ADAVANCED AUDIT AND ASSURANCE

ACCA PAPER P7

STUDY NOTE.

Contents

ABOUT PAPER P7

The Examiner – Lisa Weaver !

It builds on topics covered in Paper F8.

It is application of knowledge to more complex scenarios

Requires accounting knowledge – IASs/IFRSs

Exam Format

Section A – 2 compulsory questions		
	Question 1– 35 marks	
	Question 2 – 25 marks	60
Section B – 2 from 3 x 20 marks each =		40
		100

AUDIT FRAMEWORK AND REGULATION.

An **audit** of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with the financial reporting framework.

REGULATORY ENVIRONMENT

Corporate Governance

Guidance has been developed in the following areas:

- the need for financial controls
- the conduct and remuneration of directors
- operational controls and,
- risk.

- The main recommendations on corporate governance are embodied in the Combined Code of the Committee on Corporate Governance.
- While the directors are to disclose, in a narrative statement in the annual report, how they have applied the Code principles of good governance, the auditors are expected to read only.
- Directors are expected to include in the annual report a statement that the business is a going concern with supporting assumptions or qualifications as necessary while auditors are to review only.
- If and only if, the reading reveals that the narrative statement is apparently misstated or materially misleading does the auditor need to take further action.

Auditors' responsibilities

Auditors have different responsibilities for different parts of the annual report.

- Audit the financial statements
- Review the company's compliance with certain aspects of the national Code of Corporate Governance.
- Read all the information in the report that is not subject to any other requirement.

The auditor should obtain appropriate evidence to support the compliance statement made by the company. The Turnbull guidance requires the Board to disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report and accounts.

Audit Committees

The Combined Code requires that companies should have a committee of the board called Audit Committee. This would consist of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties.

Objectives of audit committees

1. Increasing public confidence in the credibility and objectivity of published financial information (including un-audited interim statements)
2. Assisting directors (particularly NED) in meeting their responsibilities in respect of financial reporting.
3. Strengthening the independent position of a company's external auditor by providing an additional channel of communication.

Advantages of audit committees

1. Improve the quality of management accounting
2. Lead to better communication between the directors, external auditors and management
3. Avoid conflicts arising between management and auditors

Disadvantages of Audit Committees

1. Creating the fear that their purpose is to catch management out.
2. Non-executive directors being over-burdened with detail.
3. Creating a 'two-tier' board of directors.

Internal financial control effectiveness

Clearly everyone wants effective controls. Controls cannot give absolute assurance but only reasonable assurance against material misstatement or loss.

The board of directors are responsible for the company's system of internal control. Essentially the external auditors have no responsibilities for internal controls. The internal auditor has extensive responsibilities for internal control but that does not include setting up or installing systems of internal control.

Laws and regulations in an audit of financial statements

It is the responsibility of the directors:

- to ensure that the entity complies with laws and regulations applicable to its activities,
- to establish effective arrangements for preventing any non-compliance with laws or regulations and detecting any that occurs.

Auditors are required to obtain sufficient appropriate audit evidence about compliance with the laws and regulations that determine the form and content of the financial statements.

The second category of laws and regulations are those which provide a legal framework within which the entity conduct its business.

ISA 250 requires the auditor to plan and perform the audit with an attitude of professional scepticism recognising that the audit reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations.

When carrying out their procedures for the purpose of forming an opinion on the financial statements, the auditors should in addition be alert for instances of possible or actual non-compliance with law or regulations which might affect the financial statements.

The auditor may need to seek legal advice before deciding on a course of action. Auditors can report non-compliance to management, shareholders and/or third parties.

The main sources for regulatory material are:

- International Standards on Auditing (ISAs) issued by the International Federation of Accountants (IFAC)
- The ACCA's Rules of Professional Conduct
- IFAC's Code of Ethics for Professional Accountants

ISAs contain basic principles and essential procedures covering most auditing areas.

The EU 8th Directive requires that persons carrying out statutory audits must be approved by the Recognised Supervisory Bodies (RSBs) in UK. An auditor must be a member of an RSB and be eligible under its own rules. The ACCA is a RSB.

The Financial Reporting Council (FRC) : the UK's independent regulator for corporate reporting and governance.

International Standards on Auditing are produced by the International Auditing and Assurance Standards Board (IAASB), a technical standing committee of the International Federation of Accountants (IFAC).

Laws and Regulations: auditors must be aware of laws and regulations as part of their planning and must be aware of any statutory duty to report non-compliance by the company.

An audit **cannot** detect non-compliance with **all** laws and regulations.

<u>Responsibility of management for compliance</u>

- **Monitor legal requirements** and ensure that operating procedures are designed to meet these requirements
- **Institute and operate** appropriate systems of **internal control**
- **Develop, publicise and follow a code of conduct**
- Ensure **employees** are properly **trained** and **understand the code of conduct**
- **Monitor compliance** with the code of conduct and act appropriately on non-compliance
- **Engage legal advisors** to assist in monitoring legal requirements

- **Maintain a register** of significant laws with which the entity has to comply with.

<u>Indicators of non-compliance</u>

• **Investigation** by a government department or payment of **fines or penalties**
• Payments for **unspecified services** or loans to consultants, related parties, employees or government employees
• Sales **commissions** or agents' fees that appear **excessive**
• Purchasing at prices significantly above or below market price
• **Unusual payments in cash**
• **Unusual transactions** with companies registered **in tax havens**
• Payments for goods or services made other than to the country from which the goods or services originated
• Payments without proper exchange control documentation
• Existence of an information system that fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence
• Unauthorised transactions or improperly recorded transactions
• Media comment

<u>Procedures when non-compliance is discovered</u>

When the auditor becomes aware of information concerning a possible instance of non-compliance, the auditor should:

1. Obtain an understanding of the nature of the act and the circumstances in which it has occurred
2. Obtain sufficient other information to evaluate the possible effect on the financial statements.
3. Consider the **potential financial consequences**, such as fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations and litigation on the accounts.
4. Consider whether the **potential financial consequences** require **disclosure**
5. Consider whether the potential financial consequences are so serious as to call into question the **true and fair view** (fair presentation) given by the financial statements
6. Document the findings and discuss them with management.
7. When adequate information about the suspected non-compliance cannot be obtained the auditor should consider the effect of the **lack of audit evidence** on the auditor's report
8. If the auditor suspects that members of senior management, including members of the board of directors, are involved in non-compliance, the auditor should report the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or a supervisory board.
9. Where no higher authority exists, or if the auditor believes that the report may not be acted upon or is unsure as to the person to whom to report, the auditor should consider seeking legal advice.

10. If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been properly reflected in the financial statements, the auditor should express a qualified or an adverse opinion.
11. If the auditor has a statutory duty to report to regulatory authorities, he should do so without delay. Alternatively, it may be necessary to make disclosures in the public interest.
12. Withdrawal may be the only option if the entity does not take the remedial action the auditor thinks is necessary, even for non-material matters

Money Laundering

'**Money laundering** is the process by which criminals attempt to conceal the true origin and ownership of the proceeds of their criminal activity, allowing them to maintain control over the proceeds and, ultimately, providing a legitimate cover for their sources of income.

An inter-governmental body, the Financial Action Task Force on Money Laundering (FATF) was established to set standards and develop policies to combat money laundering and terrorist financing.

In the UK, the basic requirements are for accountants to keep records of clients' identity and to report
suspicions of money laundering to the Serious Organised Crime Agency (SOCA).

Elements of a money-laundering program: Procedures

- Appoint an *MLRO* and implement internal reporting procedures
- Train *individuals* to ensure that they are aware of the relevant legislation, know how to recognise and deal with potential *money laundering,* how to report suspicions to the *MLRO*, and how to identify *clients*
- Establish internal procedures appropriate to forestall and prevent *money laundering*, and make relevant i*ndividuals* aware of the procedures
- Verify the identity of new *clients* and maintain evidence of identification – Know Your Customer (KYC)
- Maintain records of *client* identification, and any transactions undertaken for or with the *client*
- *Report* suspicions *of money launderin*g to SOCA

Money Laundering Risk Indications

1. Secrecy over transactions
2. Excessive use of wire transfers
3. Transaction s routed through several jurisdictions
4. High value deposits or withdrawals not characteristic of the account type
5. Large currency or bearer instruments
6. Repeated deposits or withdrawals just below the monitoring threshold on the same day

Money Laundering Offences

1. Failure by an individual in the regulated sector to inform SOCA or the MLRO as soon as practicable of knowledge or suspicion of money laundering.
2. Failure by the MLRO to pass on a report to SOCA as soon as possible.
3. Tipping off: when the MLRO or any individual discloses something that might prejudice any investigations.
4. Falsifying, concealing, destroying or disposing of documents relevant to the investigation.
5. MLROs also commit an offence if they consent to a transaction which they know or suspect is money laundering, where consent has not been received from SOCA.

PRACTICE MANAGEMENT

The firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements and that reports issued by the firm or engagement partners are appropriate in the circumstances.

ISA 220 Quality control for Audit Work requires that all firms implement quality control policies and procedures at the level of the audit firm, and on individual audits. Those policies should be communicated to staff via formal policy statements, audit manuals and informal briefings and monitored to ensure that they are implemented.

Reasons for quality control

1. To avoid giving an unqualified report when a qualified one is required.
2. To avoid qualifying a report unnecessary
3. To avoid being negligent
4. To avoid loss of client
5. To avoid litigation
6. To avoid adverse publicity and loss of reputation
7. To ensure that ethical guidance issued by the ACCA and IFAC is followed.
8. To ensure that the ISAs are followed at all times.

Ensuring good engagement performance involves a number of issues:

- Direction
- Supervision
- Review
- Consultation
- Resolution of disputes

Policies and procedures of audit firms should cover the following:

1. Professional requirements: principles of integrity, objectivity, confidentiality and professional behaviour.
2. Skills and competence
3. Exposure of staff to different types of audit
4. Delegation: sufficient direction, supervision and review.
5. Consultation: audit file review, professional advisory service
6. Acceptance and retention of clients should be evaluated.
7. Monitoring required.

Quality control procedures on individual audits

1. Allocation of staff
2. Working papers
3. Review
4. Consultation

Methods of quality control in large audit firms

a) training
b) the use of a manual of procedures
c) standardised documentation
d) reviews of practice organisation and individual audits
e) the use of technical manuals
f) peer reviews
g) registration under ISO 9000 and similar schemes

Methods of quality control in small audit firms

1. arrangements with other practices for consultation when necessary
2. training consortia or use of training facilities provided externally
3. use of manuals and standardised working papers
4. care with recruitment policies
5. care with acceptance and retention policies on clients
6. seconding staff from other practices
7. sub-contracting work other practices

Forms of Review

a) **Hot review:** the working papers produced by a member of the audit staff are checked by a more experienced member of the staff during the course of the audit.
b) **Cold review:** the working papers being reviewed by a colleague after the audit report is signed.
c) **Post-audit review**: this is carried out by the manager or partner at the end of the audit but before the audit report is signed.
d) **Second partner review**: for large and complex audits or where a modified opinion is to be issued.
e) **Audit review department**
f) **Peers review**: this is a system where one firm of auditors reviews the working papers of another firm.

Reasons for preparing audit working papers

- Working papers provide evidence that an effective audit has been carried out.
- Working papers increase the efficiency and effectiveness of the audit.
- It assures the reporting partner that the work delegated by him has been properly completed.

OBTAINING PROFESSIONAL WORK

<u>Advertising</u>

For Audit firms to attract new clients and maximise their income, they rely mainly on *reputation and recommendation*. The ACCA's rules on advertising and publicity require that material may not:

- bring ACCA into disrepute or discredit the firm or accountancy profession,

- discredit the services offered by others,
- be misleading,
- fall short of any relevant codes on advertising standards in the relevant jurisdiction,
- In advertisement, references to fees are best avoided but may mention the basis on which fees will be charged.

Advertising fees:

- It is inappropriate to include information about fees in short adverts because it is difficult to explain the services represented by a single fee.
- In longer adverts the basis of fees, hourly rates, etc. should be clearly stated.
- Key issue; avoid misleading clients. Free consultation may be appropriate.
- Commission offered to third parties for referral of clients should be disclosed to the client.

Practice descriptions

Members of the ACCA are entitled to :

- call themselves Chartered Certified Accountants or Certified Accountants,
- use the letters ACCA or FCCA,
- use the ACCA logo on their stationery and website.

Fees

- It is generally inappropriate to advertise fees.
- fees must be mentioned in the letter of engagement,
- fees should be charged in accordance with the seniority and expertise of personnel used on an engagement, time spent, the degree of risk or responsibility involved, the urgency of the work, the apportionable overheads and the importance of the work to the client.
- Percentage and contingency fees should not be charged.
- Explanation should always be given to clients when the fee is for extra work, is different from previous years or is in excess of quotation, estimate or tender.

Tendering

Issues to consider before submitting a tender:

- Can the firm do the work professionally at a low fee?
- Are there any independence, professional/conflict of interest reasons why the firm should not tender?
- Does the firm have the expertise and technical competence to do the audit?
- Are there any special reasons for wanting the audit?
- Why has the firm been asked to tender?
- What audit risks might arise?
- Are there any perceived problems with the current audit or auditors?

The risks of tendering

- Professional risks: why the audit was put out to tender.
- Commercial risks: is the proposed fee realistic?
- Problem with management
- What knowledge of the business do we have?
- The need for the use of experts
- Wasted time – if the audit tender is not accepted.

How companies select their auditors after a tender: factors

- Fees services available
- Reputation expertise
- geographical spread size
- dissatisfaction fear of change

Lowballing and tenders

This is the tendency for audit firms to tender below cost with the objective of getting the audit and hoping to raise the fee later and to get lucrative extra work to compensate for the low audit fee.Firms are required to ensure that tenders made are reasonable, have substance and are defensible. There is no evidence that lowballing brings negligent audits.

Terms of engagement and the engagement letter

The letter of engagement is a letter sent by the auditor (or accountant) to his client at the beginning of any new audit (or accountancy work). It sets out the terms of the engagement, forms the basis of the contract and aims to avoid any misunderstanding between the client and the auditor.

Contents of engagement letter

- objective of the audit
- management's responsibility for the financial statements,
- the scope of the work including reference to legislation and professional standards,
- a description of audit procedures including their inherent limitations,
- forms of report to be issued,
- audit timing and basis for fee computation

New engagement

When invited to become auditor, the stages should be as follows:

a) Obtain client's permission to write to the retiring auditors enquiring if there is any professional reason why the appointment should not be accepted.
b) Accept nomination and be appointed by resolution of shareholders or directors.
c) Meet with client to agree the scope of the audit.
d) Send a letter of engagement to the client defining the scope of the audit.
e) The client should be asked to acknowledge receipt of this letter

Recurring engagement.
The auditor does not have to send a new engagement letter each year to an established client. However, if the circumstances of the audit have changed, the auditor may feel that this would be useful.

CHANGES IN PROFESSIONAL APPOINTMENTS

A member of the profession who is asked to accept nomination as auditor should, where applicable, request the prospective client's permission to communicate with the present auditor by means of a professional etiquette letter. If permission is refused or if the existing auditor is refused permission to respond to the request, the prospective auditor should decline the appointment.

Professional etiquette letter is written to inform the present auditor of the nomination as (1) a matter of professional courtesy and; (2) to ascertain whether there are any circumstances concerning the change of auditor which might affect the proposed auditor's decision on whether to accept the nomination.

Reasons for change of auditors:

1. the present auditor is too large/small for the client
2. some ethical impediment to continuing the engagement
3. change in control or ownership of the client
4. present auditor may be too expensive
5. conflicts of interest threatening objectivity and independence
6. loss of confidence
7. dispute over issues such as accounting policies
8. personality clash

Where the auditor feels aggrieved by his proposed removal he normally has a statutory right under national legislation to make representations to the shareholders.

