telephone number.
- (c) The bank confirmation request should reach the branch at least two weeks in advance of the audit confirmation date.

2 Example bank confirmation letter – for information purposes only

Standard request for information

- 2.1 Local practices will vary in the way bank confirmations are requested and carried out. An example is shown below which demonstrates what used to be UK practice and it covers all the usual major areas where confirmation would be required.

	AB & Co Accountants 29 High Street London N10
The Manager Clearing Bank Ltd City Branch Dear Sir/Madam,	
.....(Name of customer)	
STANDARD REQUEST FOR BANK REPORT FOR AUDIT PURPOSES FOR THE YEAR ENDED	
In accordance with your above-named customer's instruction given	
(1) hereon)
(2) in the attached authority) Delete as appropriate
(3) in the authority date already held by you)
please send to us, as auditors of your customer for the purpose of our business, without entering into any contractual relationship with us, the following information relating to their affairs at your branch as at the close of business on and, in the case of items 2, 4 and 10 during the period since For each item, please state any factors which may limit the completeness of your reply; if there is nothing to report, state 'none'.	

We enclose an additional copy of this letter, and it would be particularly helpful if your reply could be given on the copy letter in the space provided (supported by an additional schedule stamped and signed by the bank where space is insufficient). If you find it necessary to provide the information in another form, please return the copy letter with your reply.

It is understood that any replies given are in strict confidence.

Information requested

Reply

Bank accounts

- (1) Please give full titles of all accounts whether in sterling or in any other currency together with the account numbers and balances thereon, including NIL balances:
- (a) where your customer's name is the sole name in the title;
 - (b) where your customer's name is joined with that of other parties;
 - (c) where the account is in a trade name.

NOTES

- (i) Where the account is subject to any restriction (e.g. a garnishee order or arrestment), this information should be stated.
 - (ii) Where the authority upon which you are providing this information does not cover any accounts held jointly with other parties, please refer to your customer in order to obtain the requisite authority of the other parties. If this authority is not forthcoming please indicate.
- (2) Full titles and dates of closure of all accounts closed during the period.
- (3) The separate amounts accrued but not charged or credited at the above date, of:
- (a) provisional charges (including commitment fees); and
 - (b) interest.
- (4) The amount of interest charged during the period if not specified separately in the bank statement.
- (5) Particulars (i.e. date, type of document and accounts covered) of any written acknowledgement of set-off, either by specific letter of set-off, or incorporated in some other document or security.
- (6) Details of:
- (a) overdrafts and loans repayable on demand, specifying dates of review and agreed facilities;
 - (b) other loans specifying dates of review and repayment;
 - (c) other facilities.

15: BANK AND CASH

Customer's assets held as security

- (7) Please give details of any such assets whether or not formally charge to the bank.
- If formally charged, give details of the security including the dates and type of charge. If a security is limited in amount or to a specific borrowing, or if there is to your knowledge a prior, equal or subordinate charge, please indicate.
- If informally charged, indicate nature of security interest therein claimed by the bank.
- Whether or not a formal charge has been taken, give particulars of any undertaking given to the bank relating to any assets.

Customer's other assets held

- (8) Please give full details of the customer's other assets held, including share certificates, documents of title, deed boxes and any other items in your Registers maintained for the purpose of recording assets held.

Contingent liabilities

- (9) All contingent liabilities, viz:
- (a) total of bills discounted for your customer, with recourse;
 - (b) date, name of beneficiary, amount and brief description of any guarantees, bonds or indemnities given to you by the customer for the benefit of third parties;
 - (c) date, name of beneficiary, amount and brief description of any guarantees, bonds or indemnities given by you, on your customer's behalf, stating where there is recourse to your customer and/or to its parent or any other company within the group;
 - (d) total of acceptances;
 - (e) total sterling equivalent of outstanding forward foreign exchange contracts;
 - (f) total of outstanding liabilities under documentary credits;
 - (g) others – please give details.

Other information

- (10) A list of other banks, or branches of your bank, or associated companies where you are aware that a relationship has been established during the period.

Yours faithfully,

.....
(Official stamp of bank)

.....
(Authorised signatory)

.....
(Position)

3 Chapter summary

- **Bank confirmation** letters are a reliable source of evidence in respect of the main financial statement assertions relating to bank and cash.
- The client's **bank reconciliation** must also be tested in detail, in order to verify that reconciling items are genuine.

END OF CHAPTER

Non-current assets

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain the purpose of substantive procedures in relation to financial statement assertions.
- Explain the substantive procedures used in auditing each balance, and
- Tabulate those substantive procedures in a work program for:

Tangible non-current assets:

- (i) Evidence in relation to non-current assets
- (ii) The related income statement entries.

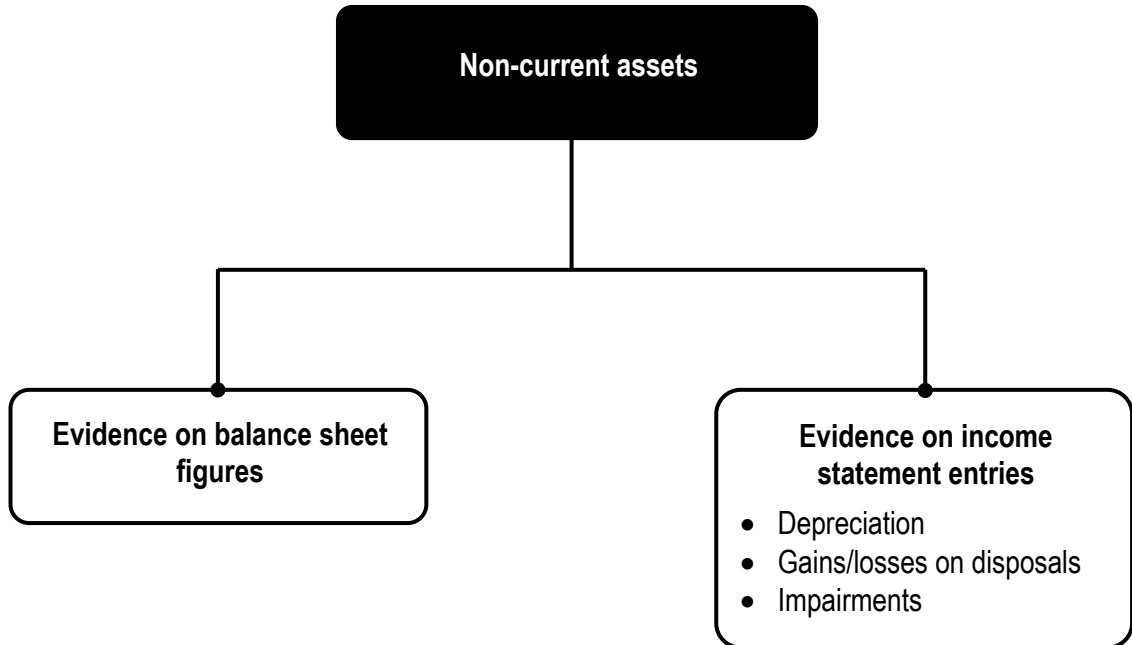
Exam Context

Tangible non-current assets are likely to feature regularly in case study questions about audit procedures.

Qualification Context

Knowledge brought forward from the Financial Accounting paper (F3) will be relevant here, particularly the principles of depreciation, revaluations and impairments. This area is likely also to be significant in the professional stage paper Advanced Audit and Assurance (P7).

Overview



1 Tangible fixed assets

Lecture example 1

<i>Audit/review objective</i>	<i>Example tests</i>
Existence	
Rights and Obligations	
Completeness	
Allocation and Valuation	See Lecture Examples 2 and 3

16: NON-CURRENT ASSETS

Allocation and valuation

- 1.1 When testing the valuation of property, plant and equipment in the financial statements, it is the IAS 16/FRS 15 disclosure note as follows that is being tested:

	<i>Land & Buildings</i>	<i>Furniture & Fixtures</i>	<i>Total</i>
<i>Net book value</i>			
Net book value at 1/1/20X1	1,600,000	420,000	2,020,000
Additions	400,000	–	400,000
Revaluation surplus	1,000,000	–	1,000,000
Charge for year	(60,000)	(60,000)	(120,000)
Disposals	(400,000)	–	(400,000)
Net book value at 31/12/20X1	<u>2,540,000</u>	<u>360,000</u>	<u>2,900,000</u>
<i>At 31 December 20X1</i>			
Cost or valuation	2,900,000	600,000	3,500,000
Accumulated depreciation	<u>(360,000)</u>	<u>(240,000)</u>	<u>(600,000)</u>
Net book value	<u>2,540,000</u>	<u>360,000</u>	<u>2,900,000</u>
<i>At 31 December 20X0</i>			
Cost or valuation	2,000,000	600,000	2,600,000
Accumulated depreciation	<u>(400,000)</u>	<u>(180,000)</u>	<u>(580,000)</u>
Net book value	<u>1,600,000</u>	<u>420,000</u>	<u>2,020,000</u>

Lecture example 2

Required

What tests would you perform on each area?

Solution

1 Opening balances?

2 Additions?

- 3 Revaluations? (assume an independent valuation)

- 4 Depreciation – charge for year?

- 5 Disposals?

Lecture example 3

Required

What work would you do to determine whether depreciation rates are reasonable?

Solution

2 Intangible non-current assets

2.1 Development expenditure

Our concern here is the work involved to ensure that the expenditure meets the IAS 38/SSAP 13 criteria that require capitalisation:

Probable future economic benefits

Intention to complete and use/sell asset

Resources adequate and available to complete and use/sell asset

Ability to use/sell the asset

Technical feasibility of completing asset for use/sale

Expenditure can be measured reliably.

2.2 Audit/review tests

- (a) Review the accounting records to ensure that the expenditure can be readily measured, eg separate cost centre or nominal ledger code.
- (b) Review invoices to verify materials expenditure on the project.
- (c) Verify wages costs to supporting documentation such as time sheets.
- (d) Discuss the technical feasibility with the company's engineers or technical staff.
- (e) Consider probability of future economic benefits and ability to sell or use the asset in relation to market research results, advance orders, budgets and forecasts.
- (f) Review budgeted revenues and costs. Ensure that they are reasonable based on results to date, discussion with directors, production forecasts and advance orders.
- (g) Review cash flow forecasts to ensure that adequate resources exist to complete the project. Discuss any shortfalls with the directors.
- (h) Obtain representations from management of their intention to complete the intangible asset and either use or sell it.

3 Chapter summary

- The main emphasis in the audit of non-current assets will be on the higher risk areas of:
 - Depreciation
 - Disposals
 - Impairments

END OF CHAPTER

Not-for-profit organisations

17

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Apply audit techniques to small not-for-profit organisations.
- Explain how the audit of small not-for-profit organisations differs from the audit of for-profit organisations.

Exam Context

Not-for-profit organisations will appear from time to time in the exam. They could form the basis of a scenario question where you would have to take care to address the practical requirements with regard to the context.

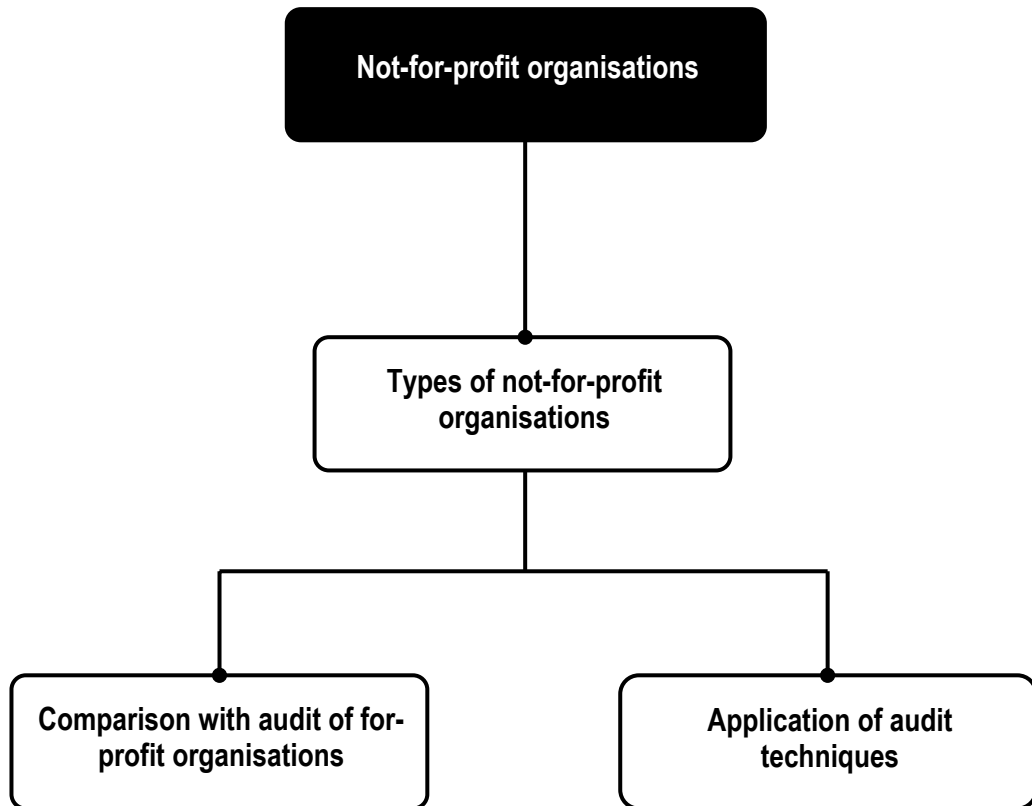
Qualification Context

This area is not specifically examinable in the professional stage paper Advanced Audit and Assurance (P7).

Business Context

Charities and other not-for-profit organisations handle large amounts of money donated by government bodies and private individuals. They must be accountable and act with integrity. Transparency in accounting is essential for these organisations, and the assurance given by an audit report can only help these organisations as they compete for funds.

Overview



1 Introduction

- 1.1 Examples of not-for-profit organisations include charities, clubs and societies. Their primary objective is not to generate profits.
- 1.2 Such organisations may fall within the scope of statutory audit if the entities concerned are limited liability companies.
- 1.3 Organisations not incorporated may require an assurance engagement due to the requirements of regulatory or governing bodies.



Section 2

2 Planning the audit

- 2.1 The planning procedures undertaken for not-for-profit organisations will differ very little from those for profit making organisations.
- 2.2 However, the auditor should have specific regard to any laws, regulations or guidelines imposed on the entity by any regulatory body.
- 2.3 The scope of the auditor's work will be detailed in the engagement letter.

3 Risk assessment

- 3.1 The auditor should, during the planning stage, fully assess the risks associated with the not-for-profit organisation.

3.2 INHERENT RISK

Key factors to consider include:

- The complexity and extent of regulation
- The significance of donations and cash receipts
- Restrictions imposed by the objectives and powers given by the entity's governing documents
- The sensitivity of certain key statistics such as proportion of resources used in administration
- The need to maintain adequate resources whilst avoiding the build up of resources which could appear excessive

3.3 CONTROL RISK

Key factors to consider include:

- Competence, training and qualification of paid staff and volunteers
- Segregation of duties
- Reliability of accounting systems / computer systems
- Controls over compliance with laws and regulations
- Power of trustees



Section 3

4 Audit evidence

4.1 When designing substantive procedures for not-for-profit organisations, the auditor should give special attention to the possibility of:

- Understatement of income, including gifts in kind, cash donations and legacies
- Incorrect accounting treatment of lifetime subscriptions
- Overstatement of cash grants or expenses
- Misanalysis or misuse of funds
- Misstatement or omission of assets including donated properties
- Misallocation of expenses to disguise excessive administration expenditure



Q23 'Tap!'

5 Reporting

5.1 For incorporated not-for-profit organisations, the reporting requirements of ISA 700 *the independent auditor's report on a complete set of general purpose financial statements* apply.

5.2 Additionally, the reporting requirements of the governing body will need to be encompassed in the auditor's report.

5.3 For organisations not incorporated under statute, the auditor or review report will be determined in accordance with the terms of appointment detailed in the letter of engagement.

Lecture example 1

Exam standard for 4 marks

'Save the Accountants' is a charitable foundation set up to provide financial assistance to accountants who have fallen on hard times. Its principal sources of income are:

- Cash donations collected on the high streets of major towns
- Regular donations by the 'Big 4' accountancy firms
- Annual donations by wealthy individuals.

Required

What audit procedures would you do to test the completeness of income?

Solution

6 Chapter summary

- Not-for profit organisations include **charities, clubs and societies**
- Particular **risk** areas for the auditor of not-for-profit entities are:
 - Complexity of regulation
 - High level of cash receipts
 - Competence of staff and volunteers
 - Segregation of duties
- The audit approach is likely to be mainly **substantive**

END OF CHAPTER

Audit review and finalisation

18

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain the purpose of a subsequent events review.
- Discuss the procedures to be undertaken in performing a subsequent events review.
- Define and discuss the significance of the concept of going concern.
- Explain the importance of and the need for going concern reviews.
- Explain the respective responsibilities of auditors and management regarding going concern.
- Discuss the procedures to be applied in performing going concern reviews.
- Discuss the disclosure requirements in relation to going concern issues.
- Discuss the reporting implications of the findings of going concern reviews.
- Explain the purpose of and procedure for obtaining management representations.
- Discuss the quality and reliability of management representations as audit evidence.
- Discuss the circumstances where management representations are necessary and the matters on which representations are commonly obtained.
- Discuss the importance of the overall review of evidence obtained.
- Explain the significance of unadjusted differences.

Exam Context

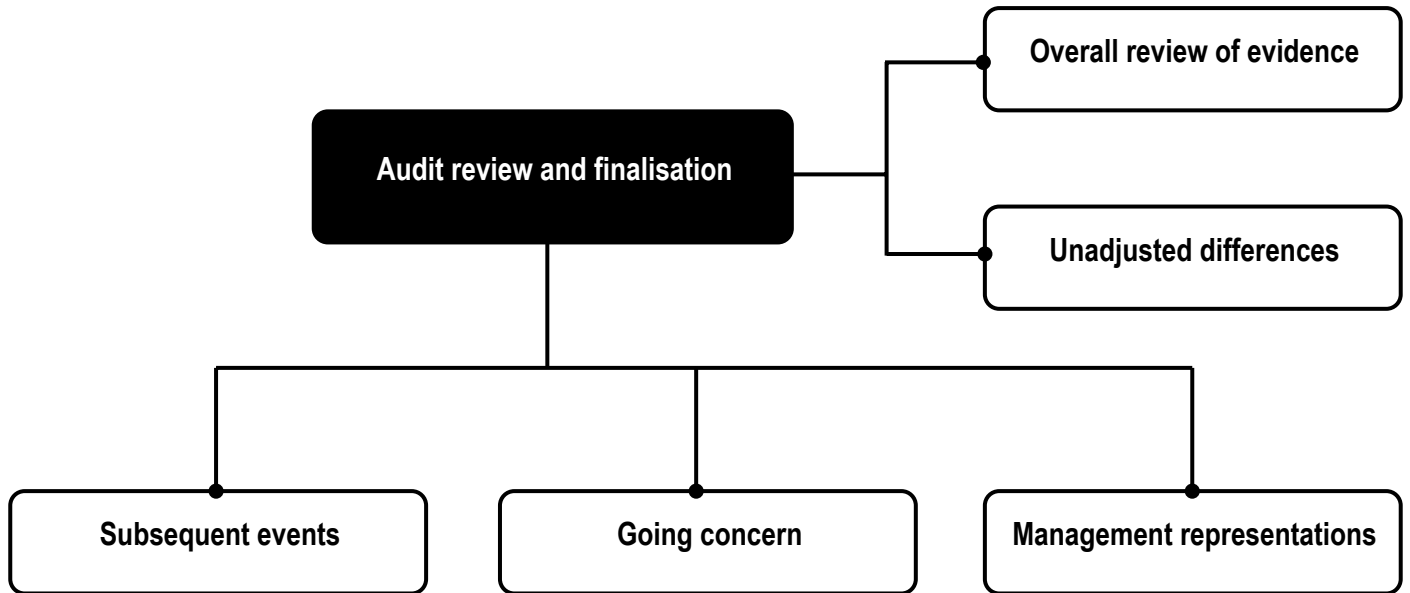
All of these topics are likely to appear regularly in the exam. Short factual requirements could be used to test your understanding of the relevant auditing standards, topics of going concern and subsequent event also lend themselves to larger practical question.

The pilot paper included a 20 mark question linking a subsequent events review with audit reporting.

Qualification Context

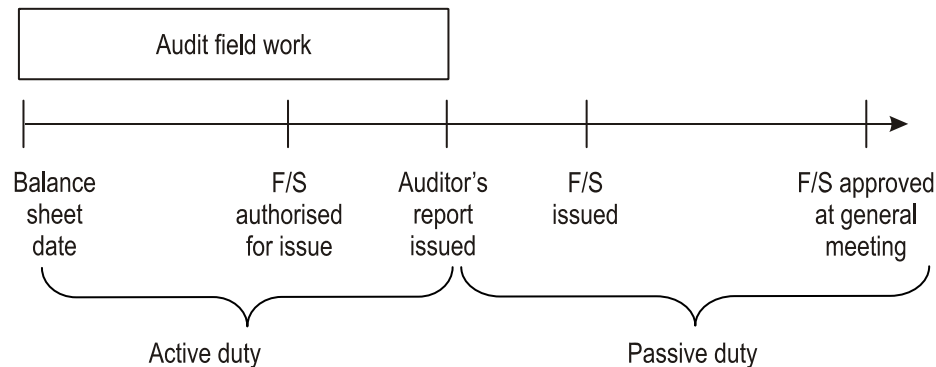
Your knowledge of the accounting issues related to events after the balance sheet date and going concern from the Financial Accounting paper (F3) will be important here. All the topics related to audit review and finalisation continue to be important elements of the syllabus for the professional stage Advanced Audit and Assurance paper (P7) where they are likely to appear in more complex scenarios.

Overview



1 ISA 560 – Subsequent events

- 1.1 The auditor should consider the effect of subsequent events on the financial statements and on the auditor's report.



Events occurring up to the date of the auditor's report

- 1.2 The auditor should perform audit procedures designed to provide sufficient appropriate audit evidence that all material subsequent events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified, properly accounted for or adequately disclosed.

Facts discovered after the date of the auditor's report but before the financial statements are issued

- 1.3 When, after the date of the auditor's report but before the financial statements are issued, the auditor becomes aware of a fact which may materially affect the financial statements, the auditor should consider whether the financial statements need amendment, should discuss the matter with management, and should take the action appropriate in the circumstances.
- 1.4 When management does not amend the financial statements in circumstances where the auditor believes they need to be amended (and the audit report has not been released to the entity), the auditor should express a qualified or adverse opinion.

Facts discovered after the financial statements have been issued

- 1.5 When, after the financial statements have been issued, the auditor becomes aware of a fact which existed at the date of the auditor's report and which, if known at that date, may have caused the auditor to modify the auditor's report, the auditor should consider whether the financial statements need revision, should discuss the matter with management, and should take action appropriate to the circumstances.
- 1.6 The new auditor's report should include an emphasis of matter paragraph referring to a note in the financial statements that more extensively discusses the reason for the revision of the previously issued financial statements and to the earlier report issued by the auditor.

Audit procedures to identify subsequent events

- 1.7 (a) Review the procedures management has established to ensure that subsequent events are identified.
- (b) Read minutes of the meetings of shareholders, those charged with governance, including established committees such as relevant executive committees and the audit committee, held after the date of the financial statements and enquire about matters discussed at meetings for which minutes are not yet available.
- (c) Read the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports.
- (d) Enquire, or extend previous oral or written enquiries, of the entity's legal counsel concerning litigation and claims.
- (e) Enquire of management as to whether any subsequent events have occurred which might affect the financial statements.

2 ISA 570 – Going concern

- 2.1 When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of management's use of the going concern assumption underlying the preparation of the financial statements.
- 2.2 Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations.
- 2.3 Management's assessment of the entity's ability to continue as a going concern should cover a period of at least 12 months after period end.
- 2.4 In obtaining an understanding of the entity, the auditor should consider whether there are events or conditions and related business risks which may cast significant doubt on the entity's ability to continue as a going concern.
- 2.5 Based on the audit evidence obtained, the auditor should determine if, in his judgement, a material uncertainty exists related to events or conditions that alone or in aggregate, may cast significant doubt on the entity's ability to continue as a going concern.
- 2.6 Examples of events or conditions, which may cast significant doubt on the going concern assumption include:

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance non-current assets.
- Indications of withdrawal of financial support by debtors and other creditors.

- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operational

- Loss of key management without replacement.
- Loss of a major market, franchise, license, or principal supplier.
- Labour difficulties or shortages of important supplies.

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied.
- Changes in legislation or government policy expected to adversely affect the entity.

2.7 Relevant audit procedures may include:

- (a) Analysing and discussing cash flow, profit and other relevant forecasts with management.
- (b) Analysing and discussing the entity's latest available interim financial statements.
- (c) Reviewing the terms of debentures and loan agreements and determining whether any have been breached.
- (d) Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- (e) Enquiring of the entity's lawyer regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- (f) Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- (g) Considering the entity's plans to deal with unfilled customer orders.
- (h) Reviewing events after period end to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.

18: AUDIT REVIEW AND FINALISATION

2.8 When analysis of cash flow is a significant factor in considering the future outcome of events or conditions the auditor considers:

- The reliability of the entity's information system for generating such information, and
- Whether there is adequate support for the assumptions underlying the forecast.

In addition the auditor compares:

- The prospective financial information for recent prior periods with historical results, and
- The prospective financial information for the current period with results achieved to date.

2.9 The auditor will form his opinion on the going concern status of the company based on the outcome of the above.

Lecture example 1

Preparation

Required

From the scenario below identify features which might cause you to have doubts about Truckers' going concern status:

You are planning the audit of Truckers Co whose principal activities are road transport and warehousing services, and the repair of commercial vehicles. You have been provided with the draft accounts for the year ended 31 October 20X2.

	Draft 20X2 \$'000	Actual 20X1 \$'000
Summary income statement		
Revenue	10,971	11,560
Cost of sales	(10,203)	(10,474)
Gross profit	<u>768</u>	<u>1,086</u>
Administrative expenses	(782)	(779)
Finance costs	(235)	(185)
Profit/(loss) for the period	<u>(249)</u>	<u>122</u>
Summary balance sheet		
<i>Non-current assets</i>	<u>5,178</u>	<u>4,670</u>
<i>Current assets</i>		
Inventories of parts and consumables	95	61
Receivables	<u>2,975</u>	<u>2,369</u>
	<u>3,070</u>	<u>2,430</u>
	<u>8,248</u>	<u>7,100</u>
<i>Share capital and reserves</i>	3,544	3,793
<i>Non-current liabilities</i>		
Bank loan	750	1,000
Finance lease liabilities	473	—
	<u>1,223</u>	<u>1,000</u>

<i>Current liabilities</i>		
Bank loan	250	–
Overdraft	1,245	913
Trade payables	1,513	1,245
Finance lease liabilities	207	–
Other payables	203	149
	<u>3,481</u>	<u>2,307</u>
	<u>8,248</u>	<u>7,100</u>

You have been informed by the managing director that the fall in revenue is due to:

- The loss, in July, of a long-standing customer to a competitor; and
- A decline in trade in the repair of commercial vehicles.

Due to the reduction in the repairs business, the company has decided to close the workshop and sell the equipment and spares inventories. No entries resulting from this decision are reflected in the draft accounts.

During the year, the company replaced a number of vehicles funding them by a combination of leasing and an increased overdraft facility. The facility is to be reviewed in January 20X3 after the audited accounts are available.

The draft accounts show a loss for 20X2 but the forecasts indicate a return to profitability in 20X3 as the managing director is optimistic about generating additional revenue from new contracts.

Solution

Lecture example 2

Preparation

Effect on the auditor's report

Required

What will be the impact on the auditor's report in each of the following situations?

- (a) The auditor believes that the company is not a going concern but the directors believe that it is. The directors refuse to amend the financial statements.
- (b) The auditor has a significant level of concern regarding the going concern basis but they do not disagree with its use. Appropriate disclosures have been made in the financial statements.

Solution

3 ISA 580 – Management representations

- 3.1 The auditor should obtain appropriate representations that management acknowledges its collective responsibility for the fair presentation of the financial statements in accordance with the applicable financial reporting framework, and has approved the financial statements
- 3.2 The auditor should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

Audit evidence

- 3.3 The representations should relate to matters where they are critical to obtaining sufficient appropriate audit evidence. Representations cannot be a substitute for other audit evidence that auditors expect to be available.
- 3.4 They should be restricted to matters where the auditor is unable to obtain independent corroborative evidence and could not reasonably expect it to be available. For example,
- Where knowledge of facts confined to management, eg management's intentions.
 - Where the matter is principally one of judgement, eg whether a receivable is a doubtful debt or not.

Procedures

- 3.5 (a) Agree procedures at early stage (e.g. letter of engagement).
- (b) Discuss letter with client first.
- (c) Usually signed by senior executive officer and senior financial officer on behalf of board.
- (d) Should be minuted.
- (e) Dated – after all other audit work completed but before signing of the auditor's report.

If the client refuses to sign

- 3.6 (a) Auditor should write letter setting out his understanding and ask for management confirmation.
- (b) If management does not reply, auditor should follow up to ascertain that his understanding is correct.
- (c) If management refuses to provide a representation that the auditor considers necessary, this constitutes a scope limitation and the auditor should express a qualified opinion or disclaimer of opinion.

- 3.7 Example of a management representation letter

The following is not intended to be a standard letter. Representations by management will vary from one entity to another and from one period to the next.

18: AUDIT REVIEW AND FINALISATION

(Entity letterhead)	(Date)
(To Auditor)	
<p>This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended December 31, 20X1 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view of (or 'present fairly in all material respects,') the financial position of ABC Company as of December 31, 20X1 and the results of its operations and its cash flows for the year then ended in accordance with (indicate applicable financial reporting framework).</p> <p>We acknowledge our responsibility for the fair presentation of the financial statements in accordance with (indicate applicable financial reporting framework).</p> <p>We confirm, to the best of our knowledge and belief, the following representations:</p> <p>Include here representations relevant to the entity. Such representations may include:</p> <ul style="list-style-type: none">• <i>There have been no irregularities involving management or employees who have a significant role in internal control or that could have a material effect on the financial statements</i>• <i>We have made available to you all books of account and supporting documentation and all minutes of meetings of shareholders and the board of directors (namely those held on March 15, 20X1 and September 30, 20X1, respectively).</i>• <i>We confirm the completeness of information provided regarding identification of related parties.</i>• <i>The financial statements are free of material misstatements, including omissions.</i>• <i>The Company has complied with all aspects of contractual agreements that could have a material effect of the financial statements in the event of noncompliance.</i>• <i>There has been no noncompliance with requirements of regulatory authorities that could have a material effect on the financial statements in the event of noncompliance.</i>• <i>The following have been properly recorded and when appropriate adequately disclosed in the financial statements:</i><ul style="list-style-type: none">(a) <i>The identity of, and balances and transactions with, related parties.</i>(b) <i>Losses arising from sale and purchase commitments.</i>(c) <i>Agreements and options to buy back assets previously sold.</i>(d) <i>Assets pledged as collateral.</i>• <i>We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities reflected in the financial statements.</i>	
<ul style="list-style-type: none">• <i>We have no plans to abandon lines of product or other plans or intentions that will result in any excess or obsolete inventory, and no inventory is stated at an amount in excess of net realisable value.</i>	

- *The Company has satisfactory title to all assets and there are no liens or encumbrances on the company's assets, except for those that are disclosed in Note X to the financial statements.*
- *We have recorded or disclosed, as appropriate, all liabilities, both actual and contingent, and have disclosed in Note X to the financial statements all guarantees we have given to third parties.*
- *Other than ... described in Note X to the financial statements, there have been no events subsequent to period end which require adjustment of or disclosure in the financial statements or Notes thereto.*
- *The ... claim by XYZ Company has been settled for the total sum of XXX which has been properly accrued in the financial statements. No other claims in connection with litigation have been or expected to be received.*
- *There are no formal or informal compensating balance arrangements with any of our cash and investment accounts. Except as disclosed in Note X to the financial statements, we have no other line of credit arrangements.*
- *We have properly recorded or disclosed in the financial statements the capital stock repurchase options and agreements, and capital stock reserved for options, warrants, conversions and other requirements.*

(Senior Executive Officer)

(Senior Financial Officer)

4 Overall review of financial statements

4.1 The auditor should carry out such a review of the financial statements as is sufficient in conjunction with the conclusion drawn from the other audit evidence obtained, to give him a reasonable basis for their opinion on the financial statements.

4.2 The review will determine whether

- Financial statements are prepared using *acceptable accounting policies, consistently applied* and *appropriate* to the entity (see 1.3).
- Information included in financial statements is *compatible* with audit findings
- Adequate *disclosure* and proper classification and presentation of information
- Financial statements comply with *statutory requirements* and *other regulations*

This review along with conclusions drawn from other tests enables him to form an opinion on the financial statements

4.3 When considering whether the accounting policies are appropriate, auditors should consider:

- Policies commonly adopted in particular industries;
- Policies for which there is substantial authoritative support;
- Whether any departures from applicable accounting standards are necessary for the financial statements to give a true and fair view;
- Whether the financial statements reflect the substance of the underlying transactions and not merely their form.



Section 4.5

Unadjusted differences

4.4 During the audit, a schedule will have been maintained of errors identified that have not been corrected by the client.

Some of these may have been individually immaterial but the schedule must be reviewed at this stage before the audit opinion is finalised. The effect of the unadjusted differences must be considered in aggregate as their combined effect may be material and thus could affect the audit opinion.

5 Chapter summary

- The auditor has a duty to perform procedures to identify **subsequent events** up to the date of the auditor's report.
- If further events are discovered after the date of the report the auditor should discuss with client management and take appropriate action.
- The auditor must consider the appropriateness of the **going concern** assumption.
- The auditor should obtain **management representations** on material matters where
 - Knowledge of the facts is confined to management, and
 - The matter involves judgement
- Before issuing the audit opinion, the auditor should carry out an **overall review** of the financial statements.

END OF CHAPTER

Reports

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Describe and analyse the format and content of unmodified audit reports.
- Describe and analyse the format and content of modified audit reports.
- Identify and analyse internal control and system weaknesses and their potential effects and make appropriate recommendations to management.
- Describe and explain the format and content of internal audit review reports and other reports dealing with the enhancement of performance.

Exam Context

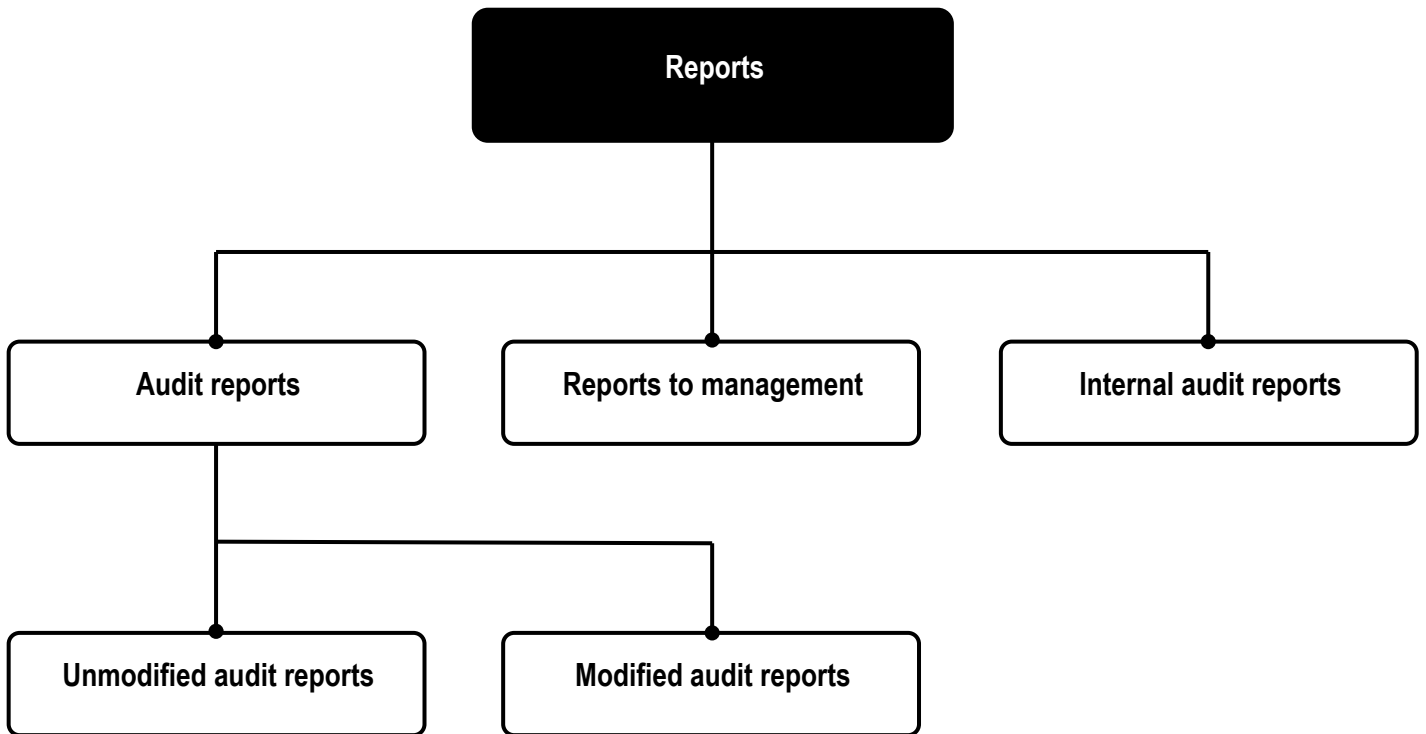
As a report is the end product of any type of audit or assurance assignment, this syllabus area is likely to be tested frequently. The pilot paper includes a 3 mark requirement on auditor's report modifications in a factual question, as well as a 6 mark requirement requiring discussion of whether an audit report should be modified in a specific scenario.