Transfer of books, papers and information
Once a new auditor has been appointed the former auditors should ensure that all books and papers belonging to their clients, in their possession, are transferred except where they can claim to exercise a "right of lien".

CONFLICT OF INTEREST:
The ACCA Code of ethics and conduct identifies that conflict of interest can arise as follows:

- <u>Conflicts between the interests of different clients</u>: Where the acceptance or continuance of an engagement would, even with safeguards, materially prejudice the interests of any client, the appointment should not be accepted or continued. Such prejudice might arise in a variety of ways, including the leakage of information from one client to another and firms being forced into a position where they have to choose between the interests of different clients. Consider the audit of two different clients that are in direct competition as an example.

- Conflict between the client and member's interest: if significant the member should not accept/resign from the engagement. Examples include:
  - The audit firm itself being in direct competition with the client.
  - A firm having a close business relationship with its assurance client or a major competitor of its assurance client.
- Where the auditor earns a commission or any material financial gain on the basis of advice given to clients.
- Agency work: The acceptance by members or their firms of an agency for the supply of services or products may present a conflict of interest which threatens compliance with the fundamental principles.

Safeguards:

- Notifying the client of the firm's business interest or activities that may represent a conflict of interest, and obtaining their consent to act in such circumstances; or
- Notifying all known relevant parties that the firm of auditors is acting for two or more parties in respect of a matter where their respective interests are in conflict, and obtaining their consent to so act; or
- Notifying the client that the firm does not act exclusively for any one client in the provision of proposed services (for example, in a particular market sector or with respect to a specific service) and obtaining their consent to so act.
- The use of separate engagement teams; and
- Procedures to prevent access to information (e.g., strict physical separation of such teams, confidential and secure data filing); and
- Clear guidelines for members of the engagement team on issues of security and confidentiality; and
- The use of confidentiality agreements signed by employees and partners of the firm; and
- Regular review of the application of safeguards by a senior individual not involved with relevant client engagements.

CODE OF ETHICS AND CONDUCT.

- Fundamental principles
- Conceptual framework
- Safeguards.
- Specific threats to independence and possible safeguards
- Confidentiality
- Changes in professional appointment
- Obtaining professional work

FUNDAMENTAL PRINCIPLES:
In order to achieve the objectives of the accountancy profession, professional accountants have to observe a number of prerequisites or fundamental principles. The fundamental principles are:

Integrity: A professional accountant should be straightforward and honest in performing professional services.

Objectivity: A professional accountant should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.

Professional Competence and Due Care: A professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques.

Confidentiality: A professional accountant should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose.

Professional Behaviour: A professional accountant should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession. A professional accountant should carry out professional services in accordance with the relevant technical and professional standards.

CONCEPTUAL FRAMEWORK
The Code set out that in operating member may come up against threats to the fundamental principles. These are more popularly called **threats to independence** and they fall under five categories:

Self-Interest Threat: this occur when a firm or a member of the assurance team could benefit from a financial interest in, or other self-interest conflict with, an assurance client.
Examples of circumstances that may create this threat include, but are not limited to:
• A direct financial interest or material indirect financial interest in an assurance client;
• A loan or guarantee to or from an assurance client or any of its directors or officers;

Self-Review Threat: this occurs when (1) any product or judgment of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement or (2) when a member of the assurance team was previously a director or officer of the assurance client, or was an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement.

Advocacy Threat: this occurs when a firm, or a member of the assurance team, promotes, or may be perceived to promote, an assurance client's position or opinion to the point that objectivity may, or may be perceived to be, compromised. Such may be the case if a firm or a member of the assurance team were to subordinate their judgment to that of the client. Examples of circumstances that may create this threat include:
• Dealing in, or being a promoter of, shares or other securities in an assurance client; and
• Acting as an advocate on behalf of an assurance client in litigation,

Familiarity Threat: this occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client's interests.
Examples of circumstances that may create this threat include, but are not limited to:

- ❖ A member of the assurance team having an immediate family member or close family member who, as an employee of the assurance client, is in a position to exert direct and significant influence over the subject matter of the assurance engagement;
- ❖ Long association of a senior member of the assurance team with the assurance client;

Intimidation Threat: this occurs when a member of the assurance team may be deterred from acting objectively and exercising professional scepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client.
Examples of circumstances that may create this threat include, but are not limited to:

- Threat of replacement over a disagreement with the application of an accounting principle; and
- Pressure to reduce inappropriately the extent of work performed in order to reduce fees.

SAFEGUARD

Safeguards fall into the following categories:

- Safeguards created by the profession, legislation or regulation;
- Safeguards within the assurance client; and
- Safeguards within the firm's own systems and procedures.
- Safeguard by the individual (ACCA)

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

- Educational, training and experience requirements for entry into the profession;
- Continuing education requirements;
- Professional standards and monitoring and disciplinary processes;
- External review of a firm's quality control system; and
- Legislation governing the independence requirements of the firm.

Safeguards within the assurance client include:

- When the assurance client's management appoints the firm, persons other than management ratify or approve the appointment;
- The assurance client has competent employees to make managerial decisions;
- Policies and procedures that emphasize the assurance client's commitment to fair financial reporting;
- Internal procedures that ensure objective choices in commissioning non-assurance engagements; and
- A corporate governance structure, such as an audit committee, that provides appropriate oversight and communications regarding a firm's services.

Safeguards within the audit firm:

- Firm leadership that stresses the importance of independence and the expectation that members of assurance teams will act in the public interest;
- second partner review, peer review;
- Rotation of senior personnel e.g. engagement partner
- Policies and procedures to ensure members of the assurance team do not make, or assume responsibility for, management decisions for the assurance client;
- Removing an individual from the assurance team, when that individual's financial interests or relationships create a threat to independence

- Using different partners and teams with separate reporting lines for the provision of non-assurance services to an assurance client e.g. tax services.
- Training and education, disciplinary procedures.
- Discussing independence issues with the audit committee or others charged with governance;

Safeguards created by individuals:
- Professional development requirement
- Keeping record of contentious issues.
- Using a mentor.
- Keeping contact with professional bodies.

SPECIFIC AREAS OF THREAT TO INDEPENDENCE.

<u>Undue dependence on an audit client (size of fees):</u>
When the total fees generated by an assurance client represent a large proportion of a firm's total fees, the dependence on that client or client group and concern about the possibility of losing the client may create a self-interest threat. The significance of the threat will depend upon factors such as:
- The structure of the firm; and
- Whether the firm is well established or newly created.

Safeguards might include:
- Discussing the extent and nature of fees charged with the audit committee.
- Taking steps to reduce dependency on the client;
- External quality control reviews; and
- Consulting a third party e.g. professional regulatory body, another professional accountant.

ACCA however sets out general guidelines for firms. It recommends that in general the recurring work paid by one client or group of connected client should not exceed **15%** of the gross practice income (**10%** in case of **listed** or other public interest companies).

Beneficial interest in share and other investment:
A financial interest in a client constitutes a substantial self interest threat. According to both ACCA and IFAC the following parties are not allowed to own a direct financial interest or a material indirect financial interest in an audit client:
- The audit firm
- Partners in the same office as the engagement partner
- A member of the assurance team;
- Immediate family members of any of the above listed individuals.

The extent of the threat depends:
- The role of the individual with the interest

- The materiality of the interest
- The degree of control over the interest.

Possible safeguards:

- Disposing of the interest
- Removing the individual from the team if required
- Informing the client's audit committee
- Carrying out a second partner review, if necessary.
- Policies and procedures within the firm that facilitates disclosure.

Family and personal relationship:

Family and personal relationships between a member of the assurance team and a director, an officer or certain employees, depending on their role, of the assurance client, may create self-interest, familiarity or intimidation threats. The significance will depend upon a number of factors including:

- the individual's responsibilities on the assurance engagement,
- the closeness of the relationship and
- the role of the family member or other individual within the assurance client.

When an immediate family member of a 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 of the assurance engagement, the threats to independence can only be reduced to an acceptable level by removing the individual from the assurance team.

Safeguards might include:

- Removing the individual from the assurance team;
- Where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of the close family member; or
- Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.

Employment with assurance client:

A firm or a member of the assurance team's independence may be threatened if a director, an officer or an employee of the assurance client in position to exert direct and significant influence over the subject matter of the assurance engagement has been a member of the assurance team or partner of the firm.

Similarly, a member of the assurance team's independence may be threatened when an individual knows or have reasons to believe that he or she is to, or may, join the assurance client in the near future.

Factors to consider:

(a) The position the individual has taken at the assurance client.

(b) The amount of any involvement the individual will have with the assurance team.

(c) The length of time that has passed since the individual was involved in the audit.
(d) The former position of the individual within the assurance team or firm.

Safeguards might include:
- Modifying the assurance plan for the assurance engagement;
- Assigning an assurance team to the subsequent assurance engagement that is of sufficient experience in relation to the individual who has joined the assurance client;
- Quality control review of the assurance engagement.
- Policies and procedures to require the individual to notify the firm when entering serious employment negotiations with the assurance client.
- Removal of the individual from the assurance engagement.
- Consideration should be given to performing an independent review of any significant judgments made by that individual while on the engagement.

ACCA provides that a key audit partner should not accept a key management position with a former audit client unless **at least two years** has elapsed since that partner was involved with the audit.

Close business relationship with an assurance client: Unless clearly insignificant, an assurance provider should not participate in any close biz relationship (e.g. a joint venture) with an assurance client. Safeguards may not reduce this threat and the firm may either end the assurance service or terminate the biz relationship.

Long association of senior personnel with assurance client:
Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat. The significance of the threat will depend upon factors such as:
- ⇒ The length of time that the individual has been a member of the assurance team;
- ⇒ The role of the individual on the assurance team;
- ⇒ The structure of the firm; and
- ⇒ The nature of the assurance engagement.

Safeguards might include:
- ⇒ • Rotating the senior personnel off the assurance team;
- ⇒ • Involving an independent professional accountant.
- ⇒ • Independent internal quality reviews.

The following rules exist for the audit of listed or other public interest entities (ACCA):
- The engagement partner should be rotated after a pre-defined period, normally no more than **five years**, and should not return to the engagement until a period of **five years** has elapsed;

- Other key partners of the audit team should be rotated after a pre-defined period, normally no more than **seven years**, and should not return to the engagement until a period of **two years** has elapsed.

Please note that in practice rotation may not be possible due to:

- Rotation arousing another threat
- Few partners with necessary knowledge and experience.
- Size of the firm.

Possible safeguards should however be applied (see above).

Actual or threatened litigation:

When litigation takes place, or appears likely, between the firm or a member of the assurance team and the assurance client, a self-interest or intimidation threat may be created.

The significance of the threat created will depend upon such factors as:

- the materiality of the litigation;
- the nature of the assurance engagement; and
- whether the litigation relates to a prior assurance engagement.

Safeguards include:

- Disclosing to the audit committee, the extent and nature of the litigation;
- If the litigation involves a member of the assurance team, removing that individual from the assurance team; or
- Independent review.

If such safeguards do not reduce the threat to an appropriate level, the only appropriate action is to withdraw from, or refuse to accept, the assurance engagement.

Gifts and hospitality:

Accepting gifts or hospitality from an assurance client may create self-interest and familiarity threat. When a firm or a member of the assurance team accepts gifts or hospitality, unless the value is clearly insignificant, the threats to independence cannot be reduced to an acceptable level by the application of any safeguard. Consequently, a firm or a member of the assurance team should not accept such gifts or hospitality.

Loans and guarantees:

A firm or member of the audit team should not make or accept a loan or guarantee in relation to an assurance client who is not a bank or similar institution. Loans from clients that are relevant financial institution should be on normal commercial terms as these are acceptable but the loan cannot be applied for partnership capital or partner concerned must not be the engagement partner.

Overdue fees:

A self-interest threat may be created if fees due from an assurance client for professional services remain unpaid for a long time. Generally the payment of such fees should be required before the report is issued and firms should avoid fees building up unnecessarily. The following safeguards may be applicable:

- Discussing the level of outstanding fees with the audit committee or others charged with governance.
- Involving an additional professional accountant who did not take part in the assurance engagement to provide advice or review the work performed.

The firm should also consider whether the overdue fees might be regarded as being equivalent to a loan to the client and whether, because of the significance of the overdue fees, it is appropriate for the firm to be reappointed.

Provision of non-assurance services to assurance clients:

Preparation of accounting records and financial statement. (Self review threat).

Auditors routinely assist management with the preparation financial statement and give advice about accounting treatments and journal entries.

For assurance clients that are not listed routine accounting and bookkeeping services that are routine, mechanical, or of a technical nature are allowable provided that appropriate safeguards are in place e.g. obtaining client approval for work undertaken, using separate staff.

Accounting work should not be performed for a listed or public interest company unless an emergency arises.

For any client, auditors are not allowed to make management decisions e.g.

(a) Determine or change journal entries without client approval
(b) Authorize or approve transactions
(c) Prepare source documents

Other services include:

- Taxation services
- Provision of corporate finance services
- Recruitment for senior management
- Recruitment for senior management
- Valuation services
- IT systems services etc.

Contingent fees:

Firms should not accept fees contingent on the outcome of the engagement in relation to an audit.

Pricing: Audit firms are entitled charge what fee they like for professional services, but a fee significantly lower than market rate (i.e. lowballing) might be a threat to the auditor being seen as independent unless the audit firm can prove that appropriate time and staff are delegated to the task and that professional standards are met.

Second and other opinions: If a company is unhappy with the audit opinion which it receives or may receive from it current auditors, then it might approach other audit firms for a second opinion. There are two potential problems with this situation:

- The approached firm may form a negligent opinion because they are not necessarily in possession of all material facts and information.

- The original auditor may be put under pressure to accept the second opinion. (intimidation and self interest threat)

Where a company approaches a member (who is not the auditor) for a second opinion on the treatment of items in the financial statements, the member should contact the company's auditor (after obtaining the company's permission) to obtain all necessary information and relevant facts required to formulate a professional judgement. If the company refuses to give permission the member should decline to act.

Recent services with an assurance client:

If during the period covered by the assurance report or preceding **two years** on which a report was given by the firm, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to exert direct and significant influence over the subject matter information of the assurance engagement, the threat created would be so significant that no safeguard could reduce the threat to an acceptable level. Consequently, such individuals should not be assigned to the assurance team.

In other situations the significance of the threats will depend upon factors such as:

(a) the position the individual held with the assurance client;

(b) the length of time that has passed since the individual left the assurance client;

(c) the role the individual plays on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

(a) involving an additional professional accountant to review the work done by the individual as part of the assurance team or otherwise advise as necessary;

(b) discussing the issue with those charged with governance, such as the audit committee.

CONFIDENTIALITY

Information confidential to a client acquired in the course of professional work should not be disclosed except where consent has been obtained from the client or where there is a public duty to do so or where there is a legal or professional right or duty to disclose.

A member should neither use nor appear to use that information for his personal advantage or for the advantage of a third party.

Where a member is in any doubt, the matter should initially be discussed fully within his firm. If it fails to resolve the problem, he should consider taking legal advice or consult the Association. An accountant should only act for a client on the understanding that the client will make full disclosure. If during the course of an engagement, the client fails to furnish all the information considered necessary, the accountant should disclose this in his report.

The auditor has neither a general right nor duty to make unauthorised disclosures to the tax authorities, police or anybody. There are however, circumstances in which he is **free** to disclose information regardless of his client's wishes, and circumstances in which he has an **obligation** to do so.