Questions may also be set requiring you to comment on the appropriateness of a given audit report in specific circumstances.

Qualification Context

Questions on auditor's reports often drawn on your knowledge from the Financial Accounting paper (F3). In the professional stage Advanced Audit and Assurance paper (P7) this syllabus area continues to be very important and is broadened out to cover reports on a wider range of assignments.

Overview





Read whole
chapter in stream-
specific text

1 ISA 700 (revised): The auditor's report on financial statements

- 1.1 The auditor's report should contain a clear written expression of opinion, in the financial statements taken as a whole.



Q27 Builders
Merchants

Basic elements of the auditor's report

- 1.2 The auditor's report should include the following basic elements, normally in this layout:
- (a) Title
 - (b) Addressee
 - (c) Introductory paragraph
 - (d) Managements' responsibility for the financial statement
 - (e) Auditor's responsibility
 - (f) Auditor's opinion
 - (g) Other reporting responsibilities
 - (h) Auditor's signature
 - (i) Date of the auditor's report
 - (j) Auditor's address

19: REPORTS

Example 1

Basic Unqualified Report

1.3 •

INDEPENDENT AUDITOR'S REPORT

(APPROPRIATE ADDRESSEE)

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of the significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risk of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

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

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

- An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the identified financial reporting framework.
An unqualified opinion also indicates implicitly that any changes in accounting policies or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.
In addition to the opinion on the true and fair view, the auditor's report may need to include an opinion as to whether the financial statements comply with other requirements specified by statutes and law.

Definitions

1.4 The IFAC 'Glossary of Terms' defines the following items:

- *Financial statements*: the balance sheets, income statements or profit and loss accounts, statements of changes in financial position (which may be presented in a variety of ways, for example a statement of cash flows or a statement of fund flows), notes and other statements and explanatory material which are identified as being part of the financial statements.
- *Materiality*: Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cutoff point rather than being a primary qualitative characteristic which information must have if it is to be useful.

2 Modified audit reports: Matters that do not affect the auditor's opinion

Emphasis of matter

- 2.1 An auditor's report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements which more extensively discusses the matter.
- 2.2 This emphasis of matter paragraph is used in the following two main circumstances:
- To highlight a material matter regarding a going concern problem
 - If there is significant uncertainty (other than a going concern problem) which may affect the financial statements on its future resolution
- The additional paragraph should be added *after* the opinion paragraph. This paragraph will start by stating 'Without qualifying our opinion...' It will then go on to describe the issue and make a reference to the note in the financial statements which explains the issue further.
- 2.3 Note, this does *not* change the auditor's opinion – it is still unqualified. It merely serves to highlight something significant, that may, or may not affect the company in the future.
- 2.4 Where there are many uncertainties the auditor may feel it is appropriate to express a disclaimer of opinion instead.

Example 2

Unqualified opinion with emphasis of matter paragraph for a significant uncertainty

"In our opinion...(remaining words are the same as illustrated in the opinion paragraph – Example 1 above)

Without qualifying our opinion we draw attention to Note X to the financial statements. The company is the defendant in lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements".

3 Modified reports: Matters that do affect the auditor's opinion

- 3.1 An auditor may not be able to express an unqualified opinion in the following two circumstances:
- There is a limitation on the scope of the auditor's work; or

- There is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of the financial statement disclosures.

Two degrees of materiality

- 3.2
- Material, but not pervasive
 - Pervasive
 - For limitation on scope, could make the accounts misleading (and so are meaningless)
 - For disagreement, makes the accounts misleading – the financial statements do not give a true and fair view.

	Material	Pervasive
Limitation on scope	Qualified 'Except for'	Disclaimer
Disagreement	Qualified 'Except for'	Adverse

4 Limitation on scope

- 4.1 A limitation on the scope of the auditor's work may occur in three ways:
- The entity does not allow the auditor to perform an audit procedure that he believes is necessary;
 - The auditor is unable to perform procedures due to circumstances, e.g. when the auditor is appointed too late to attend the inventory count; or
 - The entity's records are inadequate and the auditor is unable to satisfy himself as to their accuracy by other means.
- 4.2 The auditor's report should include an explanatory paragraph *before* the opinion paragraph covering:
- A description of the limitation; and
 - An indication of the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.
- 4.3 The auditor should issue a disclaimer of opinion when the possible effect of a limitation on scope is so material or pervasive that they are unable to express an opinion on the financial statements

A qualified opinion should be issued when the effect of the limitation is not so material or pervasive as to require a disclaimer.



Example 3

Qualified opinion: material limitation on scope

“We have audited...(remaining words are the same as illustrated in the introductory paragraph – Example 1 above).

Management is responsible for (remaining words are the same as illustrated in the management's responsibility paragraph – Example 1 above).

Our responsibility is to express an opinion on these financial statements based on our audit. *Except as discussed in the following paragraph*, we conducted our audit in accordance with (remaining words are the same as illustrated in the auditor's responsibility paragraphs – Example 1 above).

We did not observe the counting of the physical inventories as of December 31, 20X1, since that date was prior to the time we were initially engaged as auditors for the Company. Owing to the nature of the Company's records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures.

In our opinion, *except for the effects of such adjustments, if any, as might have been determined to be necessary had been able to satisfy ourselves as to physical inventory quantities* the financial statements give a true and...(remaining words are the same as illustrated in the opinion paragraph – Example 1 above).”

Example 4

Disclaimer of opinion: pervasive limitation on scope

“*We were engaged to audit* the accompanying balance sheet of the ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of the significant accounting policies and other explanatory notes.

Management is responsible for (remaining words are the same as illustrated in the management's responsibility paragraph – Example 1 above).

(Omit the sentence stating the responsibility of the auditor)

(The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances).

(Add a paragraph discussing the scope of limitation as follows:

We were not able to observe all physical inventories and confirm account receivable due to limitations placed on the scope of our work by the Company.)

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements.”

5 Disagreement

- 5.1 The auditor may disagree with management about matters such as:
- The acceptability of accounting policies
 - The application of those policies
 - The adequacy of disclosures
- 5.2 The auditor expresses a *qualified* opinion if the disagreement is material or an *adverse* opinion if the disagreement so material and pervasive that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.
- 5.3 An explanatory paragraph should be added *before* the opinion paragraph covering
- Description of the disagreement
 - Quantification of the effect on the financial statements

Example 5

Qualified opinion: disagreement on accounting policies – inappropriate accounting method

“We have audited...(remaining words are the same as illustrated in the introductory paragraph – Example 1 above).

Management is responsible for (remaining words are the same as illustrated in the management's responsibility paragraph – Example 1 above).

Our responsibility is to (remaining words are the same as illustrated in the management's responsibility paragraph – Example 1 above).

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Financial Reporting Standards. The provision for the year ended December 31, 20X1, should be xxx based on the straight-line method of depreciation using annual rates of 5% for the building and 20% for the equipment. Accordingly, the non-current assets should be reduced by accumulated depreciation of xxx and the loss for the year and retained losses should be increased by xxx and xxx, respectively.

In our opinion, *except for the effect on the financial statements of the matter referred to in the preceding paragraph*, the financial statements give a true and...(remaining words are the same as illustrated in the opinion paragraph – Example 1 above).”

Example 6

Qualified opinion: disagreement on accounting policies – inadequate disclosure

“We have audited...(remaining words are the same as illustrated in the introductory paragraph – Example 1 above)

Management is responsible for (remaining words are the same as illustrated in the management's responsibility paragraph – Example 1 above).

Our responsibility is to (remaining words are the same as illustrated in the management's responsibility paragraph – Example 1 above).

On January 15, 20X2, the company issued debentures in the amount of xxx for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 20X1. In our opinion, disclosure of this information is required by ...

In our opinion, except for the omission of the information included in the preceding paragraph, the financial statements give a true and...(remaining words are the same as illustrated in the introductory paragraph – Example 1 above) .”

Example 7

Adverse opinion



“We have audited...(remaining words are the same as illustrated in the introductory paragraph – Example 1 above)

Management is responsible for (remaining words are the same as illustrated in the management's responsibility paragraph – Example 1 above).

Our responsibility is to (remaining words are the same as illustrated in the management's responsibility paragraph – Example 1 above).

(Paragraph(s) discussing the disagreement)

In our opinion, because of the effects of the matters discussed in the preceding paragraph(s), the financial statements do not give a true and fair view of (or do not 'present fairly, in all material respects,') the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.”

Lecture example 1

Preparation

Required

During the audit of XYZ Co it comes to your attention that the company has valued a certain inventory line at its total cost price of \$7,000. These inventory items have not been sold for a number of years and it is unlikely that they can be sold in the future unless the price is reduced to \$3,000. If the write-down was charged it would have a material effect on the financial statements. How will this affect the auditor's report?

Solution**Lecture example 2**

Preparation

Required

During the audit of Godfather Co, you discover that the company has not kept any records relating to their cash sales. The company has pre-tax profits of \$500,000 and cash sales total \$100,000. The company has total sales of \$1m. What effect will the above have on the auditor's report?

Solution

6 Reports to management

The form and content of these reports were covered in Chapter 9.

7 Internal audit reports

The form and content of these reports were covered in Chapter 5.

8 Chapter summary

- The elements of the auditors report are specified by **ISA 700**.
- Auditor's report may be **unmodified** or **modified**.
- A report may be modified by an **emphasis of matter**, which does not affect the opinion.
- Modifications that do affect the opinion can arise from either a **limitation on scope** or a **disagreement**.

END OF CHAPTER

Answers to Lecture Examples



Chapter 1

Answer to Lecture Example 1

- Potential investors
- Current and potential lenders
- Employees
- Customers
- Suppliers
- Tax authorities

Chapter 2

Answer to Lecture Example 1

- (a) Shareholders are the primary users of the auditor's report. Its main purpose is to give assurance on the financial statements. This should allow shareholders to place more reliance on the information in the financial statements.

It is important that shareholders understand the nature of the audit opinion, in particular that it is not an absolute guarantee of accuracy, but rather that it gives reasonable assurance that the financial statements are free from material misstatements.

- (b) The main output of the external audit is the auditor's report, giving assurance on the information in the financial statements. In order to give that opinion, the auditor will have found out about the business, considered the risks it faces, and found out something about its systems and controls.

It is not the objective of the external auditor to advise management on reducing risk and improving performance, but if in the course of performing the audit, the auditor discovers a systems weakness or some other inefficiency, they should report this directly to the company's management.

Chapter 3

Answer to Lecture Example 1

Matters the auditor would normally communicate include:

- Relationships that may bear on the firm's independence and the relevant safeguards in place
- The general approach and overall scope of the audit
- The selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the financial statements
- The potential effect on the financial statements of material risks and exposures
- Audit adjustments
- Material uncertainties that may cast doubt on the entity's ability to continue as a going concern
- Disagreements with management about matters that, individually or in aggregate, could be material to the financial statements or the auditor's report
- Expected modifications to the auditor's report
- Material internal control weaknesses

- Questions regarding management integrity
- Fraud involving management
- Other matters warranting attention or agreed in the engagement letter

Chapter 4

Answer to Lecture Example 1

<i>Threat</i>	<i>Safeguards</i>
<p>1 This represents a familiarity threat. Renato is likely to have got to know the directors of Assynt very well over the years and could come to put too much trust in what they tell him</p>	<p>The firm should have a policy of rotation of partners limiting the number of years an individual partner remains responsible for a client.</p>
<p>2 This could be viewed as a combination of an intimidation threat and a self-interest threat. The directors could use the outstanding fees as a means of pressuring the audit firm into giving a favourable audit opinion.</p> <p>The auditors' self-interest could lead them to issue a favourable opinion rather than risk losing the amounts owed to them.</p>	<p>The firm should:</p> <ul style="list-style-type: none"> • Use normal credit control procedures to chase payment of all overdue balances. • Have a policy of refusing to start any new work for a client until overdue bills have been paid.
<p>3 This involves a self-interest threat and a familiarity threat. The auditors may wish to continue enjoying lavish hospitality so may be reluctant to raise any problems in their report. In addition, involvement in social events with the client is likely to increase the audit staff's familiarity with the client staff and make them likely to accept explanations without adequate questioning.</p>	<p>The firm should establish policies in respect of hospitality offered by clients, probably in terms of a maximum value threshold.</p>

Chapter 5

Answer to Lecture Example 1

Objective

ECONOMY

Base materials, containers and packing materials bought at best price for necessary quality

Good value quality labour

Control

- Regular price checking
- Tendering
- Existence of preferred suppliers list
- Training schemes
- Location of operations

Accommodation costs minimised

- Location
- Regular review of space usage

EFFICIENCY

Production process minimises waste

- Recycling of base materials
- Machines regularly serviced

Machines are used as intensively as possible

- Shift working so that machines are active 24 hours
- Night working when electricity cost may be lower

Minimum set-up costs for different products

- Use of adaptable machines
- Related products made on same machines

EFFECTIVENESS

Content, motivated work-force

- Team working
- Regular change of task
- Rewards for achieving set targets

Deadlines and quantities met

- Rewards for meeting deadlines
- Competition between teams

Environmental damage minimised

- Environmental manager
- Environmentally friendly resources used where possible
- Recycling
- Emissions monitored

Chapter 6

Answer to Lecture Example 1

(a) **Inherent risk:**

An example of this results from the nature of the products that Giffnock Corp sells. In any type of computer hardware business there are rapid developments in technology. This could mean that some of the inventory held by Giffnock is obsolete or can only be sold at heavily discounted prices. The risk of misstatement in the financial statements is that the inventory is overvalued.

Another example could arise from the fact that Giffnock imports the good from overseas. This means that they are likely to be billed by their suppliers in foreign currency, making the accounting for purchases and payables more complex. The related figures in the financial statements could be materially misstated.

Control risk

For the period when Giffnock Corp had no chief accountant, there was a failure of control procedures in that no one checked whether the main accounting reconciliations had been performed properly. There could be omissions, miscalculations or reconciling items may simply be balancing figures rather than genuine items.

As a result, errors that could have been made in accounting for cash at bank, revenue and receivables, payables and debtors may not have been identified by the client's control procedures and material misstatements may exist in these areas of the financial statements.

(b) **Detection risk**

Detection risk is always higher than normal on the first audit of a new client. This is because the audit firm has no previous experience of the client, so no basis for knowing whether many errors have occurred in previous years. They will also lack any in depth knowledge of the integrity of the client management.

To reduce this risk the firm should consider actions such as:

- Allowing longer time than usual for obtaining knowledge of the entity
- Use more experienced audit staff, particularly if any have previous experience of clients operating in a similar business
- Obtain more evidence (by, for example, increasing sample sizes) than they would do for a similar entity that was a long-established client.

Answer to Lecture Example 2

(a)

	20X6	20X7
Gross profit margin	$\frac{11,710}{40,750}$ = 28.7%	$\frac{13,970}{43,150}$ = 32.4%
Net profit margin	$\frac{7,420}{40,750}$ = 18.2%	$\frac{8,180}{43,150}$ = 18.9%
Inventory turnover	$\frac{2,930}{29,040} \times 365$ = 36.8 days	$\frac{3,410}{29,180} \times 365$ = 42.6 days
Debtor days	$\frac{2,150}{40,750} \times 365$ = 19.3 days	$\frac{3,600}{43,150} \times 365$ = 30.5 days
Creditor days	$\frac{1,470}{* 29,040} \times 365$ = 18.3 days	$\frac{2,060}{29,180} \times 365$ = 25.8 days

* Have used cost of sales in place of purchases, which cannot be identified for both years.

(b) Risks of misstatement

The **increase in gross profit margin** could result from

- Cut-off errors in revenue, including sales made after the year end.
- Overstatement of value of closing inventory.
- Inconsistency in cost classification between the two years.

The **net profit margin has remained fairly constant** over the period.

- This could strengthen the auditor's suspicion that costs have been missclassified.

The **increase in inventory turnover** period could result from

- A falling off in demand for the company's profits. Some items of inventory may be obsolete or unsaleable so their value may be overstated.
- Errors in year end inventory counting.

The **increase in debtor days** could indicate

- That some long overdue amounts are included that may not be recoverable, so an allowance may be required
- Cut-off errors at the year-end, overstating sales and receivables

The **increase in creditor days** could indicate

- That the company has cash flow problems and is struggling to pay its liabilities as they fall due. This could raise doubt over its status as a going concern.
- Cut-off errors with posting of cash payments at the year end.

Chapter 7

No Lecture Examples

Chapter 8

Answer to Lecture Example 1

(a) **Valuation of inventory:**

The listing taken from the client's system is the least reliable of the three pieces of evidence. It is documentary but is taken from within the client's records. On an area where the accounting requirements allow for an element of judgement (i.e. the basic rule that inventory should be valued at the lower of cost and net realisable value) this evidence is unlikely to be sufficient on its own.

Agreeing a sample of items to purchase invoices would be more reliable evidence of the *cost* of the items of inventory, as it uses documentary evidence from a third party source. This would still not be sufficient on its own because it ignores and consideration of net realisable value.

In order to conclude on this assertion it would be essential for the auditor to trace items through to their sales values after the year end in order to check whether any had to be sold for less than cost, which would indicate that an allowance would be required to write down the inventory value.

(b) **Existence of inventory:**

The suggested enquiry of management would be the least reliable evidence here, as it is oral evidence from sources within the client.

At the year end inventory count the auditor can see the inventory and this is conclusive, auditor-generated evidence that it exists!

(c) **Completeness of recording of purchases:**

Again, the suggested enquiry of management would be the least reliable evidence here, as it is oral evidence from sources within the client.

Reperforming the sequence checking (which, depending on the nature of the clients procedures might involve a manual check of invoices, or a computer-based test of a sequence check performed by the client's computerised system) is another example of auditor - generated evidence, which would be considered very reliable. Unlike the other procedures discussed in this example it is a test of the controls within the client's system (see more detail in Chapter 10) but still relevant to this assertion.