These are recognized exceptions to the general rule:

- On a court's order,
- If a member knows or suspects his client to have committed treason, drug trafficking, terrorist offences, money laundering.
- Under ISA 250, the auditor may have a responsibility to disclose significant non compliance with laws and regulations in his report.

- in the public interest;
- to protect a member's interests; e.g. in case the member is involved in a litigation,
- to a statutory authority: there are other cases of express statutory provisions where disclosure of information to a proper authority overrides any duty of confidentiality. Members should refer to the legislation relevant to the economic sector where their clients operate.
- to a non-governmental body.

When considering whether or not disclosure is justified, members should take the following into account:

(a) the relative size of the amounts involved and the extent of the likely financial damage;

(b) whether members of the public are likely to be affected;

(c) the possibility or likelihood of repetition;

(d) the reasons for the client's unwillingness to disclose the matters to the proper authority;

(e) the gravity of the matter;

(f) relevant legislation, accounting standards and auditing standards, etc.;

Fraud and error

Fraud is an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. (IAASB).

Two types of fraud relevant to the auditor according to ISA 240 are:

1. Fraudulent financial reporting; and
2. Misappropriation of assets.

Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles and standards.

'Error' refers to the unintentional misapplication of accounting policies, oversights or misinterpretations of fact and clerical errors. If a material error has been identified but has not been corrected, it becomes an **irregularity**, i.e. an unintentional act is converted to an intentional one.

A misstatement is quite simply something stated wrongly or inaccurately, either in terms of amounts in the financial statements or, for example, descriptions or narrative concerning matters included.

Director responsibility:
Management is responsible for the prevention and detection of fraud and error through the implementation and operation of adequate accounting and internal control systems.

Auditor's responsibility:
The auditor has no responsibility for the prevention and detection of fraud and error although the annual audit may act as a deterrent.
An auditor conducting an audit should obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.
An auditor should design audit procedures to obtain reasonable assurance that those frauds and errors which are material and might impair the truth and fairness have not occurred, or that if they have occurred they have either been corrected or properly disclosed in the financial statements.

Due to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements will not be detected even though the audit is properly planned and performed. The auditor should maintain an attitude of professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance.

Professional skepticism can be referred to as an attitude that includes a questioning mind and a critical assessment of evidence.

Other responsibilities of the auditor:

- Fraud risk factor consideration
- Obtaining adequate understanding of the accounting and internal control systems
- Team discussion and documentation of facts
- Consideration of potential effects of any fraud and error identified
- Modified or additional procedures in the light of fraud indicators
- Obtain management confirmation of responsibility.

Reporting responsibilities:

- Discuss with an appropriate level of management
- Report to those charged with governance (Board of directors, Audit committee)
- Report to the users of the audit report
- Report to the Regulatory and Enforcement authorities
- Withdrawal may be an option.

Auditors will increasingly be seen as guardians against fraud and error. Perhaps the future of fraud and error prevention and detection lies in distinct assurance engagements for this purpose rather than in the annual audit.

ASSIGNMENTS

This is the second section of the p7 syllabus and can be divided into two areas:

(Please see the study guide for a detailed breakdown of these areas).

- AUDIT ASSIGNMENTS:

1. The audit of historical financial information including;
   i) Planning, materiality and assessing the risk of misstatement
   ii) Evidence and procedures.
   iii) Evaluation and review*
2. Group audits

- NON-AUDIT ASSIGNMENTS *(below topics will be discussed in class)*

3. Audit-related services
4. Assurance services
5. Prospective financial information
6. Forensic audits
7. Internal audit and Outsourcing

Please note the following:

- This is the broadest section of the syllabus and will thus account for majority of the marks.
- Knowledge of financial reporting standards cannot be over emphasized, however, mere knowledge is not adequate as it application in an audit context is far more important.
- Make sure you review this note at least once or at most twice (and a final review in the week to the exam), while you should dwell more on application of knowledge through constant question practice.
- Questions 1, 2 and 3 of the exams will most likely be developed from this area

AUDIT METHODOLOGIES.

This topic review covers the major approaches that auditor often adopt. For the exams, be able to justify an audit approach based on the specifics of a scenario.

RISK BASED APPROACH:

Risk based auditing refers to the development of auditing techniques that are responsive to risk factors in an audit.
Motivation:

- Growing complexity of the biz environment.
- Need for reduced audit fees.

Forms:
Audit risk approach:

- Assessment of all items of account to determine the risk of material misstatement
- Detailed audit for high risk areas using traditional methods
- Benefits include:
    1. More attention to areas more likely to a material misstatement.
    2. Reduces the possibility of over or under auditing
    3. Saves audit costs and time
    4. The approach facilitates the use of sampling
    5. It facilitates delegation of less risky areas.

Business risk approach: (Top down approach)
The auditor should obtain an understanding of the entity's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements.
The entity conducts its business in the context of industry, regulatory and other internal and external factors. Business risks result from significant conditions, events, circumstances, actions or inactions 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.

Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk particularly may arise from change or complexity, though a failure to recognize the need for change may also give rise to risk. Change may arise, for example, from the development of new products that may fail; from an inadequate market, even if successfully developed; or from flaws that may result in liabilities and reputational risk. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks.

By understanding the various internal and external factors impacting on a business, we can identify biz risks and potential financial statement risks for consideration in our audit risk assessment.

<u>The table below highlights some of the factors that exist and their immediate Financial Statement Implications (FSI):</u>

Economic pressures causing reduced unit sales and eroding margins
FSI: Inventory values (IAS 2)
Going concern

Economic pressures resulting in demands for extended credit
FSI: Receivables recoverability

Product quality issues related to inadequate control over supply chain and transportation damage
FSI: Inventory values – net realisable value and inventory returns

Customer dissatisfaction related to inability to meet order requirements
FSI: Going concern

Customer dissatisfaction related to invoicing errors and transportation damage
FSI: Receivables valuation

Unacceptable service response call rate related to poor product quality
FSI: Going concern
Litigation – provisions and contingencies
Inventory – net realisable value

Advantages:
1. Major audit problems are usually caused by major corporate problems e.g. going concern problems, management fraud, large scale system breakdowns.
2. Increased knowledge of the business.
3. Focus on high audit risk areas.
4. Opportunity to add value to the client.
5. It tends to involve more senior members of the practice.

Business risks can be broadly divided into two:
- Internal business risks
- External business risks.

External risks

- changing legislation	changing interest rates
- changing exchange rates	public opinion, attitudes
- price wars	foreign competitors
- natural hazards	bad debts

- litigation	political factors

Internal risks

- employees	board: poor corporate governance
- obsolete plant and equipments	breakdown of systems
- fraud	weak internal control system
- overtrading	excessive reliance

OTHER APPROACHES TO AN AUDIT.

- Substantive approach
- Balance sheet audit
- Systems audit approach
- Cycles and transactions approach
- Analytical procedures
- Direction testing.

Originally, audit was conducted on what is now called **substantive approach**: each item in the FS is examined, compared with the entries in the books and evidence collected. It is ideal when auditing small entities and cheap audit staff is available otherwise it may prove expensive and time consuming. Also, this method may cause over-auditing of relatively immaterial items.

To deal with the above problem, **system audit approach** was developed. Under this method, individual items of accounts were not audited but systems and internal controls over them were investigated in detail. This approach brought about **the cycles approach** (e.g. sales and receivables cycles, purchases and payables cycle). Although this method concentrates on transactions, the account balances are subjected to some substantive testing in the form of **balance sheet audit** (on a lower scale depending on the strength of the internal control system). This approach worked well but the cost issue was still not addressed.

Following the systems approach, the idea of **analytical procedures** was developed. This proved cheap and effective as a method but needed high-grade staff to work effectively. Most audits were done on the basis of a mix of substantive tests, systems audit, and analytical procedures.

However, this approaches was still costly and time consuming (especially as regards spending too much time on items that are unlikely to be materially misstated), **the risk based approach** tends to reduce this problem.

<u>Directional testing:</u>

Directional testing is a method of discovering errors and omissions in financial statements. It is a method of undertaking detailed substantive testing. Substantive testing seeks to discover errors and omissions, and the discovery of these will depend on the direction of the test.

The concept of directional testing derives from the principle of double-entry bookkeeping, in that for every **debit** there is a **corresponding credit**, (assuming

that the double entry is complete and that the accounting records balance). Therefore, any **misstatement** of a **debit entry** will result in either a corresponding **misstatement** of a **credit entry** or a **misstatement** in the opposite direction, of **another debit entry**.
By designing audit tests carefully the auditors are able to use this principle in drawing audit conclusions, not only about the debit or credit entries that they have directly tested, but also about the corresponding credit or debit entries that are necessary to balance the books.

Advantages:

1. it gives focus to an audit.
2. It reduces the time and effort of an audit.
3. It helps to facilitate the early detection of an under and/or over statement thereby minimizing the risk of material misstatement in the FS.

Disadvantages:

1. There is a possible tendency not to obtain sufficient primary evidence in the right direction. The auditor may be testing for understatement instead of overstatement.
2. There is a need to realize that all assets and liabilities, income and expenses should be verified for all assertions in the financial statement.

PLANNING, MATERIALITY AND RISK ASSESSMENT.

The readings under this review are very similar the f8 syllabus. Please do not waste too much time here although the first four sections are very important.

1. Planning the audit of financial statement…………….ISA 300
2. Materiality… ………………………………………….ISA 320
3. Understanding the entity and its environment……….ISA 315
4. Audit risk……… ………………………………….ISA 315
5. Response to assessed risk………………………………ISA 330
6. Audit Documentation… …………………………..ISA 230.
7. Audit Sampling…………………… ..…………………ISA 530
8. Using the work of others…………………………….ISA 610 & 620

AUDIT PLANNING

Preliminary Engagement Activities.

The auditor should perform the following activities at the beginning of the current audit engagement: (ISA 300)

- Perform procedures regarding the continuance of the client relationship and the specific audit engagement.
- Evaluate compliance with ethical requirements, including independence.
- Establish an understanding of the terms of the engagement.

ISA 300 provides that the main objective of planning is to enable the audit to be performed in an effective manner.

<u>Other purposes/objectives include:</u>

1. To ensure adequate attention is paid to important areas of the audit
2. To ensure that potential problem areas are identified
3. To identify a suitable audit approach
4. To identify the nature, timing and extent of audit procedures required
5. Planning facilitates communication, delegation, supervision, coordination and review.

<u>Overall audit strategy (OAS):</u>

When planning an audit, an auditor must first establish the overall audit strategy which sets the *<u>Scope, Timing and Direction</u>* of the audit and acts as the basis for the development of a more detailed audit plan.

1. Scope:
    - Description of the business including the audit coverage in terms of locations and components to be covered
    - Relevant financial reporting framework (FRF)
    - Relevant regulatory framework
    - Industry related regulation and practices.
    - Relevant work of others e.g. internal audit, experts etc.
    - Other relevant characteristics of the engagement

2. Timing: key dates
    - Interim audit timing Vs Final audit timing
    - Year end procedures e.g. date of inventory counting
    - Timing of communication to management e.g. letter of weaknesses.
    - Timing of team meetings and review of work performed.
    - Other communication deadlines e.g. to third parties, component auditors etc

2. Direction:
    a. Likely high risk areas and possible impact on the overall financial statement

b. Overall audit approach/methodology
c. Determination of appropriate materiality levels
d. Significant developments affecting the client's business and industry.
e. Nature of the entity's internal control system.

Audit plan: The purpose of the audit plan is to ensure that the audit objectives can be achieved through efficient use of the auditor's resources while reducing audit risk to an acceptably low level. Ones the OAS has been established, the auditor can then start developing a more detailed audit plan.
Key stages / content of the audit plan include:

1. Knowledge and understanding of the business and its environment.
2. Preliminary analytical review
3. Detailed risk and materiality assessment including setting tolerable error rate.
4. Audit approach: nature, timing and extent of audit procedures for specific areas.
5. Responsibility for supervision and review.
6. Logistics related issues e.g. staffing, audit time budget and deadlines.

MATERIALITY

"Materiality" is defined in the International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements" in the following terms:

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

Auditing principle:
The auditor should consider materiality and its relationship with audit risk when conducting an audit.
If audit risk is assessed as high, then materiality level is most likely to be low.

Auditing principle
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, in accordance with an applicable financial reporting framework. The assessment of what is material is a matter of professional judgment.

In designing the audit plan, the auditor establishes an acceptable materiality level so as to detect ***quantitatively*** material misstatements. However, both the

amount (quantity) and ***nature (quality***) of misstatements need to be considered. Examples of qualitative misstatements would be:

- the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description, and
- failure to disclose the breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions will significantly impair operating capability.

Auditing principle:
The auditor considers materiality at both the overall financial statement level and in relation to classes of transactions, account balances, and disclosures.
This process may result in different materiality levels depending on the aspect of the financial statements being considered. **As a guide for the exams**: 0.5% of TURNOVER, 5% of PBT and 2% of TOTAL ASSETS.

Auditing principle:
Materiality should be considered by the auditor when:
(a) **Determining the nature, timing and extent of audit procedures; and**
(b) **Evaluating the effect of misstatements.**

Auditing principle
If the auditor has identified a material misstatement resulting from fraud or error, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance in accordance with ISA 260 "Communication of Audit Matters with Those Charged with Governance."

Factor affecting the materiality decision of the auditor:

- Results of risk assessment
- First vs. Recurring audit.
- Degree of estimation required for an item
- Critical points
- Level of offsetting.

UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

The auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures. (ISA 315).

The standard provides detailed guidance on why it is important to obtain such an understanding, how it is obtained and what should actually be obtained.

Why?

- To identify and assess the risks of material misstatement of the financial statements
- To enable the auditor to design and perform further audit procedures
- To provide a frame of reference, for exercising the audit/professional judgment e.g. when setting materiality levels

How?

- Inquiries of management and others within the entity and other relevant third parties
- Observation of systems
- Inspection relevant book and records
- Prior period knowledge/ review of prior year working papers.
- Discussion among the engagement team
- Analytical procedures
- Related press or analysts' report.

What?

- Industry, regulatory and other external factors
- Financial reporting framework
- Nature of the entity's business
- Business objectives and strategies
- Basis of selection and application of accounting policies
- The entity's business risks that can translate to financial statement risk.
- The internal control system (ICS): how effective are its components?
- The entity's financial performance: past and current.

RISK ASSESSMENT PROCEDURES:

As described in ISA 500, audit procedures *to obtain an understanding of the entity and its environment* **and** *to assess the risk of material misstatement* are referred to as *"***risk assessment procedures".**

In addition, in performing risk assessment procedures, the auditor may obtain audit evidence about:

- classes of transactions, account balances, or disclosures and related assertions and
- about the operating effectiveness of controls,

even though such audit procedures were not specifically planned as substantive procedures or as tests of controls (respectively).

The auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

- Inquiries of management and others within the entity;
- Analytical procedures;
- Observation; and
- Inspection.

AUDIT RISK

Audit risk is the risk that the auditor will give inappropriate opinion when the financial statements are materially misstated. Auditors are required to reduce audit risk to an acceptable low level.

<u>COMPONENTS OF AUDIT RISK:</u>

Audit risk has **two** components:

1. **Risk of material misstatement (entity risk**): the risk that the financial statements are materially misstated prior to audit. This may be as a result of:
   - **Inherent risk**: is the susceptibility of an assertion to a material misstatement assuming that there were no related internal controls.
   - **Control risk**: is the risk that a material misstatement that could occur in an assertion will not be prevented or detected and corrected on a timely basis by the entity's internal control.
2. **Detection risk**: the risk that the auditor's procedures will not detect a material misstatement in an assertion. Detection risk has two components:
   - **Sampling risk**: the risk that the conclusion reached based on a sample might differ from that which would have been reached conclusion reached if the entire population were tested.
   - **Non-sampling risk**: the risk that the auditor will reach the wrong conclusion for any reason not related to the size of the sample. They arise from audit mistakes e.g. failing to identify errors, misinterpretation of evidence. It can be minimized by improving quality control procedures e.g. adequate training and review procedures.

There is inverse relationship between the risk of material misstatement and detection risk – if the risk of material misstatement is high then detection risk <u>**must**</u> be low, *which is achieved by testing a larger sample.* If it is a risky area we do more work, if it is a less risky area we do less work.

The ISA 315 says that 'the auditor should identify and assess <u>**the risks of material misstatement**</u> at <u>*the financial statement level*</u>, and *at <u>the assertion level for classes of transactions, account balances and disclosures</u>***'**.

To assess the risk of material misstatement (inherent risk and control risk) the auditor must use their knowledge of the business, experience and professional judgment to evaluate numerous factors:

<u>At the Financial statement level;</u>

- Management integrity and attitude to risk
- Management experience and knowledge
- Changes in management.
- Unusual pressure on management e.g. tight reporting deadlines, financial reporting pressures

- Nature of business and its industry e.g. mono-product companies, changes in technology, competitive conditions, regulatory requirements, changes in demand, accounting practices in the industry etc.

<u>At the Assertion level:</u>

- Financial statement accounts prone to misstatement e.g. account requiring high degree of estimation.
- Complex accounts e.g. account requiring expert valuation.
- Risky asset (can be stolen or lost) e.g. cash, inventory, financial instruments.
- Transactions not subjected to ordinary processing procedures.
- High volume (unexpected) transactions: the accounting system may have problems coping with such a volume.
- The completion of unusual or complex transactions at or near the year end.

THE AUDITOR'S PROCEDURES IN RESPONSE TO ASSESSED RISKS

In order to reduce audit risk to an acceptably low level, the auditor should determine the appropriate response to assessed risk at:

- **the financial statement level, and**
- **the assertion level.**

<u>Financial statement level:</u>

The auditor should determine **<u>overall responses</u>** to address the risks of material misstatement at the financial statement level. Such responses may include:

- ✓ Emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence,
- ✓ Assigning more experienced staff or those with special skills or using experts,
- ✓ Providing more supervision,
- ✓ Making general changes to the nature, timing, or extent of audit procedures

<u>Assertion level:</u>

The auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level. This may involve performing, for each assertion:

- ✓ Tests of controls.
- ✓ Substantive procedures.

AUDIT DOCUMENTATION

Audit documentation: The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "work papers" are also sometimes used).

The auditor should prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand:

- the nature, timing, and extent of the audit procedures performed to comply with ISAs and applicable legal and regulatory requirements
- the results of the audit procedures and the audit evidence obtained, and
- significant matters arising during the audit and the conclusions reached.

IMPORTANCE OF WORKING PAPERS

Working papers are important because they:

- Enables an effective audit quality control review to be carried out.
- Provide assurance that the work delegated by the audit partner has been properly completed
- Provide evidence that an effective audit has been carried out in accordance with auditing standards.
- It may serve as a source of evidence of work done in case of litigation.
- Contain sufficiently detailed and up-to-date facts which justify the reasonableness of the auditor's conclusions, thereby providing a basis for the audit opinion.
- Retain a record of matters of continuing significance to future audits.
- Assists in planning, supervising and controlling the audit.

AVOIDING UNNECESSARY PAPERS

Before deciding to prepare a particular audit working paper, the auditor should be satisfied that it is:

1. necessary either because it will serve an essential or useful purpose in support of the auditor's report, or
2. not practicable for the client staff to prepare the working paper, or for the auditor to make copies of papers that the client staff (including internal auditors) have prepared as part of their normal regular duties.

PAPERS PREPARED BY CLIENT

Certain working papers required by the auditor may have already been prepared by client staff. The auditor should make arrangements, whenever possible, for copies of these to be made available to the audit team.

When arranging for working papers to be prepared, the auditor should take care to ensure that the working papers will give all the information required. All such working papers should normally be clearly identified as having been prepared by the client. The member of audit staff directly responsible for an audit area in which working papers prepared by client staff are included should sign those papers – this will show that they have been checked and that they can be reviewed by subsequent reviewers. The signature of the audit team member indicates that the working paper (prepared by client staff) has been 'audited'.

CONTENT

Each audit working paper must be headed with the following information:

- The name of the client
- The period covered by the audit
- The subject matter
- The file reference
- The initials (signature) of the member of staff who prepared the working paper, and the date on which it was prepared
- In the case of audit papers prepared by client staff, the date the working papers were received, and the initials of the audit team member who carried out the audit work
- The initials of the member of staff who reviewed the working papers and the date on which the review was carried out
- Each audit paper should meet the characteristics of a good working paper, as detailed below.

SOME CHARACTERISTICS OF A GOOD WORKING PAPER

On the basis of the discussion above, a good working paper should meet the requirements of ISA 230 by displaying the following characteristics:

1. It should state a clear audit objective, usually in terms of an audit assertion (for example, 'to ensure the completeness of trade creditors').
2. It should fully state the year/period end (eg 31 October 2009), so that the working paper is not confused with documentation belonging to a different year/period.
3. It should state the full extent of the test. This will enable the preparer and any subsequent reviewers, to determine the sufficiency of the audit evidence provided by the working paper.
4. Where there is necessary reference to another working paper, the full reference of that other working paper must be given. A statement that details of testing can be found on 'another working paper' is insufficient.
5. The working paper should clearly and objectively state the results of the test.
6. The conclusions reached should be consistent with the results of the test.
7. The working paper should be clearly referenced so that it can be filed appropriately and found easily when required at a later date.

8. It should be signed by the person who prepares it so that queries can be directed to the appropriate person.
9. It should be signed and dated by any person who reviews it, in order to meet the quality control requirements of the review.

If any relevant characteristic is judged absent, then this should result in an audit review point (i.e. a comment by the reviewer directing the original preparer to rectify the fault on the working paper).

Filing audit working papers. Working papers are usually found in two separate files:

a. ***Permanent audit files***; the purpose of which are to:
  - Document information of continuing importance to the audit
  - Document information of a permanent nature and other background information about the client
  - Give audit staff new to the audit information regarding the client's affairs and the nature of the audit.

  Examples include:
  - Client's memo and articles of association
  - Organizational structure of the client
  - Copies of important legal documents and agreements
  - Copies of past years financial statement
  - Board minutes of continuing relevance
  - Engagement letters
  - Accounting manuals and other relevant system notes etc.

b. ***Current audit files;*** containing information of relevance to the current year audit, the purpose of which are:
  - To provide a record of work planned
  - To detail the work performed including procedures followed, test performed, information obtained, and conclusions reached
  - To enable any person, most especially the reporting partner reviewing the audit to satisfy themselves that an adequate examination for audit purpose has been carried out.

  Examples include:
  - Overall audit strategy
  - The audit plan
  - Letter representation
  - Management letter
  - Analyses of significant ratios from the current year financial statement
  - External confirmation reports e.g. expert reports, circularization letter.
  - Management accounts details
  - Relevant board minutes
  - Financial statements etc.

Please take note of the following key principles outlined by ISA 230:

1) The auditor should document discussions of significant matters with management and others on a timely basis.
2) If the auditor has identified information that contradicts or is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor should document how the auditor addressed the contradictions or inconsistency in forming the final conclusion.
3) Where, in exceptional circumstances, the auditor judges it necessary to depart from a basic principle or an essential procedure that is relevant in the circumstances of the audit, the auditor should document how the alternative audit procedures performed achieve the objective of the audit, and, unless otherwise clear, the reasons for the departure.
4) After the assembly of the final audit file has been completed, the auditor should not delete or discard audit documentation before the end of its retention period.
5) When the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final file has been completed, the auditor should, regardless of the nature of the modifications or additions, document:
    - when they were made, and (where applicable) reviewed
    - the specific reasons for making them, and
    - their effect, if any, on the auditor's conclusions.

CONCLUSION

Working papers provide evidence that an effective, efficient, and economic audit has been carried out. They should therefore be prepared with care and skill. They should be sufficiently detailed and complete so that an auditor with no previous experience of that audit can understand the working papers in terms of the work completed, the conclusions reached, and the reasoning behind these conclusions.

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AUDIT SAMPLING

ISA 530 (Audit sampling and other selective testing procedures) defines audit sampling as the application of audit procedures to less than 100% of the items within an account balance or classes of transactions such that all sampling units have a chance of selection.
This will enable the auditor to obtain and evaluate audit evidence about some characteristics of the item selected in order to form or assist in forming a conclusion concerning the population.

Why sampling is inevitable?
Sampling is normally appropriate for areas in which there are a large number of similar transactions, where it is not cost effective to test them all.
Cases where sampling is not appropriate include the following:

1. The auditor is put on enquiry as a result of previous information.
2. Population is too small for valid conclusions to be drawn, and in any event, it is quicker to test all transactions rather than spend time constructing a sample.
3. All the transactions in a particular area are material.
4. The data may be sensitive items e.g. Director's emoluments.
5. There is a non-homogeneous population.

Distinction between sampling and selective testing:
Sampling is the application of audit procedures to less than 100% of the items in the population in order to extrapolate a conclusion about the population. The object is to select a sample that is expected to be representative of population and to examine the sample items. **Selective testing**, however, is any examination of less than 100% of the items in the population e.g. applying audit procedures to all items within a population which have a particular characteristic (say all items over a certain amount). In selective testing the sample is not expected to be representative of the population.

STATISTICAL AND NON-STATISTICAL SAMPLING METHODS
Statistical sampling involves the use of mathematical procedures such as probability theory, to draw conclusions about the population. It requires the use of random selection.

Non-statistical sampling, otherwise called judgement sampling, may use non-random selection methods, does not rely on probability theory and requires more subjectivity (i.e. auditor's judgement) in making sampling decisions.

Condition necessary for the use of statistical sampling:

1. The population to be tested must be homogeneous (i.e. items of the same kind).
2. The population must be very large; otherwise the benefits of the technique will not be achieved.

3. Expectation of error must be low e.g. control risk must have been assessed as low.
4. The item in the population must be identifiable ones selected, so that checking of the items chosen is easily carried out e.g. pre-numbering of invoices.

Advantages of statistical sampling:

1. At the conclusion of the test the auditor is able to state a definite level of confidence he may have that the whole population conforms to the sample result within a stated precision limit.
2. Sample size is objectively determined; having regard to the degree of risk the auditors are prepared to accept.
3. The process of fixing required precision and confidence levels compels the auditor to consider and clarify their audit objectives risks issues.
4. Statistical techniques are probably more defensible than judgemental ones because of its methodical process

Drawbacks:

1. It can stifle the use of professional judgement.
2. it is relatively expensive as some procedures need to be developed and staff need to be trained.
3. Unsuspected bias in sample selection may invalidate the conclusions.
4. It frequently needs back-up by further tests within the population reviewed e.g. for highly material items, non-routine items, sensitive items etc.
5. The selection exercise can be time consuming.
6. It may not be an ideal method under some circumstances as earlier identified.

CONSTRUCTING SAMPLES

The steps involved in audit sampling can be summarized as follows:

1 <u>Designing the sample</u>: the ISA provides that when designing an audit sample, the auditor should **consider**-

- **Specific audit objectives** e.g. the auditor may want to be 95% certain that receivables are not overstated by more than 5%. Clearly the more confident auditors need to be and the narrower the precision limits they wish to work with the larger the sample size will be.
- **The population**: the essential feature of population is that it must be homogeneous. Stratification may have to be used to reduce the degree of variation between items within a population.
- **Sample size**: when determining the sample size the auditor should consider –
  i. <u>Sampling risk</u>: see below.
  ii. <u>Tolerable error</u>: is the maximum error in the population that the auditor will be willing to accept and still concluding that the result from the

sample has achieved the audit objectives. The smaller the tolerable error, the larger the sample size needs to be.

iii. Expected error: if the auditors expect error to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error.

Sampling risk is the risk that the conclusion auditors draw will be different from that which they would have drawn had they examine the entire population. To reduce sampling risk to an acceptably low level, the sample size needs to be representative of the population.
Non-sampling risks arises from audit mistakes e.g. failing to identify errors, incorrect evaluation of sample results etc. it has nothing to do with the sample size. Audit firms can minimize this risk by improving training and review procedures.

2. **Selection of the sample:** the auditor should select sample items in such a way that the sample will be representative of the population. A representative sample is one where all the items in the population have equal chances of being selected.
   Selection methods include:
   - Random sampling
   - Systematic sampling
   - Selective testing
   - Haphazard selection
   - Value weighted selection e.g. monetary unit sampling (MUS)
   - Other judgemental methods.

3. **Evaluation of sample results** - having carried out the relevant audit procedures on each sample items, the auditor should:
   - Analyse any error detected in the sample.
   - Extrapolate (i.e. project) the errors found in the sample into the population to obtain the probable error which should be compared with tolerable error and additional procedures are carried out where necessary.
   - Reassess sampling risk especially where the projected/probable error is greater than or almost equal to the tolerable error.

Using the work of others in an audit.

- Using the work of internal auditing………………………………………..ISA 610
- Using the work of an expert……………………………………………….. ISA 620

USING THE WORK OF INTERNAL AUDITING.

External auditors may make use of work internal audit have done when carrying out external audit procedures. It should however be noted that the external auditor has sole responsibility for the opinion expressed.

<u>ASSESSMENT OF THE INTERNAL AUDIT (A GENERAL ASSESSMENT).</u>

ISA 610 provides that the external auditors must obtain a sufficient understanding of the internal audit function in order to assist in the planning and development of an effective audit approach and to determine whether and desirable to rely on internal audit work. This assignment will in any case have an effect on the assessment of the control environment and audit risk.

In assessing the internal audit function, the following factors should be considered:

- The organizational status of internal audit- the internal auditor should :

    1. Be able to plan and carry out their work as they wish.
    2. Have access to highest level of management e.g. the audit committee
    3. Be free of any operating responsibility
    4. Be able to communicate fully with the external auditor.

- The scope of the internal audit function- the external auditor should consider the nature of assignment performed and the action taken by management as a result of internal audit reports.
- Due professional care: a decision should be made as to whether the work of internal audit generally appears to be <u>planned</u>, <u>controlled</u>, <u>documented</u> and <u>reviewed</u> as evidenced by adequate manual and working papers.
- Technical competence- the internal auditor department should be appropriately staffed in terms of numbers qualification and experience to achieve objective.

External auditors may use the internal auditor's work on the following areas-

- <u>Recording an accounting system</u>
- <u>Evaluating and testing internal control systems</u>- if the external auditors are to rely on the work done by the completion of an internal control evaluation questionnaire, they should check that the method of evaluation is appropriate. They should confirm

that internal audit has satisfactorily tested controls in details by re-performing a sample of internal audit test; if internal audits work is satisfactory, external auditors can make a reduced assessment of control risk as a consequence.

- Substantive procedure- external auditors are primarily interested in internal audit's roles as a control, the important of internal audit as a source of substantive evidence will be less. Nevertheless, certain situation exist e.g. where the client has several site [branches], internal audit may have visited sites that external auditors will not have the chance to visit.

EVALUATION OF SPECIFIC INTERNAL AUDIT WORK.

The following are key considerations in respect of the situation where the external auditor decides that reliance can be placed on internal audit. However the external auditor would be considering whether to do the work himself in particular areas…(Do I do the work myself?)… Key considerations include:

a. The materiality of the areas or items to be tested and of the information that can be obtained from internal audit.

b. The level of audit risk inherent in the areas or items to be tested or in the information to be obtained.

c. The level of judgement required

d. The sufficiency of complementary audit evidence.

e. The specialist skills required for the area.