Chapter 9

Answer to Lecture Example 1

Stage	Risk	Controls
Customer places order/ written order form raised ↓	<ul style="list-style-type: none"> Order could be accepted and goods despatched to a customer who is not credit worthy Risk of irrecoverable debts 	Credit check separate from sales department Independent check by supervisor on prices and discounts offered
Written order passed for packing and delivery Delivery note raised when items are despatched ↓	<ul style="list-style-type: none"> Risk that order is not fulfilled, loss of future business from dissatisfied customer Risk that wrong items, wrong quantity or damage goods are despatched 	Sequentially numbered order forms Copy delivery notes passed to sales dept. once order fulfilled & sales dept. perform regular review of orders not yet delivered Delivery notes sequentially numbered Inventory cards updated Delivery notes matched to order form Physical inspection of goods once packed
Goods sent to customer ↓	<ul style="list-style-type: none"> Risk that goods do not reach the proper destination. Risk that invoice is not raised for goods despatched 	Customer signs copy of delivery note for return to client Check made to ensure all drivers return all copy delivery notes Invoices raised from delivery notes
Customer invoiced Warehouse will send copy of sales order, delivery note and invoice raised ↓	<ul style="list-style-type: none"> Risk of errors in accounting, eg incorrect amounts, posted to wrong account 	Sequence check on delivery notes and matching to invoice Sequentially numbered invoice Match to order form as checked by Supervisor Invoices raised promptly entered into Sales Day Book and customer's Sales Ledger account
Customer accounts Monitored ↓	<ul style="list-style-type: none"> Risk that cash is not received 	Regular review of receivables balances and old debts actively pursued

Stage	Risk	Controls
Payment received from customer ↓	<ul style="list-style-type: none"> Risk that cash/cheques are misappropriated 	Two people open and count cash Cash promptly banked Bankings promptly recorded in Cash Book Receivables ledger accounts promptly updated Recording of cash received in receivables ledger performed by responsible person Segregation of duties between those who update receivables ledger and those who: <ul style="list-style-type: none"> – raise invoices – raise credit notes – follow up statement queries – open and count cash
Statements sent to customer ↓	<ul style="list-style-type: none"> See above – risks of accounting errors and fraud 	Statements sent out on a regular basis Customer queries are dealt with by person not responsible for writing up sales ledger accounts
Monthly management accounts and reconciliations	<ul style="list-style-type: none"> See above – risks of accounting errors and fraud 	Control account reconciliations: <ul style="list-style-type: none"> – Cash book to bank statement – Receivables ledger to Receivables Ledger Control Account Analytical review of Sales level and profit margins Cash collection period ratios calculated and followed up

Answer to Lecture Example 2

Valuation of inventory:

Assertion	Controls
Accuracy	Regular inventory counts Reconciliations of results of count to book records
Completeness	Regular inventory counts Reconciliations of inventory count to book records
Cut-off	Procedures for cut-off of goods in transit and timing differences
Allocation	N/A
Classification/ understandability	N/A
Occurrence	Agreement of goods received to documentation Inventory issues supported by appropriate documentation
Valuation	Controls over stores environment (right temperature)
Existence	Regular monitoring of inventory levels Inventory counts Reconciliations of results of count to book records
Rights and obligations	Agreement of goods received to documentation Inventory issues supported by appropriate documentation

Note: The above table does not mention all the control activities listed in the example. Management will have devised controls to address all business risks – not all of these will be relevant to the financial statement assertions. For example, the establishment of re-order quantities is vital to avoid the risk of disruption to business from shortages of inventories, but that situation would have no direct effect in terms of misstatements in the financial statements.

Answer to Lecture Example 3

Stage	Controls
Correct hours recorded	<p>Proper recording of hours reviewed by responsible official.</p> <p>Overtime properly authorised.</p> <p>Proper procedures for non-routine circumstances eg absences, advances of pay</p>
Paid at correct rate	<ul style="list-style-type: none"> • Authorised rate of pay, charges to standing data authorised. • Authorisation of deductions from gross pay. • Procedures to verify that wages cheque cashed is for total of net wages for the period. • Review of actual pay against budgets or other periods and investigation of variances.
Bonafide employees paid	<ul style="list-style-type: none"> • Appointment/discharge of employees authorised by personnel dept. • Procedures to verify employees identity. • Cheque signatories independent of payroll preparation. • Cheque signatory reviews payroll.
Other controls	<ul style="list-style-type: none"> • Security over cash during collection, transit and distribution (if applicable). • Payment by person independent of preparation of paysheets/packets • Controls over unclaimed wages. • Employee records held independent of wages and salaries department.

Chapter 10

Answer to Lecture Example 1

Risks of misstatement	Tests of controls
Liabilities recognised for goods not received	For a sample of purchase day book entries inspect invoice and check that it has been matched to a Goods Received Note (GRN) Inspect a sample of purchase invoices for evidence of arithmetical checking.
Cut-off errors	Reperform the sequence checking of GRNs and invoices around the year end
Errors in recording amounts in the books and records	Review the reconciliations of the payables ledger to the payables ledger control accounts to check that: <ul style="list-style-type: none"> • Reconciliations have been prepared each month • Reconciliations are signed by someone independent of the purchase ledger department Reperform one of the reconciliations to ascertain that it has been carried out correctly and investigate any reconciling items. Review the reconciliations of the payables ledger balances to supplier statements and reperform a sample of the reconciliations.
Invoices posted to wrong payables ledger accounts	Supplier statement reconciliation review will also be relevant to this risk.
Payments misclassified	Review the variance analysis carried out by the client and read minutes of management meetings to assess whether action is taken to investigate any unusual variances.

Answer to Lecture Example 2

Review capital expenditure authorisation forms for evidence of approval of expenditure.

Enquire of client staff about procedures for classifying expenditure as capital or revenue

Inspect invoices for capital items for evidence of approval of classification by senior member of client staff.

Review board minutes for evidence of management review of variances in expenditure categories that could arise from misclassification, for example, repairs and maintenance expense accounts.

Chapter 11

Answer to Lecture Example 1

(a) **Completeness of accruals**

Assuming no significant changes have taken place in the entity's business during the year under audit, the expectation would be that accruals would be similar from year to year, as they generally relate to expenses that are paid at fixed intervals during the year.

A simple year on year comparison of a breakdown of the accruals figure would be an effective procedure for identifying any material omissions.

(b) **Accuracy of overdraft interest expense**

This assertion lends itself to a "proof in total". The auditor calculates an expected amount:

Average overdraft balance × average interest rate

This expected amount is compared to the actual expense recognised in the financial statements.

(c) **Accuracy of wages expense**

This could also be audited through a proof in total calculation. The detail would vary depending on the nature of the business, and might have to be performed separately for different departments. An outline of how the expected amount could be calculated is:

$$\text{Prior year wages expense} \times \frac{\text{no. of employees current year}}{\text{no. of employees prior year}} \times \% \text{ pay increase}$$

Given the level of risk in respect of wages expenses it is unlikely that the auditor would rely solely on analytical procedures but this would provide a piece of reliable, auditor-generated evidence which could then be backed up by some (reduced) tests of details.

(d) **Cut -off of sales revenue**

Gross profit margins, either calculated by the auditor, or taken from management information prepared by the client (if the auditor has taken steps to confirm its reliability) could be compared to:

- Prior years
- Budgets

Any unexpected variances should be investigated as they could indicate that material misstatements exist. For example, an unexpected increase in gross profit margin could indicate a cut-off error where sales after the year-end have been included.

Answer to Lecture Example 2

<i>CUSTOMER</i>	<i>BALANCE</i>	<i>CUMULATIVE TOTAL</i>	<i>SELECTED (Y/N)</i>
1	60,000	60,000	N
2	70,000	130,000	Y
3	90,000	220,000	Y
4	105,000	325,000	Y
5	28,000	353,000	N
6	100,000	453,000	Y
7	46,000	499,000	N
8	1,000	500,000	Y
9	84,000	584,000	N
10	94,000	678,000	Y
11	108,000	786,000	Y
12	34,000	820,000	Y
13	160,000	980,000	Y
14	20,000	1,000,000	Y
	<u>1,000,000</u>		

Answer to Lecture Example 3

- (a) Error rate in sample x total value in population

$$\frac{\$9,000}{\$200,000} \times \$1,000,000 = \$45,000$$

- (b) The projected error is above the tolerable error limit. This means that further evidence is needed. This could be done by:
- Extending the sample tested in the procedure and then reperforming the extrapolation, or
 - Designing and performing additional substantive procedures.

If the further evidence allows the auditor to conclude that the actual error in the population does not exceed tolerable error, then the auditor will conclude that no adjustment is necessary, although the error of \$9,000 will be noted on a schedule of unadjusted errors.

If the further evidence indicates that there is a misstatement that exceeds tolerable error then the auditor will ask the client to make an adjustment to the financial statements.

Chapter 12

Answer to Lecture Example 1

Darth Co

- The cash in transit should be traced to the cash receipts book post year end. I would expect it to be received within a few days of the year end.
- I would also trace the cash to the bank paying in slip. Again, this should be stamped by the bank post year end.

Skywalker Co

- The goods in transit should be traced to a GDN dated prior to the year end.
- If inventory records exist the despatch could be traced to the records to confirm that it was sent prior to the year end.

Yoda Co

- The reason for the dispute and my client's views on it should be obtained from the correspondence file between Yoda Co and my client.
- Credit notes post year end should be scrutinised to determine whether a credit was given for the disputed goods.
- Cash receipts should be reviewed post year end to determine whether Yoda Co paid the full balance.
- If the amount is outstanding at the audit date, discuss recoverability with the credit controller.

Chapter 13

Answer to Lecture Example 1

Five matters which will require action by management if the inventory count is to be effective together with corrective action are:

- (a) By allowing Mr Farditch to take responsibility for the detailed organisation of the count, the present instructions permit the person with day-to-day responsibility for the inventory area to supervise one of the most important control checks on that area. This represents a weakness in the company's system of internal check, since the opportunity is afforded to Mr Farditch to cover up any inadequacies there may be in the operational efficiency of controls in the area of inventories.

Mrs Curbar should take more direct responsibility for the detailed organisation of the count.

- (b) By giving to those members of staff responsible for the physical count of the inventories an indication of the quantity which is expected to be in inventory, there is a risk that this may prejudice their opinion in the event of there being a discrepancy. More importantly, it will tend to reduce the benefits which it is intended to derive from having an independent check on the inventory records by having to reconcile them with the quantities determined by a physical count.

The pre-printed inventory sheets should not show the balance of each inventory item on hand as shown on the inventory records held independently of the warehouse.

- (c) At the moment clear instructions do not appear to have been given of the action required in the event of there being a discrepancy in the counts arrived at by the two members of the counting team. Unless precise instructions are given, there would be a tendency to accept the quantity determined by the senior member of the count team, which is not necessarily going to be the correct one.

The teams of counters should be instructed that in the event of their independent counts of the inventory quantities not agreeing a further count should take place. If they are still unable to agree then a note of this fact should be made on the inventory count tag so that a further check may be by the inspection team.

- (d) A number of teams of checkers (2 or 3) should be appointed to go around after the counters. The task of these checkers would be to:
- Carry out sample tests on the accuracy of the original counters
 - Ensure that inventory count completion tags have been left by the counters at each inventory location.

The appointment of checkers will improve the efficiency of the overall count by acting as a check on both the accuracy and completeness of the count.

Answer to Lecture Example 2

NRV is likely to be lower than cost in the following instances:

- When the inventories are slow moving
- When there are obsolete inventories
- When the inventories are damaged
- When a decision has been made to sell inventories at a loss e.g. "loss leader" in a supermarket
- When the inventory line has been discontinued.

Chapter 14

No Lecture Examples

Chapter 15

No Lecture Examples

Chapter 16

Answer to Lecture Example 1

Property, plant and equipment

Audit/review objective	Example tests
Existence	<ul style="list-style-type: none"> • Physical verification of a sample of assets from the register. • Obtain listing of assets sold in year and compare to register to check that all disposals have correctly been removed.
Rights and Obligations	<ul style="list-style-type: none"> • Inspect invoices for ownership details • Buildings – inspect title deeds and land registry certificates • Vehicles – inspect registration documents
Completeness	<ul style="list-style-type: none"> • Reconcile non-current assets register to accounts • Physical verification from asset to asset register

Answer to Lecture Example 2

Tests on:

1 *Opening balances*

- These should be agreed to the previous year's audit file and financial statements.

2 *Additions*

- A list of additions should be obtained and the total agreed to the financial statements.
- A sample of assets should be selected and their value should be traced to invoices. The amount capitalised should be checked to verify that it excludes recoverable sales tax.
- Legal costs capitalised should be agreed to bills from the company solicitor and check that the property mentioned agrees with that capitalised.

3 *Revaluations*

- Trace the revalued amount to the valuer's report and confirm that the surplus is \$1,000,000.
- Check that the \$1,000,000 has been transferred to a revaluation reserve through scrutiny of the nominal ledger.
- Agree the basis of valuation to the valuer's report. Verify the disclosure of this to the notes to the financial statements.
- Recalculate depreciation to confirm that it is based on revalued amount.
- Review the notes to the financial statements to confirm that the revaluation has been disclosed.

4 *Depreciation – Charge for Year*

- Obtain details of the accounting policy from the notes to the financial statements.
- Confirm against last year's financial statements that there have been no changes to these policies.
- Recalculate depreciation on a sample of assets. Compare the calculations to the depreciation charge in the non-current assets register for each item in the sample.
- Confirm that depreciation rates are reasonable.

5 *Disposals*

- A list of disposals should be obtained and the total agreed to the financial statements.
- For material disposals, I would:
 - Agree the cost of the asset sold to the non-current asset register
 - Recalculate the depreciation up to the date of disposal, based on the company's accounting policy
 - Trace the proceeds to the cash receipts book and the bank statement
 - Recalculate the profit and loss on disposal and agree it with the amount in the nominal ledger; and
 - If the profit or loss is material, verify to the income statement that it is separately disclosed in accordance with IAS 1/FRS 3.

Answer to Lecture Example 3

The following work would be done to determine whether depreciation rates are reasonable:

- Discuss the asset replacement policy with the directors
- Select some assets from the non-current assets register which are approaching the end of their useful lives. Find these assets and note if they are still being used and their condition. If the assets are not being used, then they should be written down to a nil value
- Check the sales and scrapping of assets over the past year. If large losses on disposal have occurred then depreciation rates are too low; and
- Consider technological developments in relation to the company's assets.

Chapter 17

Answer to Lecture Example 1

- Discuss procedures for cash collection with management and assess risk of fraud, loss, robbery or error
- Discuss selection criteria for collectors and collection procedures with management
- Shadow the cash collection, recording and banking process
- Follow through a sample of cash received control lists to cash records and bankings made
- Prepare a reconciliation of total cash received to income
- Obtain and compare analysis of major/regular contributions with previous year
- Send circularisation letters to confirm material amounts donated by Big 4 and wealthy individuals
- Perform an analytical review of cash donations per month vs previous year taking into account factors such as number of collectors and weather
- Circularise tax authorities to confirm contributions made where tax deductions have been claimed.

Chapter 18

Answer to Lecture Example 1

The following factors might cause me to have doubts about Trucker's going concern status:

- Fall in gross profit margin. This will make a return to profitability difficult.
- Truckers are making losses. This will make negotiations with the bank difficult.
- Debtors are taking longer to pay. This will squeeze cash flow coming into the business. Bad debts will increase the existing loss.
- Worsening liquidity ratio. Loan and lease commitments may not be met.
- Increasing reliance on short term finance. The overdraft can be recalled by the bank at any time. It should not be used to finance long term investment.
- Increased gearing. Interest on debt must be paid from a decreasing cash position.
- Loss of major customer. Other customers may follow, worsening the company's prospects.
- Loss of commercial customers. This represents loss of regular income.

- Overdraft facility to be reviewed 3 months after the year end. This short period is probably not long enough to see any improvement in the company's future prospects.

Answer to Lecture Example 2

- (a) Pervasive disagreement
Adverse opinion – the financial statements do not give a true and fair view.
- (b) Significant uncertainty.
Explanatory paragraph.
Unqualified opinion.

Chapter 19

Answer to Lecture Example 1

The company has not valued the inventories at the lower of cost and NRV. They are therefore in contravention of IAS 2/SSAP 9 ⇒ we have a disagreement.

As the effect is material we would discuss it with the directors and encourage them to amend the financial statements. If they refuse we must issue a modified opinion. Assuming the effect of the write-down is material, but not pervasive, we would issue a qualified (“except for”) opinion.

Answer to Lecture Example 2

The company has not kept records relating to cash sales. These sales are material in relation to pre-tax profits. We therefore have a limitation on scope. It is material but not pervasive, so we will issue an “except for” opinion, as we are unable to form an opinion in relation to cash sales but are satisfied with the remainder of the financial statements.

END OF ANSWERS TO LECTURE EXAMPLES

Question and Answer bank



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Questions

1 Objectives, characteristics and responsibilities 27 mins

Your client, Mr Neville, has written to you saying he has been considering setting up an internal audit department but has heard from his brother that he would be better off abandoning this idea and getting the external auditor to do some assurance work instead. His brother also claimed that if the external auditor does some work for the company, there would be no need to have an external audit.

Required

Write a letter to Mr Neville explaining the objectives, characteristics and responsibilities of internal audit, external audit and assurance. **(Total = 15 marks)**

2 Independence 27 mins

It has been suggested that the most important matter affecting the credibility of the auditor is that of 'independence'.

Required

- (a) Discuss, giving examples, matters other than independence, which might be relevant in relation to the credibility of the auditor and steps that the accounting profession has taken or might take in relation to them. **(7 marks)**
- (b) Comment on the following situations in the context of the independence of the auditor, showing clearly the principles involved:
 - (i) The audit manager in charge of the audit assignment of Andrew Co holds 1,000 \$1 ordinary shares in the company (total shares in issue – 100,000). The audit partner holds no shares.
 - (ii) The audit fee receivable from Janet Co, a private company is \$100,000. The total fee income of the audit firm is \$700,000.
 - (iii) The audit senior in charge of the audit of Margot Bank Co has a personal loan from the bank of \$2,000 on which she is currently paying 13% interest.
 - (iv) The audit partner is responsible for two audit assignments, Harry Co and Jean Co. Harry Co has recently tendered for a contract with Jean Co for the supply of material quantities of goods over a number of years. Jean Co has asked the audit partner to advise on the matter. **(8 marks)**

(Total = 15 marks)

3 Glo**36 mins**

Glo-Warm Co, a limited liability company, manufactures various heating products which it sells to both High Street and catalogue retailers.

The balance sheets for the years ended 2007 and 2006 are set out below. Last year, materiality was set at \$10,000.

	2007		2006	
	\$'000	\$'000	\$'000	\$'000
Non-current assets				
Tangible non-current assets		20		21
Investments		2		2
Current assets				
Inventory	52		179	
Receivables	78		136	
Cash at bank	12		34	
Cash in hand	1		1	
	<u>143</u>		<u>350</u>	
Total assets		<u>165</u>		<u>373</u>
Current liabilities				
Trade payables	121		133	
Bank loan	5		5	
	<u>126</u>		<u>138</u>	
Long-term liabilities				
Bank loan		20		25
Provision*		20		–
Capital and reserves				
Share capital		2		2
Reserves		(3)		208
Total liabilities		<u>165</u>		<u>373</u>

*The provision of \$20,000 consists entirely of a warranty provision.