When the external auditor intends to use specific work of internal auditor, the external auditor should evaluate and perform audit procedures that work to confirm the adequacy for external auditor's purpose. The auditor should ensure that:

a. The work has been performed by those with adequate technical training and proficiency.

b. Assistants are properly supervised

c. Sufficient appropriate audit evidence is obtained to support the conclusions reached.

d. Reports are consistent with the conclusions reached.

e. Have exceptional and unusual matters arising and disclosed by internal audit been properly resolved.

Some observance of internal audit procedures may be necessary as well as re-performance of internal audit procedures. The extent of reliance by the external auditor should be documented.

USING THE WORK OF AN EXPERT

An expert is a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing. Auditors may need to obtain evidence in the form of reports, opinions, valuations, or statement from an expert e.g. valuation of certain types of assets (say, land and building); determination of amounts using specialized method (say, pension accounting); the measurement of work completed and work in progress on contracts, legal opinion etc.

Key principle: when using the work performed by an expert, the auditor should obtain sufficient appropriate audit evidence that such work is adequate for the purpose of the audit.

Explanation: the following points give an explanation of the provisions of ISA 620:

1. Determining the need to use the work of an expert: one element of audit planning is the question of whether specialist evidence may be necessary. Factors to consider include:

    a. The materiality of the item concerned,

    b. The nature and complexity of the item concerned,

    c. The risk of material misstatement,

    d. The quantity and quality of other audit evidence available.

    If it is decided that expert evidence is needed the expert should be engaged by the client or by the auditor with the client's consent. If the client refuses, for whatever reasons, and the item is material and there is no other source of evidence, the auditor should modify the audit report.

2. Competence and objectivity: in order to be able to rely on the evidence provided by the expert the auditor must be satisfied that the expert is competent and objective. If the auditor is in any doubt they should discuss it with management.

3. The expert's scope of work: there should be term of reference that will cover such areas as follows:

    - The objectives of the expert's work
    - the intended use of the work
    - the extent of the expert's relationship with the entity
    - confidentiality of the entity's information
    - assumptions and methods to be used

- The extent of the expert's access to appropriate records and files.

4. Assessing the work of the expert: auditors should assess whether the substance of the expert's findings is properly reflected in the financial statement. Some considerations include:

- The source of data used
- The appropriateness and reasonableness of assumptions and methods used.
- The results of the expert's work in the light of the auditor's knowledge of the business and the result of other audit procedures.

If the auditor is not satisfied with expert's work, the auditor should discuss the problem with management and the expert. It may occasionally be necessary to obtain the opinion of a second expert.

Reference to an expert in the audit report:
Unmodified report: NO REFERENCE TO THE EXPERT
Modified report: REFERENCE MAY BE MADE BUT WITH EXPERT'S PERMISSION

AUDIT EVIDENCE AND AUDIT PROCEDURES.

This is a very key section of paper p7. Audit evidence is needed to express an opinion on the financial statement and therefore you should be able to identify their sources and the audit procedures to be applied to generate evidence. More specifically, be able to for example apply thorough knowledge of analytical procedures in an exam context.

PLEASE REFER TO YOUR CLASS NOTES FOR A MORE DETAILED ANALYSIS OF HOW TO APPROACH PAST EXAM QUESTIONS ON THESE AREAS

ISA 500 'Audit Evidence' requires that auditors should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.
Sufficient appropriate audit evidence.
The auditor's judgement as to what constitutes a sufficient (quantity) and appropriate (quality) evidence is influenced by the following factors:

- The results of risk assessment.
- The nature of the client's accounting and internal control system.
- The materiality of the item involved.
- The auditors knowledge and experience of the business
- The source and reliability of the evidence.

Financial statement assertions:
These are representations by management, explicit or otherwise, that are embodied in the financial statements.
Management is responsible for the preparation and the fair presentation of the financial statement (FS). In representing that the FS show a "true and fair view" or "are fairly presented in all material respect" , management are making assertions about the FS. The relevance of audit evidence should be considered in relation to the overall audit objective of forming an opinion and reporting on the FS. To achieve this objective the auditor needs to obtain audit evidence to support the FS assertions.
The relevant assertions are set out in ISA 500 as the following:
Assertions about transactions and events for the period:

- Occurrence transactions and events that have been recorded actually occurred and pertain to the entity
- Completeness: there are no unrecorded transactions and events.
- Accuracy: transactions and events have been measured and recorded accurately.
- Cut-off: transactions and events have been recorded in the correct accounting period.
- Classification: transactions have been recorded in the appropriate accounts

Assertion about account balances at the period end:

- Existence: assets, liabilities and equity interest exist
- Rights and obligations: assets and liabilities pertain to the entity.
- Completeness: there are no unrecorded assets and liabilities
- Valuation and allocation: assets and liabilities have been measured at the appropriate amount and any necessary allocation adjustments have been correctly made.

Assertions about presentation and disclosure:

- Occurrence and rights and obligations: all disclosed transactions and events have occurred and pertain to the entity.
- Completeness: there is no unrecorded disclosures
- Classification and understandability: clearly expressed disclosures and appropriate presentation.

Note: when designing work programs, audit tests should be designed to obtain evidence about the FS assertions. You should try to remember the three groups of assertions so that you apply relevant assertions in the exam depending on whether you are looking at transactions e.g. sales and purchases, or balances e.g. receivables and payables. Two of the most important assertion tests are for *completeness* and *occurrence/existence.*

<u>RELIABILITY ISSUES</u>

Although the reliability of audit evidence is dependent upon the particular circumstances, the following general presumptions may be found helpful:

- Evidence obtained from independent external sources are more dependable than that obtained from the entity's records
- Internally generated evidence is more reliable when the accounting and internal control systems is operating effectively
- Self generated evidence in more reliable than that obtained by or from the client.
- Documentary evidence is more reliable than oral evidence and original documents are more reliable.

<u>SUBSTANTIVE PROCEDURES.</u>

These are procedures carried out to detect material misstatement at the assertion level and it includes:

1. Test of details of transactions and events, account balances and disclosures
2. Substantive analytical procedures.

Tests of controls should however not be confused with substantive tests. Tests of controls are performed to obtain audit evidence about the:

1. Adequacy of design of the accounting and internal control systems, and its
2. Operating effectiveness.

Substantive tests may be incorporated with other procedures e.g. an invoice is checked for both its accuracy (substantive) and its authorization (test of control). The same invoice may also be used as part of a walk-through test which the auditor will perform to confirm their understanding of the internal control systems.

<u>"Audit Procedures for Obtaining Audit Evidence</u>

The auditor obtains audit evidence to draw reasonable conclusions on which to base the audit opinion by performing audit procedures to achieve the following objectives:

- Obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and assertion levels (audit procedures performed for this purpose are referred to in the ISAs as "risk assessment procedures");
- When necessary or when the auditor has determined to do so, test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level (audit procedures performed for this purpose are referred to in the ISAs as "tests of controls"); and
- Detect material misstatements at the assertion level (audit procedures performed for this purpose are referred to in the ISAs as "substantive procedures" and include tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures)." **(IAASB HANDBOOK)**

TYPES OF AUDIT PROCEDURES.

ISA 500 sets out the types of audit procedures that the auditor can perform to generate various forms of audit evidence.

- Inspection of tangible assets*
- Inspection of records and documents*
- Observation
- Inquiry
- Confirmation*
- Re-calculation*
- Re-performance
- Analytical procedures*

*they are highly important when carrying out substantive procedures.

ANALYTICAL PROCEDURES (ISA 520)

Nature and purpose

'Analytical procedures' involve analysis of ratios, trends and relationships (financial and non-financial) including the resulting investigation of fluctuations. The analysis is usually carried out by comparisons. It basically involves identifying fluctuations and relationships that do not appear consistent with other relevant information, expected patterns or predicted amounts.

Comparisons : Financial information is compared, for example, with:

- prior periods (historical data);
- budgets and forecasts (future-oriented data);
- predictive estimates (e.g., of the annual depreciation charge);
- industry averages.

Purposes

- To assist in PLANNING the nature, timing and extent of other audit procedures.

- As SUBSTANTIVE procedures when their use is more effective or efficient than tests of details in detecting material misstatement.
- As an overall REVIEW, to conclude whether financial statements as a whole are consistent with the auditors' knowledge of the business.

Application of analytical procedures.
The first standard in ISA 520 states that auditors "should apply analytical procedures at the planning and overall review stages of an audit". Analytical procedures at these stages are therefore essential and are **required** (i.e., mandatory) in the conduct of current year audit. ISA 520 goes on to state, that analytical procedures **may** be performed as substantive procedures (i.e., are optional).

At the planning stage
Analytical procedures at this stage (sometimes called 'preliminary analytical review') assist in:

- increasing knowledge and understanding of the business through the accumulation of information on trends in key relationships;
- identifying areas of potential risk (e.g., relating to the entity's financial condition);
- determining the nature, timing and extent of other audit procedures (i.e., audit strategy) by directing tests to areas of potentially material misstatement.

Information availability
Financial information available at the planning stage may include:

- interim financial information;
- budgets or forecasts;
- management accounts AND draft financial statements.

Substantive analytical procedures
Analytical procedures at stages other than the planning and overall review stages are **optional**. Substantive analytical procedures ('SAPs') are based on the expectation that relationships which are known to exist may be expected to continue in the absence of clear evidence to the contrary. For example, the relationship between gross profit and sales revenue may be expected to remain constant unless there are changes in sales prices, sales mix and/or cost structure.

<u>Where sufficient substantive evidence is not obtained by analytical procedures alone, some tests of detail will also be required.</u>

Extent of use
Factors determining the extent of *use* of substantive analytical procedures include:

- The closeness of *relationship*s between items of data. Analytical procedures are more appropriate when relationships are plausible and predictable (e.g., between sales commission and sales revenue). A plausible relationship is one which may reasonably be expected to exist.
- The degree of *disaggregation* in available information. For example, a detailed review of gross profit margins by major product would be more effective than the review of an overall gross profit.
- The *availability* and *reliability* of financial data (e.g., budgets) and non-financial data (e.g., units produced). Independently prepared non-financial data should facilitate more effective procedures.
- The *relevance* of available information. For example, budgets based on expectation are more useful than targets.
- The *comparability* of available information.
- The auditor's *cumulative knowledge* and experience. Effective analytical procedures are based on recognizing unusual or unexpected variations. If knowledge is limited, it is difficult to know what to expect.
- The *nature* of the enterprise and its operations. When steady trends develop it is easier to know what to expect and identify variations.

The auditor is more likely to use analytical procedures for:

- existing well-established clients;
- in well-known, stable industries;
- where predictive information is readily available; and
- accounting and internal control systems are effective.

Extent of reliance
Factors determining the extent of *reliance* on substantive analytical procedures include:

- *Materiality* of items involved. The less significant an account balance or class of transactions, the more reliance may be placed on analytical procedures.
- *Other audit procedures* directed to the same financial statement assertion. For example, a reduction in the extent of tests of detail will be justified where significant fluctuations and inconsistencies have been corroborated.
- The *accuracy of predictions*. Income and expenditure accounts tend to be more predictable than balance sheet accounts because they are composed of large numbers of like transactions (whereas balances tend to be a net amount). Non-recurring accounting entries (e.g., asset revaluations) and discretionary expenses (e.g., research and development) do not lend themselves to effective analytical procedures.
- *Risk assessments*. For example, if internal control over the processing of sales orders is weak (i.e., control risk is high) more reliance on tests of details for drawing conclusions on receivables may be required.

- The *effectiveness* of controls, if any, over the preparation of information used for analytical procedures.

Types of substantive analytical procedure

- trend analysis (e.g., graphical time series and regression analysis);
- ratio analysis; and
- reasonableness tests (also called ‘proof in total’).

Reasonable tests
These provide an independent check on the total value of a population and are most useful for income and expenditure accounts. The mechanics are:

- calculate the expected value of a population;
- compare with recorded value;
- difference should not be material.

Illustration: Hotel revenue:
Calculate income for the year as:

Last year’s income (audited) x (1+i) % where i is the increase in room rate.

Investigation of fluctuations
ISA 520 requires that when unexpected trends or deviations are identified the auditor should

- seek explanations from relevant client staff .
- obtain corroborative evidence.

Reasons such as the deliberate concealment of errors, ‘window-dressing’, theft and fraud will usually only be considered as a last resort (unless the auditor has reason to suspect such irregularities).

At the overall review stage:

Analytical review at this stage is required in forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor’s knowledge of the business. The review may also identify the need for further substantive procedures. Ratio analysis is particularly useful in testing the consistency of the inter-relationships of amounts disclosed in the financial statements. It is usual to compare ratios calculated at this stage with those of the preliminary analytical review

Conclusion
As analytical procedures have applications covering three of the principal stages of an audit, it is highly likely that in any paper F8/P7 examination you will have

some opportunity to refer to them and get some marks. However, such vague and general comments as "perform analytical procedures" are clearly unworthy of marks when another candidate writes, for example,

"Schedule monthly payroll expenses and corroborate fluctuations by reference to starters/leavers and pay rises",

"Compare delivery vehicle running expenses to the number of vehicles with the prior year",

Compare trade payables individually and in total to prior year balances and explain any unusual changes

MANAGEMENT REPRESENTATION. (ISA 580)

According to the 'IAASB Handbook glossary of terms', management representations are representations made by management to the auditor during the course of an audit, either unsolicited or in response to specific inquiries. They are required for certain principal purposes in accordance with ISA 580 and these include:

1. To allow management to acknowledge its *responsibility for the fair presentation of the financial statements* in accordance with the applicable financial reporting framework, and has approved the financial statements.
2. To obtain audit evidence from management on *matters material to the financial statements* when other sufficient appropriate audit evidence cannot reasonably be expected to exist.
3. To allow management to acknowledge its responsibility for the design and implementation of *internal control* to prevent and detect error; and
4. To confirm that management believes that the effects of those *uncorrected financial statement misstatements* aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representations.

When the auditor receives such representation they should:

- ❖ Seek corroborative audit evidence from sources inside or outside the entity;
- ❖ Evaluate whether the representations made by management appear reasonable and consistent with other audit evidence obtained, including other representations; and
- ❖ Consider whether the individuals making the representations can be expected to be well informed on the particular matters.

Representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. For example, a representation by management as to the cost of an asset is not a substitute for the audit evidence of such cost that an auditor would ordinarily expect to obtain.

If a representation by management is contradicted by other audit evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.

The auditor would ordinarily include in audit working papers evidence of management's representations in the form of a summary of oral discussions with management or written representations from management.
A written representation is ordinarily more reliable audit evidence than an oral representation and can take the form of:

- A representation letter from management;
- A letter from the auditor outlining the auditor's understanding of management's representations, duly acknowledged and confirmed by management; or
- Relevant minutes of board meetings or a signed copy of the financial statements.

<u>Content and wording:</u>
The precise scope of the formal record of representations should be appropriate to the circumstance of each particular audit. Typical contents include:

- Acknowledgement of management's responsibility for the preparation of the financial statement.
- Confirmation that all books and records have been made available to the auditor
- Confirmation that there have been no fraud and any material non-compliance with relevant laws and regulations
- Confirmation of the management's belief that the financial statements free from material misstatement.
- Other representations as are relevant to the circumstance of the audit e.g. in the areas of provisions and contingencies, events after the reporting date that may require adjustment or disclosure etc.

<u>Dating of the letter:</u>
A letter of representation should be signed by persons whose level of authority is to appropriate to the significance of the representation made (normally the CEO and the CFO). The formal record of representation by management should be dated on the same day that the financial statements are approved. It should not be dated after the audit report since it is part of the audit evidence used to form an opinion contained in the report.