Required

- (a) Without carrying out any calculations, discuss whether the materiality level used in 2006 will be appropriate for this year's audit, giving reasons for your answer. **(3 marks)**
- (b) Explain audit risk. **(3 marks)**
- (c) Review the balance sheet given above and set out the areas in which audit work should be concentrated, giving reasons in each case. **(14 marks)**

(Total = 20 marks)

4 Audit evidence considerations**18 mins**

- (a) Discuss how analytical procedures can be used as substantive audit procedures to provide audit evidence. Illustrate your answer with an example. **(5 marks)**
- (b) ISA 500 *Audit evidence* requires auditors to obtain sufficient, appropriate audit evidence to be able to draw reasonable conclusions on which to base their audit opinion. Discuss the different sources of evidence available to auditors and assess their relative appropriateness. **(5 marks)**

(Total = 10 marks)

5 Knits Co

36 mins

Knits Co is a small company which manufactures and sells high quality knitwear. Its customers are mainly fashion boutiques.

Knits Co has two directors, one of who is non-executive. The other is involved in the day-to-day administration of the company. There are ten other employees. Six of these work in the factory, one works in the warehouse, one is a sales representative and two are accounts staff. The accounts staff consist of Miss Jones, who is responsible for processing sales and receivables, and Mrs Singh, who is the purchases and wages clerk. Mrs Singh works part-time, five mornings a week.

The company's sales representative visits shops throughout the region. He takes orders from customers which he records on a pre-numbered two-part order form. He passes the completed forms to the accounts department. Miss Jones files one copy of the order form in numerical sequence and passes the other to the warehouse.

The completed order is despatched from the warehouse by carrier, accompanied by one copy of a despatch note. The other copy is sent to Miss Jones, who prepares an invoice based on the information it contains and on the company's price list. She sends one copy of the invoice to the customer, and a second copy of the invoice is retained.

Each Friday, Miss Jones inputs the week's invoices to the computerised sales ledger. She then files the invoices alphabetically by customer name. Despatch notes are not retained because filing space is limited.

Miss Jones opens the post daily and lists remittances received from credit customers. Every Friday, she inputs the information listed to the sales ledger. Cheques received are banked daily by the executive director.

Miss Jones reviews the sales ledger balances every month and writes to customers who have not paid within 90 days of receiving goods. The sales ledger is printed out annually for year-end purposes. Otherwise no hard copy is printed and Miss Jones reviews the sales ledger on the computer screen.

The company's computer package includes the facility to produce a sales day book and sales ledger control account. These are not used because Miss Jones considers that the low volume of transactions (10-15 invoices per week) makes them unnecessary.

Required

- (a) State, with reasons, what you consider to be the potential weaknesses in Knits Co's present system of accounting for sales and receivables. **(12 marks)**
- (b) Suggest controls that a small firm such as Knits Co could feasibly adopt to overcome the weaknesses you have identified. **(8 marks)**

(Total = 20 marks)

Note: You are not required to consider the system for dealing with returns and credit notes.

6 Fenton Distributors

36 mins

Fenton Distributors Co is a small company which maintains its sales, purchase and nominal ledgers on a small PC, using a standard computerised accounting package. The company buys products from large manufacturers and sells them to shops which either sell or hire them to the general public. The products include drain clearing machines, portable generators, garden cultivators and wallpaper strippers.

You have been asked to carry out an audit of the nominal ledger system to verify that items are accurately recorded in the year. At the end of the year, the nominal ledger produces a trial balance, which is used to prepare the annual accounts.

The company employs a bookkeeper, who is responsible for posting the sales and purchase ledgers, and maintaining the nominal ledger. Data is posted to the nominal ledger as follows.

- (a) At the start of the financial year, all the balances on the nominal ledger accounts are set to zero (using the standard year-end procedure of the computer package).
- (b) The following procedures relate to purchase transactions.
 - (i) When invoices are posted to the purchase ledger, the purchase analysis code (for the nominal ledger), the purchases value and the sales tax value are entered. The total invoice value is posted to the purchase ledger.
 - (ii) At the end of the month, the computer posts the following items to the nominal ledger.
 - (1) The total of each category of invoice expense and sales tax for purchase invoices and credit notes posted in the month (at the same time the computer prints details of the individual invoices making up the total of each invoice expense and sales tax for the month).
 - (2) The total of purchase ledger cash payments, discount received and adjustments posted to the purchase ledger in the month (the computer prints details of the individual items comprising the total cash discount and adjustments for the month).
 - (3) Where there is no account in the nominal ledger relating to the items being posted, the computer posts the items to a payables suspense account. Also, all adjustments are posted to the suspense account.
- (c) Sales ledger data is posted to the nominal ledger in a similar way to purchase ledger data.
- (d) Journals are posted manually to the nominal ledger for:
 - (i) The opening balances at the start of the year
 - (ii) Other cash book items (other than sales and purchase ledger cash)
 - (iii) Petty cash payments
 - (iv) Wages analysis (details are obtained from the computerised payroll system)
 - (v) Adjustments, which include:
 - (1) Correction of errors
 - (2) Dealing with items in the sale and purchase ledger suspense accounts (adjustments posted to the ledger, and items where there is no account in the nominal ledger)

All these journals are written manually in an accounts journal book, and they must be authorised by the managing director before posting. The opening balances are posted to the nominal ledger when the previous year's accounts have been approved by the auditors. Although the employee wages are calculated using another computer package, the total wages expense is posted to the nominal ledger manually. The wages expense is calculated from the payroll's monthly summary, using a spreadsheet package, and the wages expense is analysed into directors, sales, warehouse and office wages (or salaries).

Required

List and describe the audit work you would perform on the computerised nominal ledger system, and in particular:

- (a) The checks you would perform to verify the accuracy of purchases transactions which are posted to the nominal ledger. **(5 marks)**
- (b) The checks you would perform to verify the validity and accuracy of journals posted to the nominal ledger. Also, you should briefly describe any other checks you would perform to verify the accuracy of the year-end balances on the nominal ledger. **(15 marks)**

Note. You should assume that sales transactions are accurately recorded and correctly posted to the nominal ledger.

(Total = 20 marks)

7 Cheque payments and petty cash

36 mins

Mr A Black has recently acquired the controlling interest in Quicksand Co, who are importers of sportswear. In his review of the organisational structure of the company Mr Black became aware of weaknesses in the procedures for the signing of cheques and the operation of the petty cash system. Mr Black engages you as the company's auditor and requests that you review the controls over cheque payments and petty cash. He does not wish to be a cheque signatory himself because he feels that such a procedure is an inefficient use of his time. In addition to Mr Black, who is the managing director, the company employs 20 personnel including four other directors, and approximately three hundred cheques are drawn each month. The petty cash account normally has a working balance of about \$300, and \$600 is expended from the fund each month. Mr Black has again indicated that he is unwilling to participate in any internal control procedures which would ensure the efficient operation of the petty cash fund.

Required

- (a) Prepare a letter to Mr Black containing your recommendations for good internal control procedures for:
 - (i) Cheque payments **(9 marks)**
 - (ii) Petty cash **(7 marks)**

(Marks will be awarded for the style and layout of the answer.)
- (b) Discuss the audit implications, if any, of the unwillingness of Mr Black to participate in the cheque signing procedures and petty cash function. **(4 marks)**

(Total = 20 marks)

8 Elsams Co

36 mins

You are the auditor of Elsams Co which operates a chain of retail shops throughout the country selling a wide range of electrical goods. Each branch has computerised cash registers linked into the central computerised sales, receivables and inventory records. At the point of sale, the information keyed in includes the following: branch reference, product number, inventory location, unit selling price, date of sale.

The file of inventory records is updated daily for sales and receipts. It contains both cost (on a FIFO basis) and selling price information. The only regular printed output is sales summaries analysed by value, product and branch.

Required

- (a) Outline the ways in which you, as the auditor of Elsams Co, could use computer programs to assist in the verification of inventory at the year-end, and indicate their limitations. **(8 marks)**
- (b) Without particular reference to Elsams Co, outline the objectives and principles of using test data and comment on the areas where it can be of most use in an audit, and on the difficulties of this technique. **(5 marks)**
- (c) Describe the following different methods of sample selection:
- (i) Random selection
 - (ii) Systematic selection
 - (iii) Haphazard selection
 - (iv) Sequence/block selection

(7 marks)**(Total = 20 marks)**

9 Sitting Pretty

36 mins

Sitting Pretty Co is a small, family-run company that makes plastic chairs in a variety of shapes and colours for children and 'fun at heart' adults. It buys in sheets of plastic which can be cut and bent into the correct shape and a plastic leg that is custom made by another company to Sitting Pretty's requirements. All off-cut plastic is sent back to the supplier who melts it down and re-uses it, for which Sitting Pretty receive a 10% discount off their purchase price.

For the inventory count, the factory manager ensures that no work-in-progress is outstanding and closes down production for the day. The factory workers come in early on the day of the inventory count to count the inventory, and they are entitled to go home as soon as inventory is counted. Good controls have always been maintained over the inventory count in previous years. There are no perpetual inventory records. Raw materials are all kept in the stores and are only taken out when they are required for production. Finished goods are kept in the end of the factory, near the delivery exit.

You are the audit assistant assigned to attend the inventory count. You have just rung the factory manager and he has mentioned that on the day of the inventory count a large consignment of plastic is going to be delivered. It is the only day that his supplier can make the delivery, and he needs the material to continue with production on the day after the count.

The audit engagement partner has told you that he is aware that Sitting Pretty changed the specification of their customised leg recently, after a series of complaints over the stability of their chairs. Last year's inventory was valued at \$200,000 in the balance sheet, of which \$30,000 related to raw material inventory.

Finished goods are all carried at the same valuation as each other as there is very little difference between the inventory ranges. Planning materiality for this year has been set at \$5,000 on the grounds, at this stage, that the figures are expected to be similar to last year.

Required

- (a) Explain the importance of the inventory count in this situation. **(3 marks)**
- (b) Prepare notes for your audit supervisor detailing the procedures you propose to undertake in relation to your inventory count attendance. **(7 marks)**
- (c) Outline the procedures which should be taken in relation to cut-off at the final audit. **(5 marks)**
- (d) List the audit procedures you would carry out on the valuation of inventory at the final audit. **(5 marks)**
- (Total = 20 marks)**

10 Going concern

36 mins

Carrington Joinery, a private company, owned by its directors, manufactures wooden window frames, doors and staircases for domestic houses. It has prepared draft accounts for the year ended 30 September 20X6 and you are concerned that they indicate serious going concern problems. The income statements and balance sheets for the last five years (each ended 30 September) are given below.

INCOME STATEMENTS

	20X2	20X3	20X4	20X5	20X6
	\$'000	\$'000	\$'000	\$'000	\$'000
Sales	625	787	1,121	1,661	1,881
Cost of sales	(478)	(701)	(962)	(1,326)	(1,510)
Gross profit	<u>147</u>	<u>86</u>	<u>159</u>	<u>335</u>	<u>371</u>
Other expenses	(88)	(86)	(161)	(240)	(288)
Interest	(6)	(9)	(58)	(90)	(117)
Net profit/(loss)	<u>53</u>	<u>(9)</u>	<u>(60)</u>	<u>5</u>	<u>(34)</u>

BALANCE SHEETS

	20X2	20X3	20X4	20X5	20X6
	\$'000	\$'000	\$'000	\$'000	\$'000
<i>Assets</i>					
<i>Current assets</i>					
Inventory	67	133	181	307	449
Trade accounts receivable	91	240	303	313	364
	<u>158</u>	<u>373</u>	<u>484</u>	<u>620</u>	<u>813</u>
Net current assets	89	161	544	600	587
<i>Total assets</i>	<u>247</u>	<u>534</u>	<u>1,028</u>	<u>1,220</u>	<u>1,400</u>

Liabilities and shareholders' funds

<i>Current liabilities</i>					
Trade accounts payable	90	317	355	490	641
Bank overdraft	10	65	211	269	365
Lease creditor	14	28	98	92	59
	<u>114</u>	<u>410</u>	<u>664</u>	<u>851</u>	<u>1,065</u>
Non-current loan	–	–	300	300	300
	<u>114</u>	<u>410</u>	<u>964</u>	<u>1,151</u>	<u>1,365</u>

	20X2	20X3	20X4	20X5	20X6
	\$'000	\$'000	\$'000	\$'000	\$'000
<i>Shareholders' funds</i>					
Share capital	17	17	17	17	17
Reserves	116	107	47	52	18
	<u>133</u>	<u>124</u>	<u>64</u>	<u>69</u>	<u>35</u>
<i>Total liabilities and shareholders' funds</i>	<u>247</u>	<u>534</u>	<u>1,028</u>	<u>1,220</u>	<u>1,400</u>

The company has been in business for about fifteen years. In January 20X3 it decided to build a new factory on a site leased from the local authority which would allow a major increase in sales. This new factory with new equipment was completed a year later. The factory was financed by a non-current loan of \$300,000 from a merchant bank and an increase in the bank overdraft.

The loan from the merchant bank is secured by a fixed charge on the leasehold factory and the bank overdraft is secured by a second charge on the leasehold factory, a fixed charge on the other non-current assets and a floating charge on the current assets.

The company purchases its main raw material, wood, from timber wholesalers. It sells around 75% of its production to about 12 local and national builders of new domestic houses. The remaining sales are mainly to smaller builders with a very few sales to local builders merchants.

Required

- (a) In relation to the accounts above, list and briefly describe the factors which indicate that the company may not be a going concern. You should also highlight certain figures and calculate relevant ratios in the accounts. **(13 marks)**

Note. You will only be given credit for going concern problems which can be determined from the accounts above.

- (b) Describe the investigations and checks you would carry out, in addition to those described in part (a) above, to determine whether the company is a going concern. **(7 marks)**

(Total = 20 marks)

11 Wiseguys National Bakeries Co

18 mins

Your firm acts as auditor of Wiseguys National Bakeries Co. The finance director has prepared financial statements of the company for year to 31 December 20X9 which show a pre-tax profit of \$450,000. You have been advised that the board of directors has approved the financial statements and decided that no amendments should be made thereto.

As partner responsible for the audit you have noted the following matters during your review of the financial statements and the audit working papers:

- (a) The freehold property which was included at cost in previous years' balance sheets, has now been restated at a professional valuation of \$1,250,000 carried out during the year. You are satisfied with the valuation, the relevant figures have been correctly adjusted and the necessary information disclosed in the notes to the financial statements.
- (b) An amount of \$45,000 due from a customer in respect of sales during the year is included in receivables but, from information made available to you, you conclude that no part of this debt will be recovered. No allowance has been made against this amount.
- (c) The financial statements do not disclose the fact that a director was indebted to the company for an amount of \$22,000 during a period of six weeks commencing 1 February 20X9.

Required

Explain how each of the above will impact on the auditor's report.

(Total = 10 marks)

12 Builders Merchants

36 mins

You are the auditor of Builders Merchants, a listed company which distributes materials to the construction industry from eight depots in the south of the country, and you are currently finalising the audit for the year ended 31 March 20X1. Your audits tests have proved satisfactory with the exception of the following four matters.

- (a) The physical inventory count sheets for one of the depots were lost before they were made available to you, and you have not been able to confirm the inventory quantities and values for this depot by alternative methods. The directors have valued this part of the inventory at \$75,000 and this figure is included in the overall inventory valuation of \$640,000.
- (b) Included in trade receivables, which total \$580,000, is a debt amounting to \$45,000 from a customer which went into liquidation on 15 June 20X1. You have ascertained from the liquidator that your client is unlikely to receive a distribution. The income statement for the year shows a pre-tax profit of \$100,000 but the directors are not prepared to provide for this debt.
- (c) The accounts of Builders Merchants do not contain a cash flow statement.
- (d) A substantial claim has been lodged against the company by a major customer. The matter is fully explained in the notes to the accounts, but no provision has been made for legal costs or compensation payable as it is not possible to determine with reasonable accuracy the amounts, if any, which may become payable. The directors have received legal advice which appears to be reliable in indicating that the claim can be successfully defended.

Required

Explain how the above items will influence the auditor's report you will issue.

(Total = 20 marks)

END OF QUESTION BANK

Answers

1 Objectives, characteristics and responsibilities

Bird & Co
1 Old Street
New Town
M1 3WQ

1 January 20X1
Mr G Neville
1 Any Street
New Town
M2 5LM

Dear Mr Neville

In response to your queries I have produced some information on the difference between statutory audit, assurance work and internal audit. I have included this information in an appendix. However, it is important to note that the external audit is a legal requirement for many companies and cannot be avoided by employing the auditor to do other work.

If you require any further details please do not hesitate to contact me.

Yours sincerely

A N Accountant

Enclosure: Appendix

Appendix

External audit Characteristics and Objectives

- The external audit is a legal requirement for limited liability companies above a certain size. Partnerships and sole traders do not normally need to have any audit, though some may opt to do so to give independent credibility to their financial statements.
- In an external audit the auditor gives an independent opinion on whether the financial statements are true and fair. Implied opinions may also be given on issues such as whether the financial statements agree with the underlying records and all information and explanations which are relevant to the audit have been received.

Assurance work

- Assurance work is voluntary for companies. Management can employ the external auditor to report on any specific areas. Directors may employ the external auditor when they feel a specific investigation or some specific work needs to be done, e.g. in support of an insurance claim or loan application.

Internal audit

- Internal audit departments are not a legal requirement, though the *Combined Code on Corporate Governance* recommends them as best practice for listed companies in the UK and other countries are following this model.
- Internal auditors are employees of the company. They report on the internal controls, identifying problems and suggesting improvements. They may also report on the effectiveness of efficiency of operations.

External audit	Assurance work	Internal audit
<ul style="list-style-type: none"> • External audits are performed annually, and the auditor is paid based on hours worked. The audit fee is normally disclosed in a set of financial statements. • The auditor's report is a formal report with standard wording, prepared for shareholders. An unqualified auditor's report indicates that the auditor believes the financial statements are true and fair. 	<ul style="list-style-type: none"> • Assurance work is a one-off specific assignment; fees are normally agreed with management and based on hours worked. • Reports are tailored to the scope of work, and addressed to management. 	<ul style="list-style-type: none"> • Internal auditors are full-time employees, and as such there are ongoing costs involved with setting up an internal audit department. • Reports are prepared for management. There is no guidance governing the wording of reports, though companies may have their own internal guidelines.
Responsibilities		
<ul style="list-style-type: none"> • Work and procedures are governed by International Standards on Auditing, produced by the International Auditing and Assurance Standards Board of IFAC. Compliance with these Standards is a good defence should the auditor end up in court. 	<ul style="list-style-type: none"> • The <i>International Framework for Assurance Engagements</i> provides guidance on the nature of assurance engagements. ISAE 3000 <i>Assurance Engagements</i> provides standards for assurance engagements other than audits or reviews of historical financial information. Auditors are expected to comply with this standard for both reasonable and limited assurance engagements. 	<ul style="list-style-type: none"> • There are no International Standards on Auditing to govern work.

2 Independence

- (a) If an auditor is to have credibility then it is vital that he should be seen to be independent of any concern on which he is required to report. However, independence is but one of a number of qualities which the modern auditor must possess if he is to be accepted as suitable for his role.

Outside of independence, perhaps the two most important qualities required of an auditor are:

- (i) Integrity

The auditor must be seen as honest. Having formed his opinion, based on the audit evidence he has collected, he will not allow others to sway his judgement to suit their own ends. It is the auditor's integrity which will allow interested parties to place reliance on his reports.

IFAC and national supervisory bodies do a great deal to try and ensure that the integrity of the profession as a whole, as well as that of individual members, is maintained. This is done by laying down ethical guidelines which all members are required to follow (disciplinary proceedings are taken against any member known to have breached such guidelines). The accounting bodies also assist in this area by providing a broad framework for the training and examination of prospective new members, such as the *Code of Ethics and Conduct* issued by ACCA.

- (ii) Professional competence

Clearly the auditor must be in possession of certain technical skills. This fact is clearly recognised so far as statutory audits are concerned, as only suitable qualified accountants are recognised as being competent to hold office as auditor. Examples of some of the skills required of the modern auditor are that he must be:

- Aware of and understand audit objectives
- Able to interpret systems
- Able to communicate well with others
- Conversant with required techniques such as sampling
- Able to cope with the impact of modern technology on accounting and internal control systems

The accounting profession is only too well aware of the need to maintain and improve standards of professional competence and for this reason has issued and recently revised a number of International Standards on Auditing. In addition the accounting bodies are heavily involved in running courses to assist members in maintaining and improving their technical skills.

- (b) Independence on the part of the auditor as a reporting accountant is seen by many to be a fundamental concept of auditing. It has been said that it would never be sufficient for an auditor to claim that he was independent. In fact, he must always be clearly seen to be independent in practice. Given this situation, it would be almost impossible to draw up a set of rules to cover every conceivable situation where an auditor's independence might be called into question.

Whilst not able to provide an exhaustive list of recommendations, the main principles which should be applied when considering the question of independence may be found in the relevant section of the ACCA's *Code of Ethics and Conduct*. With this in mind, the following comments could be made in relation to the situations specified in the question:

- (i) The audit partner has no shareholdings in the client company and so, all other things being equal, he could be seen as giving an objective audit opinion. However, the audit manager does have a shareholding in the client company which, whilst not material to the company (at 1% of issued share capital), could be material to the audit manager and certainly might

be seen to influence his ability to give an impartial opinion in relation to the company's affairs. As the partner will inevitably have to rely upon the work completed and controlled by the audit manager it is clearly undesirable for the manager to have such a financial involvement in the client's affairs.

- (ii) The code suggests that under normal circumstances no more than 15% of the gross fee income of a practice should come from any one client source. The reason for this is that the fear of losing a major client, and thus a substantial proportion of fee income, could prejudice the auditor's objectivity and make him more likely to bow to pressures from the client.

The audit fee from Janet Co contributes some 14.3% of the total fees income of the practice and so is within the 15% recommended limit. It would be necessary to consider whether any other fee income was received from this client, as this could result in the 15% limit being exceeded. However, perhaps the most important point to note is that the 15% is merely a guide. If the figure is slightly exceeded it does not automatically mean that independence is impaired and it must also be appreciated that even if the level of fee income is below 15% the auditor's independence could still be seen as being prejudiced. The firm would need to keep this situation under constant review.

- (iii) As another instance of where financial involvement in a client's affairs could be seen to impair an auditor's objectivity, the code recommends that between an auditor and a client, there should be no loans or guarantees in respect of loans either way. Any such financial involvement could be seen to impair the auditor's judgement either because of a client putting pressure on the auditor or because of the auditor's own fear of suffering some financial loss.

However, the code does allow for one exception in making the above recommendation and that is where the loan is 'in the normal course of business and on normal commercial terms', providing it is not to the engagement partner (i.e. allowed for other audit staff members and practice partners). It is part of a bank's normal business to make personal loans and if the rate of interest being paid by the audit senior is the normal commercial rate of interest, this transaction is unlikely to be seen as impairing the auditor's independence.

- (iv) The code also considers the problems that can be created when conflicts of interest arise between different clients and between clients and the auditor's own business interests. It concludes that every effort should be made to avoid conflicts of interest arising and that it would be highly unethical for an accountant to act in a situation where he knew that a conflict of interest existed.

The situation described in the question is a good example of the type of conflict of interest with which the code is concerned. The audit partner should not advise Jean Co with regard to the contract tender received from Harry Co. The auditor should explain the professional reasons why he is unable to act on this occasion and suggest that Jean Co seek advice from another firm of accountants.

3 Glo

Tutorial note. In part (a) you must discuss the issues raised by the question. It is not appropriate to answer a 3 mark question by saying 'no, it will not be appropriate.' The question asks you to discuss, so you must explain your reasoning and come to a conclusion.

Part (b) should represent easy marks. However, remember to explain what you know quickly to bank those marks and then move on to section (c) where a large number of marks are available for identifying risk areas in practice.

In part (c) you need to identify what looks odd in the balance sheet because this will indicate that it is potentially a risk area requiring a higher level of audit work. However, you should not just read through the balance sheet and compile an answer which lists the balance sheet areas in balance sheet order – you should explain why they are risky.

You should explain **why certain areas may be risky** for the audit, in other words, **explain what the balance sheet movement may indicate**. Inventory may have fallen because a large amount of inventory held at a third parties wasn't included in the inventory count, or because of a tremendous recent marketing push. The first explanation shows the risk that the financial statements are materially misstated in terms of inventory completeness.

You should **structure your answer** in terms of what you feel is the **greatest risk**. This may involve **making links between the various lines of the balance sheet** and pulling together an **overview of the situation**. In our answer below, we highlight the issue of going concern. There is no point in auditing the balance sheet in its current form if the going concern basis is inappropriate, therefore going concern is a key risk in this audit. There are various indicators that the going concern assumption may be inappropriate: fall in value in the whole balance sheet, retained loss, fall in cash position, suggestion of fall in activity.

(a) **Materiality**

It is **never appropriate** to apply the prior year's materiality figure to the current year figures. Materiality should be assessed in each year.

If the financial position has not changed much, and the results are very comparable with the prior year, it is possible that the materiality assessed year-on-year is very similar, but this does not mean that the auditors should not assess it for each audit. When assessing materiality, the auditor must consider **all known factors at the current date**. In this case, the position has changed considerably, increasing the risk of the audit, which may lower materiality itself.

As the **balance sheet position has changed considerably**, when materiality is assessed, it is unlikely that it will be similar to the prior year. Using the information available, **materiality is likely to be assessed extremely low** in monetary terms, due to the overall decrease in assets and the loss that appears to have been made in the year. It is also possible that given the current balance sheet position, the balance sheet figures will not be used to assess materiality in this year.

(b) **Audit risk**

Audit risk is the risk that the auditor will give an inappropriate opinion on financial statements. It is made up of three different elements of risk:

- **Inherent risk:** the risks arising naturally in the business and specific accounts/transactions
- **Control risk:** the risk that the accounting system will fail to detect and prevent errors
- **Detection risk:** the risk that the auditors will not detect material misstatements

Detection risk comprises **sampling risk** (the risk that the auditors' conclusion drawn from a sample is different to what it would have been, had the whole population been tested) and **non-sampling risk** (the risk that auditors may use inappropriate procedures or misinterpret evidence).

Inherent and control risk are assessed by the auditors. Detection risk is then set at a level which makes overall audit risk acceptable to them.

(c) **Specific audit areas of risk**

A review of this balance sheet suggests that audit work should be directed to the following areas:

Going concern

The **balance sheet has reduced considerably in value** since the previous year. Total assets have fallen from \$373,000 to \$165,000. Although the income statement has not been reviewed, the balance sheet shows a **retained loss** for the year of \$211,000.

Net assets show a **reduction in both inventory and receivables**, which **suggests a decrease in activity**, although trade payables do not seem to have fallen so considerably. However, this could be accounted for by Glo-Warm not paying its suppliers in a similar fashion to the previous year. It will be **necessary to review the income statement** to substantiate whether activity has reduced.

The **cash position has also worsened**, with cash falling by \$22,000. The cash flow statement should reveal more detail about this fall. However, the company has paid off \$5,000 of its bank loan, reducing overall net debt.

In summary, audit work should be directed at going concern as **several indicators of going concern problems** exist on the balance sheet. This will be further amplified when the income statement is available.

Inventory

Inventory has been mentioned above in the context of going concern. Audit work should be directed at inventory specifically as this **balance has fallen significantly** from the previous year, which seems **odd in a manufacturing company**. There is no suggestion on the balance sheet for why this should be so (for example, receivables are not correspondingly high, suggesting high pre-year end sales, and payables are not correspondingly low, suggesting low pre-year end purchases). It may be that the inventory count did not include every item of inventory. Alternatively it could simply point to a fall in activity (discussed above).

Warranty provision

A provision of \$20,000 has been included in 2006 for warranties. The reasons for this must be investigated and the auditors must check that it has been accounted for correctly.

It seems **odd that a warranty provision should suddenly appear in a balance sheet**. It suggests a change in the terms of contracts given to customers, or a change in the customers themselves (with different terms then applying). Alternatively it suggests that **IAS 37** has been **wrongly applied in the current year, or should have been applied in the previous year**, and was not.

Other material items

As stated above, given the indications of loss and the reduction in total asset value, it is likely that materiality will be assessed low in monetary terms. In this case, most balances on the balance sheet are likely to be material (excluding investments and cash-in-hand which appear to be very low risk).

However, as the bank loan is likely to be substantiated by good audit evidence, the most risky of the other balances are **trade receivables** and **trade payables**, for reasons discussed above in going concern. More detail is required to make a judgement about the risk of tangible non-current assets.

4 Audit evidence considerations

- (a) Analytical procedures can be used at the planning stage, as substantive procedures, and at the review stage of the audit. Analytical procedures consist of the analysis of significant ratios and trends including the resulting investigations of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predictable amounts. Analytical procedures include comparisons with similar information from prior periods, comparisons to budgets and forecasts, comparisons with predictions prepared by auditors, and comparisons with industry information.

When using analytical procedures as substantive tests, auditors need to consider the information available in terms of its availability, relevance and comparability. They also need to consider the plausibility and predictability of the relationships they are testing. Other factors to consider include materiality, other audit procedures, the accuracy with which the expected results can be predicted, the frequency with which a relationship is observed and the assessments of inherent and control risks.

An example of an analytical procedure that can be used as a substantive test is a proof in total test on depreciation and amortisation. In this test, the auditor predicts the expected charge for the year for depreciation and amortisation by using the client's accounting policy for depreciation and applying this to the brought forward figures for non-current assets from the prior year audited financial statements, factoring in additions and disposals for the year. The figure obtained can be compared to the charge in the draft financial statements to assess its reasonableness and accuracy.

- (b) Audit evidence is available to auditors in a variety of forms. These include auditor-generated evidence (e.g. analytical procedures), external sources of evidence from third parties (e.g. solicitors' correspondence, valuation reports from surveyors for land and buildings), internal sources of evidence from within the entity being audited (e.g. minutes of meetings from the Board of directors, reports generated from the accounting system), and oral or written evidence. Another factor to consider is whether the evidence, if written, is from an original document or a copy.

Audit evidence from external sources to the entity is more reliable than that obtained from the entity's records. Evidence from the entity's records is more reliable when the related internal control system is operating effectively. Auditor-generated evidence is more reliable than that obtained indirectly or by inference. Evidence in the form of documents or written representations is more reliable than oral representations. Where evidence is written, original documents are more reliable than photocopies which can be altered by the client relatively easily.

5 Knits Co

(a)

<i>Weaknesses</i>	<i>Reason</i>
1 There does not appear to be any list of regular customers to be visited or timetable of regular visits. There is no credit check for accepting an order.	Potential sales may be lost if customer goodwill is lost through inventory not being ordered promptly. Goods may be issued to a bad credit risk.
2 The order form set has insufficient copies.	The customer has no copy of the accepted order, disputes at a later date when the goods are despatched may become difficult to resolve.
3 The copy of the order for use in the warehouse is not sent directly to the warehouse.	The accounts department, who generate and post the sales invoice have the ability to adjust the order before it is sent to the warehouse.
4 The order form is filed before being matched to a despatch note and sales invoice.	Poor monitoring of accurate and timely completeness of sales orders.
5 No copy of the despatch note is retained in the warehouse.	No documentation is available within the warehouse to support inventory movements and prepare inventory records.
6 The sales ledger is only updated weekly.	Customers are being given an additional weeks credit which does not help Knits Co's cash flow.
7 Mrs Jones has control over most stages of the sales cycle from passing the order to despatch, raising and posting the sales invoice to receiving and posting the cash.	Sales transactions may be manipulated and company funds lost.
8 Written customer statements are only produced for balances over 90 days old.	The company is giving a very long credit period before chasing for payment. This causes cash flow problems for the company and given the nature of the customers business could easily become bad debts within a 90 day period.
9 There is no monthly reconciliation of a receivables listing to a control account balance. This is exacerbated by the fact that hard copy printouts of sales ledger balances are not retained.	Errors in updating sales invoices and cash may go undetected until a customer complains. Lack of audit trail poses problems for the company in dealing with complaints but also in making year-end provisions and providing audit evidence for the external auditor.

Additional valid points

- | | | |
|---|--|--|
| 1 | The sales representative does not monitor the completeness of orders. | Customer goodwill may be lost as a result of errors or time delay in completing orders. |
| 2 | There is no customer confirmation of receipt of goods. | Any dispute regarding receivables arising from goods delivered may be difficult to resolve. |
| 3 | There is no independent review of the sales invoices prepared by Mrs Jones. | Errors in terms of prices to be charged, any discounts due to arithmetical errors may go undetected. |
| 4 | Sales invoices are filed away, without retaining the despatch note, before the customer has paid. | Any customer disputes arising may be difficult to resolve without evidence of the goods despatched. Bad debts may arise. |
| 5 | The executive director does not appear to check the cheques received and being banked to a remittances list. | Errors in recording and banking receipts may go undetected. |

(b) Controls to overcome the weaknesses stated in part (a)

- 1 A schedule of planned visits should be prepared by the sales representative and completed with details of sales orders taken.
- This schedule should be reviewed by the executive director on a weekly basis, comparing sales made to budgeted sales.
- Any customers who are bad credit risks should be notified to the sales representative before his scheduled visit.
- 2,3,4 A four-part order form should be prepared at the customers premises, with evidence of approval by the customer.
- The parts should be distributed as follows:
- | | |
|---|---|
| 1 | Remain with customer |
| 2 | To the warehouse |
| 3 | To accounts to match with the sales invoice and despatch note |
| 4 | Remain with the sales representative, to be used to monitor the progress of orders. |
- 5 A three part despatch note system should be used as follows:
- | | |
|---|---|
| 1 | Copy with the goods |
| 2 | Filed with a copy of the order in the warehouse |
| 3 | Sent to Accounts |
- 6 Sales invoices should be posted to the sales ledger daily.
- 7 The sending of a copy of the despatch note directly to the warehouse and the monitoring of the completion of the order by the sales representative would help to introduce segregation of duties into the system.
- In addition, cash and cheque receipts received in the morning could be recorded by Mrs Singh if she was given the additional morning duty of opening the post.
- 8 Statements should be sent on a monthly basis. In addition the company should investigate whether the company's computer package could produce them automatically.
- 9 Printouts of sales invoice and cash receipts postings should be retained, to provide adequate audit trail.
- In addition the individual sales ledger balances should be listed monthly and reconciled to the nominal ledger sales ledger control account.
- This account reconciliation should be performed by the executive director.

Additional points

- 1 A schedule of goods being despatched should be prepared and the courier company should sign for the goods being taken to customers.
- 2 The executive director should review a sample of invoices per week, comparing details to despatch notes, price lists and orders and checking numerical calculations.
- 3 The copy of the sales invoice retained by Knits Co should be matched to the order and despatch note before being filed away.
- 4 Mrs Singh should prepare a list of remittances detailing the customers name, specific invoices being paid and the net and gross amounts. A copy of the form should be sent to Mrs Jones and a second copy sent to the executive director alongside the cheques for banking. The executive director should evidence the form on banking the cheques to the form filed in date order.

6 Fenton Distributors

Tutorial note. In (b) significant emphasis is placed on testing unusual or suspicious items (particularly the adjustment journals). Note also the importance of accounting controls at the year-end. Correct categorisation of expenses is important from the viewpoint of the statutory accounts (directors' emoluments), and in ensuring the quality of management information, which the auditors may use for analytical procedures.

- (a) To verify the accuracy of the purchases transactions posted to the nominal ledger I would perform the following checks.
- (i) I would check that the bookkeeper was up to date with the monthly posting of all purchases transactions to the nominal ledger.
 - (ii) Specific checks on purchase transactions will include the following.
 - (1) Purchase transactions will be traced from the invoice to the nominal ledger and the analysis and analysis code will be checked.
 - (2) The total invoice value will be traced to the nominal ledger.
 - (3) The category of invoice expense and the expense amount will be checked to confirm that it appears correctly on the detailed computer list for the month concerned.
 - (4) The total of the items on the detailed list will be checked to the nominal ledger.
 - (5) Transactions will also be traced backwards from the entries in the nominal ledger making up the monthly total posted to the purchase ledger back to both the detailed analysis and the individual invoice.
 - (6) The amount of the invoice expense will be agreed with the amount posted to the nominal ledger.

The tests above check accounting entries forwards and backwards within the system and any errors would be fully investigated as to their type, cause, materiality and pattern.
 - (iii) The test checks on the detailed list and total postings of cash payments, discounts received and adjustments will follow the same procedure as for invoices and credit notes. The monthly cash book total will be checked to the total posted from the purchase ledger to the nominal ledger.
 - (iv) A check on the analysis and coding of purchase invoices will be carried out to establish the level of accuracy achieved. Particular care will be taken to see that the expense category 'purchases' is correctly identified and coded from invoices and is not confused with other

categories, for example stationery, rates, gas and telephone. Incorrect analysis and/or coding may be indicated where the expense category is high or low in comparison with its budget to date.

Large variations between actual and budget on expense categories should be test checked to verify that they are not due to errors in analysis, coding or posting.