<u>Actions if management refuses to provide representation:</u>
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 a disclaimer of opinion. However, this would be carried out after discussions have been held with management to clarify the matters in doubt.

EXTERNAL CONFIRMATION (ISA 505)

One of the principal methods of obtaining corroborative evidence available to auditors is by inquiry. Inquiry involves seeking information from knowledgeable persons inside or outside the entity. Confirmation is the name given to a specific form of inquiry that is particularly widely used. It involves obtaining written confirmation from a third party, typically, although not exclusively, in relation to an account balance in which the third party has an interest.

General issues relating to confirmations are:

- In what situations are the use of confirmations appropriate?
- What assertions are addressed by confirmations?
- How should a request for confirmation be made?

Situations for using confirmations

Confirmations are best used where there is a knowledgeable party, independent of the entity and where alternative reliable evidence is not readily available. The most knowledgeable parties are those in a commercial relationship with the entity holding reciprocal information as to entity balances. These include debtors, creditors, banks, lenders, borrowers and custodians of entity assets such as stocks and securities. It is in their interest to respond to an auditor's request for confirmation to ensure that any differences are identified and resolved.

Generally speaking, parties from whom confirmation is sought are likely to be independent, ensuring the evidence is reliable. However, there are two situations where the auditor may need to exercise caution. The first is where the other party is 'related', e.g. a fellow subsidiary of the same parent or having majority shareholders in common. The second is where the other party might be economically dependent on the entity and may be motivated to provide an inaccurate response for fear of losing business with the entity.

Assertions

Where confirmations relate to reciprocal balances (such as debtors, creditors, banks, borrowers and lenders), they provide persuasive evidence as to rights and obligations (ownership) and existence. However, because of human nature (intentional and unintentional acts), confirmations may not always provide reliable evidence as to accuracy and valuation.

Form of request

As a general rule, the request must be presented in such a form that facilitates a response by the other party. This can be achieved by using a standard form with space for the response and enclosing a return addressed envelope.

A possible scenario is between the use of confirmations that specify the information to be confirmed, or that request the other party to supply information.

The latter approach eliminates the risk that the other party may not undertake a careful check of their records before responding, but increases the risk that the other party fails to respond.

The use of **positive or negative confirmations** is another possible scenario. Both specify the information to be confirmed but a negative request only requires a response where the information is incorrect. The debate as to their respective benefits is indeterminate. Generally speaking, negative confirmations are used where there are a large number of small balances and the risk of material misstatement is assessed as low. However, the confirmation must be seen more as a test of control than as a substantive procedure. It assists in confirming the presumed low incidence of errors and provides qualitative information on the type of errors that exist. Where detection risk is high, or the materiality of the account balance is high, positive confirmation will be needed to provide substantive evidence.

It is nearly always the case that management of the audited entity must authorise each confirmation request. This exposes the risk that the process could be interfered with by the entity because the confirmation is usually in the form of a request – from the entity – for information to be supplied to their auditor. It is important that auditors control the process by ensuring that confirmations sent are in agreement with those selected for confirmation and that respondent addresses are verified. It is also important that the envelopes bear the auditors' return address in the event of non-delivery. Where no response is received to a positive request for confirmation (after suitable follow- up requests), alternative evidence must be obtained if the information to be confirmed is material to the financial statements or to maintain the integrity of sample evidence. Although a need to make follow-up requests in seeking confirmation responses is important, examination candidates often give undue prominence to this particular aspect and inadequate attention to suitable alternative sources of evidence.

Receivables' confirmations

The use of confirmation evidence is usually very important in the audit of trade receivables because there are few other sources of external corroborative evidence. It is usually suitable when the majority of the credit customers are reasonable-sized businesses. Because existence is an important assertion being verified, it is important that the source from which the sample is selected is tested for completeness. This usually requires selecting the sample from a list of receivables balances that has been tested against the sales ledger and totalled and agreed with the general ledger balance. The list of receivables balances is usually subdivided into current due balances and overdue balances. Each present separate audit risks as overdue balances are more likely to contain errors and thus require a proportionately larger sample.

It is necessary to verify non-responses with alternative reliable evidence of the outstanding balance in order to maintain the integrity of the sample where positive confirmations are used. Such evidence includes delivery notes signed for by the customer, written customer sales orders and, if subsequently paid, a remittance advice accompanying the payment identifying the specific invoices being paid.

Payables/Creditors' confirmations:
Creditors are much less frequently confirmed than debtors. The auditor already has external evidence in the form of supplier invoices and statements. Although held by the entity and thus potentially at risk from being manipulated, they are likely to provide sufficient appropriate evidence in the absence of any suspicious circumstances. In addition, the principal assertion verified by confirmation evidence would be that of completeness. The available population (creditor balances recorded by the entity), is not a suitable starting point for selecting a sample for confirmation when verifying completeness. If time is available, auditors tend to prefer to use the complementary/reciprocal population of purchases (or payment transactions recorded after the period end) when verifying the completeness of recorded creditors.

Bank confirmations: In many countries, the auditing profession has come to a mutual agreement with the banking industry on the method to be employed in seeking confirmations. A standardised form is commonly used with open questions for the bank to complete. The evidence should be reliable because banks usually maintain a high level of internal control over records of customer balances. However, because the task of completing the confirmation is often entrusted to relatively junior personnel and is not subject to independent checks, auditors must be alert for the possibility of clerical errors when making use of the evidence obtained by confirmation.

Another consideration when confirming bank balances is that they involve both debit and credit balances and contingencies. Therefore, evidence of both completeness and existence is sought. Although balances with each bank are usually individually material (in that all banks are confirmed – not just a sample), the auditors must take reasonable care that all banks which the entity has had dealings with during the year are identified. Auditors should request confirmations from each bank, not just those with recorded balances outstanding at the period end.

GROUP AUDIT

ISA 600, Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors).

This International Standard on Auditing deals with special considerations that apply to group audits, in particular those that involve component auditors. It assists the group engagement partner in taking responsibility for the direction, supervision and performance of the group audit and the issue of an auditor's report that is appropriate in the circumstances.

Terms:
The group auditor (also called the principal auditor) is responsible for providing the audit opinion on the group financial statements. Components of the group financial statements can include subsidiaries, associates, joint ventures, and branches. The components may be audited by the group auditor, but may instead be audited by a different firm of auditors known as the 'component auditors', also known as the 'other auditor'.

Scope:
The objective of the group auditor is twofold. First, the group auditor should establish that it is appropriate to act as group auditor. Second, the group auditor should gather sufficient and appropriate evidence in order to reach an opinion on the consolidated financial statements. This note focuses on the second of these two objectives.
ISA 600 provides a three-stage process which is summarised below.

STAGE ONE – GATHERING EVIDENCE ON THE COMPONENTS

Planning and risk assessment
It is imperative that the group auditor has a good understanding of the structure of the group, the significance (i.e. materiality) of each component of the group, the mechanics of the consolidation process, and the risk of material misstatement presented by each of the company's financial statements. Materiality levels should be established for the group in aggregate, and for the individually significant components.

Involvement in the work of component auditors
In a group, it is likely that some companies will be audited by a different firm of auditors. The group auditor has two issues to resolve. First, the group auditor cannot simply rely on another auditor's opinion on the financial statements of the company. In other words, if the other auditor has concluded that the financial statements of the component are free from material misstatement, the group auditor should not just rely on this opinion and assume that the figures taken from the company's financial statements into the consolidated financial statements are correct. A material misstatement in the financial statements of a company could become a material misstatement in the financial statements of the group. For all companies within the group, regardless of materiality, the group auditor should review a report of work done by the component auditor. This report of work done could be in the form of an:

- executive summary, or
- a memorandum of audit issues arising from the audit of the company.

- a questionnaire, to be completed by the component auditor, which would highlight key issues arising from the audit of the component.

Following this review, the group auditor will need to decide on the extent of any further actions which need to be taken, or any further work which needs to be carried out, in order to ensure that the financial statements are free from material misstatement. Such actions could include:

- a review of the component auditor’s overall audit strategy
- performing a risk assessment at the company level
- participating in closing meetings with the component auditor and the management of the company
- a review of relevant parts of the component auditor’s audit working papers.

Where a company is material to the group financial statements, the group auditor should carry out further actions, including:

- discussing with the component auditor, and/or the management of the company, the business activities that are significant to the group
- discussing with the component auditor the susceptibility of the company’s financial statements to material error or deliberate misstatement
- reviewing the component auditor’s documentation of identified significant risks, and the conclusions reached on these risks.

It may be the case that, having performed the actions outlined above, the group auditor concludes that further audit work is required on the financial statements of a company. For example, the group auditor may consider that an element of the financial statements of the company could be materially misstated, and that further audit evidence is necessary.

The group auditor should determine the nature of the work necessary, and whether the work should be carried out by the group auditor or the component auditor.

Having taken the actions outlined above, the group auditor should now have obtained sufficient evidence to show that the individual company financial statements are free from material misstatement, and are a sound basis for the preparation of the consolidated financial statements.

STAGE TWO – AUDITING THE CONSOLIDATION

The consolidation process

The group auditor must plan the audit procedures to be performed on the consolidation process. For some groups, the consolidation will be complex and is likely to involve some areas of judgement, and so there is a high degree of audit risk. Thorough planning will be essential to ensure that audit risk is minimised.

The types of audit procedures that could be performed include:

- checking that figures taken into the consolidation have been accurately extracted from the financial statements of the components

- evaluating the classifications of the components of the group – for example, whether the components have been correctly identified and treated as subsidiaries, associates, or joint ventures
- reviewing the disclosures necessary in the group financial statements, such as related party transactions and minority interests
- investigating the treatment of any components which have a different financial year end from that of the rest of the group
- gathering evidence appropriate to the specific consolidation adjustments made necessary by financial reporting standards, including, for example:
    - the calculation of goodwill and its impairment review
    - cancellation of inter-company balances and transactions
    - provision for unrealised profits as a result of inter-company transactions
    - fair value adjustments needed for assets and liabilities held by the component
    - re-translation of financial statements of components denominated in a foreign currency.

Some of the evidence required to meet the above objectives will be gathered by the component auditor, and it is the group auditor's responsibility to communicate to the component auditor the evidence that they are expected to gather. This communication ideally occurs at the audit planning stage.
The group auditor must have a sound knowledge of the relevant financial reporting standards, which include:

- IFRS 3, *Business Combinations*
- IAS 28, *Investments in Associates*
- IFRS 11, *Joint Ventures*
- IFRS 9, *Financial Instruments*
- IFRS 10, Consolidated Financial Statement

Candidates are advised that, for the purposes of study for Paper P7, they must be very familiar with the above financial reporting standards.

STAGE THREE – ISSUING THE GROUP AUDIT OPINION
The group auditor issues an opinion on the consolidated financial statements. This is done after a thorough review of all evidence gathered in the first and second stages. ISA 600 states that when the group auditor concludes that the work of the other auditor cannot be used and the group auditor as not been able to perform sufficient additional procedures regarding the financial information of the component audited by the component auditor, the principal auditor should express a qualified opinion or a disclaimer of opinion because there is a limitation in the scope of the audit. If the component auditor issues a modified opinion, the principal auditor should consider whether the nature and significance of the qualification means that the principal auditors report also needs to be modified. In such cases possible actions are as follows:

- If the matter is material to the component but not material in a group context, then no further action need to be taken.

- If the matter is material to the subsidiary and also material in a group context and the group auditor audited the subsidiary, then it would be usual to carry the qualification into the group audit report. However a disclaimer of opinion in a subsidiary may become an 'except for opinion' in a group context.
- If the matter is both material to the component and in the group context, and component financial statement were not audited by the principal auditors, the same applies as above but however no mention (in the group auditor's report) should be made of the fact that the subsidiary was audited by another firm.

OTHER MATTERS RELEVANT TO A GROUP AUDIT SITUATION

JOINT AUDITING:

A joint audit is when two audit firms are appointed to jointly provide an audit opinion on a set of financial statements. This is becoming increasingly common, especially in group audits, where a component may be audited by both the group auditor and another auditor.

The main benefit of this type of arrangement is that when a new component is acquired by the group, for example the acquisition of a new subsidiary, it is advantageous to keep the subsidiary's existing audit firm, which will have built up considerable knowledge and experience of the business of the component. However, the group auditor will also need to build up knowledge of the new subsidiary's business, and also become familiar with the audit methods and procedures used by the other auditor. One way for this to happen is for the group auditor to be appointed, along with the other auditor, to jointly provide the audit opinion on the individual financial statements of the subsidiary. The two firms will work together to plan the audit, gather evidence, review the work done, and to finally provide the opinion.

Other benefits from a joint audit may include better availability of resources and the provision of a higher quality audit, as there will be access to staff from both firms of auditors. The inclusion of members of staff from the group audit firm within the audit team of the subsidiary should also improve the efficiency of the audit of the consolidation process.

However, it may be difficult for the two firms to work together if they use different audit methods and it may take time to develop a 'joint audit' approach. There will also be cost implications for the client, as it will presumably be more expensive to use two firms of auditors to provide an audit opinion instead of one. There is also the joint liability problem.

As more and more companies become acquisition targets, it can be seen that if this practice were to continue, the small and medium-sized audit firms would continue to lose audit clients to the larger audit firms, and would be left with few clients to provide a source of income. Therefore, in the interests of maintaining revenue streams for small and medium-sized audit firms, and in the interests of competition in the audit profession, joint auditing is an important current issue, and will continue to be debated for the foreseeable future.

SUPPORT LETTER;

In accounting terms a group is treated as a single entity. However, in law it is a collection of separate legal entities. This can mean that a member of a group may not be a going concern without the support of the group. If it is not a going concern and may collapse then it would seem that the group account should recognize that. However the group may well not allow the subsidiary to go bust and therefore the subsidiary is really a going concern. The auditor may accept this but needs evidence that the subsidiary will be supported by the group and the custom is for the directors to give the auditor **a comfort or support letter** assuring the auditor that the group will support the subsidiary**.** The auditor will normally accept such letter as valid evidence of the going concern basis for the subsidiary's financial statement. The auditor should also consider/verify whether the party giving such a letter as the ability to give such support.

CONCLUSION

Group audits raise a variety of issues. The group structure can be complex and the existence of numerous components within the group means that there may be several firms of auditors involved. The group auditor must ensure that the group audit is carefully planned and that communications with other auditors are made early in the audit process.

The group auditor needs to gather two types of evidence. Evidence regarding individual components of the group may be gathered using a joint audit arrangement, though this is not without disadvantages. Evidence on the consolidation process must be thorough, and planned with regard to numerous complex financial reporting standards.

EVALUATION AND REVIEW

- OVERALL REVIEW
- GOING CONCERN
- SUBSEQUENT EVENTS
- MANAGEMENT REPRESENTATION
- INITIAL ENGAGEMENTS
- COMPARATIVES
- OTHER INFORMATION

FOR THE EXAMS:

- ✓ THIS IS AN INTERESTING AREA AND IS A SUATABLE CANDIDATE FOR QUESTION 5. GET A GOOD GRAB OF GOING CONCERN, SUBSEQUENT EVENTS AND THEIR EFFECTS ON THE EXTERNAL AUDITOR'S REPORT.

- ✓ CANDIDATES ARE UNLIKELY TO BE REQUIRED TO PREPARE A FULL VERSION OF THE AUDITOR'S REPORT BUT MAY BE ASKED TO CRITICALLY APPRAISE ONE WHICH MAY FOR EXAMPLE CONTAIN SOME DEFICIENCIES.

- ✓ PLEASE REVIEW THE VARIOUS FORMATS AND CONTENT OF THE REPORTS INCLLUDED AS AN APPEXDIX TO THIS MANUAL.

OVERALL REVIEW OF FINANCIAL STATEMENT

The auditors must perform and document an overall review of the financial statements before they can reach an opinion. Once the bulk of the substantive procedures have been carried out, the auditors will have a draft set of financial statements which should be supported by appropriate and sufficient audit evidence. The review should be carried out by a senior member of the audit team, with appropriate skills and experience.

Procedure 1: Compliance with accounting regulations

The auditors should consider whether:

- ➢ The information presented in the financial statements is in accordance with local/national statutory requirements.

- The accounting policies employed are in accordance with accounting standards, properly disclosed, consistently applied and appropriate to the entity.

Procedure 2: Review for consistency and reasonableness

The auditors should consider whether the financial statements are consistent with their knowledge of the entity's business and with the results of other audit procedures, and the manner of disclosure is fair. The principal considerations are as follows.

- Whether the financial statements adequately reflect the **information** and **explanations** previously obtained and conclusions previously reached during the course of the audit
- Whether it reveals any **new factors** which may affect the presentation of, or disclosure in, the financial statements
- Whether analytical procedures applied at the overall review stage achieve its objective.
- The potential impact on the financial statements of the **aggregate of uncorrected misstatements** (including those arising from bias in making accounting estimates) identified during the course of the audit and the preceding period's audit, if any

Procedure 3: Presentation and disclosure

Auditor should not be influenced by management's desire to present fact in a more favourable (or unfavourable) form, but should reflect the substance of the underlying transaction.

Summarising errors

During the course of the audit, errors will be discovered which may be material or immaterial to the financial statements. It is very likely that the client will adjust the financial statements to take account of material and immaterial errors during the course of the audit. At the end of the audit, however, some errors may still be outstanding and the auditors will summarise these **unadjusted errors**.

- In evaluating whether the financial statements are prepared in all material respects, in accordance with an applicable financial reporting framework, the auditor should assess whether the aggregate of uncorrected misstatements that have been identified during the audit is material. **ISA 320.12**
- If the auditors consider that the aggregate of misstatements may be material, they must consider reducing audit risk by extending audit procedures or requesting management to adjust the financial statements (which management may wish to do anyway).
- If management refuses to adjust the financial statements and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor

should consider the appropriate modification to the auditor's report. **ISA 320.15**

Completion checklists

Audit firms frequently use checklists which must be signed off to ensure that all final procedures have been carried out, all material amounts are supported by sufficient appropriate evidence, etc.

GOING CONCERN (ISA 570)

ULTIMATE OBJECTIVE: Auditors should consider whether the going concern basis is appropriate, and whether disclosure of any going concern problems is sufficient.

Under the 'going concern assumption' (IASB Framework) 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. Accordingly assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business'.

Management's responsibility:

1. ISA 570 *Going concern* states that when preparing accounts, management should make an explicit assessment of the entity's ability to continue as a going concern.

2. Secondly, the directors should ensure that the financial statements are prepared using the going concern basis where it is appropriate. This would have been determined based on the assessment carried out in 1 above. However, the break-up basis should be used where the directors conclude that the entity cannot continue as a going concern.

3. Thirdly, according to IAS 1 Presentation of financial statements, the director should **disclose adequately** the **principal events or conditions** that give rise to the uncertainty about continuance as a going concern, and management's plans to deal with the situation.

The following list gives examples of possible indicators of going concern problems.

(a) Financial indications

- Net liabilities or net current liability position
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings
- Major debt repayment falling due where refinancing is necessary to the entity's continued existence

- Indications of withdrawal of financial support by lenders
- Negative operating cash flows indicated by historical or prospective financial statements
- Adverse key financial ratios
- Inability to pay suppliers on due dates
- Change from credit to cash-on-delivery transactions with suppliers
- Inability to obtain financing for essential new product development or other essential investments
- Substantial sales of non-current assets not intended to be replaced

(b) Operating indications
- Loss of key management without replacement
- Loss of a major market, franchises, license, or principal supplier
- Labour difficulties or shortages of important supplies

(c) Other indications
- Non-compliance with statutory requirements
- Pending legal proceedings against the entity that may, if successful, result in judgements that could not be met
- Changes in legislation or government policy.

Auditors' responsibilities

- 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.
- The auditor should remain alert for evidence of events or conditions and related business risks which may cast doubt on the entity's ability to continue as a going concern throughout the audit

- The auditor should evaluate management's assessment of the entity's ability to continue as a going concern. The auditors should consider:
    - The process management used
    - The assumptions on which management's assessment is based
    - Management's plans for future action
- If management's assessment covers a period of less than twelve months from the balance sheet date, the auditor should ask management to extend its assessment period to twelve months from the balance sheet date.

- When events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor should:
    - review management's plans for future actions based on its going concern assessment;
    - gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists; and

- seek written representations from management regarding its plans for future action.

- When questions arise on the appropriateness of the going concern assumption, auditors may also have to carry out additional procedures or to update information obtained earlier. The ISA lists various procedures which the auditors should carry out in this context.
  - Analyse and discuss cash flow, profit and other relevant forecasts with management
  - Analyse and discuss the entity's latest available interim financial statements
  - Review the terms of debentures and loan agreements and determine whether they have been breached
  - Read minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties
  - Enquire of the entity's lawyer regarding litigation and claims
  - Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties
  - Assess the financial ability of such parties to provide additional funds
  - Consider the entity's position concerning unfulfilled customer orders
  - Review events after the period-end for items affecting the entity's ability to continue as a going concern

PLEASE NOTE: Based on the audit evidence obtained, the auditor should determine if, in the auditors' 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. An uncertainty will be material if it has so great a potential impact as to require clear disclosure of its nature and implications in the accounts. IAS 1 requires that the accounts should:

- **Adequately describe** the **principal events or conditions** that give rise to the uncertainty about continuance as a going concern, and management's plans to deal with the situation, or
- **State clearly** that a **material uncertainty exists** and therefore the entity may be unable to realise its assets and discharge its liabilities in the normal course of business

Reporting responsibilities of the auditor

Note: to gain a good understanding of these area you may need to study and understand the various forms the external auditor’s report could take

If adequate disclosure is made in the financial statements, the auditor should express an unqualified opinion but modify the auditor's report by adding an **emphasis of a matter paragraph.**

The auditors may express a **disclaimer of opinion** if for example there are multiple material uncertainties.
If adequate disclosure is not made in the financial statements, the auditor should express **a qualified or adverse opinion**, as appropriate. The report should include explicit reference to the fact that there is a material uncertainty which may cast significant doubt about the company's ability to continue as a going concern.
If in the auditors' judgement, the entity will not be able to continue as a going concern, the auditor should express an **adverse opinion** if the financial statements have been prepared on a going concern basis.
If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor should consider the need to modify **(qualified opinion or a disclaimer**) the auditor's report as a result of the limitation on the scope of the auditor's work.

SUBSEQUENT EVENTS

Auditors must consider the effect of subsequent events on:

- the financial statements;
- the auditor's report.

Subsequent events are *all* events occurring after a period end (i.e. reporting date) i.e.:

- events after the balance sheet date (as defined in IAS 10); and
- events after the financial statements have been authorised for issue.

Events occurring up to date of auditor's report

- The auditor is responsible for carrying out procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified.
- These procedures are in addition to those applied to specific transactions occurring after the period end that provide audit evidence of period-end account balances (e.g. inventory cut-off and receipts from trade receivables). Such procedures should ordinarily include:
    - reviewing minutes of board/audit committee meetings;
    - scrutinising latest interim financial statements/budgets/cash flows, etc;
    - making/extending inquiries to legal advisors on litigation matters;
    - inquiring of management whether any subsequent events have occurred that might affect the financial statements e.g. management procedures for identification of subsequent events, new commitments or borrowings, issue of shares/debentures, sales or destruction of assets etc.
    - normal post balance sheet work performed in order to verify year-end balances
    - obtaining a letter of representation.

When the auditor becomes aware of events that materially affect the financial statements, the auditor must consider whether they have been properly accounted for and adequately disclosed in the financial statements.

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

Tutorial note: *After the date of the auditor's report it is management's responsibility to inform the auditor of facts which may affect the financial statements.*

If the auditor becomes aware of such facts which may materially affect the financial statements, the auditor:

- considers whether the financial statements need amendment;
- discusses the matter with management; and
- takes appropriate action (e.g. audit any amendments to the financial statements and issue a new auditor's report).

If management does not amend the financial statements (where the auditor believes they need to be amended) and the auditor's report has not been released to the entity, the auditor should express a qualified opinion or an adverse opinion (as appropriate).

If the auditor's report has been released to the entity, the auditor must notify those charged with governance not to issue the financial statements (and the auditor's report thereon) to third parties.

Tutorial note: *The auditor would seek legal advice if the financial statements and auditor's report were subsequently issued.*

Facts discovered after the financial statements have been issued

The auditor has no obligation to make any inquiry regarding financial statements that have been issued.

However, if 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's report to be modified, the auditor should:

- consider whether the financial statements need revision;
- discuss the matter with management; and
- take appropriate action (e.g. issuing a new report on revised financial statements).

ISA 560 requires that when management revises the financial statement, the auditor should issue a new report after carrying out revised audit procedures up to the date of the new report and should review steps taken by management to ensure that anyone in receipt of the previously issued financial statement together with the audit report thereon is informed of the situation.

The new auditor's report should include an emphasis of the matter paragraph referring to a note in the financial statement that more extensively discusses the reason for the revision to the new financial statement and the audit report. Where management does not revise or take necessary steps to withdraw the financial statements, the auditor must take steps to prevent reliance on their report and this would involve taking a legal advice and in extreme cases, directly contacting the shareholders depending on the auditor's legal rights and obligations.

MANAGEMENT REPRESENTATION. (ISA 580)

According to the 'IAASB Handbook glossary of terms', management representations are representations made by management to the auditor during the course of an audit, either unsolicited or in response to specific inquiries. They are required for certain principal purposes in accordance with ISA 580 and these include:

5. To allow management to acknowledge its *responsibility for the fair presentation of the financial statements* in accordance with the applicable financial reporting framework, and has approved the financial statements.
6. To obtain audit evidence from management on *matters material to the financial statements* when other sufficient appropriate audit evidence cannot reasonably be expected to exist.
7. To allow management to acknowledge its responsibility for the design and implementation of *internal control* to prevent and detect error; and
8. To confirm that management believes that the effects of those *uncorrected financial statement misstatements* aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representations.

When the auditor receives such representation they should:

- ❖ Seek corroborative audit evidence from sources inside or outside the entity;
- ❖ Evaluate whether the representations made by management appear reasonable and consistent with other audit evidence obtained, including other representations; and
- ❖ Consider whether the individuals making the representations can be expected to be well informed on the particular matters.

Representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. For example, a representation by management as to the cost of an asset is not a substitute for the audit evidence of such cost that an auditor would ordinarily expect to obtain. If a representation by management is contradicted by other audit evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.

The auditor would ordinarily include in audit working papers evidence of management's representations in the form of a summary of oral discussions with management or written representations from management.
A written representation is ordinarily more reliable audit evidence than an oral representation and can take the form of:

- ➢ A representation letter from management;

- A letter from the auditor outlining the auditor's understanding of management's representations, duly acknowledged and confirmed by management; or
- Relevant minutes of board meetings or a signed copy of the financial statements.

<u>Content and wording:</u>
The precise scope of the formal record of representations should be appropriate to the circumstance of each particular audit. Typical contents include:

- Acknowledgement of management's responsibility for the preparation of the financial statement.
- Confirmation that all books and records have been made available to the auditor
- Confirmation that there have been no fraud and any material non-compliance with relevant laws and regulations
- Confirmation of the management's belief that the financial statements free from material misstatement.
- Other representations as are relevant to the circumstance of the audit e.g. in the areas of provisions and contingencies, events after the reporting date that may require adjustment or disclosure etc.

<u>Dating of the letter:</u>
A letter of representation should be signed by persons whose level of authority is to appropriate to the significance of the representation made (normally the CEO and the CFO). The formal record of representation by management should be dated on the same day that the financial statements are approved. It should not be dated after the audit report since it is part of the audit evidence used to form an opinion contained in the report.

<u>Actions if management refuses to provide representation:</u>
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 a disclaimer of opinion. However, this would be carried out after discussions have been held with management to clarify the matters in doubt.

ISA 510 *Initial engagements – opening balances*

This standard provides guidance on opening balances.

1. When the financial statements of an entity are audited for the first time
2. When the financial statements for the prior period were audited by another auditor

For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

- the opening balances do not contain misstatements that materially affect the current period's financial statements;
- the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated; and
- appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately disclosed

Prior period balances audited

When the prior period's financial statements were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by **reviewing** the predecessor auditor's **working papers**. In these circumstances, the current auditor would also consider the professional competence and independence of the predecessor auditor. If the prior period's audit report was **modified**, the auditor would pay particular attention in the current period to the matter which resulted in the modification.
Where the prior period balances were audited by the current auditor, and an unqualified opinion was given, procedures relating to opening balances must ensure balances have been appropriately brought forward and accounting policies have been consistently applied. If a qualified opinion was given, the auditors must ensure that the matter has been resolved and dealt with in the current financial statements.

Prior period balances not audited

When the prior period's financial statements were not audited or when the auditor is not able to be satisfied by using the procedures described above, the auditor must perform other procedures such as those discussed below.
For **current assets and liabilities** some audit evidence can usually be obtained as part of the current period's audit procedures. For example, the **collection** (payment) of opening **receivables** (payables) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

In the case of **inventory**, however, it is more difficult for the auditor to be satisfied as to inventory on hand at the beginning of the period. Therefore, additional procedures will usually be necessary such as:

- Observing a current physical inventory count and reconciling it back to the opening inventory quantities
- Testing the valuation of the opening inventory items
- Testing gross profit and cut-off

A combination of these procedures may provide sufficient appropriate audit evidence.
For **non-current assets and liabilities**, the audit will ordinarily examine the records underlying the opening balances. In certain cases, the auditor may be able to obtain confirmation of opening balances with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

Audit conclusion and reporting

If, after performing procedures including those set out above, the auditor is unable to obtain sufficient appropriate evidence concerning opening balances, the auditor's report should include:

- a qualified opinion;
- a disclaimer of opinion; or
- in those jurisdictions where it is permitted, an opinion which is qualified or disclaimed regarding the results of operations and unqualified regarding financial position.

If the opening balances contain misstatements which could materially affect the current period's financial statements, the auditor should inform management, and any predecessor auditor.

If the effect of the misstatement is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.
The report will also be modified if **accounting policies** are **not consistently applied**.

If the current period's accounting policies have not been consistently applied in relation to the opening balances and if the change has not been properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion as appropriate.

COMPARATIVE INFORMATION (ISA 710)

Objectives

The objectives of the auditor are:

- To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and
- To report in accordance with the auditor’s reporting responsibilities.

Definitions

For purposes of the ISAs, the following terms have the meanings attributed below:

- Comparative information – The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.
- Corresponding figures – Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures”). The level of detail presented in the corresponding

amounts and disclosures is dictated primarily by its relevance to the current period figures.

- Comparative financial statements – Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

Requirements

Audit Procedures

The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

- The comparative information agrees with the amounts and other disclosures presented in the prior period or, when appropriate, have been restated; and
- The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of ISA 560. If the prior period financial statements are amended, the auditor shall determine that the comparative information agrees with the amended financial statements.

As required by ISA 580, the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any restatement made to correct a material misstatement in prior period financial statements that affect the comparative information.

Audit Reporting

<u>Corresponding Figures</u>

When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the circumstances as discussed below.

If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

- Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
- In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, and the corresponding figures have not been properly restated or appropriate disclosures have not been made, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein.