- (b) To verify the validity and accuracy of the journals posted to the nominal ledger I would carry out the following checks.
- (i) Firstly, I would check the opening balances at the start of the financial year. To do this I would check the value of each trial balance item on the opening trial balance back to the closing entries on the previous year's accounts. After this, each item would be checked to the nominal ledger ensuring that both the value and analysis are correct. These opening postings should be the first entries in the new year as all nominal ledger balances should have been set to zero, and this should be confirmed.
 - (ii) Other cash book items would be test checked to the nominal ledger to confirm that postings are correct as to value and expense category. Large items would require a larger sample size and large, unusual or suspicious items should all be checked and evidenced by supporting documentation or Board approval.
 - (iii) The year-end balances of cash and bank on the nominal ledger should be agreed with the year-end balances in the cash book. This would require the last month to be checked as the closing balances at all previous month-ends will have been checked already.
 - (iv) The checks on petty cash payments transactions would include the following.
 - (1) Check that transactions are supported by vouchers and correctly posted to the right nominal ledger account. This would include checking that transactions are valid and coded to the correct expense category.
 - (2) Check that petty cash transactions are within any limits, regarding the type of expenditure or maximum value, established by management.
 - (3) Check that the petty cash balance in the nominal ledger at the end of each month and at the financial year-end agrees with the balance in the petty cash book.
 - (v) The wages expense is posted manually to the nominal ledger from the monthly payroll summaries by means of a journal. To verify that the journals are correctly posted I would select several journals and check the following matters.
 - (1) The totals of the analysis columns on the monthly summary shown on the spreadsheet should be posted to the journal, and forward to the nominal ledger.
 - (2) The breakdown of wages expense into directors and the several departmental categories will be checked. The correct identification of directors' pay is important as this requires statutory disclosure. I would obtain the current list of directors. I would add up the totals in the analysis columns to confirm the summary total, and consider its reasonableness.
 - (3) Amounts owing at the year-end for income tax, accrued pay and other deductions will be verified and any reconciliation drawn up by the bookkeeper agreed.
 - (4) Any additions to, or amendments of, weekly wages records posted to the nominal ledger through the adjustments journal will be fully investigated and their validity established.
 - (5) The analysis of wages expense for the year will be compared with the budget and an explanation will be sought for any significant variances.
 - (vi) Adjustment journals are potentially a high-risk area and any checks would include the following.

- (1) Check that all the manually written adjustment journals were authorised by the managing director and supported by documentation and proper narratives.
- (2) Check journals are posted in numerical order and there should be no missing numbers gaps in the postings.
- (3) Examine all large adjustments and the reasons given for the errors. These will be traced to the nominal ledger to ensure that postings do correct the errors.
- (4) Investigate closely recurring errors to establish their cause and whether these can be avoided in future by management action.
- (5) Examine the purchase ledger suspense account (payables suspense) and trace all postings in and out.
- (6) Where there was no account in the nominal ledger, check back to the purchase invoice, establish the account number and verify that the item has been posted from the suspense account to the correct account.
- (7) Where the adjustment is due to the wrong account number being used, check that the journal correctly transfers the item to the right account.
- (8) Where the bookkeeper has created contra entries between the purchase ledger and the sales ledger, check that the supplier/customer company concerned is posted with a purchase ledger and sales ledger contra of the same value.
- (9) All other adjustments will be checked for validity and supporting documentation.

Reasons will be established for postings that increase or reduce purchase ledger balances.

- (vii) Year-end balances on the nominal ledger would be further checked as follows.
- (1) Any balances remaining on the purchase ledger and sales ledger suspense accounts should be itemised on a supporting schedule and the existence of each item justified.
 - (2) Nominal ledger balances for the cash book, petty cash book, sales ledger and purchase ledger should agree to, or be reconciled to, the cash book, petty cash book, total sales ledger and total purchase ledger balances at the year-end. I will check that any difference is reconciled and explained. It may be that further adjustments are required to reduce or eliminate a difference.
 - (3) All non-current asset movements should be checked, including purchases, sales, revaluations and depreciation.
 - (4) All outstanding liabilities should be verified and their size reviewed for reasonableness.
 - (5) The bank reconciliation should establish the correctness of balances on all types of bank account, ie loan, current, deposit, special transactions and so on.
 - (6) A review of the financial statements would be carried out to ensure that material changes in assets, expenses, revenues, liabilities and share capital are justified and explained. Justification would be sought in both relative and absolute terms.

7 Cheque payments and petty cash

Tutorial note. This question asks you to assess the controls over a particular area of a business. Notice that the answer refers to the objectives of the suggested controls as well as the controls themselves. Thinking through the control objectives in any given area will help you to suggest relevant controls. In another situation, it might help you to explain why current controls are weak.

- | | |
|--|---|
| <p>(a) A Black
Managing Director
Quicksand Co
12 Kelvin Street
Anytown</p> | <p>MNO & Co
3 Green Street
Anytown
Date</p> |
|--|---|

Dear Mr Black

You recently requested that we should advise you on good internal controls over cheque payments and petty cash.

The main objectives of control over payments are to ensure that payments are made only in respect of valid transactions and that they are suitably authorised. The following control procedures will contribute toward attaining these objectives.

Cheque payments

- (i) Cheques should be raised only on the basis of authorisation, for example a purchase invoice which has been suitably authorised.
- (ii) Cheques should be signed by people other than those who approve invoices.
- (iii) There should be two independent signatories for each cheque, for instance, two directors might act as signatories. Signatories should inspect the documents supporting the cheque to ensure that the details agree. They should also mark the document so that it cannot be reused.
- (iv) Cheques should be restrictively crossed.
- (v) Unused cheques should be kept in a secure place. Blank cheques should never be signed.
- (vi) Cheques should be under sequential control and all numbers should be accounted for. Spoilt cheques should therefore be retained.
- (vii) When cheques have been signed, they should be despatched immediately.

Petty cash

- (i) Petty cash payments should be made only on the basis of suitably authorised vouchers, which should be under sequential control. Vouchers should be retained for subsequent references. Where independent evidence is also available, for example invoices and receipts, this should be retained.
- (ii) An imprest system should be used to control petty cash. This means that the petty cash float is maintained at a specific amount and is reimbursed at regular intervals on the basis of vouchers showing the payments which have been made. It is suggested that the float should be kept at a level of \$300 and be reimbursed on a weekly basis.
- (iii) The petty cash float should be subject to periodic surprise counts by a responsible person not involved with the petty cash system. The balance in-hand should be reconciled to the imprest account by reference to the vouchers not yet reimbursed.
- (iv) The size of individual payments out of petty cash should be subject to a maximum to be agreed by the directors.

- (v) Staff should not be allowed to cash personal cheques or borrow from petty cash.

I hope that the above information is useful to you in designing your systems of internal control. If you require any more information, please let me know.

Yours sincerely,

A Smith

- (b) Mr Black presumably feels that involvement in cash and cheque controls will be time-consuming, and that he is too busy to be involved in it. He may feel that he does not want to play a direct part in the petty cash function. Because of the small amounts involved, he may wish to delegate this function to another director. He should appreciate, however, that involvement at least in the authorisation of cheque payments would help to ensure that he is aware of major transactions in his business. He might consider the possibility of authorising cheques in excess of a given amount; this would minimise the demands on his time, while exercising control and keeping him informed of significant outgoings from the business.

Auditors may wish to consider whether Mr Black's lack of involvement may be symptomatic of insufficient attention being given to financial matters by the board.

8 Elsams Co

- (a) *Use of computer programs to verify inventory*

If physical inventory counting takes place at the year-end, it may be assumed that the results of the physical inventory count are entered into, and valued by, the computer. If so, then it is important to compare the results of the physical count with the book quantities. The client may have a computer program to make this comparison. It would be possible for the auditor to check this comparison by re-performance using his own specially written computer audit program or a computer audit package. The auditor's computer audit program or package, when run against the file of book inventory, might also be used to carry out the following tasks.

- Select a monetary unit or random sample of book inventory items for the auditor to check the physical count quantities.
- Select items with specific characteristics, e.g. no sale since a specific date, unit selling price over a specified figure for further testing (test counts or obsolescence enquiries).
- Prepare an aged analysis of inventory items.
- Re-perform calculation of the FIFO cost of each inventory item, compare with the book inventory figure and print details if there is a discrepancy.
- Cast the file of book inventory and print the total.
- Print details (product number, supplier, quantity, cost, date of supply) for a sample of recent inventory receipts contained on the file of book inventory for substantiation against suppliers' invoices.
- Prepare summaries of inventory by branch, product number and location to assist in analytical procedures on the inventory figure, especially when comparing with previous years.
- Compare the unit FIFO cost of each inventory item with the unit selling price and print details of all inventory items where unit selling price is the lower to assist in evaluating net realisable value.

Limitations

Computer audit programs specific to the client are expensive to write. Computer audit packages which are tailored to the client's computer and file structure are less expensive. However, packages are often only compatible with certain makes of computer. The audit software can work

only with the information contained in the computer files. For example, an inventory ageing cannot be produced if the dates of inventory movements are not available. Clearly audit software cannot perform audit tests where an element of judgment is involved. For example, it can produce an inventory ageing analysis but the auditor must decide, on the basis of all available evidence, what level of obsolescence provision is reasonable. Audit software requires the auditor to have a detailed knowledge of the software and of the computer files to be used.

(b) *Test data*

Audit test data consists of data submitted by the auditor for processing by the enterprise's computer-based accounting system. It may be processed during a normal production run (live test data) or during a special run separate from the normal cycle (dead test data). The auditor predicts the results of processing the data and compares the prediction with the actual results. The primary objective of test data is to test programmed controls. For example, if the program contains a control which rejects overtime hours greater than 20 per week, then the test data might include the case of 21 hours overtime to see if it is rejected. The basic principle of using test data is that if the program processes the test data correctly, then the logic of the program and the program coding works and will process the actual data correctly.

Difficulties

- When live test data is used there is difficulty in ensuring that the dummy data does not become included in the actual data.
- When dead test data is used it may be difficult to ensure that the program tested is identical with that used for the actual data.
- The initial time spent designing the test data is excessive in relation to the benefit it brings – many auditors would rather devote that time to substantive audit work.

(c) *Audit sampling*

- (i) Random selection ensures that all items in the population have an equal chance of selection, e.g. by use of random number tables or computerised generator.
- (ii) Systematic selection involves selecting items using a constant interval, the first interval having a random start. When using this method, the auditor must be sure that the population is not structured in such a way that the sampling interval corresponds with a particular pattern in the population.
- (iii) Haphazard selection is an alternative to random selection, as long as the auditor is satisfied that the sample is representative of the whole population. This method requires care to guard against making a selection that is biased. It should not be used if statistical sampling is being carried out.
- (iv) Sequence/block selection can be used to check whether certain items have particular characteristics. However it may produce samples that are not representative of the population as a whole, especially if errors only occurred during a certain part of the period and hence the errors found cannot be projected onto the rest of the population.

9 Sitting Pretty

Tutorial note. This question covers all the important aspects of inventory; existence, valuation and cut-off. Part (b), which is for the most marks, requires you to plan the inventory count attendance. As you are planning, you should look for risk areas given to you in the question.

In part (a) don't just give a standard answer about the importance of an inventory count (although this should form part of your answer). The question asks you to be specific about this scenario.

The Study Text gives useful steps in planning an inventory count attendance so you should bear these in mind, although not all the matters it mentions are important in this case. You must practise being able to use standard lists of matters to consider and apply them to a given scenario.

Similarly in parts (c) and (d), do not just write down everything you know about auditing cut-off and valuation of inventory. You must tailor your answer to the facts given in the question. In part (d), therefore, you will have to make a comment about the 10% discount, for example.

(a) **Importance of the inventory count**

The inventory count provides important **audit evidence** as to the **existence** and **completeness** of inventory included in the financial statements.

In this case, the inventory count is particularly important because the **company does not maintain perpetual inventory records**. As no perpetual records are maintained, the only basis for the inventory entries in the financial statements is the results of this inventory count.

Inventory is **generally material** to the balance sheet of a manufacturing company and is also one of the **higher risk areas** on the balance sheet. The inventory count provides important audit evidence reducing the risk of material misstatement in relation to inventory.

(b) **Planning for attendance**

Gain knowledge: I must review the notes of last year's inventory count and I must contact the factory manager to obtain details of this year's. I must review this year's details to ensure that the inventory count appears to be planned efficiently and effectively.

Tutorial note. It is possible you assumed that this part of planning was already completed as the question tells you that you have just rung the factory manager. If so, you should have stated that assumption, or to cover yourself as we have, noted that this is a requirement. However, you should not have spent long on this aspect of the question.

Assess key factors: There are various key factors given in the scenario:

- (i) **Nature and volume of the inventory.** There should be no WIP, so I will count raw materials (approximately 10% of the inventory) and finished goods. However, raw material plastic should be low because a delivery is required to continue with production.
- (ii) **Possible obsolescence.** I must make a note of the number of old chair legs maintained in raw materials as these are now obsolete, a new specification having been agreed.
- (iii) **Cut-off issues.** I need to ensure that the delivery on the day is isolated and that I obtain details of the delivery made during the inventory count. I need to determine whether this should be included as deliveries for the year, but most of all ensure that it does not get counted twice (as it arrives, and if it is put into stores). I should also obtain copies of the relevant documents, for example, the last invoices in the year and the last goods received and despatched notes.
- (iv) **Off-cuts.** I need to consider whether any off-cuts are maintained on site and whether these are being included in the inventory count. As the company receives a discount

relating to them, they are unlikely to be considered Sitting Pretty's legally and so should not be included.

- (v) **Staff issues.** It appears that the inventory count is undertaken by the people who work in the factory and handle the inventory on a daily basis. This is not best practice, although in practical terms it is difficult to avoid. However, I should discuss this with the factory manager to assess whether staff can be allocated to counting inventory they have not produced. Also, as the staff are allowed to go home as soon as the inventory count is completed, there is a risk that the inventory count will be rushed and mistakes will be made. The manager should ensure that it is made clear that the inventory count should be thorough and that no one will leave before checks on the thoroughness of the counts have been made.

Plan procedures: I need to determine my sample sizes and whether there is a need for expert assistance at this inventory count.

- (i) **Procedures.** I will carry out test counts, checking from a sample of physical items to the count sheets and a sample of count sheet items to the physical items.
- (ii) **Samples.** There are no higher value items that I should concentrate particularly on. Materiality for the year has been set at \$5,000 currently. Dividing last year's figures for inventory by this materiality level would give a sample size of six items for raw materials and 34 items for finished goods. I need to determine the batches in which inventory is valued to ensure that I count the correct items. I need to assess the levels of inventory when I arrive to ascertain whether this remains appropriate.

(c) **Cut-off at final audit**

General procedures

The audit team should take a **sample of delivery notes** for sales and purchases on either side of the year-end and **trace** these to **invoices** and **ledgers** and **inventory** records to ensure that **sales and purchases have been included in the correct period** and that **inventory is accounted for where appropriate** (that is, sales have not been counted twice and purchases have been included in inventory). As the factory has been shut down, there is a lower risk that sales cut-off is inappropriate than purchases cut-off.

Inventory count delivery

Once it is determined whether this delivery should count as this year's inventory (which it should if the inventory count was the year-end date), the delivery information should be traced to purchase invoices and ledgers to ensure that the purchase is recorded in the year and that the creditor is accounted for in the year. The inventory should then also be included.

Other matters

If **inventory returns** are material, the returns after the year-end should be reviewed to ensure that items are not included as sales in the year and that the inventory is added to the inventory figure unless it is now obsolete, whereupon it should be written-off.

(d) **Valuation of inventory**

The auditors should obtain the client's working papers relating to the valuation of inventory. Items which the auditor sampled at the inventory count should already have been verified to the inventory count records as part of the verification of existence.

Cost

The auditors should then **trace a sample of items to purchase invoices** to ensure that **cost has been correctly applied**. Cost of purchase excludes trade discounts and rebates, so the auditors should ensure that the valuation **cost excludes the 10% discount** received for returning the off-cuts of plastic.

The auditors should then ensure that for a sample of finished goods items, **costs of conversion** (comprising costs of labour and overheads) have been included. This should be on a comparable basis to the previous year and therefore can be audited by analytical review.

Net realisable value

The auditors should ensure that **cost is lower than net realisable value** by tracing their sample to **after-date sales**. If no invoices are yet available, the auditors can make confirmations by reviewing sales orders and price lists.

Obsolete

Lastly, the auditors should ensure by review and by discussion with management that inventory which has been identified as **obsolete** at the inventory count has **not been attributed value** and has been **scrapped**.

Analytical procedures

The auditors will undertake general analytical procedures to ensure that the inventory figure stacks up. This could include calculating ratios such as inventory turnover and ensuring that they tally with the facts that have been presented them in the course of the inventory audit.

10 Going concern

Tutorial note. Part (a) demonstrates what can be deduced from the calculations, for example short-term funds used to purchase non current assets and delayed payments to suppliers. It is vital when you approach questions like this that you do not spend so long calculating ratios that you fail to make comments and draw conclusions from your work. Equally, having been asked in the question to undertake some calculations, it would be wrong not to do so. You must apply judgement in the balance between calculations and analysis in your answer, remembering that you will score better marks for analysis.

Workings

The following significant accounting ratios are based on the accounts provided in the question.

	20X2	20X3	20X4	20X5	20X6
Gross profit (%)	23.50	10.90	14.20	20.20	19.70
Other expenses: sales (%)	14.10	10.90	14.40	14.40	15.30
Interest: sales (%)	0.90	1.10	5.20	5.50	6.20
Net profit (%)	8.50	(1.10)	(5.40)	0.30	(1.80)
Current ratio	1.39	0.91	0.73	0.73	0.76
Liquidity ratio	0.80	0.59	0.46	0.37	0.34
Leverage (%)	84.71	57.14	9.52	9.45	4.83
Inventory (months)	1.68	2.28	2.26	2.77	3.57
Receivables (months)	1.75	3.66	3.24	2.26	2.32
Payables (months)	2.26	5.43	4.43	4.43	5.09

Notes

$$\text{Inventory age} = \frac{\text{Year - end inventory}}{\text{Cost of sales}} \times 12$$

$$\text{Receivables age} = \frac{\text{Year - end receivables}}{\text{Sales}} \times 12$$

$$\text{Payables age} = \frac{\text{Year - end payables}}{\text{Sales}} \times 12$$

$$\text{Leverage} = \frac{\text{Shareholders' equity} + \text{Long - term loans} + \text{Bank overdraft} + \text{Lease}}{\text{Shareholders' equity}}$$

- (a) The various factors in the accounts which may be indicative of going concern problems are as follows.
- (i) Only losses or low profits are being made and the company is not generating sufficient funds to finance the expansion required
 - (ii) There has been a dramatic increase in the level of overdraft over the last year and there seems little prospect of the borrowing being reduced and the security is threatened.
 - (iii) There are signs of overtrading as the expansion has been financed by borrowings and the increase in current assets is being financed by trade accounts payable.
 - (iv) The leverage is low and decreasing, with very little security being available for the loans.
 - (v) There is a low current ratio and short-term funds are being used to finance long-term assets.
 - (vi) The liquidity ratio is low and decreasing and the company's ability to meet its liabilities on demand must be very questionable.
 - (vii) Inventory levels are increasing, suggesting that one or more of the following problems may exist: deteriorating sales, poor inventory control, obsolete or slow-moving inventories.
 - (viii) The value and age of trade accounts is increasing: some suppliers must be having to wait a considerable time before being paid and it can only be a matter of time before pressure is put on the company by one or more of its creditors.
 - (ix) High and increasing interest charges make the company very vulnerable, especially in a period of recession and high interest rates.
 - (x) The fluctuating gross profit would suggest that the company's profit margins are under pressure. The present level of gross profit does not seem sufficient given the company's high level of expenses.
- (b) The other important steps to be taken by the auditors in determining whether or not the company may be properly regarded as a going concern at the year-end would include:
- (i) Review carefully the cash and profit forecasts for the next year to see if they suggested any improvement in the company's position
 - (ii) Seek some evidence that the company's bank is prepared to continue supporting the company
 - (iii) Review the level of post balance sheet trading to see if this supports the forecasts and show any signs of improvement in the company's position
 - (iv) Examine correspondence files for any evidence that suppliers might be putting pressure on the company for repayment of monies owing
 - (v) Consider how the company's position compares with similar companies in the same business
 - (vi) Discuss generally the situation with management and review any recovery plans which they may have in mind

11 Wiseguys National Bakeries Co

(a) *Freehold property*

In past years this property has been shown in the statement at its original cost, whereas it is now restated at \$1,250,000 as professionally valued during the year. The auditor is satisfied as to the basis of the revaluation, adjustment to and disclosure made in the financial statements. As a result of the audit evidence obtained no further reference to the property revaluation will be required in the auditor's report.

(b) *Allowance for doubtful debts*

No part of the debt of \$45,000 due from XYZ Co will be recovered by the company. Since the financial statements which the directors have approved include no allowance for this debt, it will be necessary for the auditor's report to state that:

- (i) No allowance has been made against an amount of \$45,000 owing by the customer
- (ii) They believe such amount to be irrecoverable
- (iii) In their opinion, except for the failure to make such provision, a true and fair view of the state of the company's affairs and its results is given by the financial statements

(c) *Loan to a director*

Since the director's indebtedness of \$22,000 which subsisted during a six week period, has not been disclosed in the financial statements in accordance with IAS 24 *Related Party Disclosures*, the auditors are obliged to include in their report an explanatory paragraph giving the required disclosure.

The particulars include:

- (i) The amount of the loan and any interest
- (ii) The zero outstanding balance at the year-end
- (iii) Terms and conditions

The auditor's report will conclude with the statement of their opinion that the financial statements, except for the information specified above, give a true and fair view.

12 Builders Merchants

- (a) This represents a material limitation on scope because the 'missing' inventory represents 12% of the total. The auditor would expect all inventory counting sheets to be available. The auditor's report would be modified.

The basis of opinion paragraph would refer to the fact that the inventory counting sheets for this depot were lost. The opinion would state that "except for" adjustments that may have been necessary in relation to these inventory, the financial statements give a true and fair view.

The auditor's report would also state that in relation to inventory quantities:

- all information and explanations considered necessary were not obtained; and
- the auditor was unable to determine whether proper accounting records were kept.

- (b) This represents a material disagreement. The debt represents 8% of the total receivables balance and 45% of the profit for the year.

The auditor's report would be qualified.

The opinion paragraph would refer to the fact that the customer is in liquidation and there is little prospect of payment. It would also state that net assets and profits are overstated by \$45,000.

The actual opinion would state that "except for" the absence of this allowance the financial statements give a true and fair view.

- (c) As the client is listed, its accounts should include a cash flow statement.

The audit opinion should therefore be qualified on the grounds of disagreement. This disagreement is not pervasive to the accounts, it is limited to the cash flow statement, so this would be an except for qualification.

The opinion section should be headed 'Qualified opinion arising from disagreement over the omission of the cash flow statement'. It should state that the accounts give a true and fair view and have been properly prepared in accordance with an applicable financial reporting framework except for the omission of a cash flow statement.

The omission should be detailed in a paragraph above the opinion section, where the auditors should give details of the net cash flows and state that in their opinion, information about the cash flows is necessary for a proper understanding of the company's affairs.

- (d) The auditors need to determine whether the legal claim is a material matter and even whether it is pervasive to the accounts as a whole. For example, if the customer involved is a major customer, it could be that an adverse outcome could affect the going concern basis of the company.

It appears that the disclosure in the financial statements is adequate and there appears to be no basis on which to make a provision in the financial statements. Therefore there is no question that there is a disagreement in the audit.

However, the audit report will be affected by the fact that there is an uncertainty affecting the business. The auditors will have to decide whether the inherent uncertainty is material or fundamental. If material, it does not need to be mentioned in the audit report. However, if they decide that it is fundamental, the report should contain a paragraph giving the appropriate details. It should also state that the opinion is not qualified in relation to this matter.

Thereafter, no reference should be made to the legal claim in the opinion section of the report.

END OF ANSWER BANK

Appendix: Pilot Paper Questions



Pilot paper

Paper F8

Audit and Assurance (UK)

Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

ALL FIVE questions are compulsory and MUST be attempted.

ALL questions are compulsory and MUST be attempted

Question 1

1 Westra Co assembles mobile telephones in a large factory. Each telephone contains up to 100 different parts, with each part being obtained from one of 50 authorised suppliers.

Like many companies, Westra's accounting systems are partly manual and partly computerised. In overview the systems include:

- (i) Design software
- (ii) A computerised database of suppliers (bespoke system written in-house at Westra)
- (iii) A manual system for recording goods inwards and transferring information to the accounts department
- (iv) A computerised creditors' ledger maintained in the accounts department (purchased off-the-shelf and used with no program amendments)
- (v) Online payment to suppliers, also in the accounts department
- (vi) A computerised nominal ledger which is updated by the creditors' ledger

Mobile telephones are assembled in batches of 10,000 to 50,000 telephones. When a batch is scheduled for production, a list of parts is produced by the design software and sent, electronically, to the ordering department. Staff in the ordering department use this list to place orders with authorised suppliers. Orders can only be sent to suppliers on the suppliers' database. Orders are sent using electronic data interchange (EDI) and confirmed by each supplier using the same system. The list of parts and orders are retained on the computer in an 'orders placed' file, which is kept in date sequence.

Parts are delivered to the goods inwards department at Westra. All deliveries are checked against the orders placed file before being accepted. A hand-written pre-numbered goods received note (GRN) is raised in the goods inwards department showing details of the goods received with a cross-reference to the date of the order. The top copy of the GRN is sent to the accounts department and the second copy retained in the goods inwards department. The orders placed file is updated with the GRN number to show that the parts have been received.

Paper invoices are sent by all suppliers following dispatch of goods. Invoices are sent to the accounts department, where they are stamped with a unique ascending number. Invoice details are matched to the GRN, which is then attached to the invoice. Invoice details are then entered into the computerised creditors' ledger. The invoice is signed by the accounts clerk to confirm entry into the creditors' ledger. Invoices are then retained in a temporary file in number order while awaiting payment.

After 30 days, the creditors' ledger automatically generates a computerised list of payments to be made, which is sent electronically to the chief accountant. The chief accountant compares this list to the invoices, signs each invoice to indicate approval for payment, and then forwards the electronic payments list to the accounts assistant. The assistant uses online banking to pay the suppliers. The electronic payments list is filed in month order on the computer.

Required

- (a) List the substantive audit procedures you should perform to confirm the assertions of completeness, occurrence and cut-off for purchases in the financial statements of Westra Co. For each procedure, explain the purpose of that procedure. **(12 marks)**
- (b) List the audit procedures you should perform on the trade creditors balance in Westra Co's financial statements. For each procedure, explain the purpose of that procedure. **(8 marks)**
- (c) Describe the control procedures that should be in place over the standing data on the trade creditors' master file in Westra Co's computer system. **(5 marks)**
- (d) Discuss the extent to which computer-assisted audit techniques might be used in your audit of purchases and creditors at Westra Co. **(5 marks)**

(Total = 30 marks)

Question 2

- (a) ISA 210 *Terms of audit engagements* explains the content and use of engagement letters.

Required

State six items that could be included in an engagement letter. **(3 marks)**

- (b) ISA 500 *Audit evidence* explains types of audit evidence that the auditor can obtain.

Required

State, and briefly explain, four types of audit evidence that can be obtained by the auditor. **(4 marks)**

- (c) ISA 700 *The auditor's report on financial statements* explains the form and content of audit reports.

Required

State three ways in which an auditor's report may be modified and briefly explain the use of each modification. **(3 marks)**

(Total = 10 marks)

Question 3

You are the audit manager in the audit firm of Dark & Co. One of your audit clients is NorthCee Co, a company specialising in the manufacture and supply of sporting equipment. NorthCee have been an audit client for five years and you have been audit manager for the past three years while the audit partner has remained unchanged.

You are now planning the audit for the year ending 31 December 2007. Following an initial meeting with the directors of NorthCee, you have obtained the following information.

- (i) NorthCee is attempting to obtain a listing on the London stock exchange. The directors have established an audit committee, as required by corporate governance regulations, although no further action has been taken in this respect. Information on the listing is not yet public knowledge.
- (ii) You have been asked to continue to prepare the company's financial statements as in previous years.
- (iii) As the company's auditors, NorthCee would like you and the audit partner to attend an evening reception in a hotel, where NorthCee will present their listing arrangements to banks and existing major shareholders.
- (iv) NorthCee has indicated that the fee for taxation services rendered in the year to 31 December 2005 will be paid as soon as the taxation authorities have agreed the company's taxation liability. You have been advising NorthCee regarding the legality of certain items as "allowable" for taxation purposes and the taxation authority is disputing these items.

Finally, you have just acquired about 5% of NorthCee's share capital as an inheritance on the death of a distant relative.

Required

- (a) Identify, and explain the relevance of, any factors which may threaten the independence of Dark & Co's audit of NorthCee Co's financial statements for the year ending 31 December 2007. Briefly explain how each threat should be managed. **(10 marks)**
- (b) Explain the actions that the board of directors of NorthCee Co must take in order to meet corporate governance requirements for the listing of NorthCee Co. **(6 marks)**
- (c) Explain why your audit firm will need to communicate with NorthCee Co's audit committee for this and future audits. **(4 marks)**

(Total = 20 marks)

Question 4

SouthLea Co is a construction company (building houses, offices and hotels) employing a large number of workers on various construction sites. The internal audit department of SouthLea Co is currently reviewing cash wages systems within the company.

The following information is available concerning the wages systems:

- (i) Hours worked are recorded using a clocking in/out system. On arriving for work and at the end of each day's work, each worker enters their unique employee number on a keypad.
- (ii) Workers on each site are controlled by a foreman. The foreman has a record of all employee numbers and can issue temporary numbers for new employees.
- (iii) Any overtime is calculated by the computerised wages system and added to the standard pay.
- (iv) The two staff in the wages department make amendments to the computerised wages system in respect of employee holidays, illness, as well as setting up and maintaining all employee records.
- (v) The computerised wages system calculates deductions from gross pay, such as employee taxes, and net pay.

Finally a list of net cash payments for each employee is produced.

- (vi) Cash is delivered to the wages office by secure courier.
- (vii) The two staff place cash into wages packets for each employee along with a handwritten note of gross pay, deductions and net pay. The packets are given to the foreman for distribution to the individual employees.

Required

- (a) (i) Identify and explain weaknesses in SouthLea Co's system of internal control over the wages system that could lead to mis-statements in the financial statements;
- (ii) For each weakness, suggest an internal control to overcome that weakness. **(8 marks)**
- (b) Compare the responsibilities of the external and internal auditors to detect fraud. **(6 marks)**

The computer system in the wages department needs to be replaced. The replacement will be carried out under the control of a specialist external consultant.

- (c) Explain the factors that should be taken into consideration when appointing an external consultant. **(6 marks)**

(Total = 20 marks)

Question 5

EastVale Co manufactures a range of dairy products (for example, milk, yoghurt and cheese) in one factory. Products are stored in a nearby warehouse (which is rented by EastVale) before being sold to 350 supermarkets located within 200 kilometres of EastVale's factory. The products are perishable with an average shelf life of eight days. EastVale's financial statements year-end is 31 July.

It is four months since the year-end at your audit client of EastVale and the annual audit of EastVale is almost complete, but the auditor's report has not been signed.

The following events have just come to your attention. Both events occurred in late November.

- (a) A fire in the warehouse rented by the company has destroyed 60% of the stock held for resale.
- (b) A batch of cheese produced by EastVale was found to contain some chemical impurities. Over 300 consumers have complained about food poisoning after eating the cheese. 115 supermarkets have stopped purchasing EastVale's products and another 85 are considering whether to stop purchasing from EastVale. Lawyers acting on behalf of the consumers are now presenting a substantial claim for damages against EastVale.

Required

In respect of EACH of the events at EastVale Co mentioned above:

- (i) Describe the additional audit procedures you will carry out; **(8 marks)**
- (ii) State, with reasons, whether or not the financial statements for the year-end require amendment **(6 marks)**
- (iii) Discuss whether or not the audit report should be modified. **(6 marks)**

Note: The total marks will be split equally between each event.

(Total = 20 marks)

Pilot paper

Paper F8

Audit and Assurance (International)

Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

ALL FIVE questions are compulsory and MUST be attempted.

SECTION A: This question is compulsory and MUST be attempted

Question 1

Westra Co assembles mobile telephones in a large factory. Each telephone contains up to 100 different parts, with each part being obtained from one of 50 authorised suppliers.

Like many companies, Westra's accounting systems are partly manual and partly computerised. In overview the systems include:

- (i) Design software
- (ii) A computerised database of suppliers (bespoke system written in-house at Westra)
- (iii) A manual system for recording goods inwards and transferring information to the accounts department
- (iv) A computerised payables ledger maintained in the accounts department (purchased off-the-shelf and used with no program amendments)
- (v) Online payment to suppliers, also in the accounts department
- (vi) A computerised general ledger which is updated by the payables ledger

Mobile telephones are assembled in batches of 10,000 to 50,000 telephones. When a batch is scheduled for production, a list of parts is produced by the design software and sent, electronically, to the ordering department. Staff in the ordering department use this list to place orders with authorised suppliers. Orders can only be sent to suppliers on the suppliers' database. Orders are sent using electronic data interchange (EDI) and confirmed by each supplier using the same system. The list of parts and orders are retained on the computer in an 'orders placed' file, which is kept in date sequence.

Parts are delivered to the goods inwards department at Westra. All deliveries are checked against the orders placed file before being accepted. A hand-written pre-numbered goods received note (GRN) is raised in the goods inwards department showing details of the goods received with a cross-reference to the date of the order. The top copy of the GRN is sent to the accounts department and the second copy retained in the goods inwards department. The orders placed file is updated with the GRN number to show that the parts have been received.

Paper invoices are sent by all suppliers following dispatch of goods. Invoices are sent to the accounts department, where they are stamped with a unique ascending number. Invoice details are matched to the GRN, which is then attached to the invoice. Invoice details are then entered into the computerised payables ledger. The invoice is signed by the accounts clerk to confirm entry into the payables ledger. Invoices are then retained in a temporary file in number order while awaiting payment.

After 30 days, the payables ledger automatically generates a computerised list of payments to be made, which is sent electronically to the chief accountant. The chief accountant compares this list to the invoices, signs each invoice to indicate approval for payment, and then forwards the electronic payments list to the accounts assistant. The assistant uses online banking to pay the suppliers. The electronic payments list is filed in month order on the computer.

Required

- (a) List the substantive audit procedures you should perform to confirm the assertions of completeness, occurrence and cut-off for purchases in the financial statements of Westra Co. For each procedure, explain the purpose of that procedure. **(12 marks)**
- (b) List the audit procedures you should perform on the trade payables balance in Westra Co's financial statements.

For each procedure, explain the purpose of that procedure.

(8 marks)

22: APPENDIX: PILOT PAPER QUESTIONS

- (c) Describe the control procedures that should be in place over the standing data on the trade payables master file in Westra Co's computer system. **(5 marks)**
- (d) Discuss the extent to which computer-assisted audit techniques might be used in your audit of purchases and payables at Westra Co. **(5 marks)**
- (Total = 30 marks)**

Question 2

- (a) ISA 210 *Terms of Audit Engagements* explains the content and use of engagement letters.
Required
State SIX items that could be included in an engagement letter. **(3 marks)**
- (b) ISA 500 *Audit Evidence* explains types of audit evidence that the auditor can obtain.
Required
State, and briefly explain, four types of audit evidence that can be obtained by the auditor. **(4 marks)**
- (c) ISA 700 *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements* explains the form and content of audit reports.
Required
State three ways in which an auditor's report may be modified and briefly explain the use of each modification. **(3 marks)**
- (Total = 10 marks)**

Question 3

You are the audit manager in the audit firm of Dark & Co. One of your audit clients is NorthCee Co, a company specialising in the manufacture and supply of sporting equipment. NorthCee have been an audit client for five years and you have been audit manager for the past three years while the audit partner has remained unchanged.

You are now planning the audit for the year ending 31 December 2007. Following an initial meeting with the directors of NorthCee, you have obtained the following information.

- (i) NorthCee is attempting to obtain a listing on a recognised stock exchange. The directors have established an audit committee, as required by corporate governance regulations, although no further action has been taken in this respect. Information on the listing is not yet public knowledge.
- (ii) You have been asked to continue to prepare the company's financial statements as in previous years.
- (iii) As the company's auditors, NorthCee would like you and the audit partner to attend an evening reception in a hotel, where NorthCee will present their listing arrangements to banks and existing major shareholders.
- (iv) NorthCee has indicated that the fee for taxation services rendered in the year to 31 December 2005 will be paid as soon as the taxation authorities have agreed the company's taxation liability. You have been advising NorthCee regarding the legality of certain items as 'allowable' for taxation purposes and the taxation authority is disputing these items.

Finally, you have just inherited about 5% of NorthCee's share capital as an inheritance on the death of a distant relative.

Required

- (a) Identify, and explain the relevance of, any factors which may threaten the independence of Dark & Co's audit of NorthCee Co's financial statements for the year ending 31 December 2007. Briefly explain how each threat should be managed. **(10 marks)**
- (b) Explain the actions that the board of directors of NorthCee Co must take in order to meet corporate governance requirements for the listing of NorthCee Co. **(6 marks)**
- (c) Explain why your audit firm will need to communicate with NorthCee Co's audit committee for this and future audits. **(4 marks)**
- (Total = 20 marks)**

Question 4

SouthLea Co is a construction company (building houses, offices and hotels) employing a large number of workers on various construction sites. The internal audit department of SouthLea Co is currently reviewing cash wages systems within the company.

The following information is available concerning the wages systems:

- (i) Hours worked are recorded using a clocking in/out system. On arriving for work and at the end of each days work, each worker enters their unique employee number on a keypad.
- (ii) Workers on each site are controlled by a foreman. The foreman has a record of all employee numbers and can issue temporary numbers for new employees.
- (iii) Any overtime is calculated by the computerised wages system and added to the standard pay.
- (iv) The two staff in the wages department make amendments to the computerised wages system in respect of employee holidays, illness, as well as setting up and maintaining all employee records.
- (v) The computerised wages system calculates deductions from gross pay, such as employee taxes, and net pay.

Finally a list of net cash payments for each employee is produced.

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The computer system in the wages department needs to be replaced. The replacement will be carried out under the control of a specialist external consultant.

- (c) Explain the factors that should be taken into consideration when appointing an external consultant. **(6 marks)**
- (Total = 20 marks)**

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(Total = 20 marks)

END OF APPENDIX