When the prior period financial statements that are misstated have not been amended and an auditor's report has not been reissued, but the corresponding figures have been properly restated or appropriate disclosures have been made in the current period financial statements, the auditor's report may include an Emphasis of Matter paragraph describing the circumstances and referring to where relevant disclosures that fully describe the matter that can be found in the financial statements

<u>Prior Period Financial Statements Audited by a Predecessor Auditor</u>

If the financial statements of the prior period were audited by a predecessor auditor and the auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor shall state in an Other Matter paragraph in the auditor's report:

- That the financial statements of the prior period were audited by the predecessor auditor;
- The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
- The date of that report. (Ref: Para. A7)

Prior Period Financial Statements Not Audited

If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

Comparative Financial Statements

When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed.

When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with ISA 706.

<u>Prior Period Financial Statements Audited by a Predecessor Auditor</u>

If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:

- that the financial statements of the prior period were audited by a predecessor auditor;
- the type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
- the date of that report, unless the predecessor auditor's report on the prior period's financial statements is reissued with the financial statements.

If the auditor concludes that a material misstatement exists that affects the prior period financial statements on which the predecessor auditor had previously reported without modification, the auditor shall communicate the misstatement with the appropriate level of management and request that the predecessor auditor be informed. If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period.

<u>Prior Period Financial Statements Not Audited</u>

If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph that the comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

AUDITOR'S RESPONSIBILITIES FOR 'OTHER INFORMATION'

The auditor has a professional responsibility to read other information to identify material inconsistencies with the audited financial statements (ISA 720 'Other Information in Documents Containing Audited Financial Statements').

Other information is financial and non-financial information *other than* the audited financial statements and the auditors' report, which an entity may include

in its annual report, either by custom or statute. Examples include directors' report, financial summaries, employee data, operating and financial review (OFR) etc.
A 'material inconsistency' arises when other information contradicts that which is contained in the audited financial statements. It may give rise to doubts about:

- the auditor's conclusions drawn from audit evidence; and
- the basis for the auditor's opinion on the financial statements.

In certain circumstances, the auditor may have a statutory obligation (under national legislation) to report on other information (e.g. Management Report). Even where there is no such obligation (e.g. chairman's statement), the auditor should consider it, as the credibility of the financial statements may be undermined by any inconsistency.
The auditor must arrange to have access to the other information on a timely basis prior to dating the auditor's report.

Material inconsistency

- If a material inconsistency is identified, the auditor should determine whether it is the audited financial statements or the other information which needs amending.
- If an amendment to the audited financial statements is required but not made, there will be disagreement, resulting in the expression of a qualified or adverse opinion. (Such a situation would be extremely rare.)
- Where an amendment to other information is necessary, but refused, the auditor's report may draw necessary attention to the issue through the other matter paragraph (since the audit opinion cannot be other than unqualified with respect to this matter).

Material misstatement of fact

- A material misstatement of fact in other information exists when information which is not related to matters appearing in the audited financial statements is incorrectly stated or presented in a misleading manner.
- If management do not act on advice to correct a material misstatement the auditors should document their concerns to those charged with corporate governance and obtain legal advice.

REPORTING.

EXTERNAL REPORTING (INDEPENDENT AUDITOR'S REPORT)

INTERNAL REPORTING (INTERNAL AUDIT AND REVIEW REPORTS)

INDEPENDENT AUDITOR'S REPORT

ISA 700 'The Independent Auditor's Report on a complete set of General Purpose Financial Statement' addresses circumstances when the auditor is able to express an unqualified opinion and no modification to the auditor's report is necessary.

ISA 701, "Modifications to the Independent Auditor's Report" establishes standards and provides guidance on the modifications to this report for an emphasis of matter, a qualified opinion, a disclaimer of opinion, or an adverse opinion.

UNMODIFIED REPORT (ISA 700)

An unqualified opinion should be expressed when the auditor concludes that the financial statements (FS) give a true and fair view (or are presented fairly in all material respect) in accordance with the applicable financial reporting framework. An unmodified auditor's report includes an unqualified opinion without any other modification in the form of emphasis of matter.

Elements of the Auditor's Report:

Consistency in the auditor's report, when the audit has been conducted in accordance with the ISAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the reader's understanding and to identify unusual circumstances when they occur.

Title

The auditor's report should have a title that clearly indicates that it is the report of an independent auditor.

A title indicating the report is the report of an independent auditor, for example, "Independent Auditor's Report," affirms that the auditor has met all of the relevant ethical requirements regarding independence and, therefore, distinguishes the independent auditor's report from reports issued by others.

Addressee

The auditor's report should be addressed as required by the circumstances of the engagement.

National laws or regulations often specify to whom the auditor's report on general purpose financial statements should be addressed in that particular jurisdiction.

Ordinarily, the auditor's report on general purpose financial statements is addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

Introductory Paragraph

The introductory paragraph in the auditor's report should identify the entity whose financial statements have been audited and should state that the financial statements have been audited. The introductory paragraph should also:

(a) Identify the title of each of the financial statements that comprise the complete set of financial statements;

(b) Refer to the summary of significant accounting policies and other explanatory notes; and

(c) Specify the date and period covered by the financial statements.

Management's Responsibility for the Financial Statements

The auditor's report should state that management is responsible for the and the fair presentation of the financial statements in accordance with the applicable financial reporting framework and that this responsibility includes:

(a) 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;

(b) Selecting and applying appropriate accounting policies; and

(c) Making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

The auditor's report should state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.

The auditor's report should state that the audit was conducted in accordance with International Standards on Auditing. The auditor's report should also explain that those standards require that the auditor comply with ethical requirements and that the auditor plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

Auditor's Opinion

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 applicable financial reporting framework and where appropriate, whether the FS comply with statutory requirements.

Other reporting responsibilities:

When the auditor addresses other reporting responsibilities within the auditor's report on the financial statements, these other reporting responsibilities should be addressed in a separate section in the auditor's report that follows the opinion paragraph.

Auditor's signature

The report must contain the signature, whether this is the auditor's own name or the audit firm's name (mostly used) or both.

Date of report

The auditor should date the audit report as of the completion date of the audit. This informs the users that the auditor has considered the effects on the FS and on the report of events and transaction of which the auditor became aware and that occurred up to that date. The auditor's report should never be dated earlier than the date on which the FS was signed or approved by the directors.

Auditor's address

The report should name a specific location, which is ordinarily the city where the auditor maintains the office that has responsibility for the audit.

Matters that Do Not Affect the Auditor's Opinion (ISA 706)

(a) Emphasis of matter
(b) Other matter paragraph

Matters that Do Affect the Auditor's Opinion (ISA 705): Modified Opinion

(a) Qualified opinion,
(b) Disclaimer of opinion, or
(c) Adverse opinion.

Matters that Do Not Affect the Auditor's Opinion: Emphasis of matter paragraph

In certain circumstances, 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 that more extensively discusses the matter. The addition of such an emphasis of matter paragraph does not affect the auditor's opinion. The paragraph would preferably be included after the paragraph containing the auditor's opinion but before the section on any other reporting responsibilities, if any. The emphasis of matter paragraph would ordinarily refer to the fact that the auditor's opinion is not qualified in this respect.

Examples of situations where it may be used:

- The auditor should modify the auditor's report by adding a paragraph to highlight and draw attention to a material matter regarding a **going concern problem** that is already disclosed in the FS.

- The auditor should consider modifying the auditor's report by adding a paragraph if there is a significant uncertainty (other than a going concern problem). A significant uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may materially affect the financial statements. **(Contingencies)**

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

- It can also be used for additional statutory reporting responsibilities.

- If the auditor has determined that the financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation, the auditor shall accept the audit engagement only if the following conditions are present:
  - Management agrees to provide additional disclosures in the financial statements required to avoid the financial statements being misleading; and it is recognized in the terms of the audit engagement that the auditor's report on the financial statements will incorporate an Emphasis of Matter paragraph, drawing users' attention to the additional disclosures.
- Stating in a new or amended audit report the reasons for recalling and amending an already issued financial statements

Matters that Do Affect the Auditor's Opinion (Modified Opinion)
An auditor may not be able to express an unqualified opinion when either of the following circumstances exists and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:

a) There is an inability to obtain sufficient appropriate audit evidence (**limitation on the scope** of the auditor's work); or
b) The financial statements are materially misstated (otherwise called **disagreement with management)** regarding:
   i. the acceptability of the accounting policies selected,
   ii. the method of their application or
   iii. the adequacy of financial statement disclosures.

The circumstances described in (a) could lead to a qualified opinion or a disclaimer of opinion. The circumstances described in (b) could lead to a qualified opinion or an adverse opinion.

A *qualified opinion* should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being '**except for**' the effects of the matter to which the qualification relates.

A *disclaimer of opinion* should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

An *adverse opinion* should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

Basis of a modified opinion:

Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s) on the financial statements.

Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion on the financial statements and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

Inability to obtain sufficient appropriate evidence (i.e. limitation on the scope of the auditor's work) may be:

- Imposed by management
- Imposed by the nature and timing of the auditor's appointment (for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories). It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable.
- Imposed by circumstances beyond the control of management

When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report **should describe** the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

The process of forming an audit opinion in an exam question can be summarised in a step format, as follows:

- Analyse the requirement.
- Read through all the information given in the question carefully.
- Ascertain whether all the evidence reasonably expected to be available has been obtained and evaluated.
- If not, identify whether the effect of not gaining evidence is such that the financial statements could as a whole be misleading (disclaimer of opinion) or in material part could be misleading ('except for' opinion).
- Ascertain whether the financial statements have been prepared in accordance with generally accepted accounting principles (GAAP).
- If not, determine whether departure was required to give a true and fair view and if so, whether it has been properly disclosed.
- Decide whether any unnecessary departure is material to the financial statements ('except for' opinion) or is pervasive to them (adverse opinion).
- Conclude whether the financial statements as a whole give a true and fair view.

INTERNAL AUDIT AND REVIEW REPORTS

Internal auditors, external auditors, and consultants who perform internal audit and review engagements provide reports to management (internal audit reports). These reports are important because they provide documentary evidence of the work performed, the conclusions reached and the recommendations made. The quality and presentation of such reports makes a substantial difference to the value added by internal audit and those performing similar functions.

Internal audit reports are different to statutory auditors' reports produced by external auditors because statutory reports are governed by legislation and either national auditing standards, or International Standards on Auditing. Statutory auditors' reports are highly codified, and usually fairly brief by comparison with internal audit reports, and they are often available for public inspection. Statutory auditors' reports are produced for the benefit of shareholders and other stakeholders whereas internal audit reports are produced for the benefit of management; they are generally private documents and are not normally available for public inspection.

On the other hand, internal audit reports are similar, in some respects, to reports to management on the design and implementation of controls provided by external auditors to management during the course of, and at the end of, statutory audits. The method of production of such reports is similar, for example. Both internal and external auditors draft these sorts of reports on the basis of the findings of their work and there will usually be a split between significant and insignificant matters, and a summary or overall evaluation of the more important matters. Draft reports will often be discussed with management to confirm the findings and to establish management's likely response. Responses are often incorporated into the report. Reports will often be redrafted several times, particularly in large organisations, after which the report will be issued. If management have not commented at an earlier stage, a formal response may be expected later. It is normal to follow up on recommendations or agreed action points in order to establish how the issues have been dealt with.

External auditor reports to management typically called **letter of weaknesses/management letter** deal in substance with, inter alia, issues relating to the design and implementation of internal controls that have come to the external auditors' attention during the course of the statutory audit. They generally deal with weaknesses in systems, the potential consequences and provide recommendations to management. Whilst internal audit reports may appear to be similar, they are different in substance.

Internal audit engagements are usually undertaken as part of a pre-planned program of work with a variety of objectives as part of an entity's overall corporate governance arrangements. These objectives can relate to **the risks**

faced by the business, internally and externally, and / or they can deal with **the enhancement of performance**.

Whilst there are common elements to the two types of reporting, risk-based reporting tends to look at the current position and internal issues, whereas enhancement of performance tends to be more outward and forward-looking. Risk-based reports might include establishing whether existing systems are properly aligned with the overall objectives of the entity. For example, internal auditors may be requested to establish whether human resources systems are capable of, and are actually delivering, the development and retention of the best staff in an entity's particular market. Where it is believed that systems are not properly aligned, internal audit may be requested to make recommendations in relation to changing the existing systems, or implementing new systems, in order to achieve corporate objectives. Reports relating to the enhancement of performance may involve a review of the market, and management's business strategies and overall risk management systems at a higher level. Whatever the assignment, there will almost always be a formal report which should be **clear**, **balanced and constructive**, **consistent in style and concise**.

Internal audit reports will usually **contain** a header page giving a title (the subject matter of the report), a distribution list, the date of production of the report, the identity of the authors and some sort of reference number. They will usually include an executive summary providing the background to the project (an introduction), summary terms of reference, the major outcomes of the work, the key risks identified and key action points or recommendations, and a summary of any further work required.

The **main body** of the report includes detailed findings, action points or recommendations and will often include alternative recommendations. It gives details of responsibility for actioning the points, the costs involved with the various recommendations, and time-scales for implementation. **Appendices** will often contain the full terms of reference, tables or questionnaires used, flowcharts and systems diagrams, timetables, details of tests performed, and any other relevant information.

APPENDIX

THE STANDARD UNMODIFIED AUDIT REPORT

XYZ AUDITOR'S REPORT

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 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 amount and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also include 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 it is financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Report on other legal and regulatory requirements

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

Limitation on Scope—Qualified Opinion

"We have audited ... (remaining words are the same as illustrated in the introductory paragraph – see standard report). Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – see standard report).

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 – see standard report).

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 we been able to satisfy ourselves as to physical inventory quantities, the financial statements give a true and fair view of ... (remaining words are the same as illustrated in the opinion paragraph – see standard report)."

Limitation on Scope—Disclaimer of Opinion

"We were engaged to audit the accompanying financial statements of ABC Company, which comprise the balance sheet as of 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 significant accounting policies and other explanatory notes.

Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – see standard report).

(Omit the sentence stating the responsibility of the auditor.)

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

(Add a paragraph discussing the scope limitation as follows:

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

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

Disagreement on Accounting Policies—Inappropriate Accounting Method—Qualified Opinion

"We have audited ... (remaining words are the same as illustrated in the introductory paragraph – see standard report).

Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – see standard report).

Our responsibility is to … (remaining words are the same as illustrated in the auditor's responsibility paragraphs – see standard report).

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 fixed assets should be reduced by accumulated depreciation of xxx and the loss for the year and accumulated deficit should be increased by xxx and xxx, respectively.

In our opinion, *except for the effect on the financial statements of the matter referred to in the preceding paragraph*, the financial statements give a true and fair view of ... (remaining words are the same as illustrated in the opinion paragraph – see standard report)."

Disagreement on Accounting Policies—Inadequate Disclosure—Qualified Opinion

"We have audited ... (remaining words are the same as illustrated in the introductory paragraph – see standard report).

Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – see standard report).

Our responsibility is to … (remaining words are the same as illustrated in the auditor's responsibility paragraphs – see standard report).

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, 19X1. In our opinion, disclosure of this information is required by … (refer to relevant statute or standard)

In our opinion, *except for the omission of the information included in the preceding paragraph*, the financial statements give a true and fair view of ... (remaining words are the same as illustrated in the opinion paragraph – (see standard report)

Disagreement on Accounting Policies—Inadequate Disclosure—Adverse Opinion

"We have audited ... (remaining words are the same as illustrated in the introductory paragraph – (see standard report)

Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – see paragraph 60 of ISA 700 (Revised)).

Our responsibility is to … (remaining words are the same as illustrated in the auditor's responsibility paragraphs – see standard report).

(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,') and fair view of (or 'do not present fairly, in all material respects,') the financial position of ABC Company as of December 20, 19X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards."