



## Advanced Audit and Assurance

**Study Text**

**The Institute of Chartered**

**Accountants of Nigeria**

ICAN 2021

# ICAN

**Advanced audit and assurance**

ICAN 2021



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Chartered Accountants  
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**Professional level**  
**Advanced Audit and Assurance**

S

## Syllabus

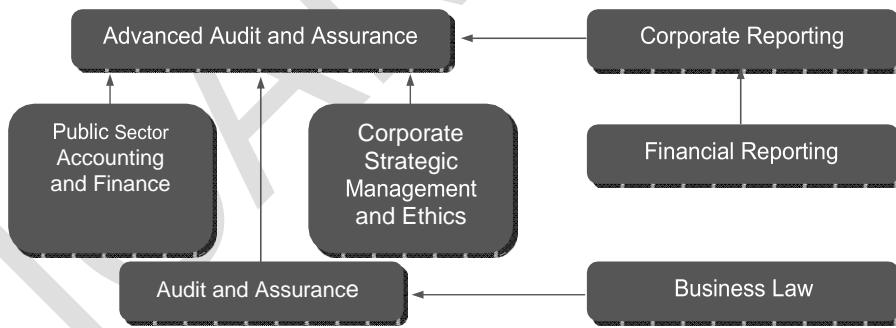
### **PROFESSIONAL LEVEL** **ADVANCED AUDIT AND ASSURANCE**

#### Aim

The candidate is expected to understand the critical aspects of managing audit and assurance engagements: acceptance; planning; concluding; and reporting.

#### Linkage with other subjects

This diagram depicts the relationship between this subject and other subjects.



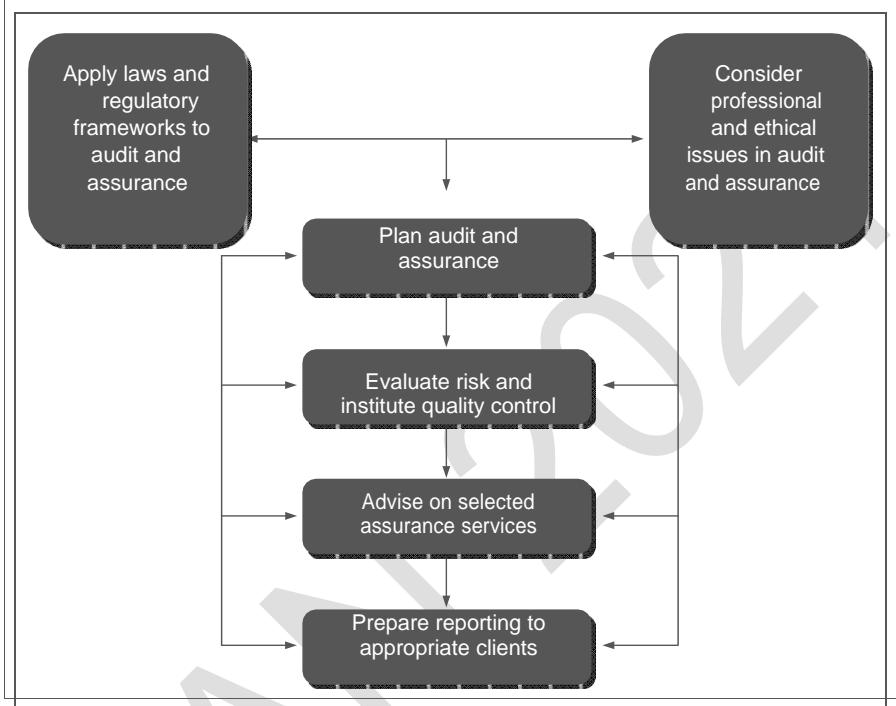
### Main competencies

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

- Explain and advise on professional, ethical and legal issues arising during assurance engagements;
- Advise on various planning procedures involved in carrying out assurance engagements;
- Advise on risks associated with assurance engagements and various types of business and relevant control measures to mitigate those risks; and
- Identify features of assurance engagement reports and also be able to write relevant reports after concluding the assignment on assurance engagements.

### Linkage of the main competencies

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



Syllabus overview	
Grid	Weighting
A Laws and regulations on audit and assurance engagements	20
B Accepting professional engagements and managing assignments	15
C Planning and undertaking audit work	30
D Drawing conclusions and reporting	25
<b>E Application of information technology in auditing</b>	<b>10</b>
<b>Total</b>	<b>100</b>

Contents and competencies		Chapter
<b>A Laws and regulations on audit and assurance engagements</b>		
<b>Laws, regulations and ethical issues</b>		
1	Advise on technical, professional and ethical issues that may arise during assurance engagements in the public and private sectors including evaluation and communication with any party to the engagement.	2-4
2	Identify and make judgements on when it may be appropriate to refer a matter to a senior colleague or for third party advice or consultation.	5, 8
3	Identify and explain the nature and purposes of laws, regulations, standards and codes in the context of assurance engagements.	2-4
4	Evaluate, explain and communicate the process and issues involved in standards setting process at national and international levels.	2
5	Evaluate and communicate the interactions between national laws and regulations and the requirements of an assurance engagement.	2
6	Evaluate and communicate the differences between various jurisdictions and how they deal with audit issues including national and international approaches such as the US Sarbanes-Oxley and related requirements for audit.	2, 15
7	Evaluate and explain how audits may fail to meet users' expectations.	4
8	Evaluate and explain the extent of legal liabilities including criminal and civil law liabilities and professional negligence and how they can be mitigated.	4
<b>B Accepting professional engagements and managing assignments</b>		
1	<b>Accepting engagements</b>	
	(a) Discuss the processes that must be followed before acceptance of audit engagements.	5
	(b) Analyse and evaluate the issues that may arise during the process of obtaining audit work.	5
	(c) Identify and explain the legal, professional and ethical issues that may arise during the acceptance of assurance or audit assignments.	3, 5
	(d) Analyse and evaluate the potential issues that determine the nature, scope and extent of an assurance or audit engagement.	6-7
	(e) Discuss the basic elements of an engagement letter, including those agreed with the client and those imposed by laws and regulations	5

<b>Contents and competencies</b>		<b>Chapter</b>
<b>2</b>	<b>Practice management</b>	
	(a) Evaluate and apply appropriate procedures and policies for management of an assurance or audit engagement.	5
	(b) Evaluate and apply appropriate quality control measures that may be used by a firm during the course of an assurance or audit engagement.	5
	(c) Identify and evaluate the extent to which assurance and audit functions within an entity can be used or relied upon.	8
	(d) Evaluate and apply appropriate monitoring and review procedures to effectively manage an audit or assurance engagement.	5
	(e) Identify and explain the purposes of external monitoring of audit and assurance assignments and how this might ensure engagement or firm's quality.	5
	(f) Identify and evaluate the considerations by an auditor of risk issues identified prior to accepting an engagement.	5
<b>C</b>	<b>Planning and undertaking audit work</b>	
<b>1</b>	<b>Overall audit strategy</b>	
	(a) Analyse, evaluate and explain the key areas of a business that are important to understand in developing an effective strategy or plan based on a business scenario. ( <b>ISA 300 – Planning an audit of financial statements</b> )	6-7
	(b) Analyse and evaluate the relevant techniques needed for an effective understanding of the audit work.	6-7
	(c) Analyse and evaluate the situations when third party expertise may be required ( <b>ISA 620 - Using the Work of an Auditor's Expert</b> )	8
	(d) Evaluate and advise on elements of audit risks, including inherent and control (risk of material misstatement), sampling and non-sampling (detection risk) and their relationships with audit planning procedures ( <b>ISA 315 – Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment</b> ).	7
	(e) Identify and evaluate the components of risk for any assurance engagement.	7
	(f) Evaluate and explain how business process effectiveness may affect an audit assignment.	7

Contents and competencies			Chapter
	(g)	Identify and evaluate the risks arising from accounting manipulation, error, fraud or other irregularities in a business scenario.	7
	(h)	Identify and evaluate the risks arising from business and financial issues in a business scenario.	7
	(i)	Evaluate and apply judgements and measures of materiality in carrying out an audit or assurance engagement ( <b>ISA 320 – Materiality in Planning and Performing an Audit</b> ).	7
	(j)	Evaluate and apply analytical procedures that may be used to plan an audit or assurance engagement, including data analytics	8
	(k)	Analyse and evaluate how risk and materiality judgements affect the planning of an assurance or audit engagement, including the nature, timing and extent of work.	6-7
	(l)	Develop an audit plan, justifying judgements made on an audit or assurance engagement based on a business scenario including considerations relating to:	
		■ Materiality decisions;	7
		■ Internal control assessments including information technology (IT);	6-7
		■ Reliance on internal audit, specialists and the work of other auditors;	8, 10, 13
		■ Use of client's generated data, information and reports;	8
		■ Tests of control, substantive and analytical procedures; and	8
		■ Visits to locations, branches and departments.	8, 10
	(m)	Describe the appropriate procedures for assurance engagements in respect of corporate social responsibility and sustainability reports.	15
	(n)	Describe the differences between assurance engagements and audit engagements for profit and not-for-profit entities, including those in the public sector.	7
	(o)	Explain local and international frameworks for auditing and assurance work in private and public sectors.	6, 7
<b>2</b>	<b>Assessment of risks, internal controls, internal financial controls</b>		
	(a)	Identify and assess reporting and compliance risks in the context of an assurance or audit engagement in the public or private sector based on a given business scenario.	7, 14

<b>Contents and competencies</b>			<b>Chapter</b>
	(b)	Give an advice based on the assessment above.	14
	(c)	Analyse the role of information technology control framework in internal control.	6
	(d)	Analyse technology risk management and cyber security.	6
<b>3</b>	<b>Evaluation of accounting treatments</b>		
		Evaluate and draw conclusions on the appropriateness of stated accounting treatments in the context of a given scenario for public or private sector based on national and international standards on auditing and international financial reporting standards (IFRS).	8,9,14
<b>4</b>	<b>Specialised audits and investigations</b>		
	(a)	Understanding special features of certain types of audit and investigation situations.	12
	(i)	Forensic investigation and reporting	12
		<ul style="list-style-type: none"> <li>■ Describe the major applications of forensic auditing e.g. fraud, negligence, insurance claims and analyse the role of a forensic auditor as an expert witness.</li> </ul>	12
		<ul style="list-style-type: none"> <li>■ Distinguish among forensic accounting, forensic investigation and forensic audit.</li> </ul>	12
		<ul style="list-style-type: none"> <li>■ Identify the various government agencies associated with forensic auditing.</li> </ul>	12
		<ul style="list-style-type: none"> <li>■ Apply the fundamental ethical principles to forensic auditor's engagement.</li> </ul>	12
		<ul style="list-style-type: none"> <li>■ Describe the procedures to be adopted in forensic audit.</li> </ul>	12
		<ul style="list-style-type: none"> <li>■ Select investigative procedures and evaluate the evidence appropriate to determine the amount of loss in specific circumstances.</li> </ul>	12
	(ii)	Not-for-profit organisations – charities, non-governmental organisations (NGOs).	7
		<ul style="list-style-type: none"> <li>■ Identify and explain various types and objectives of not-for-profit organisations.</li> </ul>	7
		<ul style="list-style-type: none"> <li>■ Explain how the audit of a not-for-profit organisation differs from the audit of a profit oriented organisation.</li> </ul>	7
		<ul style="list-style-type: none"> <li>■ Assess the audit risks associated with not-for-profit organisations.</li> </ul>	7
		<ul style="list-style-type: none"> <li>■ Develop plans and procedures for the audit of not-for-profit organisations.</li> </ul>	7

Contents and competencies		Chapter
	■ Suggest various control measures that can be applied by a not-for-profit organisation in its operations.	7
	■ Determine the form and contents of audit report for a not-for-profit organisation.	7
(b)	Joint audits	10
	(i) Explain the term joint audit.	10
	(ii) Develop a plan for a joint audit.	10
	(iii) Identify circumstances under which a joint audit occurs.	10
	(iv) Describe the factors to consider in sharing audit work in joint audits.	10
	(v) Advise management on the merits and demerits of joint audits.	10
	(vi) Advise on matters to consider by firms engaging in joint audits.	10
(c)	Investigations	11
	(i) Identify and discuss various circumstances under which an investigation may be conducted.	11
	(ii) Differentiate between investigation and statutory audit.	11
	(iii) Analyse and evaluate various stages involved in conducting investigations.	11
	(iv) Write an appropriate report on each investigation.	11
	(v) Discuss the nature and methods of investigation relating to liquidation and bankruptcy.	11
(d)	Due diligence reviews for mergers, acquisitions and business combinations	11
	(i) Differentiate between due diligence and external audit.	11
	(ii) Describe the procedures involved in carrying out due diligence.	11
	(iii) Write a report on the outcome of a due diligence assignment.	11
(e)	Discuss the duties and responsibilities of a reporting accountant in raising capital.	12

Syllabus and study guide

Contents and competencies			Chapter
D	Drawing conclusions and reporting		
1	Drawing conclusions		
	(a)	Analyse, evaluate and propose how issues identified during the course of an assignment may be raised and dealt with in communication with management, directors and those charged with governance, including actions taken when issues cannot be agreed.	9, 14
	(b)	Identify, explain and apply procedures that may be used and considerations relating to the identification of subsequent events that may require adjustments or disclosures.	9
	(c)	Identify, explain and apply procedures that may be used and considerations relating to the identification of risk issues that require disclosures.	9, 14
	(d)	Evaluate and apply quantitative and qualitative judgements based on the results of tests and evidence obtained.	9, 14
2	Audit report		
	(a)	Discuss the concept of key audit matters (KAM) and justify the basis for reporting same.	14
	(b)	Explain the responsibilities of an auditor with respect to KAM.	14
	(c)	Explain the audit documentation requirements of ISA 701 with respect to KAM.	14
	(d)	Identify the additional national requirements beyond those of ISA 701 for entities that should be within the scope of ISA 701 per the requirements of the Financial Reporting Council of Nigeria.	14
	(e)	Appraise the form and contents of the audit report under ISA 700 (revised), given a specific situation.	14
	(f)	Explain the responsibilities of auditors in respect of other information in line with the requirements of ISA 710.	14
	(g)	Explain circumstances under which emphasis of matters or other matters paragraph may be appropriate to an audit report.	14
	(h)	Draft extracts of suitable audit, assurance and management reports based on a given scenario in accordance with Nigerian laws and international standards on auditing.	11, 12, 14

<b>Contents and competencies</b>			<b>Chapter</b>
	(i)	Evaluate and apply suitable judgments on when it may be appropriate to refer to a specialist in giving an opinion or preparing a report.	14
	(j)	Evaluate and apply suitable judgments on when it may be appropriate to withhold an opinion, withdraw an opinion or take other such appropriate actions on an audit or assurance engagement.	11, 12, 14
	(k)	Identify and explain the issues that may be relevant and the nature of report that may be given relating to risk management, internal controls and governance.	14
<b>E</b>	<b>Application of information technology in auditing</b>		
1	Discuss the impact of IT in an audit environment.		7,15
2	Analyse the benefits of IT control frameworks in internal controls (example COBIT Framework).		6
3	Discuss cyber security in relation to audit and investigation		
4	Discuss application and web trust assurance		
5	Evaluate application of algorithm reviews in business		
6	Discuss application of digital forensics		
7	Discuss data protection regulation audit		
8	Discuss utilisation of robotic process automation in audit		
9	Discuss audit in a blockchain environment		

**Professional level**  
**Advanced Audit and Assurance**



## Examinable documents

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

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

Examinable documents

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Examinable document	B2 A&A	C2 AAA
<b>International Standards on Related Services (ISRss)</b>		
4400 Engagements to Perform Agreed-upon Procedures Regarding Financial Information.		Y
4410 Compilation Engagements.		Y
<b>IFAC Statements</b>		
ISQC1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services.		Y
IFAC IESBA Code of Ethics for Professional Accountants.	Y	Y
<b>Other relevant laws and pronouncements including:</b>		
Insurance Act		Y
BOFIA, including prudential guidelines and other circulars issued by CBN from time to time		Y
Money (Prohibition) Laundering Act 2011		Y
Corporate Governance Codes		Y
ICAN Professional Code of Ethics and Guide for Members	Y	Y
International Financial Reporting Standards (IFRS)		Y
Companies and Allied Matters Act (CAMA 2020)	Y	Y

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



## Foreword

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

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

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

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

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

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

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

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

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

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

# A

## Acknowledgement

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

### Taxation

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

### Business Law

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

### Public Sector Accounting and Finance

1.	Osho, Bolaji	Writer/Reviewer
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3.	Ashogbon, Bode	Writer

### Advanced Taxation

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2.	Kareem, Kamilu	Writer

### Case Study

Adesina, Julius Babatunde	Writer/Reviewer
---------------------------	-----------------

**Information Technology Skills**

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

**Soft Skills**

1. Adesina, Julius Babatunde	Reviewer
2. Adeplate, Olutoyin Adeagbo	Writer

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

**Business Management and Finance**

1. Ogunniyi, Olajumoke
------------------------

**Management Information**

1. Adesina, Julius Babatunde
2. Ezeribe, Chimenka

**Financial Accounting**

1. Adeyemi, Semiu Babatunde
-----------------------------

**Financial Reporting**

1. Okwuosa, Innocent
----------------------

**Performance Management**

1. Durukwaku, Sylvester
-------------------------

**Corporate Strategic Management and Ethics**

1. Adeplate, Olutoyin Adeagbo
-------------------------------

**Audit & Assurance**

1. Amadi, Nathaniel
---------------------

**Corporate Reporting**

1. Adeadebayo, Shuaib
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**Advanced Audit and Assurance**

1. Okere, Onyinye
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### **Strategic Financial Management**

1. Omolehinwa, Ademola

The Institute also appreciates the services of the following:

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**Registrar/Chief Executive**

## The meaning of audit and assurance

### Contents

- 1 The meaning of assurance
- 2 The meaning of audit and audit-related services
- 3 Chapter review

## INTRODUCTION

### Exam context

This short chapter provides a bridge from the skills level Audit and Assurance module to the professional level paper. This chapter reminds the student of the core concepts underlying Audit and Assurance.

At the end of this chapter, readers should be able to:

- Explain the basic concepts of assurance, audit and levels of assurance
- Describe examples of audit-related services including reviews, agreed-upon procedures and compilations

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## 1 THE MEANING OF ASSURANCE

### Section overview

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

#### 1.1 Introduction

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

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

#### 1.2 Assurance

In an assurance engagement a practitioner:

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

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

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

Because of the amount of work carried out, a statutory audit provides a high (reasonable) **level of assurance**. Other assurance engagements may provide a lower (limited) level of assurance, or comfort, to the person receiving the opinion. The level of assurance given by other assurance engagements will depend on various factors that are discussed in later chapters.

### 1.3 Examples of non-audit assurance engagements

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

- corporate social responsibility
- environmental policy
- employment policies
- non-financial performance indicators.

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

### 1.4 Elements of an assurance engagement

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

- A three party relationship:
  - Practitioner
  - Responsible party
  - Intended users
- Subject matter
- Suitable criteria
- Sufficient and appropriate evidence
- Assurance Report

## 2 THE MEANING OF AUDIT AND AUDIT – RELATED SERVICES

### Section overview

- Audit
- Audit-related services

#### 2.1 Audit

ISA 200 states that the purpose of an audit (a form of assurance engagement) is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the auditor expressing an opinion on whether the financial statements of an entity are prepared, in all material respects, in accordance with an applicable financial reporting framework. A financial reporting framework may be provided, for example, by country-specific legislation plus international financial reporting standards.

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

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

#### 2.2 Audit-related services

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

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

##### Review

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

The higher level of assurance provided by an audit enhances the credibility provided by the assurance process. However, an audit is more time-consuming (and therefore more costly) than a review.

##### Agreed-upon procedures

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

### **Compilation**

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

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### **3 CHAPTER REVIEW**

#### **Chapter review**

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

- Explain the basic concepts of assurance, audit and levels of assurance
- Describe examples of audit-related services including reviews, agreed-upon procedures and compilations

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### Quick quiz questions

- 1 Which of the following is NOT an assurance engagement?
  - A An audit of financial statements
  - B A review of financial statements
  - C An agreed-upon procedures engagement
  - D A report on a company's compliance with its environmental policies
  
- 2 An audit may never offer absolute assurance. Which one of the following statements does NOT support this statement?
  - A Audit evidence is persuasive, not conclusive
  - B An audit opinion is a matter of judgement
  - C In a simple audit it should be possible for the auditor to test all the transactions undertaken
  - D There are inherent limitations in any accounting systems and internal control systems
  
- 3 What provides the highest level of assurance?
  - A Limited assurance engagement
  - B Audit
  - C Review
  - D Compilation
  
- 4 A statutory audit is what form of engagement?
  - A Agreed-upon procedures
  - B Compilation
  - C Limited assurance
  - D Reasonable assurance
  
- 5 Which of the following combinations describes are view?
  - A Reasonable assurance provided. Positive opinion expressed
  - B Limited assurance provided. Negative opinion expressed
  - C No assurance provided. Positive opinion expressed
  - D No assurance provided. Negative opinion expressed

**Quick quiz answers**

1 C

Explanation:

No assurance is provided in an agreed-upon procedures engagement. The accountant carries out the procedures that have been agreed with the client and reports his findings.

2 C

Explanation:

The testing of all the transactions undertaken removes one source of uncertainty (sampling risk), but other uncertainties remain (e.g. the use of judgement to assess fair values, depreciation values, etc.).

3 B

Explanation:

An audit is a reasonable assurance engagement, offering high but not absolute assurance. A review is a limited assurance engagement. A compilation engagement offers no assurance.

4 D

Explanation:

A statutory audit is an example of a reasonable assurance engagement

5 B

Explanation:

A review offers limited assurance. The accountant's opinion is expressed in negative form, i.e. nothing has come to our attention to suggest there are material misstatements.

CHAPTER  
**2**

## The regulatory environment

### Contents

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

## INTRODUCTION

### Competencies

#### Laws, regulations and ethical issues

- A1** Advise on technical, professional and ethical issues that may arise during assurance engagements in the public and private sectors including evaluation and communication with any party to the engagement.
- A3** Identify and explain the nature and purpose of laws, regulations, standards and codes in the context of assurance engagements.
- A4** Evaluate, explain and communicate the process and issues involved in standards setting process at national and international levels.
- A5** Evaluate and communicate the interactions between national laws and regulations and the requirements of an assurance engagement.
- A6** Evaluate and communicate the differences between various jurisdictions and how they deal with audit issues including national and international approaches such as the US Sarbanes-Oxley and related requirements for audit.

### Exam context

It is important that students understand the regulatory environment that surrounds various industries of a nation's economy. This chapter provides details of that environment.

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

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

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

At the end of this chapter, readers should be able to:

- Explain the need for regulation of audit and assurance services
- Explain the process of appointment, resignation and removal of auditors
- Describe the eligibility, rights and duties of an auditor
- Describe the role and structure of professional standards including the standard setting process
- Summarise the key features of corporate governance in relation to audit
- Explain what money laundering is and summarise the obligations and duties this places on the auditor
- Apply ISA 250 to the audit of financial statements

## 1 THE NEED FOR REGULATION OF AUDIT AND ASSURANCE SERVICES

### Section overview

- The public interest
- Ethical regulation
- Legal regulation
- Appointment of auditors in Nigeria (s401 CAMA 2020)
- Removal of auditors in Nigeria (s409 CAMA 2020)
- Resignation of auditors in Nigeria (s412, s413 CAMA 2020)
- Eligibility to act as an external auditor
- Rights and duties of auditors
- Professional regulation
- Harmonisation of the accountancy and auditing profession

### 1.1 The public interest

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

- within ethical boundaries
- to consistent standards.

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

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

### 1.2 Ethical regulation

Assurance providers are given ethical guidance by:

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

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

### 1.3 Legal regulation

Most countries have legal requirements associated with some assurance providers, particularly auditors. Examples of these legal requirements in Nigeria can be found, for example, in the ICAN Act 1965, Companies and Allied Matters Act 2020, Bank & Other Financial Institutions Act 1991 and Insurance Act 2003.

#### 1.4 Appointment of auditors in Nigeria (s401CAMA 2020)

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

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

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

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

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

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

Subject as to as provided [by CAMA 2020], the first auditors of a company may be appointed by the directors at any time before the company is entitled to commence business and auditors so appointed shall hold office until the conclusion of the next annual general meeting, provided that:

- the company may at a general meeting remove any such auditors and appoint in their place any other person who has been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company at least 14 days before the date of the meeting; and
- if the directors fail to exercise their powers under this subsection; the company may, in a general meeting convened for that purpose, appoint the first auditors and thereupon the said powers of the directors shall cease.

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

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

### 1.5 Removal of auditors in Nigeria (s409CAMA 2020)

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

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

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

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

When this occurs the company shall within 14 days give notice of that fact in the prescribed form to the Commission and if a company fails to give the notice required, the company and every officer and liable to a penalty as the Commission shall specify in its regulations.

### 1.6 Resignation of auditors in Nigeria (s412, s413 CAMA 2020)

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

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

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

The procedures for the resignation of the current auditors are:

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

- The auditors may require the directors to call a meeting of the shareholders in order to discuss the circumstances of the auditor's resignation.
- If default is made in complying with the above provisions, the company and every officer of it who is in default shall be and liable to a penalty as the Commission shall specify in its regulations.

## 1.7 Eligibility to act as an external auditor

### Self-regulation by the audit profession

Eligibility to act as an external auditor is usually determined by membership of an appropriate 'regulatory body', such as ICAN.

The role of such regulatory bodies normally includes the following:

- Offering professional qualifications for auditors, to provide evidence that auditors possess a minimum level of technical competence.
- Establishing procedures to ensure that the professional competence of auditors is maintained. This includes matters such as:
  - ensuring that audits are performed only by 'fit and proper' persons, who act with professional integrity.
  - requiring that the members carry out their audit work in accordance with appropriate technical standards (for example, in accordance with International Standards on Auditing, known as ISAs).
  - ensuring that auditors remain technically competent and up to date with modern auditing practice (for example, by following a programme of continuing professional development).
  - providing procedures for monitoring and enforcing compliance by its members with the rules of the regulatory body. This includes rules and procedures for the investigation of complaints against members and the implementation of disciplinary procedures where appropriate
- Maintaining a list of 'registered auditors', which is made available to the public.

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

### Regulation by government

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

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

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

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

- an officer or servant of the company;
- a person who is a partner of or in the employment of an officer or servant of the company; or
- a body corporate.

A person does not qualify for appointment as an auditor of a company if he is:

- A debtor to the company or its subsidiaries in an amount exceeding ₦500,000;
- Shareholders and their spouses;
- A person who has an interest in the keeping of the register of holders of debentures of the company;
- An employee of or consultant to the company who has been engaged for more than one year in the maintenance or preparation of any of its financial statements/records.

### 1.8 Rights and duties of auditors

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

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

#### Duties of the external auditor

The primary duty of the external auditor is to:

- examine the financial statements, and
- issue an auditor's report on the financial statements, which is then presented to the shareholders together with the financial statements.

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

- give a true and fair view (or "present fairly") the financial position and performance of the company, and
- have been prepared in accordance with the applicable financial reporting framework.
- In Nigeria, s404 CAMA 2020 requires the auditor to also form an opinion on matters stated in schedule 5 to CAMA 2020 as provided below.
- Whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purpose of their audit.
- Whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.
- Whether the company's statement of financial position and (unless it is framed as a consolidated profit and loss account) profit and loss account dealt with by the report agree with the books of account and returns.
- Whether, in their opinion and to the best of their information and according

to the explanations given them, the said statements give the information required by the Act in the manner so required and give a true and fair view:

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

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

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

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

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

#### Rights of the external auditor

External auditors have certain statutory rights, to enable them to perform their statutory duties. The main statutory rights of the auditor per CAMA 2020 (sections 407 and 410) include the following:

- The right of access to all accounting books and records at all times.
- The right to all information and explanations (from management) necessary for the proper conduct of the audit.
- The right to receive notice of all meetings of the shareholders (such as the annual general meeting) and to attend those meetings.
- The right to speak at shareholders' meetings on matters affecting the audit or the auditor. This can be important when the auditors disagree with the directors of the client entity and are unable to communicate with the shareholders effectively by any other method.
- If the company uses written resolutions, the auditors should have a right to receive a copy of all such resolutions.

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#### Responsibility of management and those charged with governance

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

- Prevention and detection of fraud
- Preparation of the financial statements
- Design and implementation of effective internal controls – for example authorising payments above a certain amount, monthly bank reconciliation and a monthly trade payables control account reconciliation.

They are also responsible for:

- Providing the auditor with:

- Access to information relevant to the preparation of the financial statements
- Additional information relevant to the audit
- Unrestricted access to persons whom the auditor needs access to in order to complete the audit
- Providing written representations to the auditor at the end of the audit (see later chapter for details)

### 1.9 Professional regulation

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

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

### 1.10 Harmonisation of the accountancy and auditing profession

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

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

- These include **advantages** such as the adoption of global auditing standards, which should improve the efficiency of the audit process for multinational companies and should improve transparency in audit reporting.
- Disadvantages** include the problems of getting international agreement on auditing practices, and the need for many countries to change their local law to bring it in line with the agreed international practice.

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

- Audits of all listed companies in the European Union should now be carried out in accordance with International Standards on Auditing.
- Moves to establish a more formal, statute-based corporate governance regime (such as Sarbanes-Oxley in the USA).
- The development of national regulatory models for the profession, headed by a single unified body. The Financial Reporting Council of Nigeria is envisaged to play this unifying role in Nigeria.

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

- sets accounting standards
- sets auditing standards
- enforces and monitors compliance with those standards
- oversees the self-regulatory professional bodies, such as ACCA, the ICAEW and ICAN.

It has been suggested that stricter regulation from an external authority (such as the SEC in Nigeria, the SEC in the US, the FRC in Nigeria and the FRC in the UK) is needed to balance the increasing global power of the 'Big Four' professional accountancy firms.

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## 2 PROFESSIONAL STANDARDS

### Section overview

- The international standard-setting process
- Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services
- The IAASB's Clarity Project
- ISA 200: Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing

#### 2.1 The international standard-setting process

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

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

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

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

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

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

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

As discussed above, the IAASB's pronouncements do not override local laws or regulations. If local laws or regulations differ from, or conflict with, the IAASB's standards then a professional accountant should not state that he has complied

with the IAASB's standards unless he has **fully complied** with all of those relevant to the engagement.

#### **International Standards on Auditing (ISAs)**

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

Each ISA contains:

- An introduction
- objectives
- definitions (if necessary)
- requirements which are shown by the word 'shall' and are to be applied as relevant to the audit
- application and other explanatory material which is for guidance only.

This structure arose out of the work carried out as part of the IAASB's "Clarity Project" (see below).

#### **International Standards on Quality Control (ISQCs)**

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

#### **Other International Standards**

The other international standards (ISREs, ISAEs and ISRSs) follow the format of the original ISAs. They contain:

- basic principles and essential procedures (identified in bold type and by the word '**should**'), and
- related guidance in the form of explanatory and other material, including appendices.

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

#### **Professional judgement**

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

### **2.3 The IAASB's Clarity Project**

#### **IAASB Clarity Project Update**

In October 2008 the IAASB issued a final *Clarity Project Update* – slightly ahead of the December 2008 date by which the last of the clarified ISAs were to be approved by the Public Interest Oversight Board. The clarified ISAs came into effect for audits of financial statements beginning on or after 15 December 2009.

Key points from this update, which give some background to the project, are as follows:

- The Clarity Project was the IAASB's 18-month program to comprehensively review all of its ISAs and ISQCs to improve their clarity and therefore the consistency of their application.
- 36 clarified ISAs were issued, along with a clarified ISQC1.
- 16 of the ISAs were substantially revised as well as redrafted and one new ISA (ISA 265) was issued. The other 19 ISAs were redrafted, but not revised.
- All the clarified ISAs contain improvements, including:
  - identifying the overall objectives of the auditor when conducting an audit in accordance with ISAs
  - setting an objective in each ISA
  - establishing an obligation on the auditor in relation to those objectives
  - clarifying the obligations imposed on auditor by the requirements of the ISAs and the language used (using "shall" instead of "should")
  - eliminating ambiguity about the requirements which an auditor needs to fulfil.
- The ISAs have a new structure with Introductory Material, Objectives, Definitions, Requirements and Application and Other Explanatory Material presented in separate sections in the ISA.

#### **Summary of the main changes in the new ISAs**

The summary covers only those ISAs which were redrafted *and* revised, not those that were redrafted only. The summary does not claim to be a comprehensive analysis of all the changes but lists those changes that are expected to impact on required audit procedures.

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

ISA 200 has been revised to:

- set out the overall objectives of the independent auditor
- explain the nature and scope of an audit designed to enable the auditor to meet those objectives.
- It also explains the scope, authority and structure of the ISAs and includes general responsibilities of the independent auditor applicable to all audits, including the obligation to comply with the ISAs.
- New requirements make it clear that the auditor uses the objectives in other ISAs to:
  - decide whether any additional audit procedures are needed, beyond those required by the ISAs, and
  - evaluate whether sufficient appropriate evidence has been obtained.
- ISA 200 also includes material explaining important concepts related to an audit, such as management's responsibilities, professional scepticism, professional judgment and the inherent limitations of an audit.

### **ISA 210 Agreeing the terms of audit engagements**

The auditor is now required to perform specific procedures to establish whether the **preconditions for an audit** are present. These include:

- determining whether the financial reporting framework to be used is acceptable
- obtaining management's confirmation that it understands its responsibilities for:
  - preparing financial statements that are in accordance with the applicable financial reporting framework (including giving a true and fair view)
  - implementing internal controls that will enable the preparation of financial statements that are free from material misstatement
  - providing the auditor with access to all relevant and all additionally requested information, and unrestricted access to employees.

The revised *ISA 580 Written representations* requires the auditor to obtain representations from management in respect of these responsibilities (see below).

### **ISA 260 Communication with those charged with governance**

The revisions to ISA 260 were intended to reflect significant developments to regulatory and auditing standards in several jurisdictions and shifts in the expectations of those charged with governance and other stakeholders.

Additional requirements include:

- explaining why significant accounting practices, which are acceptable under the applicable financial reporting framework, are not the most appropriate in the circumstances
- documenting matters communicated orally
- communicating any significant difficulties encountered during the audit
- communicating any significant matters arising from the audit that were discussed, or subject to correspondence, with management.

### **ISA 265 – Communicating deficiencies in internal control to those charged with governance and management**

This is a new ISA which is intended to improve the auditor's communication of deficiencies in internal control identified by him. The term "deficiency in internal control" is defined.

Requirements include:

- determining whether identified deficiencies constitute "significant deficiencies"
- communicating in writing all significant deficiencies, including a description of the deficiency and its possible effects.

### **ISA 320 Materiality in planning and performing an audit**

In revising ISA 320 the IAASB:

- updated the definition of materiality to make it clearer that materiality depends on the size and nature of an item, judged in the surrounding circumstances

- introduced guidance on the use of benchmarks for the initial setting of materiality (but did not set formulaic rules)
- indicated that during the audit the auditor should be alert for possible management bias – such that when evaluating whether the financial statements as a whole are free of material misstatement the auditor is required to consider both uncorrected misstatements and qualitative aspects of the entity's accounting practices.

The IAASB concluded that it would be better to address materiality and the evaluation of misstatements in separate ISAs – which led to the creation of ISA 450 (see below).

New requirements include:

- determining a lower amount called “performance materiality” for the purpose of assessing risk and deciding on appropriate audit procedures
- revising materiality during the audit if the auditor becomes aware of information that would have caused him to initially have set a different threshold
- specific documentation requirements for thresholds determined and any changes made during the audit.

#### **ISA 402 – Audit considerations relating to an entity using a service organisation**

ISA 402 - was revised to reflect:

- the increased use of service organisations
- the need to bring the ISA into line with the risk assessment ISAs.

Requirements include:

- specifying matters to be included in the auditor's understanding of how the entity uses the services of a service organisation
- where the auditor has concluded that controls at the service organisation operate effectively, specifying procedures to be performed in testing the operating effectiveness of controls, including:
  - obtaining a Type 2 report
  - testing controls at the service organisation
  - using another auditor to test controls at the service organisation
- specifying procedures to be performed if the auditor plans to use a report from another auditor as audit evidence, including:
  - being satisfied with the other auditor's professional competence and independence and the standards followed
  - procedures to determine whether a Type 2 report provides sufficient evidence about the effectiveness of controls at the service organisation.

#### **ISA 450 - Evaluation of misstatements identified during an audit**

As explained above, ISA 450 is a new ISA which arose from the revision of ISA 320 on audit materiality. There are a number of new requirements which include:

- accumulating all identified misstatement other than those that are clearly trivial

- prior to evaluating the effect of uncorrected misstatements, reassessing materiality.
- determining whether uncorrected misstatements are material, considering their nature as well as their size.
- documenting:
  - the amount below which misstatements would be regarded as trivial
  - all misstatements accumulated during the audit and whether they have been corrected
  - the auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

#### **ISA 505 - External confirmations**

The revision of ISA 505 was in response to concerns that requirements in this area needed to be more rigorous. Compared to the previous version of ISA 505 there are more detailed requirements in relation to:

- maintaining control over the confirmation requests
- obtaining further evidence to resolve doubts over the reliability of responses
- conditions which must be present if negative confirmations are to be used.

#### **ISA 540 - Auditing accounting estimates, including fair value accounting estimates, and related disclosures**

ISA 540 was revised in order to improve the rigor of the auditing of accounting estimates, particularly in view of the potential for management bias/earnings management by manipulation in this area.

- The revised ISA:
- introduces requirements for greater rigor and scepticism in this area
- provides standards and guidance on what constitutes a misstatement and on indicators of management bias.
- focuses work on areas of estimation uncertainty and risk
- aligns more closely with the audit risk model.

New requirements include:

- obtaining an understanding as to how management identify the need for accounting estimates and how they make those estimates
- reviewing the outcome of accounting estimates made in prior periods
- evaluating estimation uncertainty and whether high estimation uncertainty leads to significant risks.
- for identified significant risks:
  - evaluating how management has considered alternative assumptions or outcomes.
  - obtaining sufficient appropriate evidence about whether management decisions are in accordance with the applicable financial reporting framework.
  - evaluating the adequacy of disclosure of the estimation uncertainty

- reviewing management's judgment and decisions in order to identify possible management bias.

#### **ISA 550 - Related parties**

ISA 550 was revised in response to:

- recent major corporate scandals (e.g. Enron and WorldCom in 2002) which often involved related parties
- a need to focus more on a risk-based approach, in line with other ISAs.
- The revised ISA 550 which also seeks to assist auditors with the difficult task of identifying related parties and undisclosed related party transactions.

New requirements include:

- considering the susceptibility of the financial statements to material misstatements due to fraud or error arising from the entity's related party relationships and transactions
- obtaining an understanding of the controls put in place to identify, account for and disclose related party relationships and transactions and to approve significant transactions outside the normal course of business
- treating significant related party transactions as giving rise to "significant risks"
- specifying procedures to be performed if the auditor identifies related parties or significant related party transactions that management has not previously disclosed to the auditor
- specifying procedures to be performed for significant related party transactions outside the normal course of business
- obtaining sufficient appropriate evidence about a management assertion that a related party transaction was conducted on normal commercial terms.

#### **ISA 580 Written representations**

ISA 580 was revised to respond to concerns that auditor may be over relying on written representations. The revised standard introduces a number of significant changes. The main one is that it is made clearer that, although written representations provide necessary audit evidence, **they do not on their own provide sufficient appropriate evidence** about any of the matters included.

- New requirements include:
- obtaining written representations about management's responsibilities, including responsibilities for:
  - preparing financial statements that are in accordance with the applicable financial reporting framework (including giving a true and fair view)
  - providing the auditor with access to all relevant information as agreed in the terms of the engagement
  - recording all transactions and reflecting them in the financial statements

- if management does not provide the above, disclaiming an opinion on the financial statements should be the auditor's option.

#### **ISA 600: Special considerations – audits of group financial statements (including the work of component auditors)**

The revised ISA introduces a number of new requirements where other auditors audit group components, increasing the group auditor's involvement in the work of component auditors.

New requirements include:

- in deciding whether to accept or continue an appointment as group auditor, considering whether the group engagement team will be able to be involved in the work of component auditors to the extent necessary to obtain sufficient appropriate audit evidence
- obtaining an understanding of the group, its components and their environment and assessing the risk of material misstatement of the group financial statements (which can be mitigated by strong group-wide controls)
- obtaining an understanding of component auditors, including their professional competence and whether they will comply with ethical requirements which apply to the group audit.
- determining a materiality level for the group as a whole and for each component where component auditors will perform an audit or a review for the purposes of the group audit.
- responding to assessed risks including:
  - requiring an audit of the financial information (using component materiality) of any component which is of individual financial significance.
  - requiring an audit of the financial information, or an audit of specific areas or specified audit procedures for any component which is significant because it is likely to include group level significant risks
  - requiring analytical procedures at group level for non-significant components.
  - determining the level of involvement of the group engagement team in the work performed by component auditors (for significant components, the group engagement team must be involved in the component auditor's risk assessment in order to identify the risks of material misstatement).

#### **ISA 620: Using the work of an auditor's expert**

ISA 620 was revised in response to concerns that:

- experts could be used, not only in relation to account balances, but also for other purposes such as risk assessment
- the increased use of fair value accounting may require more frequent use of experts in other disciplines by the auditor.

The revised ISA:

- is restricted to the use of an expert **engaged or employed by the auditor**. Amendments were made to ISA 500 to cover the use of management's experts

- includes more specification of audit procedures, in particular in respect of agreeing the work to be performed and evaluating the reasonableness of the expert's findings.

#### **2.4 ISA200: Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing**

The **objectives** of the auditor, per ISA 200 are:

- to obtain **reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. This allows the auditor to give an opinion on whether or not the financial statements have been prepared in accordance with the applicable financial reporting framework.
- to report on the **financial statements**, and communicate as required by the ISAs, in accordance with the auditor's findings.

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

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

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

### 3 CORPORATE GOVERNANCE

#### Section overview

- The meaning and nature of corporate governance
- Directors' and auditors' responsibilities
- Codes of corporate governance in Nigeria
- The audit committee

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

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

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

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

Directors are seen as 'agents' of the shareholders and as agents of the shareholders:

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

#### The need for regulation for good corporate governance

There is some regulation of corporate governance in company law. However, basic legal requirements have proved inadequate for protecting shareholders from losses, in a number of corporate scandals caused by directors of the company.

As a result, more specific regulations or guidelines have been introduced to improve corporate governance.

Regulations and guidelines vary from country to country. In some countries there are detailed 'rules', in others there are none. You are not expected to have a detailed knowledge of the corporate governance rules for this exam.

#### 3.2 Directors' and auditors' responsibilities

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

- The directors are responsible for:
  - Preparation of financial statements
  - Internal controls

- Providing the auditor with:
  - Access to information relevant to the preparation of financial statements
  - Additional information relevant to audit
  - Unrestricted access to persons
  - Written representations
- The auditors are responsible for reviewing that information and, in some cases, reporting on the extent to which the directors have complied with their responsibilities.

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

### 3.3 Codes of corporate governance in Nigeria

There are two codes that you need to be aware of for this exam. However, detailed knowledge is only examinable in the *B6 Management, Governance and Ethics* paper.

- Code of Corporate Governance for Banks in Nigeria Post Consolidation.*  
This code is issued by the Central Bank of Nigeria. Compliance with the provisions of the code by banks is mandatory in Nigeria.
- Code of Corporate Governance for Public Companies in Nigeria.*  
This code is issued by the Nigerian Securities & Exchange Commission (which issued codes in both 2003 and 2011) and is applicable to:
  - All public companies whose securities are listed on a recognised securities exchange in Nigeria;
  - All companies seeking to raise funds from the capital market through the issuance of securities or seeking listing by introduction;
  - All other public companiesOther companies are encouraged but not required to comply with the provisions of the code.

The Financial Reporting Council of Nigeria has released the Nigerian Code of Corporate Governance 2018 which harmonises the various codes that currently exist. The commencement date of the Code was January 1, 2019.

### 3.4 The audit committee

#### Audit committees in Nigeria

In many countries, listed companies are required or expected to have an audit committee. In Nigeria, CAMA 2020 (section 404) requires every public company to establish an audit committee.

The audit committee is a 'sub-committee' of the board of directors, and it reports to the main board. All members of the audit committee shall be financially literate, and at least one member shall be a member of a professional accounting body in Nigeria established by an Act of the National Assembly.

A key purpose of an audit committee is to establish a 'buffer' between the auditors and the executive directors, in order to minimise the risk that the auditors might come under undue pressure from the executive members of the board. (For example, the auditors may be influenced by the threat that the company will take away their audit work or non-audit work, and so may be more inclined to agree with the opinions and arguments of the management.)

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

The *Companies and Allied Matters Act* stipulates that:

- the audit committee shall consist of five members comprising of three members and two non-executive directors;
- the audit committee member presenting to the members shall not be entitled to remuneration and shall be subject to re-election annually; and
- any member may nominate a shareholder as a member of the audit committee by giving notice in writing of such nomination to the secretary of the company at least 21 days before the annual general meeting.

#### Duties and responsibilities

Both the *Code of Corporate Governance for Public Companies in Nigeria* issued by the SEC and the *Companies and Allied Matters Act* provide guidance as to the duties and responsibilities of the audit committee.

The *Code of Corporate Governance for Public Companies in Nigeria* requires the duties and responsibilities of the audit committee to be set out in written terms.

The duties and responsibilities should be to:

- assist in the oversight of the integrity of the company's financial statements, compliance with legal and other regulatory requirements, assessment of qualifications and independence of external auditor, and performance of the company's internal audit function as well as that of external auditors;
- establish an internal audit function and ensure there are other means of obtaining sufficient assurance of regular review or appraisal of the system of internal controls in the company;
- ensure the development of a comprehensive internal control framework for the company, obtain assurance and report annually in the financial report, on the operating effectiveness of the company's internal control framework;
- oversee management's process for the identification of significant fraud risks across the company and ensure that adequate prevention, detection and reporting mechanisms are in place;
- at least on an annual basis, obtain and review a report by the internal auditor describing the strength and quality of internal controls including any issues or recommendations for improvement, raised by the most recent internal control review of the company;
- discuss the annual audited financial statements and half yearly unaudited statements with management and external auditors;
- discuss policies and strategies with respect to risk assessment and management;

- meet separately and periodically with management, internal auditors and external auditors;
- review and ensure that adequate whistle-blowing procedures are in place and that a summary of issues reported are highlighted to the chairman;
- review, with the external auditor, any audit scope limitations or problems encountered and management's responses to same;
- review the independence of the external auditors and ensure that where non-audit services are provided by the external auditors, there is no conflict of interest;
- preserve auditor independence, by setting clear hiring policies for employees or former employees of independent auditors;
- consider any related party transactions that may arise within the company or group;
- invoke its authority to investigate any matter within its terms of reference for which purpose the company must make available the resources to the internal auditors with which to carry out this function, including access to external advice where necessary; and
- report regularly to the board.

The *Companies and Allied Matters Act* states that subject to such other additional functions and powers that the company's articles of association may stipulate, the objectives and functions of the audit committee shall be to:

- ascertain whether the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices;
- review the scope and planning of audit requirements;
- review the findings on management matters in conjunction with the external auditor and departmental responses thereon;
- keep under review the effectiveness of the company's system of accounting and internal control;
- make recommendations to the Board in regard to the appointment, removal and remuneration of the external auditors of the company; and
- authorise the internal auditor to carry out investigations into any activities of the company which may be of interest or concern to the committee.

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## 4 MONEY LAUNDERING

### Section overview

- Definition of money laundering
- Regulation
- Obligations placed on professional firms
- Duty of confidentiality and money laundering

#### 4.1 Definition of money laundering

Money laundering can be defined as the process by which criminals attempt to conceal the true origin and ownership of the proceeds from their criminal activities.

Criminal activities include drug trafficking, terrorism, theft, tax evasion and other types of fraud.

Money laundering is a process by which money earned from criminal activities ('dirty money') is transferred and transformed so that it appears to have come from a legitimate source ('clean money').

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

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

- possessing, in any way dealing with, or concealing, the proceeds of any crime. Examples of the proceeds of crime might include the following:
  - Tax evasion.
  - Offences that involve saved costs (as these could result from environmental offences or failure to follow health and safety regulations).
  - Retaining overpayments from customers.
  - Payments made overseas that are deemed to be bribes and would be illegal in Nigeria.
- attempting, conspiracy or incitement to commit the above offence
- aiding, abetting, counselling or procuring the commission of such an offence
- an act which would constitute any of these offences if done in Nigeria
- failure by a person in the regulated sector to inform the appropriate party of a knowledge or suspicion that another person is engaged in money laundering
- failure to make a disclosure which is likely to prejudice an investigation into money laundering (tipping off)

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

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

There are various defences to charges of money laundering:

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

## 4.2 Regulation

Due to the work of inter-governmental bodies such as the Financial Action Task Force on Money Laundering (FATF), many countries now have legal provisions in place designed to detect, report and ultimately prevent money-laundering activities. These provisions vary from country to country and include the US Patriot Act 2001 in the USA and the Money Laundering Regulations 2007 in the UK.

In Nigeria the *Money Laundering (Prohibition) Act, 2011* implements the recommendations of FATF in relation to customer due diligence, record-keeping, reporting of suspicious transactions and compliance.

## 4.3 Obligations placed on professional firms

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

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

- Putting into place systems, controls and procedures to ensure that the firm is not used for money laundering purposes.
- Appointing a Money Laundering Reporting Officer (MLRO), whose responsibility is to receive reports on suspected money laundering activities from other employees and report them to the appropriate authorities.
- Establishing and enhancing the record-keeping systems (1) for all transactions (which must be kept for at least five years, with controls to ensure that they are not inadvertently destroyed) and (2) for verifying the identity of clients (by obtaining official documents, such as – for an individual – passport or driving license, supported by recent utilities bills, and – for a company – certificate of incorporation).
- Establishing procedures within the firm for reporting any suspicion of money laundering by client companies.
- Training and educating staff in procedures for detecting and reporting suspicions of money laundering activities.

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



**Example:**

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

**Guidance from professional bodies**

To ensure that practitioners are aware of their responsibilities, ICAN's Monitoring Unit – as part of its monitoring process – checks to see if practitioners have understood their obligations by asking a series of questions during their visits.

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

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

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

This paper highlights:

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

#### 4.4 Duty of confidentiality and money laundering

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

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

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

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

## 5 CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS: ISA 250

### Section overview

- The legal environment and non-compliance by a client company
- Action by the auditor in the event of non-compliance or suspected non-compliance by a client company

#### 5.1 The legal environment and non-compliance by a client company

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

- obtain a general understanding** of the applicable legal and regulatory framework and how the entity is complying with that framework. This is part of obtaining an understanding of the entity and its environment – here, the legal environment – as required by ISA315
- obtain sufficient appropriate audit evidence** in respect of compliance with those laws and regulations which might be expected to have a direct effect on material amounts and disclosures in the financial statements
- perform the following audit procedures** to help identify such instances of non-compliance:
  - make enquiries of management as to whether or not the entity is complying with the relevant laws and regulations
  - inspect any correspondence with the relevant authorities
- during the audit, remain alert to the possibility that other audit procedures might bring instances of non-compliance to the auditor's attention
- obtain **written representations from management** that all known instances of non-compliance or suspected non-compliance have been disclosed to the auditor
- document all identified or suspected instances of non-compliance and the results of discussions with management and/or other parties.

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

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

- Obtain an understanding of the nature of the act and the circumstances under which it has occurred.
- Evaluate the possible effect of the non-compliance on the financial statements.
- For suspected non-compliance, discuss the matter with management. If compliance is not demonstrated, take legal advice.
- If there is insufficient evidence of a suspected non-compliance, consider the impact on the audit report (this would constitute a "limitation on scope" which is considered in a later chapter).

- Consider whether or not the non-compliance impacts on other areas of the audit (for example, on the overall risk assessment).
- Consider how to report the non-compliance – to those charged with governance and/or to shareholders and/or to the authorities.

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## 6 CHAPTER REVIEW

### Chapter review

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

- Explain the need for regulation of audit and assurance services
- Explain the process of appointment, resignation and removal of auditors
- Describe the eligibility, rights and duties of an auditor
- Describe the role and structure of professional standards including the standard setting process
- Summarise the key features of corporate governance in relation to audit
- Explain what money laundering is and summarise the obligations and duties this places on the auditor
- Apply ISA 250 to the audit of financial statements

### Quick quiz questions

- 1 Which one of the following statements is INCORRECT?
  - A If an ISA conflicts with national auditing regulations, auditors should follow the national regulations.
  - B ISAEs apply to engagements dealing with matters other than historical financial information.
  - C The guidance given in ISAs may be used in providing non-audit assurance services
  - D ISQCs apply to audits but not to other types of assurance engagement.
  
- 2 Which of the following may be an effective defence for an accountant accused of money laundering?
  - 1 An accountant owes a duty of confidentiality to his client
  - 2 The accountant has reported the issue to the appropriate police authority
  - 3 The accountant had reasonable grounds for fearing that his life was in danger
  - 4 The accountant acted in good faith at all times
  - A 1, 2 and 3 only
  - B 1, 3 and 4 only
  - C 2, 3 and 4 only
  - D 1, 2, 3 and 4
  
- 3 Which of the following should be responsibilities of the audit committee?
  - 1 Reviewing the independence of the external auditor
  - 2 Making a recommendation on the re-appointment of the auditors
  - 3 Reviewing the work of internal audit
  - 4 Report to shareholders on the accuracy of the financial statements
  - A 1, 2 and 3 only
  - B 1, 3 and 4 only
  - C 2, 3 and 4 only
  - D 1, 2, 3 and 4
  
- 4 If the head of the audit team discovers evidence of money laundering in a client company, he or she should report the matter in the first instance to:
  - A the criminal investigation authorities for money laundering
  - B the firm's Money Laundering Reporting Officer
  - C the company's board of directors
  - D the company's shareholders

- 5 Are the following statements true or false about auditors' responsibilities with regard to money laundering in a client company?
- 1 If an audit firm reports reasonable suspicions of money laundering by a company's senior management to the criminal investigation authorities but these suspicions prove to be unfounded, the audit firm may be liable in law to the client company.
  - 2 If an auditor discovers evidence of money laundering in a client company, the audit firm must resign immediately from the audit.
- A Statement 1 is correct but statement 2 is incorrect. B  
Statement 2 is correct but statement 1 is incorrect. C  
Both statements are correct.  
D Both statements are incorrect.

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#### Quick quiz answers

- 1 D  
Standards on quality control apply to all services provided under IAASB's engagement standards.
- 2 C  
Money laundering regulations override the accountant's duty of confidentiality so that any suspicion of money laundering must be reported to the authorities.
- 3 A  
The external auditors report on whether the financial statements give a true and fair view and the board as a whole, state their responsibility for the financial statements. The audit committee is not responsible for the accuracy of the financial statements and does not include this matter in its annual report to shareholders.
- 4 B  
Reporting to the board of directors of the client company would put the auditor at risk of 'tipping off' the suspects, which is a criminal offence. In the first instance the matter should be reported to the firm's MLRO.
- 5 D  
It would be a criminal offence for the audit firm not to report reasonable suspicions of money laundering to the authorities. The firm should not resign immediately from the audit if it discovers money laundering activity, because this would 'tip off' the criminal suspects.

CHAPTER  
**3**

## **Rules of professional conduct**

### **Contents**

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

## INTRODUCTION

### Competencies

#### Laws, regulations and ethical issues

- A1** Advise on technical, professional and ethical issues that may arise during assurance engagements in the public and private sectors including evaluation and communication with any party to the engagement.
- A3** Identify and explain the nature and purpose of laws, regulations, standards and codes in the context of assurance engagements.

#### Accepting professional engagements and managing assignments

- B1 (b)** Identify and explain the legal, professional and ethical issues that may arise during the acceptance of assurance or audit assignments.

### Exam context

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

This chapter is a continuation of the ethics you studied in the earlier Audit and Assurance paper. However, the ethical dilemmas encountered in this exam will be more complex and involve a greater degree of judgement. Furthermore the ethical dilemma may not be as obvious to spot as in previous exams.

At the end of this chapter, readers should be able to:

- Describe the fundamental principles of the IESBA Code of Ethics
- Apply the conceptual framework to identify threats to the fundamental principles and suggest appropriate safeguards across a range of common scenarios.

## 1 THE FUNDAMENTAL PRINCIPLES

### Section overview

- Introduction: rules of conduct for professional accountants
- The fundamental principles of the IESBA Code

#### 1.1 Introduction: rules of conduct for professional accountants

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

In setting a code of practice, each professional body is complying with one of its regulatory functions, which is to ensure that statutory audits are performed only by 'fit and proper' persons who act with professional integrity.

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

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

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

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

#### 1.2 The fundamental principles of the IESBA Code

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

Principle	Explanation
<b>Integrity</b>	A professional accountant shall be straightforward and honest in all professional and business relationships.
<b>Objectivity</b>	A professional accountant shall not compromise professional or business judgements because of bias, conflict of interest or undue influence of others.
<b>Professional competence and due care</b>	A professional accountant has a continuing duty to attain and maintain professional knowledge and skill at the level required to ensure that a client or employer receives a competent professional service, based on current technical and professional standards and relevant legislation. A professional accountant shall act diligently and in accordance with applicable technical and professional standards.

Principle	Explanation
<b>Confidentiality</b>	A professional accountant shall respect the confidentiality of information acquired as a result of professional or business relationships and shall not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information must not be used for the personal advantage of the professional accountant or third parties.
<b>Professional behaviour</b>	A professional accountant shall comply with relevant laws and regulations and avoid any conduct that the professional accountant knows or should know might discredit the profession.

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

## 2 INTEGRITY, OBJECTIVITY AND INDEPENDENCE

### Section overview

- The requirement for independence
- Threats to independence
- Safeguarding independence
- The provision by auditors of non-audit services
- Making referrals
- Illustration

#### 2.1 The requirement for independence

For an auditor's report to be of value, the auditor:

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

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

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



#### Illustration: Independence of mind and independence in appearance

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

Independence of appearance means the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude that a firm's, or a member of the auditor assurance team's, integrity, objectivity or professional skepticism has been compromised. For example, if an auditor owned shares in an audit client then a reasonably informed third party could safely assume that the auditor will not be truly objective as they would not want to see the value of their investment in the client reduced.

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

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

- Auditors need to be fully aware of situations that may damage their independence and objectivity. Such situations are referred to as **threats** to auditor independence.
- Any threats to independence may be reduced by **safeguards** that are taken by an audit practice (audit firm).

It is a matter of public confidence in the audit process.

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

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

## 2.2 Threats to independence

### General categories of threat

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

The Code recognises the following general sources of threat to the fundamental principles:

- Self-interest threat.** This arises when the accountant or the audit firm has a financial interest or other interest in a matter. Typically, this means that the accountant's decisions might be influenced by self-interest and the accountant will therefore not act with objectivity and independence.

Examples of this type of threat include:

- owning shares in a client company;
- accepting goods, services or hospitality from an audit client that are neither trivial nor inconsequential.

**Self-review threat.** This occurs when an accountant is required to review or re-evaluate (for a different purpose) a previous judgement he has made or action that he has taken. Self-review threats can also apply to audit firms, for example:

- if an audit firm prepared the financial statements for a client company and then acted as auditor it would be reviewing its own work and would be reluctant to criticise or question it. This would be a threat to objectivity and independence.

- Advocacy threat.** This occurs when the accountant is in a position where he is expected to defend or justify the position of the client, and act as an 'advocate' for the client's position or point of view. This would be a threat to objectivity and independence.

Examples of this type of threat include:

- defending the client in court on material matters that are relevant to the financial statements; and
- promoting and/or underwriting a share issue for an audit client.

- Intimidation threat.** This occurs when the accountant is deterred from acting with objectivity due to threats against him or his firm. For example:

- the client may threaten that it will take work away from the firm unless it agrees with the point of view of the client management.

- **Familiarity threat.** This occurs when the accountant becomes too sympathetic with the client's position due to close relationships.

Examples of this type of threat include:

- long association – when a practitioner or audit firm is engaged over many years in carrying out the annual audit and becomes overly trusting of the client;
- when a member of the engagement team has a family or personal relationship with someone at the client office who can exercise significant influence on the financial statements; and
- where there is an interchange of employee between the firm and client.

The Code goes on to give guidance about a number of specific threats which an accountant might be faced with.

#### Financial interests

A financial interest in a client might constitute a self-interest threat, although the role of the individual holding the interest, the materiality of the interest and the degree of control the accountant has over it will affect the level of the risk.

The guidance recommends that a member of the assurance team or an immediate family member of that team shall not hold a direct financial interest or an indirect material interest in a client. The interest should either be disposed of, or the team member removed from the engagement.

#### Loans and guarantees

A loan from a client which is a bank or similar institution, made on normal commercial terms would not constitute a threat to independence. However, loans or guarantees made to or by assurance clients in other circumstances constitute a self-interest threat and shall be avoided.

#### Close business relationships

Close business relationships with assurance clients, such as having a material joint venture, represent a self-interest threat or an intimidation threat. They must be avoided. Purchasing goods and services from an assurance client would not generally cause a threat to independence provided that it was at arm's length and in the normal course of business.

#### Example: Financial interest

Pear Company is developing a new product which is expected to be very profitable, but it needs additional finance to complete the product development work and for the market launch. It has invited its audit firm, Push & Pull, to make an investment in the product. The financing arrangement would take the form of either convertible debentures in Pear Company or a separate joint venture company. If a joint venture company is established, Pear Company and Push & Pull would share control of the business. The joint venture company would develop, manufacture and market the new product.

What are the ethical issues to consider in this situation?



### Answer

If Push & Pull retain Pear Company as an audit client, the ethical situation is as follows:

The audit firm **must not** provide a loan to a client. Buying debentures in the company would be a form of loan. It would create a major self-interest threat for which there could be no suitable safeguards.

A further problem is that convertible debentures could eventually be converted into equity shares in Pear Company, which would also create a major self-interest threat for Push & Pull.

### Joint venture company

A joint venture arrangement would also be unacceptable on ethical grounds, because of the significant mutual financial interests that Pear Company and Push & Pull would share.

A financial interest by an audit firm in an audit client is permissible only if the interest is not material, the relationship with the client is insignificant and the audit firm does not exercise significant influence. These conditions do not apply here.

### If the audit firm resigns from the audit

If Push & Pull resigns from the audit of Pear Company, a different situation would arise. The audit firm would be allowed to invest in its former audit client, since the ethical threats would no longer exist. However, it is questionable whether an audit firm would want to diversify its business interests into the manufacture and marketing of a new product – an area of business in which the firm's partners would have no direct experience or expertise.

### Commercial transactions between an audit client and a member of the audit team

The Code does not prohibit commercial transactions between an audit client and a member of the audit team, provided that:

- they are made in the normal course of the client's business,
- they are at an arm's length (in other words, they are made on normal commercial terms), and
- the value of the transaction is not material to either party.

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

An audit firm has a client company, Zoomco, which operates a motor racing circuit. The audit firm has discovered that the audit manager for the Zoomco audit keeps a racing car at Zoomco's circuit and uses the race track regularly. Because he is the audit manager, Zoomco allow him 50% off normal charges for garaging the car and for use of the race track.

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



### Answer

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

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

- The ethics partner of the audit firm should be consulted and asked to assess the materiality of the transaction between Zoomco and the audit manager and to consider whether disciplinary action is appropriate.
- The audit manager should be removed immediately from the Zoomco audit team and replaced by someone else.
- Those charged with governance of Zoomco (the board of directors) or the audit committee should be told about the action that the audit firm has taken, and the reasons why the action was necessary.
- In view of the threat to the objectivity and independence of the former audit manager, the audit plan for the Zoomco audit should be reviewed and amended if this is considered necessary.

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

### Family and personal relationships

Family and personal relationships between assurance staff and clients might cause self-interest, familiarity or intimidation threats. It is impracticable to outline every relationship that might cause such a risk and each situation should be considered individually, bearing in mind the role of the assurance staff and the closeness of the relationship.

However, when an immediate family member of a member of the assurance team is a director, officer or employee in a position to exert significant influence over the subject matter of the engagement, then the threat to independence is great and can only be avoided by removing the individual from the assurance team.

### Employment with assurance clients

The assurance team's independence might be threatened if a director or other senior employee at the client has recently been employed by the assurance firm. There might be self-interest, familiarity and intimidation threats, particularly if close connections remain between the individual and the assurance firm.

However, it may be possible to reduce the threat with safeguards, such as involving an independent third party to review the audit file.

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

Self-interest threats might also arise if a member of the assurance team has reason to believe that they might soon be employed by the assurance client, for example, if they have applied for a job there. This threat can be avoided by having disclosure policies within the firm for if an employee is entering into employment negotiations with an assurance client, removing such an individual from the engagement team and reviewing any significant judgements made by the individual whilst on the team.

#### **Recent service with assurance clients**

If an employee of the assurance client transfers to the assurance firm, then self-interest, self-review and familiarity threats might arise. Therefore, individuals who have served as a director or officer of an assurance client in the period under review shall not be assigned to the assurance team.

In other situations, it may be sufficient to apply safeguards to independence.

#### **Serving as an officer or director of an assurance client**

Assurance providers should not serve as an officer or director of assurance clients. However, providing routine administrative services, perhaps such as those provided by a company secretary may be appropriate. It is important not to be involved in making management decisions.

#### **Long association of senior personnel with assurance clients**

Using the same staff on an assurance engagement over a long period of time might cause a familiarity threat. The firm should consider factors such as the nature of the person's role and the length of time that he has been doing it when deciding which staff members to involve in assurance work.

Safeguards might include:

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

For the **audit of public interest entities**, the Code states:

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

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

When an audit client **becomes a listed entity** the length of time an individual has served that client as a key audit partner should be considered when deciding when the individual should be rotated (i.e. seven years minus time already served as a key audit partner).

### Fees

Where fees from a particular client represent a large proportion of a firm's total fees, there is a significant self-interest or intimidation threat. This will depend on factors such as the structure of the firm and whether it is established or emerging.

The IESBA Code of Ethics states that, for public interest entities, when recurring fees paid by one client or a related group of clients exceed 15% of the total fee income of the audit practice for two consecutive years, the firm shall:

- Disclose the fact to those charged with governance
- Conduct a review (either by an external professional accountant or a regulatory body).

If total fees significantly exceed 15% then a pre-issuance review is likely to be necessary rather than a post-issuance review.

The ICAN code of Ethics applies a higher threshold of 25%.



#### Definition: Pre-issuance review

A pre-issuance review is a review of the audit work performed by a party who is not a member of the audit team (typically another partner) before the auditor's report is issued.



#### Definition: Post-issuance review

A post-issuance review is a review of the audit work performed by a party who is not a member of the audit team (typically another partner) after the auditor's report has been issued.

Larger firms may find that the proportion of an individual office's income is higher than these figures, but not firm income as a whole. Where an individual office has fee income in excess of these figures from a single client, responsibility for signing off the audit file should be passed to a different office.

Overdue fees from an assurance client might become in effect a loan to that client and should therefore be avoided.

### Inducements, including gifts and hospitality

Assurance team members/firms shall not accept inducements (such as goods or hospitality) from an assurance client unless the value of that gift is trivial and inconsequential (to all parties).

If members of an audit team accept inducements from an audit client, the following issues might need consideration.

- Materiality. Was the value of the inducement sufficiently large that it could affect the objectivity and independence of the audit team member(s)?
- In the case of hospitality, was the hospitality accepted during normal working hours? If so, this would raise questions about the professional conduct of the auditors. The auditors should be carrying out their professional duties in normal working time – this is what the audit client pays them to do. It might also raise questions about the adequacy of supervision of the audit: with proper supervision, audit team members

should not have been allowed to accept hospitality during working hours. This would raise a broader question about quality control in the audit firm.

- Did the individuals receiving inducements check first with a senior person whether this would be acceptable? If not, there may be a disciplinary matter to deal with.

#### **Actual and threatened litigation**

Threatened or actual litigation between the client and the firm might cause self-interest or intimidation threats to independence. Safeguards can be applied, but the only appropriate response, particularly in the case of actual litigation, may be resignation from the engagement.

#### **Provision of other services (non-audit work)**

The independence of an audit firm might be threatened when the firm carries out a large amount of non-audit work for a company that is also its audit client.

- The non-audit work may provide a large amount of income that makes the audit firm economically dependent on the company (self-interest threat).
- In addition, employees of the audit firm who carry out the audit may be required to audit the work that has been done for the company by colleagues in the audit firm. It might be difficult for them to find faults with the work that has been done by other employees of the firm (self-review threat).

#### **Prohibition on assuming management responsibilities**

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

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

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

#### **Preparing accounting records and financial statements**

Accounting or bookkeeping services, including payroll services and the preparation of financial statements, must not be undertaken for a client that is a public interest entity. For clients that are not public interest entities, the auditor

may provide accounting or book-keeping services, including payroll services, of a routine or mechanical nature with appropriate **safeguards**, such as:

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

#### **Temporary staff assignments**

An audit client may ask an audit firm to 'lend' it one or more of its staff to work in the audit client's accounts department on a temporary basis. This creates several ethical threats:

- Self review threat.** There is a risk that the individual, having worked for the audit client for a time, will be assigned to the audit team on returning to the audit firm. This would create a self-review threat, because the individual would not want to be critical of any work that he has done for the client;
- Familiarity threat.** There is also the risk that the individual will become familiar with the audit client's staff during the temporary assignment, and so might be reluctant to challenge them properly if he subsequently returns as a member of the audit team; and
- Advocacy threat:** There is a risk that the views of the firm or individual on loan become too closely aligned to the views and interests of management.

It is permissible for an audit firm to provide staff on a temporary basis to an audit client, but it must be on the strict understanding that:

- such assistance is only for a short period of time;
- the individual is not performing non-assurance services that are prohibited under the Code
- the individual who is assigned to the client must not be involved in any management decisions; and
- the audit client is responsible for directing and supervising the activities of the loaned staff.

This may be difficult if the person who is assigned has been a senior person in the audit team: such an individual would have status as a senior auditor and would have extensive knowledge of the client's business. It might therefore be difficult to avoid involvement in management decisions.

To deal with the ethical threat, a person who has been on temporary assignment is not allowed to work again as a member of the audit team. However, there is a practical problem for the audit team in this arrangement, since it would be unable to use members of its staff on an audit, even though they have extensive knowledge of the client and may be experienced and senior auditors.

Small and medium-sized audit firms will therefore be reluctant to allow their staff to work on temporary assignment with a client, even though the practice is not prohibited.

### **Second opinions**

Second opinions are opinions that are provided when a company approaches an ICAN member (who is not that company's auditor) for a second opinion on the treatment of items in the financial statements.

The member should obtain the company's permission to contact the company's auditor. If permission is not given, then the member should refuse to act.

### **Specialist valuations**

An accountant may be asked by a client to carry out a specialist valuation.

Specialist valuations include:

- actuarial valuations;
- valuations of intellectual property and brands;
- valuations of other intangible assets;
- valuations of property; and
- valuations of unquoted investments.

Specialist valuations do not include valuations of shares prior to a stock exchange listing.

The threat to independence is that an audit firm may be required, when performing an audit, to review a valuation that it has made for the client. The audit would therefore involve a review of the audit firm's own work (a self-review threat to independence). An advocacy threat might also be created where the views of the audit firm are aligned too closely with those of the audit client.

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

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

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

## **2.3 Safeguarding independence**

The responsibility for safeguarding independence is shared between:

- the individual auditor (or audit practice)and
- the profession as a whole.

### **The responsibilities of individual auditors and audit practices**

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

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

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

- Appropriate training**, including training in how to maintain an independent opinion during audit work.
- Quality control procedures**. A firm shall have procedures for quality control to ensure that independence is considered in respect of all work undertaken by the audit firm.
- Consultation procedures**. A firm shall have internal procedures for consultation, whereby questions arising in relation to independence can be discussed.

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

- It might be possible to remove the threat to independence by a simple action, such as not accepting an offered gift, or for an audit partner to dispose of shares that he holds in a client company, and soon.
- Sometimes, it might be necessary to reject a proposed appointment as auditor. For example, an audit firm may have to reject its appointment as auditor of a new client company where the guidance on fee income level would be breached (because the fee income from the client would exceed the maximum limits established by the professional guidelines).
- With an existing client, if an independence issue cannot be resolved, the ultimate action is to resign from the audit of the client.

#### The responsibilities of the profession

Professional bodies expect their members to comply with codes of conduct relating to independence and will take disciplinary action as appropriate. Such action might lead to a fine, reprimand or exclusion from membership.

The profession and other interested parties regularly suggest new practices and procedures designed to improve auditor independence. Suggestions have included:

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

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

#### 2.4 The provision by auditors of non-audit services

In addition to the provision of accounting or valuation services considered above, the Code recognises that there may be (or there may appear to be) a threat to objectivity and independence where the auditor provides additional, non-audit, services to the client.

Such non-audit services might include:

- accounting and bookkeeping services (see earlier);
- taxation work;
- the 'outsourcing' of internal audit services (to the external audit firm);
- IT work; and
- Consultancy assignments.

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

- Larger firms will operate in a number of separate departments, each with its own partners and members of staff. By dividing the work of the audit firm into different functions, employees involved in audit work will not be the same as those involved in providing, say, consultancy advice to the same client.
- In some of the largest practices, the consultancy department has been legally separated from the accounting/auditing arm of the firm as a further step towards preserving auditor objectivity and independence.
- A similar approach is often taken by smaller audit firms. Although these firms may not be large enough to be organised in separate departments, efforts are usually made to ensure that different members of staff and partners are responsible for different services provided to clients.

#### **Example: non-audit work and safeguards**

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

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

#### **Answer**

The engagement would involve non-audit work. If the client is not a public interest entity, the audit firm can accept this engagement subject to certain conditions:

- The management of the client company must recognize that they have the responsibility for internal controls in the company. This responsibility cannot be passed on to the auditors.
- The engagement team will not be required to act in a management capacity in any way. For example, they must not be given any responsibility for the design or implementation of any improvements in internal control that they recommend. In addition, management must designate a competent employee to be responsible for management decisions.
- There must be sufficient controls against a self-review threat. For example, the individuals assigned to the engagement team to do the work should not include anyone who will also be a member of the audit team.

If the client is a public interest entity, the engagement is not permitted by the Code.

#### **ICAN Code of Ethics guidance on providing non-audit services**

The Code recognises the value to both client and auditor of the provision of non-audit services but requires the auditor to evaluate the significance of any threat to independence created by the provision of such services.

In some cases, it may be possible to eliminate or reduce the threat by applying safeguards. However, ICAN considers that safeguards are not possible for the following activities:

- authorising or executing a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so
- determining which recommendation of the firm should be implemented
- reporting, in a management role, to those charged with governance.

All the above activities involve the auditor or audit firm in **assuming a management role**.

ICAN considers several specific areas of non-audit service provision. Most of these activities are considered permissible, provided that:

- management decisions are not taken; and
- appropriate safeguards are put in place.

Some of these areas are set out below:

- Taxation services.** Routine compliance, planning and advisory work on taxation is generally permissible, subject to the condition that the auditor must not make management decisions.
- Internal audit services.** Internal audit services may be provided by an external audit firm, if there are appropriate safeguards (e.g. use different teams for internal audit services and the audit), on condition that the auditor does not act in a management capacity, and that the client acknowledges its responsibilities for internal controls.
- IT systems services.** IT systems services are permissible with appropriate safeguards. (The client must acknowledge its responsibilities and make all management decisions.)

#### Litigation support services

Such services may include:

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

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

**Safeguards** might include:

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

#### Legal services

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

However, the Code states that acting for an **audit client** in the resolution of a dispute or litigation where the amounts involved are material to the financial

statements creates such significant **advocacy and self-review threats** that the work **should not be taken on**.

#### **Recruitment of senior management**

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

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

#### **2.5 Making referrals**

An audit firm may enter into an arrangement with another entity, whereby the other entity agrees to pay a fee to the audit firm for referring clients. For example, a software company may specialise in selling accounting software packages or writing bespoke accounting software. It may enter an arrangement with an audit firm whereby the audit firm will receive a fee every time that it refers a client to the software firm with a view to buying a software package or software services.

This type of arrangement will create a self-interest threat for the audit firm. However, it is permissible, provided that suitable safeguards are in place. Suitable safeguards would include the following:

- When making a referral, the audit firm should notify the client that it will receive a fee for the referral. This means that the client will be made fully aware of the financial benefit for the audit firm;
- The audit firm should monitor the quality of the products or services provided. In the case of referrals to a software company, this means having to keep the quality of the software packages and services under review, to make sure that they meet appropriate standards. (It is important that audit clients should not be referred to someone who provides poor-quality goods or services.)
- The firm should also obtain verification from all staff involved with the audit of a client who is referred, that they do not personally have any financial interest in the company or other entity to which the referrals are made.

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

With respect to obtaining new clients, paragraph 7.1.5 of ICAN's code of ethics states that in Nigeria:

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

## 2.6 Illustration



### **Further examples: threats to independence**

A Nigerian audit firm, Tyre and Sleep, is faced with the following situations:

#### **Situation 1**

Mr Tyre is one of the audit firm's partners. He and his wife have been invited by the managing director of Entity X to a weekend of celebrations in Cape Town to mark the 20<sup>th</sup> anniversary of the incorporation of Entity X . Mr Tyre has been the engagement partner throughout this time

#### **Situation 2**

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

#### **Situation 3**

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

#### **Required**

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



### **Answer**

#### **Situation 1**

The fact that Mr Tyre and his wife have been invited to a 'free' weekend in Cape Town represents a threat to the firm's independence, because it would be perceived that they are too close to Entity X and therefore not truly independent.

The offer should be refused as goods, services or hospitality should only be accepted when the value is trivial and inconsequential, which it is not to MrTyre and his wife.

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

#### **Situation 2**

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

The firm must ensure that Mr Knapp is not part of the audit team and is notable to influence any members of the audit team. If this cannot be demonstrated, then the firm should not accept the audit engagement.

**Situation 3**

The key ethical issues that arise in this situation are familiarity and possible intimidation.

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

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

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

### 3 CONFIDENTIALITY AND CONFLICTS OF INTEREST

#### Section overview

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

#### 3.1 The basic principle

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

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

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

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

#### 3.2 Recognised exceptions to the duty of confidentiality

##### Disclosure permitted by law and authorised by the client or employer

For example:

- when an auditor is asked to report to a bank in relation to compliance with a loan covenant the auditor will seek the client's authorisation before disclosing confidential information to the bank;
- when an auditor is asked to report to a listing authority (stock exchange) in relation to listing rules, again the auditor will seek the client's authorisation before disclosing confidential information to the listing authority.

##### Disclosure required by law

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

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

- Producing documents or other evidence in the course of legal proceedings; or
- Disclosure to the appropriate public authorities of infringements of the law that come to light.

One specific example is money laundering, where an ICAN member is required by law to make disclosure to the relevant legal authorities if he knows, or has reason to suspect that a client has committed

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

Note that the Money Laundering Act requires an accountant to report mere suspicion of money laundering, even if those suspicions ultimately turn out to be false. The accountant remains protected by law from being sued by the client.

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

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

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

- To comply with the quality review of a member body or professional body;
- To respond to an inquiry or investigation by a member body or regulatory body;
- To protect the professional interests of a Chartered Accountant in legal proceedings (for example when it is reasonably necessary to protect the interests of the member in making a defence against an official accusation of professional negligence);
- To comply with technical standards and ethics requirements, or
- Other similar situations not covered above.

#### **Other considerations**

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

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

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

### **3.3 Improper use of information**

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

For example:

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

### 3.4 Confidentiality of working papers

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

However, situations may arise where government agencies (for example, tax authorities) ask to see the accountant's working papers relating to a particular client. In such situations, the accountant should act in the best interests of his client. If he feels that releasing the papers is in the best interests of his client, and the client has no objections, then the papers should be made available.

Ultimately the tax authorities are likely to have legislative powers to obtain the papers. Any lack of co-operation on behalf of the auditor or his client may add to any existing suspicions.

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

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

### 3.5 Conflicts of interest

Conflicts of interest can arise under two situations:

- Conflicts between members and clients; and
- Conflicts between competing clients.

#### Conflicts between members and clients

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

Examples of this might be:

- when members compete directly with a client

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

### Safeguards

Accountant should have procedures in place to:

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

Possible procedures include the following:

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

### Conflicts between competing clients

A firm might act for two clients that are in direct competition with each other.

The firm has a professional duty of confidentiality, and so will not disclose confidential information about one client company to its competitor. Again, the test is whether a "reasonable and informed third party" would consider the conflict of interest as likely to affect the judgement of the firm.

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

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

- Giving careful consideration to whether or not it is appropriate to accept an assurance engagement from a new client that is in direct competition with an existing client, it may be appropriate to decline the offer from the potential new client.
- Careful management of the clients, for example by ensuring that different members of staff are used on the two engagements.
- Full and frank disclosure to the clients of the potential conflict, together with suitable steps by the firm to manage the potential conflict of interest.
- Procedures to prevent access to information (such as physical separation of the teams and confidential and secure data filing). Such an approach is known as creating "Chinese walls".

**Chapter 3: Rules of professional conduct**

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- Establishing clear guidelines on security and confidentiality and the use of confidentiality agreements.
- Regular review of safeguards in place.
- Advising one or both clients to seek additional independent advice.

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## 4 CORPORATE FINANCIAL ADVICE

### Section overview

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

#### 4.1 Introduction

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

- promote, deal in or underwrite an audit client's shares
- provide corporate finance advice to an audit client where the effectiveness of such advice is dependent on a particular accounting treatment or presentation in the financial statements being audited.

In other cases, **safeguards** such as not making management decisions, an independent review of the audit or corporate finance work and using individuals who are not members of the audit team should be considered.

#### 4.2 Advising clients involved intake - overbids or share issues

Auditors are often asked to give advice. However, where clients are involved in a contested take-over bid, the auditors could find themselves in a position where they are potentially acting for both parties.

In this situation:

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

Guidelines in this area are as follows:

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

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

## 5 CHAPTER REVIEW

### Chapter review

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

- Describe the fundamental principles of the IESBA Code of Ethics
- Apply the conceptual framework to identify threats to the fundamental principles and suggest appropriate safeguards across a range of common scenarios

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### Quick quiz questions

- 1 In which of the following situations would an auditor be required to disclose confidential information about a client to the authorities?
  - 1 Suspicion of terrorism
  - 2 Suspicion of tax evasion
  - 3 Suspicion of money laundering
  - 4 Suspicion of drug trafficking

A 1, 2 and 3 only  
B 1, 3 and 4 only  
C 2, 3 and 4 only  
D 1, 2 and 4 only
- 2 Which of the following statements is INCORRECT?
  - A Internal audit services may be provided by an audit firm for an audit client provided that the audit firm can take on the responsibility for internal controls.
  - B To protect its independence, an audit firm should have internal consultation procedures in place.
  - C Temporary staff assignments by an audit firm to an audit client are permissible.
  - D An audit firm must not perform a professional valuation of an asset for an audit client if the asset is material to the financial statements.
- 3 If a member of the audit team owns shares in a client company, what sort of threat to independence arises?
  - A Self-interest
  - B Self-review
  - C Advocacy
  - D Familiarity
- 4 Which of the following are fundamental ethical principles for professional accountants?
  - 1 Competence
  - 2 Compliance
  - 3 Integrity
  - 4 Objectivity

A 1, 2 and 3 only  
B 1, 3 and 4 only  
C 2, 3 and 4 only  
D 1, 2 and 4 only

- 5 Which of the following are threats to the independence of an auditor?
- 1 Loans between the auditor and the client
  - 2 The provision of non-audit services by the auditor
  - 3 Long association between the audit firm and the client
  - 4 Using the work of the client's internal audit department
- A 1, 2 and 3 only
  - B 1, 3 and 4 only
  - C 2, 3 and 4 only
  - D 1, 2 and 4 only

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### Quick quiz answers

1 B

For certain suspected crimes, the requirements of law override the duty of confidentiality.

2 A

Responsibility for internal controls must remain with management of the audit client and management of internal controls must not become the responsibility of the audit firm.

3 A

The auditor might be motivated for the company to report high profits so that the value of his shareholding will increase. He therefore has a self-interest in the audited results of the company.

4 B

The five fundamental principles are integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

5 A

As long as the external auditor believes that internal audit is technically competent and operates with due professional care, the external audit can use internal audit's work. No threat arises to the external auditor's independence.

CHAPTER  
**4**

## **Professional responsibility and liability**

### **Contents**

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

## INTRODUCTION

### Competencies

#### Laws, regulations and ethical issues

- A1** Advise on technical, professional and ethical issues that may arise during assurance engagements in the public and private sectors including evaluation and communication with any party to the engagement.
- A3** Identify and explain the nature and purposes of laws, regulations, standards and codes in the context of assurance engagements.
- A7** Evaluate and explain how audits may fail to meet users' expectations.
- A8** Evaluate and explain the extent of legal liabilities including criminal and civil law liabilities and professional negligence and how they can be mitigated.

### Exam context

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

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

At the end of this chapter, readers should be able to:

- Explain what the expectation gap is and how it arises
- Apply the provisions of ISA240
- Describe how an auditor's liability may arise (both criminal and civil) and explain how it can be managed.

## 1 AUDITORS' LIABILITY AND THE EXPECTATIONS GAP

### Section overview

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

#### 1.1 Introduction

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

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

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

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

#### 1.2 Audit expectations gap

The expectations gap is the difference (or 'gap') between:

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

There are three main elements in the expectations gap:

- A **standards gap**. This occurs because of a perception that auditing standards are more prescriptive than they actually are, and that auditors have wide-ranging rules that they must follow.
- A **performance gap**. This occurs because of a perception that audit work has fallen below the required standards.
- A **liability gap**. This arises from a lack of understanding about the auditor's liability and who the auditor may be liable to.

In addition, there is a perception that auditors have a responsibility for detecting all **fraud**, whenever this occurs.

Consequences of the expectation gap include:

- higher rates of litigation due to the perceived negligence of auditors (high levels of expectation about what auditors should do may lead to legal action against auditors if this level of expectation is not met);
- incorrect decisions by users of audit reports who base such decision on incorrect premises; and
- an increase in mutual distrust between the auditing profession and users of audit reports.

### 1.3 Closing the expectations gap

To reduce the frequency and cost of legal action, and to maintain the image of the audit profession in the mind of the public, it is in the interests of the profession to take steps to close the expectations gap. A number of strategies exist that could assist in closing the expectation gap and are discussed below.

- The profession should attempt to improve the general level of knowledge and understanding about the audit process. One such attempt has been made with updates to the auditing standards on auditor's reports published by IFAC in 2015. These updates enhanced the auditor's report to make it more relevant and transparent to users, for example, by introducing a new section on key audit matters, more requirements with regards to reporting going concern and improved descriptions of the responsibilities of the auditor.
- Controls over the auditing profession are important in enhancing public confidence. For example:
  - The European Union requires the audit of companies whose shares are quoted on a stock market in the EU to be conducted in accordance with international auditing standards (ISAs);
  - National oversight bodies such as PCAOB (Public Company Accounting Oversight Board) in USA and FRCs (Financial Reporting Councils) in the UK and Nigeria monitor the compliance of audit firms in their conduct of audits by performing audit inspections;
- Significant guidance for auditors and management aimed at increasing quality and addressing issues such as going concern has been issued by standard setters, professional bodies and regulators. There has been an increased focus on corporate governance and the role that audit committees play in companies, reducing inconsistencies and enhancing quality.
- Open and candid communication between internal and external auditors, financial management and the audit committee is increasingly being seen as critical in helping reduce the expectation gap. Such communication helps the audit committee to perform their governance role with the necessary transparency and realistic expectations that will help achieve effective risk management.
- Enhanced communication between the parties and confirmation of their respective roles and responsibilities should be presented in the audit committee and directors' reports to the shareholders. This will ensure that users become much more aware of the various parties' roles and responsibilities beyond the understanding they gain just from the audit report.
- The expectation gap will hopefully narrow further as financial reporting participants work together even more effectively to improve the deterrence and detection of financial reporting fraud.

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

One thing that is certain is that audit committees are well positioned to play a vital role in reducing the expectation gap given their open and direct relationship

with all the key parties including shareholders, board of directors, internal audit and external audit.

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

##### **Foreword**

The public places value on the independent financial statement audit because it enhances the degree of confidence of intended users in the financial statements. A high-quality audit features the exercise of professional judgment by the auditor and, importantly, a mind-set that includes professional scepticism throughout the planning and performance of the audit.

The need for professional scepticism in an audit cannot be overemphasized. Professional scepticism is an essential attitude that enhances the auditor's ability to identify and respond to conditions that may indicate possible misstatement. It includes a critical assessment of audit evidence. It also means being alert for audit evidence that contradicts other audit evidence or that brings into question the reliability of information obtained from management and those charged with governance (TCWG). This critical assessment is necessary in order for the auditor to draw appropriate conclusions.

The IAASB's International Standards on Auditing (ISAs) explicitly recognize the fundamental importance of professional scepticism. Nevertheless, adopting and applying a sceptical mind-set is ultimately a personal and professional responsibility to be embraced by every auditor. It is an integral part of the auditor's skill set and is closely interrelated to the fundamental concepts of auditor independence and professional judgment and contributes to audit quality.

Professional scepticism is also influenced by personal behavioural traits, including motivation, and competencies. Thus auditor education, training and experience are important. Audit firms themselves therefore have an important role to play in cultivating a sceptical mind-set in auditors. This includes designing and implementing policies and procedures that promote an internal culture recognizing that scepticism is essential in performing audit engagements.

Today's financial reporting seeks to address information that is more relevant to users. As a result, more judgment and increased subjectivity is involved in management's accounting and reporting decisions (for example in relation to some fair value measurements). Also, many entities today face difficult economic conditions that give rise to unique financial reporting and auditing challenges. These developments heighten the importance of professional scepticism by auditors, especially in areas of financial reporting that are complex or highly judgmental.

In the aftermath of the 2008–2009 global financial crisis, recent audit inspection reports in various jurisdictions have noted areas, such as fair values, related party transactions, and going concern assessments, where regulators and oversight bodies believe that auditors should have more clearly demonstrated professional scepticism. It is therefore in the public interest to re-emphasize to both auditors and others the important role that professional scepticism has to play in audits of financial statements. The IAASB's Staff Questions & Answers (Q&A) publication was developed for this purpose.

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

**Q&A**

<b>Question</b>	<b>Answer</b>
<b>1. What is professional scepticism?</b>	The ISAs define professional scepticism as "an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence." They explicitly require the auditor to plan and perform an audit with professional scepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. i.e. An inquisitive mind.
<b>2. Why is professional scepticism important in audits of financial statements?</b>	Professional scepticism plays a fundamentally important role in the audit and forms an integral part of the auditor's skill set. Professional scepticism is closely interrelated with professional judgment. Both are essential to the proper conduct of the audit and are key inputs to audit quality. Professional scepticism facilitates the appropriate exercise of professional judgment by the auditor, particularly regarding decisions about, for example: <ul style="list-style-type: none"> <li>- The nature, timing and extent of audit procedures to be performed.</li> <li>- Whether or not sufficient appropriate audit evidence has been obtained and whether or not more needs to be done to achieve the objectives of the ISAs.</li> <li>- The evaluation of management's judgments in applying the entity's applicable financial reporting framework.</li> <li>- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.</li> </ul>

Question	Answer
<b>3. What can be done by audit firms and auditors to enhance the awareness of the importance of professional scepticism and its application?</b>	<p>Professional scepticism within the engagement team is also influenced both by the actions of the firm's leadership and the engagement partner, and by the culture and business environment of the firm. The ISAs and ISQC 1 include requirements and guidance designed to help create an environment at both the firm and engagement levels in which the auditor can cultivate appropriate professional scepticism. For example:</p> <ul style="list-style-type: none"> <li>- Auditors must consider the integrity of the principal owners and management during engagement acceptance (ISQC1)</li> <li>- The auditor must consider the reasonableness of significant assumptions used by management for accounting estimates giving rise to significant risks (ISA540)</li> <li>- ISA 240 (relating to fraud) notes that the auditor must maintain an ongoing questioning mind and be alert to the possibility of fraud</li> <li>- When considering going concern (ISA 570) the auditor must consider the reasonableness of assumptions and whether management's plans are feasible in the circumstances</li> <li>- Another area where professional scepticism is particularly important is in relation to auditing significant unusual or highly complex transactions (ISA330)</li> <li>- The auditor is required to document how they have applied professional scepticism (ISA230)</li> </ul>
<b>4. At what stage in the audit process is professional scepticism necessary?</b>	<p>Professional scepticism is relevant and necessary throughout the audit, even though reference to it is not repeated within each ISA, including:</p> <ul style="list-style-type: none"> <li>- Engagement acceptance – integrity of owners and management</li> <li>- Identifying and assessing risks of material misstatements</li> <li>- Designing nature, timing and extent of further audit procedures that are responsive to assessed risks of material misstatement, and evaluating audit evidence</li> <li>- Forming the audit opinion</li> </ul>

Question	Answer
<b>5. How does professional scepticism relate to the auditor's responsibilities with respect to fraud?</b>	<p>Due to the characteristics of fraud, including the fact that fraud may include sophisticated and carefully organized schemes designed to conceal it or may involve collusion, the auditor's professional scepticism is particularly important when considering the risks of material misstatement due to fraud.</p> <p>ISA 240 places special emphasis on professional scepticism</p>
<b>6. In addition to fraud, are there other aspects of an audit where professional scepticism may be particularly important?</b>	<p>Professional scepticism is important and necessary throughout the entire audit process. The auditor's professional scepticism becomes particularly important when addressing areas of the audit that are more complex, significant or highly judgmental such as:</p> <ul style="list-style-type: none"> <li>- Accounting estimates e.g. fair value</li> <li>- Going concern – e.g. management's plans for future actions</li> <li>- Related party relationships and transactions – e.g. business rationale</li> <li>- Consideration of laws and regulations</li> <li>- When auditing significant unusual or highly complex transactions</li> </ul>
<b>7. How can the application of professional scepticism be evidenced?</b>	<p>Professional scepticism is often demonstrated in the various discussions held by the auditor during the course of an audit. For example, the auditor's communication with TCWG includes, where applicable, why the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework not to be most appropriate to the particular circumstances of the entity.</p> <p>Documentation remains critical. The ISAs require auditors to document discussions of significant matters with management, TCWG, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. Such documentation helps the auditor demonstrate how significant judgments and key audit issues were addressed and how the auditor has evaluated whether sufficient and appropriate audit evidence has been obtained.</p> <p>Examples of circumstances where it is particularly important to prepare documentation:</p> <ul style="list-style-type: none"> <li>- Significant decisions from engagement team discussions regarding fraud</li> <li>- Identified or suspected non-compliance with laws and regulations</li> </ul>

Question	Answer
<b>8. Do regulators and oversight bodies of audit firms and those charged with governance have a role to play in supporting sceptical behaviour among auditors?</b>	<ul style="list-style-type: none"><li>- Basis of auditor's conclusions about estimates</li><li>- Identifying information that is inconsistent with the auditor's final conclusions on a significant matter</li><li>- Reasonableness of areas of subjective judgments</li></ul> <p>The ISAs do not set forth requirements for regulators and oversight bodies of the audit firms, nor for TCWG. However because of the critical role that those stakeholders serve in achieving audit quality, they are in a position to further challenge auditors</p>

## 2 FRAUD AND ERROR: ISA240

### Section overview

- The distinction between fraud and error
- Responsibilities of management and auditors for fraud and error
- The auditor's procedures where fraud or error is suspected
- Professional scepticism and fraud

#### 2.1 The distinction between fraud and error

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

**Fraud:** may be defined as intentional acts which may involve:

- fraudulent financial reporting (falsification of records or documents, a deliberately incorrect application of accounting policies)
- misappropriation of assets.

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

**Error** may be defined as:

- unintentional misapplication of accounting policies
- oversights
- unintentional clerical mistakes, or
- unintentional misinterpretation of facts.

The key distinction between fraud and error is therefore whether the effect on the financial statements is deliberate (fraud) or unintentional (error). However, there may be little or no difference between fraud and error as far as the impact on the audit is concerned. In both cases the auditor will be concerned about the impact on the 'true and fair view' presented by the financial statements.

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

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

##### Responsibilities of management

Management is responsible for **preparing** financial statements that show a 'true and fair view'. This role is reinforced by principles of good corporate governance, which require management to set up appropriate internal control systems and corporate governance systems.

**Management** is therefore responsible for the **prevention and detection** of fraud and error.

### Responsibilities of the auditor

The auditor is responsible for **reporting** on whether the financial statements show a 'true and fair view' of the financial position and performance of the client. He is therefore only concerned with fraud and error that has a material effect on the true and fair view.

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

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

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

ISA240 states the responsibilities of management and the auditor as follows:

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

### 2.3 The auditor's procedures where fraud or error is suspected

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

- Identify the extent and possible impact on the financial statements of the fraud or error. Document the facts fully in the audit files. Additional testing may be required to establish the likely extent of any misstatement.
- Consider the possible impact on other areas of the audit and on the overall assessment of audit risk. This may result in a revision to the original audit plan.
- The findings should be discussed with management, regardless of the extent of the problem, and management should be kept informed of developments.
- The auditor should determine the action that management should take. This should include the possibility of seeking legal advice if fraud is suspected.
- The auditor should normally communicate on a formal basis to management at an appropriate level. In the case of a company, the auditor communicates formally with the board of directors or the audit committee. However, if management themselves are involved in a suspected fraud, the auditor should consider taking legal advice to decide the best course of action. In extreme cases, the auditor may feel it is appropriate to resign.
- The auditor should consider the impact on his audit report to the shareholders, in terms of any impact on the true and fair view presented by the financial statements.

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

#### **2.4 Professional scepticism and fraud**

The auditor should perform the audit with a suitable degree of professional scepticism.

- The audit team should discuss the possibility of fraud in the context of the specific characteristics of the audit engagement.
- Discussions should be held with management on the procedures (controls) in place to detect or prevent fraud.
- The risks of possible fraud should be identified and its possible impact on the financial statements should be evaluated.
- Audit procedures should be designed to obtain evidence that fraud, which may impair the financial statements, has not occurred, or has been detected and corrected (or disclosed in the financial statements).

### 3 THE AUDITOR'S LIABILITY

#### Section overview

- Introduction
- Criminal liability
- Civil liability

#### 3.1 Introduction

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

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

The precise details about an auditor's criminal and civil liabilities vary from one country to another, depending on national legislation. Whilst students will study Nigerian law relevant to accountants in full in module *A5 Business Law*, this section addresses the areas of Nigerian law most directly relevant to Nigerian auditors, in particular liability arising through auditor negligence.

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

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

and laws being established by:

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

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

#### 3.2 Criminal liability

Examples of when the auditor may be criminally liable include:

- Where he accepts appointment as auditor under a statutory provision **without being qualified to act**.
- Where he is involved in **fraud**, such as falsifying accounting documents or records.
- Where he is guilty of '**insider dealing**'. The criminal law of many countries makes it an offence for a person with inside knowledge of price-sensitive information to use or pass on that information. Insider dealing is also prohibited under the IFAC and ICAN rules of professional conduct.

Auditing practices should take suitable steps to reduce the risk of insider dealing. For example, it is normal practice for audit firms to impose restrictions on the amount of shares that their staff may hold in client companies and to require staff to declare all their shareholdings.

Criminal liability may also arise for certain offences relating to:

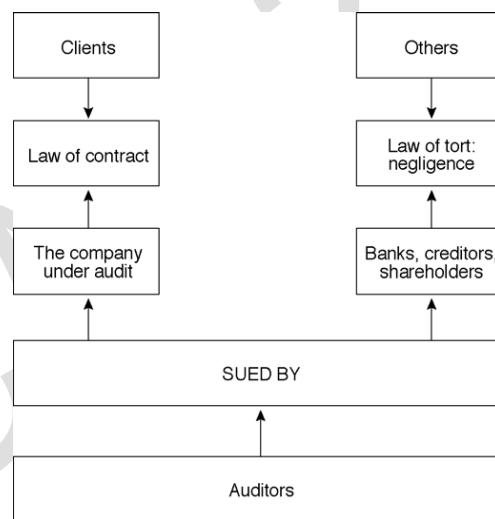
- the winding up of a company
- tax law
- financial services legislation, in areas such as dealing in investments or giving investment advice
- Money laundering (as discussed in Chapter 2)

### 3.3 Civil liability

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

#### Contract law and the law of tort

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



#### Contract law

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

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

When a legal action is brought against an auditor by a company for breach of contract (negligence), the action is usually initiated by the board of directors of the company.

#### The auditor's duty of care

During the course of the twentieth century, views changed as to the responsibility of the auditor to detect fraud and other problems in the client's affairs. Early on the judge in the famous English case **Re Kingston Cotton Mill No 2 (1896)** declared that it was the role of the auditor to act 'as a watchdog, not a bloodhound'. This implies that the auditor should be on their guard for fraud and error within the company's activities, but does not have an active duty to go searching for them. The same view was expressed in another English case of the same period, **Re London and General Bank (1895)**, in which the judge said that the auditor's responsibility was to convey information rather than arouse enquiry.

However by the time of the case **Re Thomas Gerrard (1967)** views had changed. In this English case the auditors were held liable by the judge as they had failed to detect over several years that the managing director of the company had been falsifying invoices. Although it was not the auditor's prime responsibility to detect fraud by the client there was a greater expectation that they would detect material or significant problems.

#### Standards of skill and care

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

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

The Companies and Allied Matters Act makes specific reference to negligence as follows:

**Illustration: Companies and Allied Matters Act 2020 [section 415]**

- (1) A company's auditor shall in the performance of his duties, exercise all such care, diligence and skill as is reasonably necessary in each particular circumstance.
- (2) Where a company suffers loss or damage as a result of the failure of its auditor to discharge the fiduciary duty imposed on him by subsection (1) of this section, the auditor shall be liable for negligence and the directors may institute an action for negligence against him in the court.
- (3) If the directors fail to institute an action against the auditor under subsection (2) of this section, any member may do so after the expiration of 30 days' notice to the company of his intention to institute such action.

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

### Liability in tort

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

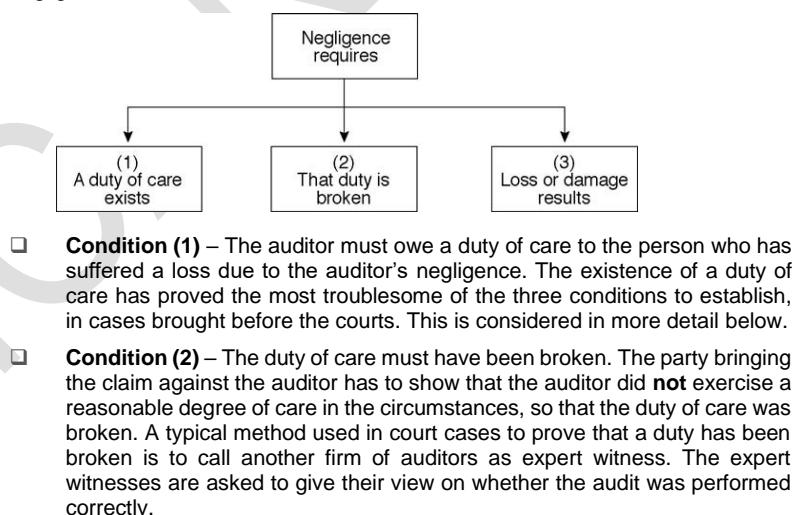
A **tort** can be defined as a 'civil wrong' other than that arising under contract law, giving rise to a claim for damages. (A civil wrong is wrongdoing that is not a criminal offence, but which allows the injured person to bring an action in civil law against the wrongdoer.) **Negligence** is just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

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

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

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

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



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

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

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

You should concentrate on the principles involved, rather than the details of the cases. Whilst some of the cases do not deal specifically with auditors, the principle established by the court is however applied by the courts to auditors in similar situations.



#### Illustration: *Candler v Crane Christmas* (1951)

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

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

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



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

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

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

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



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

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

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



#### Illustration: *Caparo Industries v Dickman and Touche Ross & Co (1989)*

This is seen as a leading case in English law in the area of 'how does the audit or owe a duty of care'.

Fidelity plc was taken over by Caparo Industries. Fidelity's accounts had been audited by Touche Ross. Caparo alleged that the accounts overstated the profits of Fidelity plc and that they had relied on the audited accounts of Fidelity when deciding to purchase shares in the company and make a takeover bid.

The court held that a duty of care was not owed to potential investors in a company, or persons making a takeover bid, because of:

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

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

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

The auditor does not exist to aid investment decisions.

#### Out-of-court settlements

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

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

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

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

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

**Example:**

An audit firm has been the auditor of Entity AZ for a number of years.

Its audit team has recently discovered that during that time, the managing director of AZ has been consistently over valuing inventories.

Entity B has recently purchased a major stake in Entity AZ, relying on the audited financial statements to do so.

**Required**

What possible defence might the audit firm use if it issued by Entity B after a successful takeover?

**Answer**

The audit firm can claim that it did not owe a duty of care to Entity B.

If the audit work has been performed to expected standards, the firm should be able to claim that the audit work was performed with diligence and care, and in accordance with ISAs. The audit work could not reasonably have detected the fraud given its nature and the seniority of the individual committing the fraud.

The firm might also be able to claim that Entity B has not suffered any financial loss as a result of its reliance on the audited financial statements.

**Use of disclaimers in audit reports**

A disclaimer is not a requirement of an audit report, but some audit reports include one. A disclaimer states that:

- the auditor's report is intended for use of the company and the company's shareholders as a body, and
- no responsibility is accepted by the auditor to anyone except the company or the shareholders as a body for the content of the report.

The purpose of a disclaimer is to reduce the risk of legal claims by 'third parties' against the auditor for negligence.

The main problem with a disclaimer however is that in spite of the ruling in the Bannerman case, a disclaimer cannot guarantee protection for an auditor against third party claims, because the circumstances of each individual claim may be different.

## 4 MANAGING THE AUDITOR'S LIABILITY

### Section overview

- Avoiding liability
- Meeting claims: professional indemnity insurance
- Limiting liability

#### 4.1 Avoiding liability

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

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

#### 4.2 Meeting claims: professional indemnity insurance

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

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

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

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

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

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

### 4.3 Limiting liability

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

- One suggestion is that there should be a statutory limit on claims, either a maximum percentage of the audit fee or a maximum fixed amount.
- Another suggestion is that auditors should be permitted to agree a 'cap' (limit) on their liability with their clients, so that a company cannot make a claim against its auditors for more than the agreed amount (cap). This is now permissible in the UK, where a company and its auditors can agree to a specified monetary sum as a ceiling or use a formula.
- The use of 'limited liability partnerships' whereby an audit firm that is structured as a limited liability partnership cannot lose more than its total fixed capital. This is similar to limited liability for companies.
- The use of the equivalent of PII for directors of client companies. This may expose the directors of companies to legal actions by other parties, rather than the audit firm, because the plaintiffs will know that the directors can afford to pay any successful claims for negligence.
- Including disclaimers of liability to parties other than the company and its shareholders in the auditors' report.

## 5 CHAPTER REVIEW

### Chapter review

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

- Explain what the expectation gap is and how it arises
- Apply the provisions of ISA240
- Describe how an auditor's liability may arise (both criminal and civil) and explain how it can be managed

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**Quick quiz questions**

- 1 Which one of the following statements is correct?
  - A An auditor has no responsibility at all for detecting fraud in an audit client.
  - B An auditor has the main responsibility for detecting fraud in an audit client.
  - C An auditor has a responsibility for detecting fraud in a client company if it might cause a material misstatement in the financial statements
  - D An auditor has a responsibility for fraud in an audit client only if the audit procedures discover fraud.
  
- 2 Directors of a company may assign one or more of their responsibilities with regard to the financial statements, internal control and risk management to:
  - A Audit committee, internal audit, legal department, risk committee
  - B Audit committee, external specialist, internal audit
  - C Internal audit, external specialist, risk committee
  - D Internal audit, external audit, audit committee
  
- 3 Which of the following statements are correct?
  - 1 Error and fraud may both be deliberate.
  - 2 Fraud is deliberate, but error is unintentional.
  - 3 Both error and fraud may be criminal activities.
  - 4 Fraud is a criminal activity, but error is not.

A Statements 1 and 3 are correct  
B Statements 1 and 4 are correct C  
Statements 2 and 3 are correct D  
Statements 2 and 4 are correct
  
- 4 Which of the following actions by an auditor would be a criminal offence, if they were to occur?
  - 1 Negligence in conducting an audit
  - 2 Insider dealing in shares of a client company
  - 3 Acting as auditor without an appropriate professional qualification

A 1 and 2 only  
B 1 and 3 only  
C 2 and 3 only  
D 1, 2 and 3

- 5 Which of the following measures might be taken by an audit firm in Nigeria to reduce the exposure to potential liability for negligence arising from a legal claim by the client company?
- 1 PII
  - 2 Including disclaimers of liability to parties other than the company and its shareholders in the auditors' report
  - 3 Resigning from the audit when any legal action is taken
- A 1 only
  - B 2 only
  - C 3 only
  - D 1, 2 and 3

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**Quick quiz answers**

1 C

Management has the main responsibility for preventing and detecting fraud in their company. However the auditor has a responsibility to give an opinion on the financial statements, and if undiscovered fraud would lead to a material misstatement, the auditor therefore has a responsibility to discover the fraud.

2 A

Directors may assign responsibilities to particular departments within their company. They may not assign their responsibilities to external parties such as external experts or external auditors.

3 D

Errors might give rise to legal action in the civil courts but is not deliberate (by definition) and it is not a criminal activity.

4 C

Negligence by an auditor can lead to litigation and a claim from the injured party (e.g. the audit client); however negligence is not criminal. Insider dealing and acting as an auditor without the proper qualification are criminal activities.

5 A

Whilst some countries allow disclaimers in the audit report (e.g. the UK) this is not yet the case in Nigeria. Resigning from the audit after negligence has occurred does not reduce the potential liability as the breach of duty of care would already have occurred. Whilst PII does not reduce the total claim liability, it would reduce the exposure to the auditor since the insurance company would bear a portion of any damages awarded and the cost of defending a claim.

CHAPTER  
**5**

## **Practice management**

### **Contents**

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

## INTRODUCTION

### Competencies

#### Laws and regulations on audit and assurance engagements

- A2** Identify and make judgements on when it may be appropriate to refer a matter to a senior colleague or for third party advice or consultation.

#### Accepting professional engagements and managing assignments

- B1 (a)** Analyse and evaluate the issues that may arise during the process of obtaining audit work.
- B1 (b)** Identify and explain the legal, professional and ethical issues that may arise during the acceptance of assurance or audit assignments.
- B1 (d)** Discuss how engagement terms can be agreed and recorded by an auditor including those agreed with a client and those imposed by laws or regulations.
- B2 (a)** Evaluate and apply appropriate procedures and policies for management of an assurance or audit engagement.
- B2 (b)** Evaluate and apply appropriate quality control measures that may be used by a firm during the course of an assurance or audit engagement.
- B2 (d)** Evaluate and apply appropriate monitoring and review procedures to effectively manage an audit or assurance engagement.
- B2 (e)** Identify and explain the purposes of external monitoring of audit and assurance assignments and how this might ensure engagement or firm's quality.
- B2 (f)** Identify and evaluate the considerations by an auditor of risk issues identified prior to accepting an engagement.

### Exam context

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

You need to fully understand the system of quality control used in an accountancy firm incorporating both ISQC1 and ISA 220.

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

At the end of this chapter, readers should be able to:

- Describe the components of a system of quality control applied to a firm of accountants performing audit and assurance engagements
- Explain the process around changes in professional appointment including the legal, commercial and ethical considerations
- Apply ISA 210 in agreeing the terms of an engagement

## 1 QUALITY CONTROL: ISA 220 AND ISQC 1

### Section overview

- The need for a quality control system in accountancy firms
- Quality control procedures
- Quality control arrangements for individual engagements: ISA 220
- Quality control arrangements at the overall firm level: ISQC 1
- Quality control procedures specific to individual engagements
- Quality control in large accountancy firms and small accountancy firms

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

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

### 1.1 The need for a quality control system in accountancy firms

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

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

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

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

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

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

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

## 1.2 Quality control procedures

Quality control procedures can be considered at two levels:

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

## 1.3 Quality control arrangements for individual engagements: ISA 220

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

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

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

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

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

- conclusions in respect of new and continuing engagements
  - the nature and scope of conclusions from consultations undertaken.
- For audits of listed companies**, and any other audits where the firm has determined that an engagement quality control review is required, the engagement partner is also **required** to appoint an **engagement quality control reviewer**, who:
- performs an objective evaluation of the significant judgements made by the audit team and the conclusions reached, including:
    - discussion of significant matters with the engagement partner
    - review of the financial statements and the proposed audit report
    - review of selected audit documentation relating to significant judgments
    - an evaluation of the conclusions reached and whether the proposed audit report is appropriate
  - considers the engagement team's evaluation of the firm's independence in relation to the audit engagement
  - considers whether appropriate consultation has taken place on difficult or contentious matters
  - considers whether audit documentation selected for review reflects the work performed and the conclusions reached.

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

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

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

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

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

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

- the firm and its personnel comply with professional standards and applicable legal and regulatory regulations, and
- reports issued by the firm are appropriate.

The quality control procedures that are applied within an audit firm will reflect the nature and size of the audit practice. However, personnel within the firm who are responsible for establishing and maintaining quality control procedures must have an understanding of **the entire text** of ISQC 1. As the firm must meet the requirements of ISQC 1, it should have a system in place which addresses each of the following elements:

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

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

#### **Leadership responsibilities for quality**

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

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

#### **Ethical requirements**

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

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

The firm should:

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

The policies and procedures should include requiring:

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

At least annually, the firm should obtain written confirmation from all staff of compliance with the firm's policies and procedures on independence.

The firm should also establish criteria for determining the use of safeguards to reduce the familiarity threat to an acceptable level when the same senior personnel have been used on an assurance engagement for a long time. For listed entity clients, there must be rotation of the engagement partner after a specified period, in compliance with relevant ethical requirements.

#### **Acceptance and continuance of engagements**

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

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

The policies and procedures should include requiring the firm to:

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

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

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

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

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

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

#### **Human resources**

ISQC 1 **requires** the firm to ensure:

- it has sufficient personnel with the **competence, capabilities and commitment to ethical principles** to meet its overall quality control objectives, and

- that for each engagement an appropriate engagement partner and team are assigned.

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

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

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

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

#### **Engagement performance**

Policies and procedures are **required** to include:

- those to promote consistent quality engagement performance
- supervision responsibilities
- review responsibilities (on the basis that more experienced team members review the work of less experienced team members)
- guidance on consultation to ensure that:
  - appropriate consultation takes place on difficult or contentious matters
  - sufficient resources are available for such consultation
  - the nature, scope and conclusions of the consultation are documented (by both parties)
  - conclusions arising from the consultation are implemented.
- guidance on engagement quality control reviews to ensure that:
  - an engagement quality control review is required for audits of all listed entity clients
  - criteria are established to determine which other engagements should be subject to an engagement quality control review
  - the review covers certain procedures (the same as set out in ISA220 – see above)
  - engagement quality control reviewers are eligible to carry out such reviews via technical qualifications, experience, authority and objectivity from the engagement
  - engagement quality control reviews are properly documented (again, as also set out in ISA 220)
- procedures for dealing with any differences of opinion between the engagement team and those consulted or between the engagement partner and the engagement quality control reviewer

- procedures in respect of completion of the final audit files on a timely basis and the confidentiality and safe custody of such documentation for an appropriate period.

#### **Monitoring of quality control procedures**

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

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

The firm should:

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

**Appropriate remedial action** might include:

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

If the results of monitoring procedures indicate that:

- an inappropriate report may have been issued, or
- procedures were omitted during the engagement
- the firm should determine what further action is needed. This might include obtaining legal advice.

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

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

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

#### **Documentation of quality control procedures**

The following matters are **required** to be documented.

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

Documentation must be retained for a sufficient period of time, as a minimum to comply with relevant laws and regulations.

### 1.5 Quality control procedures specific to individual engagements

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

- the direction and supervision of staff, and
- review of their work.

#### Direction of audit staff

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

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

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

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

The members of the audit team should:

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

#### Supervision of audit staff

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

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

- Monitoring the behaviour of team members (particularly inexperienced junior members of the team), to ensure that they maintain ethical standards.

#### Review of audit work

Review of audit work is a key aspect of quality control. All audit work should be reviewed, ideally by an auditor with a higher level of competence and experience than the audit team members who performed the audit work. The review process may take any of the following forms:

- Peer review:** This is a review carried out by another partner in the assurance firm.
- Engagement quality control review (EQCR):** a peer review performed before the audit report is signed as required by ISQC1 during the audit of a listed or public interest entity. An EQCR forms part of the quality control procedures specific to an individual assignment.
- Hot review:** Similar in substance to an EQCR except that the hot review is not performed as a direct requirement of ISQC1. E.g. when an engagement partner on a non-listed / public interest entity audit wants a second opinion or to monitor the work of a new partner during probation.
- Monitoring review (also called a 'cold review'):** This is a peer review performed after the audit report is signed. A cold review forms part of the monitoring of quality control procedures.

The purpose of audit review is to check whether:

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

The review of the audit work should cover:

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

The review process itself should also be documented.

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

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

- review the audit documentation, and
- hold discussions with the audit team.

This process is usually referred to as the **partner's review**. It should be scheduled into the audit plan, towards the completion of the audit.

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

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

### **Assessing the adequacy of quality control**

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

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

#### **Example: quality control issues**

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

What professional and ethical issues exist in this situation?



### Answer

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

- Junior members of an audit team must be given suitable directions about their responsibilities, and their activities should also be properly supervised. In this situation, a junior member considered that he was allowed to offer advice to the client, which clearly should not be the case. This suggests poor direction and supervision in the audit.
- The junior member obviously believed that he could offer advice directly to the client. In practice, if any member of the audit team identifies weaknesses in the client's internal controls their findings should be reported to a senior member of the audit team, who should then decide the appropriate action to take. Failure by the junior team member to report his findings to a senior auditor also raises a concern about quality control. The firm may require much better training of staff about audit responsibilities and procedures.
- It is important to establish the details of the advice that the junior team member has given to the client, and to find out whether the client has acted on that advice yet. The audit partner should discuss the situation with the client's management in order to find out whether the advice has been acted upon. If the client has acted on the advice and this advice was poor, the audit firm may be liable.

## 1.6 Quality control in large accountancy firms and small accountancy firms

### Quality control in large firms

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

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

### Quality control in small firms

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

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

## 2 CHANGES IN A PROFESSIONAL APPOINTMENT

### Section overview

- Why a change might arise
- Procedures before accepting a new audit appointment
- Deciding whether to accept a new audit appointment
- Books, documents and records

#### 2.1 Why a change might arise

An ICAN member may be asked to accept a new audit appointment in a situation where the previous auditor ('old' auditor) will not be reappointed.

This may be for any of the following reasons:

- The current firm is too small to cope with the demands of an expanding client (who now operates from multiple locations, in different towns or countries).
- There may be a change in the composition of the company's board of directors, and the new directors wish to appoint an auditor of their own choice.
- There may be a perceived lack of independence, possibly one that has just arisen.
- There may have been a disagreement between the directors and the 'old' audit firm (for example, over the accounting treatment of an item in the financial statements).
- There may have been a loss of confidence in the 'old' audit firm.

In theory, the auditor is appointed by the shareholders. However, in practice recommendations are made by the directors to the shareholders when they consider that there should be a change of auditors.

If the outgoing auditor feels that the change is for a reason that should be brought to the attention of the shareholders (for example, in the case of a dispute) then national legislation will allow him to make representations to the shareholders. In Nigeria, Section 409, 412 and 413 of the Companies and Allied Matters Act 2020 deal with the removal of Auditors, resignation of auditors and the right of resigning auditor to requisition a company meeting respectively.

#### 2.2 Procedures before accepting a new audit appointment

Before accepting an appointment, the audit firm should take the following steps:

- It should assess whether there are any professional problems attached to accepting the engagement. These might include, for example, problems of lack of independence, or a lack of technical expertise, or a conflict of interest.
- It should ensure that resources are available to complete the audit assignment; in particular it must ensure that there will be sufficient staff (of the right level of expertise) available at the right time.

- It should take up references on the proposed client company and its directors, if they are not already known to the auditors. This is usually referred to as **client screening**.
- It should communicate with the incumbent (existing) auditors, if there are any, to discuss the appointment, the client and the audit work. The method of communication is referred to in ICAN's Code of Conduct as **professional enquiry** (see below).

#### Client identification

In order to comply with anti-money laundering regulations, the audit firm should carry out client identification procedures. The purpose of these procedures is to confirm that the client 'is who he says he is', and that there are no grounds for suspicion that the client may be involved in money laundering activities.

- If the client is a company or other business entity, documentary evidence of the identity of the entity should be obtained – for example a certificate of incorporation in the case of a company.
- Evidence should also be obtained to confirm the address of the entity, such as headed letter paper.
- If the client is an individual, evidence of identity can be obtained from a passport or driving licence, and evidence of address (possibly) from a recent utility bill.
- The audit firm should consider whether the business of the potential new client 'makes commercial sense'. For example, it would not make sense for a very large company to be engaged in operating a number of dry-cleaning shops, because the size of the company would be too large for the nature of its business operations. When this happens, the client's declared business may simply be a front or cover for hidden illegal activities.

In most cases, the client identification procedures should be a formality, and the client may be surprised that they are necessary. The audit firm should explain the regulatory purpose of client identification, to remove any doubts or concerns that the new client may have.

#### Professional enquiry

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

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

- When a member is first approached by a prospective client to act or be nominated, he should explain that he has a professional duty to communicate with the existing auditor or advisor.
- Client permission is required for any such communication. If the client refuses to give its permission, the appointment as auditor should not be accepted.

- If the client does not give the current auditor permission to reply to any relevant questions, the current auditor should communicate this fact to the prospective auditor who should subsequently not accept appointment.
- If the current auditor does not provide any information relevant to the appointment, the new auditor should accept or reject the engagement based on other available knowledge.
- The existing auditor or adviser should answer without delay the communication from the prospective auditor. If there are no matters of which the latter should be aware, the existing auditor or adviser should write to say that this is the case.
- If, however, there are such matters (see paragraph 4.3.16 below) he should inform the prospective auditor of those facts within his knowledge of which, in his opinion, the prospective auditor should be aware. It is not sufficient to state that unspecified facts exist.
- The existing auditor or adviser might prefer to explain these facts orally and the prospective auditor or adviser should be prepared to confer with the existing auditor or adviser if the latter so desires, and each should make his own record of such a discussion.
- If an issue of conflicting viewpoints between the client and himself has been raised by the existing auditor in his reply, the prospective successor should discuss the conflict with the client and satisfy himself either that the client's view is one which he can accept as reasonable or that the client will accept that the incoming auditor or adviser might have to express a contrary opinion.
- Where the existing auditor or adviser does not respond within a reasonable time, the prospective successor should endeavour to contact the existing auditor by some other means, for instance, by telephone, facsimile or e-mail.
- Should this fail, and where the prospective successor has no reason to believe that there are untoward circumstances surrounding the change, he should send a final letter by recorded delivery service stating that unless he receives a reply within a specified time he will assume that there are no matters of which the existing auditor is aware that should be brought to his attention. A member who accepts nomination in such circumstances is not precluded from complaining to the Institute that the existing auditor did not respond to his enquiry letter.
- If the prospective auditor is satisfied that he can properly act, and is prepared to accept nomination/appointment, he should so inform the client in writing.

#### **Unpaid Fees**

A member in public practice should not accept an audit assignment previously carried out by another member, without first ensuring that the other member has been properly removed from office as auditor and that all outstanding fees due to the other member have been fully paid.

### **Confidentiality**

The prospective auditor should ordinarily treat in confidence any information provided by the existing auditor. However, it may be essential to the fulfilment of a prospective auditor's obligations that he should disclose such information. It may, for example, be unavoidable for the prospective auditor to disclose to officers or employees of the client matters brought to his attention by the predecessor firm, which needs to be properly investigated. Such disclosure should be no wider than is necessary.

### **Defamation**

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

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

### **Joint auditor**

A member whose firm is nominated as a joint auditor should communicate with all existing auditors and be guided by similar principles to those set out in relation to nomination as an auditor. Where it is proposed that a joint audit appointment becomes a sole appointment, the surviving auditor should communicate formally with the outgoing joint auditor.

### **Vacancy**

A member whose firm is invited to accept nomination on the death of a sole practitioner auditor should endeavour to obtain such information as he may need from the late practitioner's alternative (where appropriate), the administrators of the estate or other relevant sources.

### **Additional work**

A member invited to undertake recurring or non-recurring work, which is additional to and related to continuing work carried out by another Chartered Accountant or adviser should normally notify that other Chartered Accountant of the work he has been asked to undertake.

- It is generally in the interest of the client that the existing auditor be aware of the nature of the additional work being undertaken. The existing Chartered Accountant will be provided with the opportunity to communicate with the member to provide information, lack of which might otherwise prevent the additional work from being carried out effectively. Additionally, such notification could affect the way an existing Chartered Accountant discharges his continuing responsibilities to his client.
- Notification should always be given to the existing Chartered Accountant.
- Provision of all opinions on the application of accounting standards or principles clearly requires particular sensitivity to avoid adversarial positions between an auditor and other Chartered Accountants wherever possible.

### 2.3 Deciding whether to accept a new audit appointment

An accountancy firm may occasionally decide that to accept a new audit appointment would threaten the firm's reputation and might also raise serious ethical issues.



#### Example: accepting a new audit appointment

Backle Company is an owner – managed company. It has asked your firm to become its auditors. The following information has been obtained about the company, mainly from the company's current auditors.

- (1) The current auditors have just resigned from the audit because they no longer have sufficient resources to carry out the audit work for Backle. They had taken on the audit two years earlier, after the previous auditors had resigned due to a dispute about fees. The current auditors commented that the company's management liked to keep a close control over costs, and they had agreed to do the audit for a lower fee.
- (2) The current auditors had discovered a number of internal control weaknesses in Backle and had reported them to management, but nothing appeared to have been done by management to improve the control system.
- (3) There were ongoing disputes with the tax authorities about the amount of tax payable by Backle on profits for the previous three years.
- (4) Backle Company has a poor public relations image. It is currently under investigation by both the police authorities and the regulatory authorities for alleged breaches of regulations, and some of these had been widely reported.
- (5) The company is ambitious and plans to expand its business in the next year or so. It expected to obtain bank loans to finance most of the expansion.

What issues should the audit firm consider when deciding whether or not to accept the new audit appointment?

**Answer**

The following matters may be considered.

- Reputation. The audit firm may decide that it does not wish to be associated with a client company whose public relations image is poor. The bad reputation of the company may transfer to its auditors.
- Advocacy threat. The criminal or regulatory investigation may lead to legal action, and the audit firm may be faced with an advocacy threat, and be expected to defend the company against the allegations that have been made against it.
- Aggressive management. Backle Company has aggressive managers who are willing to argue with auditors and who want to keep costs as low as possible. There is a high risk of continuing disputes over audit fees.
- Audit risk. If the company applies for new bank loans, it will probably be required to submit audited financial statements to the bank as part of the loan application. The management of Backle have a strong interest in presenting financial statements that show strong profits and a healthy statement of financial position. The risk that the financial statements may be misstated could therefore be high. (The audit firm would probably wish to consider including a disclaimer in their audit report, to reduce the risk of liability to a bank for 'negligent' auditing in the event that the financial statements turn out to be misstated and the errors are not identified by the auditors.)
- High audit risk is also suggested by the weak internal controls and failure by management to improve controls.
- The high audit risk means that a new auditor would want to conduct a very careful audit of the opening balances: this would add to the cost and time required for the audit, which Backle management may refuse to accept.

However there is no evidence of fraud (or suggestion of fraud) by anyone in the company, and the audit firm may decide to accept the audit appointment, subject to agreement about fees. Acceptance of a new audit client is a matter of judgement.

## 2.4 Books, documents andrecords

### Client books and records: right of lien

Once a new auditor has been appointed, the outgoing auditor should arrange for the transfer of any books and records belonging to the client that are in his possession.

However, where fees remain unpaid, the outgoing auditor may wish to exercise a legal **right of lien** over those client books andrecords.

- A lien is a right to retain possession of property belonging to another until amounts due arepaid.
- Auditors have a 'particular' (as opposed to a 'general') lien. This means that the right of lien is only in respect of those books and records on which the auditor has performed auditwork.

In order for the lien to be applied:

- the documents must have come into the auditor's possession lawfully, and
- an invoice must have been sent to the client company for the fees owing, and there must be no dispute overfees.

Unfortunately, in some countries, legal decisions have been taken that mean a lien cannot be exercised over books and records which the client is required to keep by law. In many cases, this legal requirement applies to most of the client's books and records. Consequently, these legal decisions may significantly reduce the effectiveness of the right of lien.

#### **Auditor working papers**

Audit working papers are documents prepared by the auditors for the purpose of carrying out their audit work. In general, these belong to the auditors, unless there is a provision to the contrary in the engagement letter or in national law.

However, the outgoing auditor will be expected to provide the proposed new auditor with information that is sufficient for a reasonable handover of audit responsibilities. The precise nature of this information will depend on the stage that the audit has reached when the responsibility for the audit passes from the 'old' audit firm to the new one.

### 3 OBTAINING AND CHARGING FOR PROFESSIONAL WORK

#### Section overview

- Obtaining professional work
- Advertising and publicity
- Fees
- Tendering
- Credit control within an audit firm

#### 3.1 Obtaining professional work

Audit practices will want to increase the size of their client base as a means of increasing the profits of the practice. This can be achieved by:

- promoting their (good) reputation in the business community
- recommendations from existing clients
- advertising
- publicity and promotion (such as sponsorship activities).

#### 3.2 Advertising and publicity

When a professional accountant in public practice solicits new work through advertising or other forms of marketing, there may be a threat to compliance with the fundamental ethical principles. For example, a self-interest threat to compliance with the principle of professional behaviour is created if services, achievements, or products are marketed in a way that is inconsistent with that principle.

Advertising and publicity activities by accountancy firms are therefore regulated by IFAC and ICAN through their codes of ethics and conduct respectively. Note that ICAN has adopted all of IFAC's guidance in this matter.

The main requirements for marketing professional services are that the advertising and publicity material used by any firm:

- must not bring into disrepute the professional body, the firm or the profession as a whole
- should not make exaggerated claims for services offered, qualifications possessed or experience gained – it should be honest and truthful and not mislead
- must not discredit the services provided by other firms or make disparaging references to unsubstantiated comparisons to the work of another Chartered Accountant
- must not break any locally-recognised codes of advertising practice.

In addition, it is recommended that advertising and publicity material should avoid any reference to fees. If fees are mentioned, there should be a statement of the basis on which the fees are to be charged. Comments about fees:

- must not be misleading
- must not offer discounts, and

- must not make comparison with the fees of other service providers.

ICAN's Professional Code of Conduct and Guide for Members states that if a Chartered Accountant in public practice is in doubt whether a proposed form of advertising or marketing is appropriate, they should consult through the Registrar/Chief Executive of ICAN.

### 3.3 Fees

#### General approach

The question of setting a 'price' for the provision of a service is always a sensitive matter, because of disputes that may arise if the fees are unreasonable.

In establishing the fee for professional work, the accountant should follow professional guidance. In any case they must ensure they do not breach any of the fundamental ethical principles.

For example, a self-interest threat to professional competence and due care may be created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards for that price. Safeguards against threats may include:

- making the client aware of the terms of the engagement and, in particular, the basis on which fees are charged and which services are covered by the quoted fee (through the engagement letter); and
- assigning appropriate time and qualified staff to the task.

ICAN's Code of Conduct states that a member is entitled to charge for his services. Where the basis of a fee has not specifically been agreed then a member should charge a fee which is fair and reasonable taking into account:

- the seniority and professional expertise of the persons necessarily engaged in the work;
- the time expended by each;
- the degree of risk and responsibility which the work entails;
- the priority and importance of the work to the client together with any expenses properly incurred.

Firms should then charge the client the fee that they have quoted or the tender that the client has accepted, unless extra work is required. If extra work is required that was not expected when the original fee was agreed, the firm must provide an explanation to justify the higher fee.

#### Other ICAN code of conduct guidelines

ICAN's code of conduct provides further specific guidance regarding fees as follows:

- ICAN advises minimum charge-out rates in respect of fees for professional services which are intended to set a benchmark below which members are not ordinarily expected to charge
- A member should inform a client in writing prior to commencement of any engagement the basis upon which any fee he proposes to charge for his services will be calculated and, on request and where practicable, the level of fees likely to be charged for any assignment

- The member should discuss and explain the basis on which fees will be calculated, including the estimated initial fee, at the earliest opportunity. This discussion should be confirmed in writing, normally in an engagement letter.
- Firms should not quote a level of fees for new audit work which is lower than that charged by an existing auditor. Firms should also not quote by tender a level of fees which they have reason to believe is significantly lower than those quoted by other tendering firms. In both instances the firm's objectivity could be threatened.
- When performing audit work firms should ensure that their work complies with auditing standards and guidelines and, in particular, quality control procedures. In the event of a complaint being made to the Institute (which might have arisen as a result of a Professional Practice Monitoring Committee's inspection), where fees were a feature in obtaining or retaining the work, firms should be prepared to demonstrate that:
  - the work done was in accordance with Auditing Standards; and
  - the client was not misled as to the basis on which fees for the current and subsequent years were to be determined.
- A member whose fees have not been paid may be entitled to retain certain books and papers of a client upon which he has been working by exercising a lien and may refuse to pass on information to the client or his successor Chartered Accountant, until those fees are paid. However, a member who so acts should be prepared to take reasonable steps to resolve any dispute relating to the amount of that fee. The incoming auditor has a duty to assist in the recovery of such fees within a reasonable time.
- Fees should generally not be based on a percentage or on contingency calculations for audit work, reporting assignments and similar non-audit roles.

#### **Companies and allied matters act (CAMA)**

Section 408 of CAMA provides that the remuneration of auditors may be fixed by the directors, if the auditors are appointed by the directors. However, in other cases, the auditors' remuneration shall be fixed by the company at the annual general meeting or in such manner as the company in general meeting may determine. Remuneration in this context consists of the auditors' fees and expenses.

### **3.4 Tendering**

#### **Introduction**

Tendering is a commercial process widely-used by companies (especially larger companies) when they wish to change auditors. Tendering involves two or more audit firms being invited by a company to submit a proposal for its audit work. The invitation may or may not include the existing auditor.

This section describes the commercial tender process used by companies to select new auditors. Section 2 above addresses the specific legal and ethical mechanism associated with actually changing the auditor in Nigeria.

### Initial considerations

Tendering should commence only when a firm has been approached by a prospective client. In any case, a firm should not submit a tender for the work unless it can give satisfactory answers to the following questions:

- Does the firm have the expertise to carry out this audit?
- Does the firm have (or could it have) sufficient staff available at the appropriate time?
- Are there any ethical reasons why the firm could not act (for example, a problem with independence, or a conflict of interest)?
- Are there any problems, of which the firm is aware, with the current audit or auditors?

Specifically in relation to a tender, the firm should also ask itself:

- Why has it been asked to tender?
- Could it (and should it?) offer to do the audit for a lower fee than other firms are likely to quote?
- Are there any reasons why this audit is particularly attractive to the firm? For example, will the work be carried out at a quiet time of year, or is the company in an industry area where the firm wishes to develop its audit experience and expertise?
- What audit risks might arise with this particular client?

### The tendering process

The principal benefit to the client of a tendering process should be lower audit fees, because several firms are competing for the work.

In response to the pressure to reduce their fees, audit firms have become more efficient and lowered their costs. Even so, the tendering process can still be 'high risk' for a firm. For example:

- The firm needs to be confident that the client is one that it can deal with professionally and economically if the tender is accepted.
- If the tender is not accepted, the time and cost involved in the tendering process (which may be considerable) has been wasted. The firm needs to be sure that a sufficiently high proportion of its tenders will be successful, to justify the costs.

The tendering process should be broken down into the following stages (assuming that a firm is submitting a tender for the audit of a new client):

- Collect background information about the possible new client. (This is necessary when evaluating any new client, whether the fee is to be set by tender or by any other method.)
- Establish the precise scope of the work to be performed and the specific requirements of the prospective client.
- Carry out a preliminary audit risk assessment and prepare a preliminary plan for the audit. The plan must cover the staffing requirements and the time requirements for the work.
- Estimate a fee.

- Prepare a **submission document** for the potential client. The contents of this document will typically include:
  - an outline of the key characteristics of the firm
  - clarification of the nature of the audit work or other non-audit work to be performed
  - a statement of the requirements of the client and how the firm will comply with them
  - an outline of how the work will be performed
  - the proposed fee and the basis of its calculation
  - the range of other services which the firm could offer to the client.
- If required, prepare and give a presentation to the potential client.

#### Evaluating the tender

In evaluating the tender, the client (company) is likely to consider the following issues:

- Fees
- The services that the firm is able to provide
- Geographical locations and coverage of the firm's offices
- Expertise of the firm and its staff
- Reputation of the firm
- Whether the senior management of the company think that they will be able to work well (on a personal level) with the potential engagement partner and key audit staff
- The formal presentation itself by the audit firm
- The extent to which the company wants to change its audit firm, and its dissatisfaction with the current audit firm.

#### Lowballing

Lowballing is the practice of tendering for the audit work at a very low fee, with the objective of winning the audit. If it is successful in obtaining the audit, the firm will hope that:

- it will be able to raise the audit fee in future years, or
- it will be able to recover losses on the audit fee by providing other, more lucrative non-audit services.

Although there is no evidence that lowballing leads to a poor-quality audit, the fact that it exists does nothing to improve the reputation of the auditing profession. The existence of low fees may suggest to the business community and to the general public that audit work is of a low quality. All fees should be sufficiently adequate to compensate a firm for the work that it carries out.

### 3.5 Credit control within an audit firm

An audit firm does not just charge fees. It has to collect the fees that it charges. A failure to invoice clients promptly or a failure to collect payment within a reasonable time after the invoice date would be an indication of poor credit.

management. Any such management weaknesses should be corrected if they occur.

Occasionally, non-payment of fees may be due to the fact that the audit client is in financial difficulties and cannot pay.

- Overdue fees are a threat to the independence and objectivity of the auditor, because it might be argued that audit work has been provided free of charge. If the unpaid amount has been overdue for a long time, it could be regarded as a form of loan by the audit firm to the client.
- The risk to auditor independence could be significant if the unpaid amount is material.
- When a client is in temporary financial difficulties it is permissible for an auditor to make commercial arrangements for staged payments of the fees due. The client should be made aware, however, of the ethical problems that non-payment or late payment create for the audit firm.
- For future audits, if the audit engagement is retained, the auditor should pay particular attention to the going concern assumption. If the client still has continuing cash flow problems, the going concern assumption may be challenged.

When unpaid fees are owed by a client, and the period of late payment is in excess of what might be regarded as commercially acceptable, the audit firm should consider whether it would be ethically appropriate to resign as auditors.

- The ethics partner of the firm should be asked to assess the ethical threat to the firm's independence and integrity.
- If the decision is to continue as auditor of the client, the reason should be documented.
- The most recent audit papers should be checked to ensure that sufficient appropriate evidence was obtained to support the going concern assumption in the financial statements.

## 4 AGREEING THE TERMS OF AUDIT ENGAGEMENTS: ISA 210

### Section overview

- The objective of the engagement letter
- The content of the engagement letter
- Annual review of the engagement letter
- Acceptance of a change in the terms of the engagement

#### 4.1 The objective of the engagement letter

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

- establishing whether the preconditions for an audit are present; and
- confirming that there is a common understanding between the auditor and management.

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

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

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

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

#### 4.2 The content of the engagement letter

The engagement letter must include reference to the following:

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

Because it specifies what the auditor will be doing and what the auditor's exact responsibilities will be, the engagement letter is also seen to be an important way of reducing the 'expectation gap'. This is the difference between:

- the view of the role and responsibilities of the auditors that is held by the users of financial statements, and
- the auditor's actual (statutory) role and responsibilities.

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

- Regulations, ISAs, and ethical pronouncements.
- The fact that because of the inherent limitations of an audit, and the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected even though the audit was properly planned and performed in accordance with ISAs.
- Arrangements regarding the planning and performance of the audit, including the composition of the audit team.
- The expectation that management will provide written representations.
- The basis on which fees are computed and any billing arrangements.
- A request for management to acknowledge receipt of the engagement letter and to agree to its terms.
- Arrangements concerning the involvement of other auditors, experts or internal auditors (or other staff of the entity).
- Any restriction of the auditor's liability when such possibility exists.

Best practice also recommends that the engagement letter should include an explanation of the auditor's responsibility with regard to anti-money laundering checks and procedures.

#### 4.3 Annual review of the engagement letter

The engagement letter that is issued on the initial appointment of the firm as auditors may specify that its provisions will apply to all future audits, until it is revised.

However, ISA 210 **requires** the auditor, for recurring audits, to assess whether:

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

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

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

- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

#### 4.4 Acceptance of a change in the terms of the engagement

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

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

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

## 5 CHAPTER REVIEW

### Chapter review

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

- Describe the components of a system of quality control applied to a firm of accountants performing audit and assurance engagements
- Explain the process around changes in professional appointment including the legal, commercial and ethical considerations
- Apply ISA 210 in agreeing the terms of an engagement

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### Quick quiz questions

- 1 According to ISA 220, who should have the responsibility for key quality control matters and for the overall quality of the audit?
  - A The senior partner of the audit firm
  - B The board of directors of the client company
  - C The engagement partner
  - D The entire audit team
- 2 Which of the following items does a letter of engagement normally include?
  - 1 Statement of the auditor's duty to prepare the financial statements
  - 2 Basis of fees
  - 3 Auditor's unrestricted access to documents and records
  - 4 Provision of a letter of weakness (management letter)
  - A 1, 2 and 3 only
  - B 1, 3 and 4 only
  - C 2, 3 and 4 only
  - D 1, 2 and 4 only
- 3 Quality control procedures for **specific** audit engagements may be applied by means of:
  - A training of audit staff
  - B supervision of audit staff
  - C compliance with IFAC ethical rules
  - D monitoring the independence of audit staff
- 4 Client screening before accepting a new audit appointment involves:
  - A checking whether the firm has sufficient technical expertise to do the work
  - B checking whether a conflict of interests might exist
  - C taking up reference for the company and its directors if these are not known to the firm
  - D communicating with the previous auditors about the circumstances leading to the change of auditor
- 5 A review of an audit by the engagement partner should be carried out:
  - A after the audit report is signed and after a similar review by the audit senior'
  - B after the audit report is signed and before a similar review by the audit senior'
  - C after a similar review by the audit senior but before the audit report is signed'
  - D before a similar review by the audit senior and before the audit report is signed'

### Quick quiz answers

1 C

2 C

It is management's duty to prepare the financial statements, not the auditor's.

3 B

Quality control procedures specific to individual audit engagements involve the direction and supervision of staff and review of their work.

4 C

Before agreeing to accept a new audit engagement, the audit firm should consider several issues, including conflicts of interest and technical capacity to do the work. However, client screening is specifically checking the references provided by the company and its directors, when these are not known to the audit firm.

5 C

The review by the audit engagement partner takes place towards the end of the audit, before the audit report is signed. Usually, the audit senior carries out a similar review before the review by the engagement partner, in an attempt to anticipate issues that the engagement partner might raise.

CHAPTER  
**6**

## The audit approach

### Contents

- 1 Audit strategies
- 2 The business risk approach
- 3 The systems-based approach
- 4 The statement of financial position approach
- 5 Chapter review

## INTRODUCTION

### Competencies

#### Accepting professional engagements and managing assignments

- B1 (c)** Analyse and evaluate the potential issues that determine the nature, scope and extent of an assurance or audit engagement.

#### Planning and undertaking audit work

- C1 (a)** Analyse, evaluate and explain the key areas of a business that are important to understand in developing an effective strategy or plan based on a business scenario. (**ISA 300 – Planning an audit of financial statements**)
- C1 (b)** Analyse and evaluate the relevant techniques needed for an effective understanding of the audit work.
- C1 (k)** Analyse and evaluate how risk and materiality judgements affect the planning of an assurance or audit engagement, including the nature, timing and extent of work.
- C1 (l)** Develop an audit plan, justifying judgements made on an audit or assurance engagement based on a business scenario, including considerations relating to:
- Internal control assessments including information technology(IT)
- C1 (o)** Explain local and international frameworks for auditing and assurance work in private and public sectors.

#### Assessment of risks, internal controls, internal financial controls

- C2 (c)** Analyse the role of information technology control framework in internal control.

#### Application of information technology in auditing

- C5 (b)** Analyse the benefits of IT control frameworks in internal controls (example COBIT Framework).

### Exam context

It is critical that audit and assurance students appreciate the different strategies that can be adopted in performing an audit.

In this chapter students will gain a thorough understanding of the modern risk-based approach to auditing which represents the fundamental approach adopted in ISAs. You will also study in some depth the system of internal controls, also very relevant to modern audit strategy. Finally students will study the more traditional 'balance sheet approach'.

At the end of this chapter, readers should be able to:

- Summarise the different types of audit strategies and factors that impact which strategy is adopted
- Explain the business risk approach and be able to identify and assess business and financial risks
- Describe the systems-based approach and articulate the components of a system of internal control
- Summarise the statement of financial position approach

## 1 AUDIT STRATEGIES

### Section overview

- A choice of audit strategies
- Summary of available audit strategies
- Factors in the choice of audit strategy

#### 1.1 A choice of audit strategies

An audit strategy is the **overall approach** that the auditor decides to take for an audit, from which a detailed audit plan can be developed.

Several possible audit strategies are available:

- a business risk approach, or risk-based approach
- a systems-based approach
- a substantive testing approach
- a statement of financial position approach (usually for small entities).

These strategies are not mutually exclusive, and they may be used in combination. For example, although most of the work on a particular audit might be 'systems-based', the auditor will also carry out some substantive testing on balances and transactions.

The different approaches describe the emphasis of the audit approach, and where the auditor expects to find most of the evidence that he needs to reach an audit opinion about the 'fair presentation' or 'true and fair view' in the financial statements.

#### 1.2 Summary of available audit strategies

The main audit strategies are summarised in the following table. They will be described in more detail in the rest of the chapter.

Strategy/approach	Outline of approach
<b>Statement of financial position approach</b>	<ul style="list-style-type: none"><li>■ This audit approach concentrates on the statement of financial position figures using substantive testing, on the argument that if the opening and closing statements of financial position are accurate, then the profit or loss for the year must also be stated accurately.</li></ul>

Strategy/approach	Outline of approach
<b>Substantive testing approach</b>	<ul style="list-style-type: none"> <li>■ This approach focuses on applying substantive tests to a large number of transactions and account balances recorded in the accounting system of the client.</li> <li>■ This focus on recorded transactions and balances means that under-statements may not be detected. (The auditor may ignore transactions that have not been recorded.)</li> <li>■ This approach is time-consuming and costly for the audit of large companies.</li> <li>■ This approach is appropriate where systems and controls are weak or not operating. Substantive tests on transactions and balances are therefore necessary to reach an opinion about the financial statements.</li> <li>■ It is widely used for the audit of smaller entities where controls are likely to be weak.</li> <li>■ There is a danger of spending too much time auditing transactions or balances that are not material.</li> <li>■ There is a risk that misstatements in the financial transactions will not be detected unless <b>all</b> transactions and balances are tested, not just a sample.</li> </ul>
<b>Systems-based approach</b>	<ul style="list-style-type: none"> <li>■ The audit focus is on the <b>application of tests of control to the systems</b> that produce the figures in the financial statements, rather than on the figures themselves.</li> <li>■ A systems-based approach is supported by some degree of substantive testing, because of the unavoidable limitations or weaknesses in internal control systems. (The amount of substantive testing required will depend on the auditor's judgement about the effectiveness of the internal controls.)</li> <li>■ It is also supported by the use of analytical procedures.</li> <li>■ It is more cost-effective than a full substantive testing approach, but there is still a danger of doing too much unnecessary auditing of areas where controls are operating well.</li> </ul>

Strategy/approach	Outline of approach
Risk-based approach and business risk approach	<ul style="list-style-type: none"> <li>■ An assessment is made of the likelihood of material misstatements existing in each area of the audit.</li> <li>■ Areas that are assessed as high-risk are audited extensively (using substantive tests, a systems-based approach and analytical procedures).</li> <li>■ Areas assessed as low-risk are given a low level of attention in the audit.</li> <li>■ Auditing methods (applied mainly by large audit practices) focus on 'business risk' rather than overall 'audit risk'.</li> </ul>

### 1.3 Factors in the choice of audit strategy

The selection of the audit strategy will depend on a number of factors, including:

- the nature and size of the client's business: a business risk approach is best-suited for large companies, and a statement of financial position approach is usually the most suitable for small companies
- the control procedures and control environment in place: a systems-based approach is most suitable when there is a strong control environment and internal control system
- the audit methods and techniques favoured by the audit firm: for example, larger audit firms may favour a business risk approach.

You may be asked to select and justify an audit strategy for a particular client in the examination, in which case, students would be considering factors, such as those mentioned above.

## 2 THE BUSINESS RISK APPROACH

### Section overview

- The development of audit strategy and practices
- The meaning of the business risk approach
- The nature of the business risk approach
- Internal business risks and external business risks
- Risk evaluation
- Advantages and disadvantages of the business risk approach
- Comparison of business risk and financial statement risk

#### 2.1 The development of audit strategy and practices

Auditing practice has developed significantly over recent years. The main reasons have been:

- the increasing size and complexity of business units, and the challenges created for the audit process by size and complexity
- an attempt to improve the efficiency of the audit process.

The first major development in the 'normal' audit approach was a switch from an emphasis on substantive testing to a systems-based approach, that concentrates much more on internal control systems and the testing of systems and controls, and normally relies much less on substantive testing.

Then the concept of the 'risk-based' audit developed. In a risk-based audit, the auditor concentrates most of the audit work on areas of high overall audit risk. (As you know, audit risk is a combination of inherent risk, control risk and detection risk.)

More recently, larger audit practices in particular have developed a 'business risk' approach to audit work.

**Business risk is the threat that an event or development may adversely affect the ability of the entity to achieve its objectives.** It is the risk of an adverse development that could have a major impact on the company's business, such as the loss of a major customer, or an increase in the cost of a key commodity. An adverse business event is likely to affect the company's business significantly, and so should be expected to affect its financial statements.

Business risks are risks faced by management of the client entity, which could have an impact on the financial statements (including the going concern assumption).

## 2.2 The meaning of the business risk approach

The business risk approach involves the auditor looking **at the business as a whole** and carrying out an evaluation of the risks to which it may be exposed.

The auditor identifies the business risks which may have an impact on the financial statements of the client company. The general approach is to:

- identify the key business risks
- evaluate their possible impact on the financial statements
- plan the approach to the audit around the key business risks that have been identified.

This approach cannot work effectively unless the auditor has a good understanding of the client's business and the environment in which it operates. (Understanding the client's business and business environment is a requirement for all auditors, in ISA 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment*.)

## 2.3 The nature of the business risk approach

The business risk approach starts at an earlier stage than the 'conventional' audit risk model, which is based on inherent risks and control risks (and detection risks).

By looking at the nature of the client's business, the auditor should develop an understanding of the events and circumstances that may affect the entity's ability to meet its objectives. By understanding business risks, the auditor should also develop a better understanding of the inherent risks and the control risks facing the client.

The business risk approach is sometimes referred to as a '**top down**' approach to an audit.

- The approach starts 'at the top' with the business, which generates the financial transactions.
- The approach ends 'at the bottom' with the financial statements which record the outcome of the business transactions.

The business 'drives' the financial statements.

This is a 'high level' approach to the audit, and has similarities with business management and strategy. Using this approach to an audit successfully depends on having adequate and up-to-date information about the client's business and business environment.

For this reason, the larger auditing practices that use the business risk approach will often organise their audit teams into specialised industry groups, or may have industry experts available or may construct specialised databases for particular industries.

When the auditor takes a business risk approach he needs to be aware not only of the current position of the client's business, but also of possible future developments that may affect its goals and objectives.

**The auditor is interested in business risk not for its own sake, but in the light of its possible impact on the financial statements.**

## 2.4 Internal business risks and external business risks

With the business risk approach, the auditor must identify key business risks for the client company. Business risks may arise from the external environment in which a company operates, or from within the company itself.

### External business risks

Examples of **external** business risks might include the following:

- The possible loss of a major contract as a result of a dispute with the customer.
- Long-term decline in demand for the company's products, and failure to invest in research and development of new products.
- The impact of a new competitor moving into the market.
- The impact of proposed changes in laws and regulations: for example where a company needs a licence to operate (as in financial services) there may be a risk that the licence will be withdrawn or will not be renewed.
- The effect of recently discovered new technology.
- The effect of changes in the macro-economy, such as changes in interest rates or exchange rates, or a downturn in the economy (lower economic growth, or possibly an economic recession).
- The impact of natural hazards (such as storms and flooding that may affect the company's ability to maintain operational capacity).
- Threats from competitors to a company's patents or copyrights.

### Internal business risks

Examples of **internal** business risks might include the following:

- Risks arising from ineffective employees or weak management.
- The risks from a lack of customer care and attention to customer needs: poor customer awareness will eventually have an effect on sales demand.
- Poor financial management (such as excessive levels of gearing, poor cash management and poor working capital control).
- Lack of finance for capital expenditure on equipment replacement or modernisation.
- Risks due to systems weaknesses or system failures: internal control weaknesses.
- Risks from over-reliance on one or two key individuals.
- The risk of fraud or the misappropriation of assets.

The internal and external risks listed above are examples of risk, not a comprehensive list of business risks. In an examination question, you may be expected to identify key business risks (both external and internal) from the nature of the business and the facts given to you in the question.

For your examination, you need the ability to read a case study or scenario and:

- identify and explain business risks that are apparent in the information you are given, and

- explain how these risks have an impact on the company's ability to meet its objectives, and so have an impact on the audit.

Attempt your own answer to the following example before reading the answer provided.



**Example: Business risks**

Sting, a limited liability company, was incorporated in Ruritania on 1 June Year 1. In July, the company exercised an exclusive right that it had been granted by the government of Sordobia to provide daily flights direct between Zob (the capital city of Sordobia) and Polletta (the main commercial city of Ruritania).

The service has been widely advertised in the national newspapers of both countries as 'prompt, efficient and reliable'. As a result of these flights, it is expected that the travelling time between Zob and Polletta will be reduced by about eight to ten hours. This shortened travelling time should increase the volume of commerce and trade between the two countries.

Sting operates a refurbished 30-year-old aircraft. This is leased from an international airline and registered with the Sordobian Airways Authority (SAA). The SAA has a strict requirement that the engines of all aircraft on its register should be overhauled every two years. The overhaul of an aircraft engine usually puts the aircraft out of operational activity for up to five weeks.

The air craft can carry 20 First Class, 50 Business Class and 80 Economy Class passengers. It also has a large hold for transporting cargo, in addition to passenger luggage.

On-board meals for the three-hour journey are prepared in Zob under a contract with an airport catering company. Market research by Sting has shown that passengers are in general dissatisfied with the quality of in-flight food, especially on the Polletta to Zob flight.

Sting employs 12 full-time cabin crew attendants whose training in air-stewardship includes first aid training and medical procedures in the event that passengers are taken ill or injured during a flight. The captain and co-pilots for the aircraft are provided under contract by the international airline that leases the aircraft to Sting.

Flight tickets are sold by Sting (by telephone and at its offices and airport reception desks) and by travel agents in Ruritania and Sordobia. On several occasions there has been over-booking of Economy Class seats. When this happens, customers are upgraded to Business Class. At the moment there is spare capacity in First Class and Business Class on all flights. Ticket prices for each class depend on several factors, such as whether the tickets are refundable (so that customers get their money back if they cancel their trip), exchangeable (so that customers can exchange tickets on one flight for tickets on an earlier or later flight). Ticket prices also vary with the day of the week and time of year.

Sting has extensive insurance cover, including employer's liability insurance (against the risk of accidents to employees) and passenger liability insurance (against the risk of liability to passengers for death, injury, extensive flight delays and other risks).

**Required:**

Identify and explain the business risks facing Sting.

**Answer**

The business objective of Sting is to make profits from the provision of a daily air service between the two cities.

An analysis of business risks should identify what risks exist within the business of Sting that might threaten the successful achievement of this objective, and in doing so have an impact on the financial statements of Sting.

Key word or phrase in the text of the scenario	Business risk indicated
Exclusive right	Sting has a right to operate the flights, but there are presumably terms and conditions attached to this right that Sting must comply with. The risk is a risk of non-compliance with the terms and conditions, which might put into doubt the company's continued right to operate the flights.
Exclusiveright	Sting is currently operating a monopoly, but this may not always be the case and potential future competition could significantly affect the company's business.
	Widely advertised ...as 'prompt, Sting might not live up to its own efficient and reliable' advertising and might disappoint customers, affecting its business.
30 year-old aircraft	The age of the aircraft could cause operating problems if it needs frequent repair. The relatively old age might also mean that fuel consumption (and therefore costs) is higher.
Leased	Sting will have no means of operating its service if it does not keep up the lease payments.
Overhaul of an engine usually puts the aircraft out of operational activity for up to five weeks.	Sting must have the engine overhauled regularly under the regulations of the SAA, but this will mean a break in its services as there is only one plane.

Note that a case study might include information about problems that are not sufficient to justify the attention of the auditors. There are three examples here: the quality of in-flight food, over-selling Economy Class tickets and having to upgrade some passengers to Business Class, and the need to obtain insurance.

## 2.5 Risk evaluation

Not all risks are of equal significance. The significance of a risk to the auditors depends on two factors:

- The 'impact' that it will have on the financial statements if an adverse event occurs. It is the 'size' of the risk. In an auditing context, this could be broadly interpreted as the 'materiality' of the risk.

- The likelihood or probability that an adverse event will occur so that the risk becomes 'reality'.

Auditors may use a standard model to assist them to rank risks in order of importance. The model below is widely used in management and strategy areas – it is not specifically an auditing model.

	High likelihood	Low likelihood
High impact	Category 1 risk	Category 2 risk
Low impact	Category 3 risk	Category 4 risk

Most of the emphasis in an audit will be placed on risks in Category 1, where the impact of an adverse event and the probability that it will happen are both high. The least emphasis will be placed on risks in Category 4, because the impact of an adverse event will be small and the probability of it happening is low. Ranking risks in categories 2 and 3 in order of seriousness/priority will depend on the judgement of the auditor.

## 2.6 Advantages and disadvantages of the business risk approach

The business risk approach has some advantages and also some disadvantages.

### Advantages

- The approach requires the auditors to acquire an in-depth knowledge of the client's business. This should make the auditors more knowledgeable, and able to make a better judgement about the client's financial statements.
- When the business environment is changing rapidly, a business risk approach keeps the auditor up-to-date.
- Evidence suggests that major audit problems are more likely to result from business-related problems than from internal control weaknesses.
- A business risk approach may allow the auditor to 'add value' by making effective recommendations to improve the performance of the client's business.
- Audit costs may be reduced, because there is less audit testing, which saves time, especially the time of junior audit staff.
- The approach may benefit the auditor's own business, because its use of a 'modern' business risk approach may differentiate the firm's audit services from those of its competitors.

### Disadvantages

- The business risk approach requires audit staff with suitable experience, including partners and managers. The time of these individuals is expensive. This may offset some of the cost savings (mentioned above) from a reduced need for junior audit staff.
- The business risk approach requires a closer involvement by the auditor in the client's business. This may raise questions about auditor independence.
- Some auditors feel uneasy about the 'broad' view taken by the business risk approach, and consider a systems-based view to be more appropriate for reaching an opinion on the financial statements.
- The approach may be effective only for the audits of larger companies.

## 2.7 Comparison of business risk and financial statement risk

Business risk is a risk that the business entity will fail to meet its objectives. Financial statement risk is the risk that the financial statements will not give a true and fair view, due to misstatements and omissions.

There is normally a close connection between these two categories of risk.

- When there is a significant business risk, failure by management to deal with the risk could affect items in the financial statements. For example, a risk from declining sales demand for a product should raise questions about the obsolescence of product inventories and the realistic useful economic life and net realisable value of the non-current assets that make the product. The going concern assumption may be challenged, if the product has been a major source of income and profit in the past.
- Weaknesses in internal control are a business risk which could result in misstatements in the financial statements.

### Example: Business risk and financial risk

An audit team has just completed the audit of an important client. One of the risks they identified is as follows:

The client's new research laboratory was threatened with closure due to failure by the company to obtain official planning permission for its construction. The laboratory was therefore constructed illegally, and there was the risk that it would have to be demolished.

- The business risk was the risk that the laboratory would be forced to close, for regulatory reasons.
- The financial statement risk was that if this were to happen, the value of the laboratory (and possibly all the equipment within it) would be overstated in the accounts and should be written down substantially in value, possibly to ₦0.

Both business risk and financial risk should be assessed by the auditor, in order to assess the elements of the financial statements where misstatement is most likely to happen.

### 3 THE SYSTEMS-BASED APPROACH

#### Section overview

- The nature of a systems-based approach to an audit
- What makes an effective system of internal controls?
- The control environment
- The entity's risk assessment process
- The information system
- Control activities
- Monitoring of controls
- How the auditor uses internal controls
- The auditor's evaluation of internal controls
- Summary of the approach to reliance on internal controls

#### 3.1 The nature of a systems-based approach to an audit

A systems-based approach to an audit focuses on the internal control system of the client company and the adequacy of its internal controls.

As part of his risk assessment exercise, the auditor is required by ISA 315 to 'obtain an understanding of the entity and its environment, including its internal controls.'

It is the responsibility of management to put in place a suitable system of internal control, to address identified financial statement risks, operational risks and compliance risks. Effective internal controls, provided that they are implemented properly, should ensure:

- reliable financial reporting;
- the effectiveness and efficiency of operations; and
- compliance with appropriate laws and regulations.

#### The effectiveness of internal controls: testing the controls for effectiveness

With a systems-based approach, the auditor **aims to rely** on the accounting systems and the related internal controls to ensure that transactions are properly recorded.

- His assumption is that if the systems and the internal controls are adequate, the transactions should be processed correctly, and the financial statements should therefore give a true and fair view.
- The audit emphasis is therefore, as much as possible, on the systems that process the transactions rather than on the transactions themselves.

Before the auditor can rely on the systems and controls that are in place, he must establish what those systems and controls are, and carry out an evaluation of the effectiveness of the controls.

### **3.2 What makes an effective system of internal controls?**

ISA 315 identifies five components which together make up an internal control system. These are:

- the control environment;
- the entity's risk assessment process;
- the information system;
- control activities (internal controls); and
- the review and monitoring of controls.

### **3.3 The control environment**

The 'control environment' is often referred to as the general 'attitude' to internal control of management and employees in the organisation.

The control environment has been defined by the Institute of Internal Auditors as follows: "the attitude and actions of the board [of directors] and management regarding the significance of control within the organisation. The control environment provides the discipline and structure for the achievement of the primary objectives of the system of internal control. The control environment includes the following elements:

- integrity and ethical values;
- management's philosophy and operating style;
- organisational structure;
- assignment of authority and responsibility;
- human resource policies and practice; and
- competence of personnel."

A strong control environment is typically one where management shows a high level of commitment to establishing and operating sound controls.

The existence of a strong control environment cannot guarantee that controls are operating effectively, but it is seen as a positive factor in the auditor's risk assessment process. Without a strong control environment, the control system as a whole is likely to be weak.

#### **Evaluating the control environment**

ISA 315 requires auditors to gain an understanding of the control environment. Part of this understanding involves the auditor evaluating the control environment, and assessing its effectiveness.

In evaluating the control environment, the auditor should consider such factors as:

- management participation in the control process, including participation by the board of directors;
- management's commitment to a control culture;
- the existence of an appropriate organisation structure with clear divisions of authority and responsibility;
- an organisation culture that expects ethically-acceptable behaviour from its managers and employees; and

- appropriate human resource policies, covering recruitment, training, development and motivation, which reflect a commitment to quality and competence in the organisation.

### 3.4 The entity's risk assessment process

Within a strong system of internal control, management should identify, assess and manage business risks, on a continual basis. Significant business risks are any events or omissions that may prevent the entity from achieving its objectives.

Identifying risks means recognising the existence of risks or potential risks. Assessing the risks means deciding whether the risks are significant, and possibly ranking risks in order of significance. Managing risks means developing and implementing controls and other measures to deal with those risks.

ISA 315 requires the auditor to gain an understanding of these risk assessment processes used by the client company's management, to the extent that those risk assessment processes may affect the financial reporting process.

The quality of the risk assessment and management process within the client company can be used by the auditor to assess the overall level of audit risk. If management has no such process in place, the auditor will need to do more work on this aspect of the audit planning.

### 3.5 The information system

ISA 315 requires the auditor to gain an understanding of the business information systems (including the accounting systems) used by management to the extent that they may affect the financial reporting process.

This aspect of the auditor's work will involve identifying and understanding the following:

- the entity's principal business transactions;
- how these transactions and other events relevant to the financial reporting process are 'captured' (identified and recorded) by the entity;
- the processing methods, both manual and electronic, applied to those transactions;
- the accounting records used, both manual and electronic, to support the figures appearing in the financial statements;
- the processes used in the preparation of the financial statements; and
- The IT risk management processes and how risks to cybersecurity are managed.

The information system therefore consists of:

- infrastructure (physical and hardware components) – manual accounting systems may have little infrastructure;
- software (in IT-based accounting systems);
- people;
- procedures; and
- data.

The existence of an accepted framework such as COBIT used for systems development may provide additional assurance to the auditor in their assessment of the client's information system.



#### Illustration: COBIT

COBIT is a globally accepted suite of tools that a client might use in order to ensure IT is working effectively. Collectively they provide a framework for integrating industry standards and good practice in the development of IT systems. COBIT is all about doing the right things the right way in order to deliver benefits to the client including:

- More effective management of IT ensuring that the client's business follows best practice;
- Ensuring the IT associated with growing or new areas of the business is effective;
- Enabling the client's business to be compliant with regulations; and
- Increasing the confidence of the client's suppliers and customers with regard to the security and quality of their data.

The benefits of this include:

- Increased reliability of IT operations and reduction of IT risks (e.g. hacking); and
- Increased efficiency of audit as auditors have assurance over the IT systems.

The auditor should understand the development background of the client's information system to help the masses how robust it is and how strong the associated financial controls are. The key question they need to answer is whether the information system is capable of recording and maintaining accounting information that will enable a set of financial statements to be extracted that reflects the underlying transactions recorded in the system.

COBIT is described in more detail in chapter 7.

### 3.6 Control activities

**Control activities** are the practices and procedures, other than the control environment, used to ensure that the entity's objectives are achieved. They are the application of internal controls.

Control activities are the specific procedures designed:

- to prevent errors that may arise in processing information, or
- to detect and correct errors that may arise in processing information.

#### Categories of control activities (internal controls)

Internal controls include the following types: (In the examination, if you are asked to suggest suitable internal controls within a given system the items in this list should provide a useful checklist.)

- Authorisation controls.** These require that all significant transactions must be authorised by a manager at an appropriate level in the organisation.
- Physical controls** over assets. These are controls for safeguarding assets from unauthorised use, or from theft or damage. An example is limiting access to inventory areas to a restricted number of authorised personnel.
- Arithmetic controls.** These are checks on the arithmetical accuracy of processing. An example is checking invoices from suppliers, to make sure that the amount payable has been calculated correctly.

- Accounting controls.** These are controls that are provided within accounting procedures to ensure the accuracy or completeness of records. An example is the use of control account reconciliations to check the accuracy of total trade receivables or total trade payables.
- Management controls.** These are controls applied by management. They include supervision by management of the work of subordinates, management review of performance and control reporting (including management accounting techniques such as standards setting, variance analysis, budgeting and budgetary control).
- Segregation of duties.** This type of control is explained below.

#### Segregation of duties

Segregation of duties means dividing the work to be done between two or more individuals, so that the work done by one individual acts as a check on the work of the others. This reduces the risk of error or fraud.

- If several individuals are involved in the completion of an overall task, this increases the likelihood that errors will be detected when they are made. Individuals can often spot mistakes of other people more easily than they can identify their own mistakes.
- It is more difficult for a person to commit fraud, because a colleague may identify suspicious transactions by a colleague who is trying to commit a fraud.

### 3.7 Monitoring of controls

It is important within an internal control system that management should review and monitor the operation of the controls, on a systematic basis, to satisfy themselves that the controls remain adequate and that they are being applied properly. ISA 315 requires the auditor to obtain an understanding of this monitoring process.

### 3.8 How the auditor uses internal controls

When a client operates an effective system of internal control the most efficient method of generating audit evidence normally involves the testing of controls where possible (rather than substantive procedures). 'Systems-based' techniques therefore complement the business risk approach described above in an effort to maximise audit efficiency and focus testing on the higher risk areas.

The auditor **relies** on the accounting systems and the related controls to ensure that transactions are properly recorded. The audit emphasis is therefore, as much as possible, on the systems processing the transactions rather than on the transactions themselves.

#### Understanding the controls

ISA 315 requires the auditor to obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

ISA 315 requires the auditor to:

- gain an understanding of each of the five components of the client's internal control system, and
- document the relevant features of the controlsystems.

Once this understanding has been gained, the auditor should confirm that his understanding is correct by performing '**walk-through procedures**' on each major type of transaction (for example, sales transactions, purchase transactions, payroll).

Walk-through testing involves the auditor selecting a small sample of transactions and following them through the various stages in their processing in order to establish whether his understanding of the process is correct.

If he understands the controls that are in place, the auditor can go on to assess their effectiveness, and the extent to which he can rely on those controls for the purpose of the audit.

#### **Assessing the effectiveness of controls**

The degree of effectiveness of an internal control system will depend on the following two factors:

- The **design of the internal control system** and the individual internal controls. Is the control system able to prevent material misstatements, or is it able to detect and correct material misstatements if they occur? Do the internal controls appear to be adequate and effective 'on paper'?
- The proper **implementation of the controls**. Controls are not effective unless they are implemented properly. So are the controls operated properly by the client's management and other employees?

The outcome of this evaluation helps the auditor to assess the **control risk**. This is the risk that the internal controls will fail to prevent or detect and correct errors in the financial statements. This evaluation will allow the auditor to decide on the extent to which he can take a systems-based approach to the audit.

### **3.9 The auditor's evaluation of internal controls**

The auditor may judge that the control risk is high, or that the control risk is low because the internal controls are effective.

- If the auditor assesses the control risk as **very high**, he will probably take the view that a systems-based audit approach will not be appropriate. He will therefore move on to detailed testing of transactions and balances (and take a **substantive testing** approach to the audit).
- Before he can assess the control risk as **low**, the auditor must be satisfied that the controls are well-designed and should be effective (in other words, they seem effective 'on paper'). Even if the controls appear to be acceptable on paper, the auditor cannot rely on them and perform a systems-based audit unless he is confident that the controls are actually working in practice. In this situation, the next stage in the audit process is to carry out **tests of controls**.

If the outcome of the tests of control indicates that controls are actually operating effectively, the audit can use a systems-based approach, with a reduced amount of substantive testing. Even if the internal control system seems to be effective, the auditor will never rely 100% on his assessment of the controls. He will always do some substantive testing before reaching his conclusion about the financial statements.

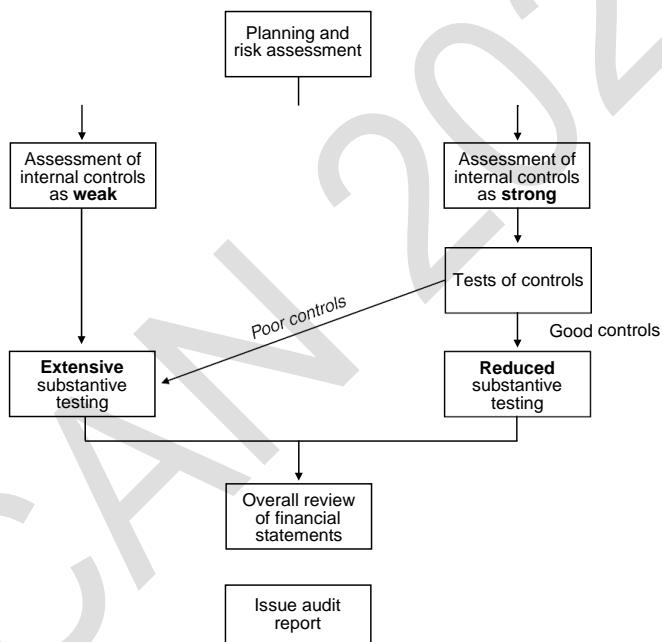
This is because of the limitations that are inherent in **all** control systems. It is impossible to avoid the risk of control failure that is caused by:

- human error (and a failure to apply a control properly)
- over-riding of controls by management (which is a deliberate decision to ignore a control), and
- the possibility of collusion and fraud.

Auditors will always supplement their work on systems with some substantive testing. The amount of this testing will depend on the auditor's evaluation of the effectiveness of the controls.

### 3.10 Summary of the approach to reliance on internal controls

The auditor's use of a systems-based approach to an audit is summarised in the following flow chart:



## 4 THE STATEMENT OF FINANCIAL POSITION APPROACH

### Section overview

- Substantive tests
- The statement of financial position approach
- Smaller entities

#### 4.1 Substantive tests

When an auditor assesses the control risk as high, he will not be able to adopt a systems-based approach to the audit. Instead he will carry out extensive substantive testing.

**Substantive tests** are audit procedures performed to detect material misstatements in the figures reported in the financial statements. They are designed to obtain evidence about the financial statement assertions. They include:

- tests of detail on transactions, account balances and disclosures, and
- analytical procedures.

#### 4.2 The statement of financial position approach

The **statement of financial position approach** is also an approach to the audit based wholly on substantive testing. However, with this approach the auditor concentrates primarily on:

- testing **balances**, as opposed to
- testing balances and transactions.

It is an approach that is often well-suited to small companies and to companies where assets and liabilities are substantial in relation to transactions (e.g. investment companies).

This approach is based on the following accounting equation:

Opening net assets + Profit for the year = Closing net assets

The theory is that if the opening and closing statements of financial position are 'correct' then the profit for the year must also be correct.

#### 4.3 Smaller entities

ISAs apply to the audits of all entities – whatever their size. However, additional considerations specific to audits of smaller entities are included within the application and other explanatory material of a ISAs, where appropriate. These additional considerations assist in the application of the requirements of the ISA in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of the ISAs.



### Definition: Small entity

The IAASB's *Glossary of terms* defines a *smaller entity* as one which typically possesses the following characteristics:

- Concentration of ownership and management in a small number of individuals (often a single owner-manager)
- One or more of the following:
  - Uncomplicated transactions
  - Simple record-keeping
  - Few lines of business/products
  - Few internal controls
  - Few levels of management with responsibility for a broad range of controls
  - Few personnel, many having a wide range of duties.

Nigerian Auditing Practice Statement (NAPS) 2 defines small entities as an entity where:

- One or more of the following are also found:
  - Few sources of income
  - Unsophisticated record keeping
  - Limited internal controls together with the potential for management override of controls

Many of the control activities that would typically be found in a large company may be inappropriate, too costly or impractical for a small entity. Segregation of duties is an obvious example of this. Smaller entities do not have enough employees for an 'ideal' segregation of duties.

Often, control systems in smaller entities are based on a high level of involvement in day-to-day operations by the directors or owners of the company. Authorisation controls and review controls, with the owner-manager personally authorising many transactions, might therefore be a key feature of the control systems in smaller entities.

Although the active involvement of an owner-manager might mitigate risks arising from a lack of segregation of duties, the auditor will often see the involvement of an owner-manager in day-to-day operations as only a partial substitute for 'normal' control systems. The following problems may arise in such types of businesses:

- There may be a lack of evidence as to how systems are supposed to operate. The auditor will need to rely more on inquiry than on review of documentation.
- There may be a lack of evidence of the application of controls in practice (for example, authorisations may not be documented).
- Management may override whatever internal controls are in place.
- Management may lack the expertise necessary to control the entity effectively and efficiently.

- There is unlikely to be any independent person within the management team as there would be within “those charged with governance” in a larger entity.

The attitudes and actions of the owner-manager will be key to the auditor's risk assessment. There is unlikely to be a written code of conduct so a culture of integrity and ethical behaviour, as demonstrated by management example, will be important.

The auditor needs to understand and evaluate whatever controls are in place and plan his audit work accordingly. However, it is likely that a lower level of reliance will be placed on controls in a smaller entity, which means that a considerable amount of substantive testing will be needed.

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## 5 CHAPTER REVIEW

### Chapter review

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

- Summarise the different types of audit strategies and factors that impact which strategy is adopted
- Explain the business risk approach and be able to identify and assess business and financial risks
- Describe the systems-based approach and articulate the components of a system of internal control
- Summarise the statement of financial position approach

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### Quick quiz questions

- 1 If inherent risks and control risks are high, which of the following is MOST likely?
  - A A business risk approach to the audit
  - B A substantive approach to the audit
  - C A modified audit report
  - D Greater reliance on the work of internal audit.
  
- 2 The five components of an internal control system identified by ISA315 are the control environment, the risk assessment process, internal controls, monitoring of controls and:
  - A the information system
  - B management responsibility
  - C personnel
  - D the organization structure
  
- 3 Which of the following statements are correct?
  - 1 Substantive testing is not required provided that internal controls are strong.
  - 2 Extended substantive testing is required whenever internal controls are weak.
  - A Statement 1 only is correct.
  - B Statement 2 only is correct.
  - C Both statements are correct.
  - D Neither statement is correct.
  
- 4 What is the purpose of walk-through tests in an audit?
  - A They are used for substantive testing of transactions.
  - B They are used to select samples of items for substantive testing.
  - C They are used by the auditor to learn about a process and its controls.
  - D They are used by the auditor to check their understanding of a process and its controls.
  
- 5 Which one of the following is considered to be a key problem with auditing small entities?
  - A Directors may not work as hard in large companies
  - B Management may override internal controls that exist
  - C The organisation may have a poor cash flow forecasting system
  - D The staff may be unhelpful

**Quick quiz answers**

1 B

If inherent and control risks are high, then a substantive approach is likely, involving much detailed testing of transactions and balances. A business risk approach is unlikely to be appropriate due to the scale of the risks and the need to reduce audit risk to an acceptable level.

2 A

ISA 315 identifies five components of internal control: the control environment, the entity's risk assessment process, the information system, control activities and the monitoring of controls.

3 B

Some substantive tests are needed even when internal controls are strong.

4 D

Walk through tests are used by the auditor to check their understanding of a process and its controls. This helps them to assess the effectiveness of those controls, and decide on the extent to which the auditor can rely on those controls (and the amount of substantive testing that will be required).

5 B

Regardless of how well-designed internal controls are, they are of limited use if management can override them, as often occurs in small companies.

CHAPTER  
**7**

## **Planning**

### **Contents**

- 1 The audit plan (strategy document)
- 2 Audit risk
- 3 Materiality
- 4 Computers in auditing
- 5 Not-for-profit organisations
- 6 Chapter review

## INTRODUCTION

### Competencies

#### Accepting professional engagements and managing assignments

- B1 (c)** Analyse and evaluate the potential issues that determine the nature, scope and extent of an assurance or audit engagement.

#### Planning and undertaking audit work

- C1 (a)** Analyse, evaluate and explain the key areas of a business that are important to understand in developing an effective strategy or plan based on a business scenario. (**ISA 300 – Planning an audit of financial statements**)
- C1 (b)** Analyse and evaluate the relevant techniques needed for an effective understanding of the audit work.
- C1 (d)** Evaluate and advise on elements of audit risks, including inherent and control (risk of material misstatement), sampling and non-sampling (detection risk) and their relationships with audit planning procedures (**ISA 315 – Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment**).
- C1 (e)** Identify and evaluate the components of risk for any assurance engagement.
- C1 (f)** Evaluate and explain how business process effectiveness may affect an audit assignment.
- C1 (g)** Identify and evaluate the risks arising from accounting manipulation, error, fraud or other irregularities in a business scenario.
- C1 (h)** Identify and evaluate the risks arising from business and financial issues in a business scenario.
- C1 (i)** Evaluate and apply judgements and measures of materiality in carrying out an audit or assurance engagement (**ISA 320 – Materiality in Planning and Performing an Audit**).
- C1 (k)** Analyse and evaluate how risk and materiality judgements affect the planning of an assurance or audit engagement, including the nature, timing and extent of work.
- C1 (l)** Develop an audit plan, justifying judgements made on an audit or assurance engagement based on a business scenario, including considerations relating to:
- Materiality decisions
  - Internal control assessments including information technology (IT);
- C1 (n)** Describe the differences between assurance engagements and audit engagements for profit and not-for profit entities including those in the public sector.
- C1 (o)** Explain local and international frameworks for auditing and assurance work in private and public sectors.

#### Assessment of risks, internal controls, internal financial controls

- C2 (a)** Identify and assess reporting and compliance risks in the context of an assurance or audit engagement in the public or private sector based on a given business scenario.

### Specialised audits and investigations

- C4 (a)** Understanding special features of certain types of audit and investigation situations.
- C 4(a) ii Not-for-profit organisations – charities, non-governmental organisations (NGOs)**
- Identify and explain various types and objectives of not-for-profit organisations
  - Explain how the audit of a not-for-profit organisation differs from the audit of a profit-oriented organisation.
  - Assess the audit risks associated with not-for-profit organisations.
  - Develop plans and procedures for the audit of not-for-profit organisations.
  - Suggest various control measures that can be applied by a not-for-profit organisation in its operations.
  - Determine the form and contents of audit report for a not-for-profit organisation.

### Application of information technology in auditing

- C5 (a)** Explain the impact of IT in an auditing environment.

### Exam context

Planning is a fundamental phase of any audit and assurance engagement in Nigeria and other jurisdictions. This chapter expands on the basic introduction to planning that students studied previously and provides comprehensive notes on the audit plan, audit strategy, audit risk and materiality.

Given the ever-increasing relevance of computers to both practitioners and their clients in Nigeria and beyond, the chapter closes with a section on computers in auditing.

At the end of this chapter, readers should be able to:

- Describe how to plan an audit engagement;
- Explain the various components of audit risk;
- Discuss the principles and application of materiality;
- Articulate the relevance of computers to auditing;
- Describe and critically assess general and application computer controls.

## 1 THE AUDIT PLAN (STRATEGY DOCUMENT)

### Section overview

- ISA 200: Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing
- The need for an audit plan (strategy document)
- ISA 300: Planning an audit of financial statements
- Audit strategy memorandum
- Information required to effectively plan an assignment

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

As you saw in your earlier studies, the **objectives** of the auditor, per ISA 200 are:

- to obtain **reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. This allows the auditor to give an opinion on whether the financial statements have been prepared in accordance with the applicable financial reporting framework.
- to report on the **financial statements**, and communicate as required by the ISAs, in accordance with the auditor's findings.

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

ISA 200 **requires** the auditor to:

- comply with all **ISAs** relevant to the audit
- comply with relevant **ethical requirements**
- plan and perform an audit with **professional scepticism**
- exercise **professional judgement** in planning and performing an audit
- obtain **sufficient and appropriate audit evidence** to allow him to obtain reasonable assurance

### 1.2 The need for an audit plan (strategy document)

A plan is a course of action, decided in advance, to achieve a stated goal or objective. A plan is necessary for each audit so that the auditor can decide in advance what needs to be done so that (by the required date for completion of the audit) he will be able to express an opinion on the truth and fairness of the financial statements and achieve the objectives of ISA 200.

The extent and type of audit work performed is determined largely by the professional judgement of the auditor. The planning process enables the auditor to apply his judgement to the circumstances of the particular audit to decide how the audit will be conducted.

A starting point for the audit plan is deciding which audit strategy to adopt. The auditor will need to consider, amongst other things:

- audit risk (including control risk)
- materiality
- the use he might make of computers, and the effect that the client's computer-based system might have on his audit approach.

These factors are described in the rest of this chapter.

### 1.3 ISA 300: Planning an audit of financial statements

The auditor's work on planning is regulated primarily by ISA 300 *Planning an audit of financial statements*, which requires the auditor to plan the audit so that the audit work will be performed in an effective manner. An overall audit plan should be developed, detailing the expected scope of the audit and how the audit should be conducted.

ISA 300 states that:

- an audit should be planned so that it is performed effectively
- the auditor should establish an overall audit strategy, and
- the audit plan should include measures for the direction, supervision and review of audit work.

### 1.4 Audit strategy memorandum

Most auditors prepare an **audit strategy memorandum**. This is a document setting out the main points involved in the planning process and the key planning decisions that have been taken.

The memorandum will cover the following areas:

- The assignment objectives and reports to be issued.
- The audit timetable, to meet the required reporting deadlines for the auditor's report.
- Changes in the client's organisation or business, or external ('environmental') changes affecting the client's business, since the previous audit.
- A summary of key financial ratios and other ratios from previous years.
- Planning decisions for the audit.
- The use that will be made of the client's staff in the audit (for example, internal auditors) and the use that will be made of external experts.
- Possible problem areas in the audit and the approach to be adopted to deal with them.
- Staffing requirements for the audit, the planned allocation of the work between members of the audit team, time budgets and records from previous audits.
- Attendance locations (if the client has more than one location).
- Proposed methods of communication with the client (for example, meeting/reports).

The memorandum should be reviewed and approved by the audit engagement partner.

## 1.5 Information required to effectively plan an assignment

### Relevant information

ISA 300 Planning an Audit of Financial Statements requires the auditor to prepare an audit strategy and an audit plan. ISA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment requires that the auditor has sufficient understanding of the entity and its environment in order to understand the risks of material misstatement within the client's financial statements.

In order to satisfy the requirements of both of these ISAs the auditor will need to access a wide number of information sources. Remember that every assignment and client is different so the auditor (and you in the exam!) will need to use initiative and judgement in assessing relevant and reliable information to assist in the planning.

Note too that during the 'planning' phase we are not yet performing the responses to the assessed risks of material misstatement – i.e. the detailed audit tests. These occur at a later stage (as directed by ISA 330 *The Auditor's Responses to Assessed Risks*) so the auditor must balance efficiency and sufficiency during the planning phase to ensure they do not invest time in information and matters that are not relevant to the planning of an assignment.

A common exam requirement involves a scenario that misses out some information that would be relevant to the auditor either for planning or executing the audit. You may be asked to identify any additional information required. For example:

- Obtain a copy of a new loan agreement with the bank to ensure that details of any overdraft limit and debt covenants are understood and whether any breaches have occurred;
- Review legal correspondence between the client and its legal advisors regarding an incident that occurred during the year to establish the impact of the incident on the financial statements;
- Review details of any significant new sales contracts agreed with key clients;
- Obtain a copy of prior years' financial statements in order to review the accounting policies used and any provisions and contingent liabilities recognised in the accounts relating to financial instruments, pension obligations and legal cases.

### Non-relevant information

Remember that the objective of the audit is to identify whether material misstatement exists in the financial statements. Therefore information relating to immaterial matters or operational matters that will not assist in concluding whether a material misstatement exists in the financial statements may not be relevant for audit planning.

You will encounter other types of non-audit engagement in this syllabus such as reviews, assurance engagements, compilations and agreed-upon procedures where information not relevant to audit planning may still be relevant to other types of assignment.

## 2 AUDIT RISK

### Section overview

- Risk-based approach to auditing
- The audit risk model
- Inherent risk
- Control risk
- Detection risk
- Audit risk assessment: a summary
- The connection between business risk, financial statement risk and audit risk

#### 2.1 Risk-based approach to auditing

A key feature of modern auditing is the 'risk-based' approach that is taken in most audits. At the planning stage, as required by ISAs 300 and 315, the auditor will identify and assess the main risks associated with the business to be audited. The auditor will then design and implement appropriate responses to those assessed risks in accordance with ISA 330 *The auditor's responses to assessed risks* including:

- Overall responses
- Audit procedures responsive to the assessed risks of material misstatement at the assertion level (i.e. appropriate mix of tests of controls and/or substantive procedures)

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

The auditor shall also consider whether external confirmation procedures (covered by ISA 505 *External confirmations*) are to be performed as substantive audit procedures.

The risk-based approach to auditing should enable the auditor to then conclude whether a 'true and fair view' is presented by the financial statements.

#### 2.2 The audit risk model

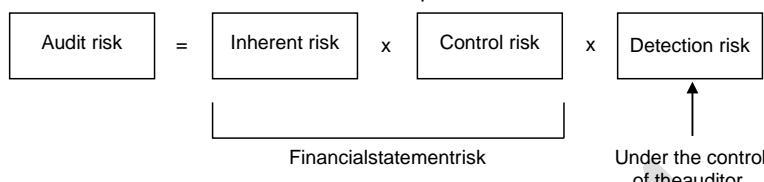
A standard audit risk model is available to help auditors to identify and quantify the main elements making up overall audit risk.

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

The audit process is designed to give a **high level of assurance** about the information that is subject to audit. However, the audit process does not give an absolute level of assurance, that the information is 100% correct.

The implication of this is that the auditor will seek to reduce the level of audit risk to an 'acceptable' level, but will not attempt to eliminate audit risk entirely.

If the auditor is to 'manage' risk effectively, he needs to be able to measure the risk attached to any given audit situation, and establish a maximum acceptable limit to the audit risk. This led to the development of the **audit risk model**.



This model can be stated as a formula:

$$AR = IR \times CR \times DR$$

where:

AR = audit risk

IR = inherent risk

CR = control risk, and

DR = detection risk.

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

### 2.3 Inherent risk

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

- the nature of the items themselves: for example, estimated items are inherently risky because their measurement depends on an estimate rather than a precise measure; or
- the nature of the entity and the industry in which it operates. For example, a company in the construction industry operates in a volatile and high-risk environment, and items in its financial statements are more likely to be misstated than items in the financial statements of companies in a more low-risk environment, such as a manufacturer of food and drink.

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

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

#### The assessment of inherent risk

The auditor's assessment of inherent risk will be based mainly on:

- the knowledge gained from previous audits, and
- an assessment of the current environment within which the entity operates.

It is normal practice to assess inherent risk at two 'levels':

- the financial statement level, and
- the account balances and transactions level.

At **the financial statement level**, the auditor will consider the inherent risk in the client's business, such as:

- the integrity, skills and abilities of the management
- the nature of the business
- industry-wide and macroeconomic factors.

At **the account balances and transactions level**, the auditor will consider:

- the degree of subjectivity involved in the account balance or the transaction
- the degree of complexity of a transaction and how it is processed
- the characteristics of the client's assets and the level of risk that they may be misappropriated.

#### **Example: Inherent risk**

It is difficult to provide a comprehensive list of inherent risks, but you may be required to identify one or more such risks within a case-study type of examination question.

For example, suppose that the CEO of an audit client company is also a majority shareholder of the company, and you are aware that he intends to sell some of his shares soon after the financial statements are approved and issued. In this situation there would be an inherent risk at the financial statement level, arising from the fact that the CEO/majority shareholder has a personal interest in presenting favourable financial statements – the reported profit for the year or the reported statement of financial position – and may therefore have deliberately 'window dressed' (misstated) the draft financial statements.

## **2.4 Control risk**

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

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

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

It is unlikely that control risk will be zero because of the inherent limitations of any internal control system.

(**Note:** Control risk can be reduced by introducing new controls or better controls. However, the design and implementation of controls is the responsibility of the management of the company. Management may introduce better controls to reduce the control risk in next year's audit, perhaps on the recommendation of the auditors, but control risk cannot be reduced for the current year's audit).

## 2.5 Detection risk

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

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

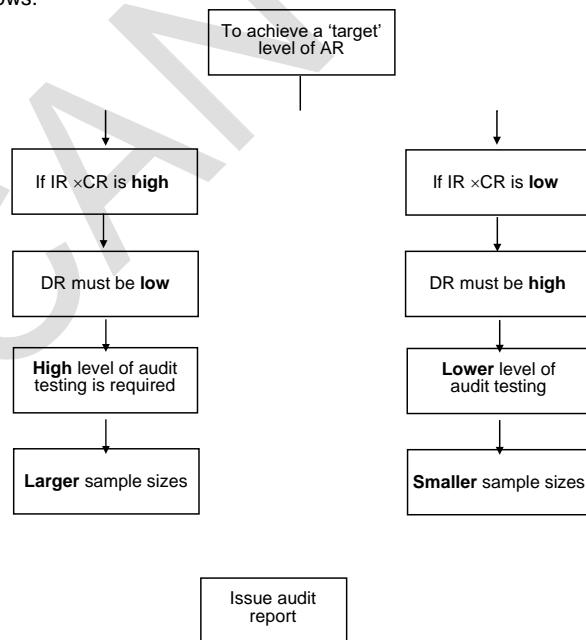
In preparing an audit plan, the auditor will usually:

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

In other words, the detection risk can be managed by the auditor in order to control the overall audit risk. As noted above, inherent risk cannot be controlled because it operates independently of controls. Control risk can be reduced by improving the quality of internal controls; however, recommendations to the client about improvements in its internal controls can only affect control risk in the future, not control risk for the financial period that is subject to audit. Audit risk can be reduced by increasing testing and reducing detection risk.

## 2.6 Audit risk assessment: a summary

The implications of this approach for the audit work can be summarised as follows:



In the left hand column the auditor needs to achieve a low detection risk to compensate for the high IR x CR. This is likely to require extended testing and hence larger sample sizes.

In the right hand column the auditor is comfortable to accept high detection risk because they have assessed IR x CR to be low. In this case they are unlikely to need to extend testing significantly and hence can adopt smaller sample sizes.

## 2.7 The connection between business risk, financial statement risk and audit risk

It is important to understand the connection between business risk, financial statement risk and audit risk. The connection between business risk and financial statement risk was mentioned in a previous chapter. The connection is explained in more detail here.

### Business risk

Business risk is any risk that threatens the ability of a business entity to achieve its objective, which can usually be stated as the objective of maximising profit or maximising wealth. Anything that threatens this objective is therefore a risk that profits might be lower. In extreme cases, it could mean a risk that losses will be very large and the going concern status of the business entity might be called into question.

Business risks can be divided into two categories.

- A risk might have a low probability of happening, or if an adverse event does occur, the resulting loss might be small. Where the probability of loss is low and the severity of the loss would be low, the risk can be regarded as acceptable. The cost of control measures to reduce the risk would not justify the benefits from the lower risk.
- A business risk is an **applicable risk** when the financial impact of the risk could be high.

For applicable risks, management should decide on a suitable plan or strategy for managing the risk. The chosen strategy might be any of the following.

- Reduce the risk** by introducing more internal controls.
- Transfer the risk**, for example by insuring against it.
- Avoid the risk** entirely, by withdrawing from the business operations to which the risk relates.
- Accept the risk**, and take no action to reduce it or transfer it.

### Business risk and financial statement risk

For the auditor, the significance of business risk is the impact that it could have on the financial statements. Most business risks increase the likelihood that the financial statements could be materially wrong. Some business risks can be linked to specific financial statement risks such as the risk of:

- an understatement of bad debts or the allowance for doubtful debts
- over-stating the value of inventory (where net realisable value is less than cost)
- over-stating the value of a non-current asset (tangible or intangible) due to a failure to recognize impairment.

Some business risks do not create any specific financial statement risk, although the risk might ultimately lead to going concern problems for the business entity.

#### Audit risk and financial statement risk

Business risk is a risk that management must deal with. Audit risk is a risk that faces the auditor. It is the risk that the auditor will give an inappropriate audit opinion when the financial statements are materially wrong (mis-stated).

Audit risk follows on from financial statement risk. The auditor should therefore assess the financial statement risks as a step towards assessing the audit risk.



Business risk could lead to financial statement risk

Financial statement risk affects audit risk

Audit risk results from:

- (1) **Inherent risk:** risk of a misstatement where there is no internal control to prevent it
- (2) **Control risk:** risk that existing internal controls will fail to detect or prevent a material misstatement
- (3) **Detection risk:** Risk that substantive testing will fail to detect a misstatement.

You may be required in the exam to identify the main audit risks in a case study. Within the case study, there may be inherent risk, risk from weaknesses in the internal control system and even detection risk (for example there might be only a short amount of time and limited resources to perform the audit).

It is probable however that most of the audit risks will be identifiable as financial statement risks. The types of risk to consider will include the following:

- Risk of over-statement of revenue** or other income. There may be some risk that revenue has not been recognised in accordance with the requirements of IFRS 15 Revenue from contracts with customers, and is over-stated. This risk will occur when customers make staged payments (for example staged payments for contract work) or pay deposits in advance (for example customer bookings for holidays): revenue should not be recognised until the performance obligation has been met, not when the payment is received.
- Risk of over-statement of current assets.** For example, there may be some doubts about whether amounts receivable will actually be recovered. A company may fail to make a sufficient allowance for irrecoverable amounts, and when this happens receivables and profit will be over-stated. Another example may be the risk of over-statement of inventories, due to

the timing of the physical inventory count or the procedures used in the inventory counting process.

- Risk of over-statement of non-current assets.** There may be a risk that some non-current assets are over-stated in value, when there is some reason to suppose that impairment has occurred (for example impairment to a building due to fire or flood damage).
- Risk of under-statement of liabilities.** There may be a risk that some liabilities are not fully stated, particularly provisions. There may be no provision in the financial statements when it would be appropriate to make one, and so reduce profit and increase liabilities.
- It is also possible that an exam question includes a scenario where the company makes a provision for the cost of repairs to fire damage, when the losses were insured, but ignores the amount recoverable through the insurance claim. In this case profit (and other receivables) would be understated.
- Risk of understatement of operating expenses.** As a general rule there is usually a fairly consistent ratio from one year to the next between elements of cost and sales revenue. For example the ratio of administrative expenses to revenue and the ratio of sales and distribution costs to expenses are often fairly consistent from one year to the next. Some changes may occur, but not usually large changes. So for example if sales revenue is increasing but the ratio of administrative costs to sales is falling sharply, this could indicate a risk of under-statement of operating expenses.
- Risk from accounting estimates.** The auditor should check accounting estimates carefully. These rely on management judgement and when estimates are a material amount there will be a significant risk of misstatement.
- Failure to comply with the requirements of specific accounting standards.** An exam question may provide details about the accounting treatment of items that are the subject of specific accounting standards, such as contingent liabilities, deferred tax, share-based payments and related party transactions. You may be required to discuss the risks of misstatement or non-disclosure due to a failure to comply properly with the requirements of the accounting standard.

#### Example: Financial statement risks

Zarma, a limited liability company, manufactures 'high-tech' computer-controlled equipment for use in other production industries. Its directors and senior managers are also the company's shareholders. On 1 July Year 7 they accepted a offer from a US corporation to buy Zarma's own manufacturing equipment and technology, which is protected by patent rights.

Management notified the employees, suppliers and customers that Zarma would cease all manufacturing activities on 31 August Year 7. All the factory workers and most of the employees in the accounts and administration departments were made redundant, and the same was duly completed on 31 August.

Most of the employees who remained in employment with the company after 31 August were made redundant from 31 October Year 7. However, the company retained a small head office operation, consisting of the chief executive officer, the marketing and sales directors, the chief accountant and a small accounting and administrative support team. This head office unit will continue to operate for a few more years until the company's operations are wound down completely.

Before the sale, Zarma operated from twelve premises. Eight of these were put on the market on 1 August. Three of the other premises are held on leases that will expire in the next three to five years. Under the terms of the lease agreements, none of these premises can be sub-let and the leases cannot be sold. A small head office building will continue to be occupied and used until the lease expires in three years' time. Zarma accounts for all its tangible non-current assets at depreciated cost.

All the products sold by Zarma carry a one-year warranty. Until 31 August, the company sold extended two-year and five-year warranties, but extended warranties were not offered on any products sold from 1 September.

Zarma sold its products through national and international distributors, under three-year agreements. Zarma also had annual contracts with its major suppliers for the purchase of components. So far, none of the distributors or suppliers has initiated legal proceedings against Zarma for breach of contract. However, some distributors are withholding payments from Zarma on their account balances, awaiting settlement of the large penalty payments that they claim are now due to them from Zarma.

**Required:**

Using the information provided, identify and explain the financial statement risks to be taken into account in planning the final audit of Zarma in respect of the year ended 30 September Year 7.

**Answer**

**Tutorial note**

There are some points that you should note about this question, for answering examination questions on financial statement risks.

- The 'question' refers to **financial statement risk**. Any comments about general business risks will not gain marks in an examination unless you link them directly to financial statement risks.
- The 'question' asks about financial statement risks in relation to the **final audit of Zarma**. This means that general comments about financial statement risks, or comments about financial statement risks that are not relevant to Zarma, would not earn you any marks in an examination.

It is particularly important when discussing financial statement risks to ensure that the risks you identify are specifically linked to the financial statements.

For example, Zarma manufactures 'high-tech' products. A business risk associated with this is that inventory might quickly become obsolete. This means that there is a financial statement risk, that is, **inventory might be overstated in the financial statements**. It is important in answering an examination question on financial statement risk that you should identify the financial statement risk, not (just) the business risk. The implication for planning the audit is that audit work should be directed at testing for a possible overvalue of the inventory due to obsolescence.

**Suggested ideas for a solution**

The financial statement risks that might be identified are set out in the table below. The left-hand column identifies the words or phrases in the case study that should enable you to identify the risks.

Key words or phrases in the case study	Financial statement risk
<i>manufactures 'high-tech' computer-controlled equipment</i>	The company operates in a high-tech environment and inventories might be subject to obsolescence (business risk). Therefore <b>inventories in the financial statements might be overstated (financial statement risk)</b> .
<i>offer from a US corporation to buy Zarma's own manufacturing equipment</i>	This will affect the way that items are presented in the financial statements. Profits or losses on sales must be disclosed separately, for example.
<i>cease all manufacturing activities on 31 August Year 7</i>	<b>Financial statements should therefore not be prepared on a going concern basis</b> , but on a different basis, such as a break-up basis.
<i>made redundant</i>	If redundancy payments have not been paid at year end, <b>provisions for redundancy payments will be needed in the financial statements</b> .
<i>small accounting ... team</i>	This may increase errors in processing accounting transactions towards the end of the year. Segregation of duties (as an internal control) might have been affected
<i>Eight [premises] were put on the market on 1<sup>st</sup> August</i>	This will affect the way that the premises are presented in the financial statements – as assets held for sale.
<i>leases that will expire in the next three to five years. .... none of these premises can be sub-let and the leases cannot be sold.</i>	<b>Full provision should be made for these onerous contracts in the financial statements.</b> (This does not apply to the head office building which is still being used)
<i>...warranty</i>	<b>Provisions will be needed in the financial statements for these warranties.</b>
<i>national and international distributors, under three-year agreements</i>	The financial statements will need to include a <b>provision for costs associated with breaching these agreements</b>



### Example: Business risks and financial statement risks

Fit keeper, a limited liability company, operates twelve fitness centres around Nigeria. The facilities at each centre are of a standard design and each centre contains a heated twenty-five metre swimming pool, a sauna, a gymnasium and a fitness lounge. Each centre also provides supervised child care facilities. The day-to-day operations of each centre are the responsibility of a centre manager, who is required however to manage the centre in accordance with strict company policies. The centre manager is also responsible for preparing and submitting monthly accounting returns to head office in Abuja.

By law, each centre must have a licence to operate from the local government authority. Licences are granted for periods of four years and are renewable at the end of each four-year period subject to satisfactory inspection reports from the inspecting authority. The average annual cost of a licence is ₦95,000.

All customers of the centres are enrolled as 'members'. Members pay a ₦1,500 joining fee, plus ₦800 per month for 'peak' membership or ₦400 per month for 'off-peak' membership. Fees are payable annually in advance. All fees are stated to be non-refundable.

One of the fitness centres was closed between May and August in the financial year just ended, after a serious accident in the sauna involving chemicals. The centre was re-opened at the end of August, but head office management issued an instruction to all the fitness centre managers that the sauna facilities should be shut down until further notice.

Head office also is sued the fitness centre managers with revised guidelines for the minimum levels of supervision for child care. This followed complaints from some dissatisfied members to the local government authority. Centre managers have been finding it difficult to provide the additional supervision specified in the revised guidelines and some of them have recommended strongly that the childcare facilities should be withdrawn.

Each centre operates early morning fitness sessions for members that run from 07.00 to 08.00 on four days each week. Every centre has had problems with late arrivals by staff, and many members have complained strongly that they have turned up for sessions that were shortened in length or did not run at all.

Training staff is costly and time – consuming but staff retention rates in the fitness centres are poor. In addition, staff turnover rates among the centre managers are also high. Most leavers complain of excessive directions imposed on them by head office and by company policy.

Three of the fitness centres are expected to have run at a loss for the year to 31 December (just ended) due to falling membership. Fit keeper has invested heavily in building a hydrotherapy pool a tone of these centres, with the aim of attracting members who are past retirement age. Completion of construction is behind schedule and costs to date are far in excess of the original budget. The pool is now expected too pen within the next two months.

The company has experienced cashflow difficulties in the current year. As a consequence, head office management has decided to defer by at least one year the replacement of gym equipment in most of its centres.

**Required:**

- (a) Identify and explain the business risks that should be assessed by the management of Fitkeeper.
- (b) Identify how each of the business risks identified in (a) may be linked to a financial statement risk.

**Answer****Tutorial note**

You should approach a solution to this question in two stages.

- (1) Identify business risks. Note that part (a) refers to **business risks** relevant to Fitkeeper, so comments about audit risk will not gain any marks in an examination.
- (2) Having identified a business risk, consider the impact of this risk on the financial statements. You should comment on the financial statement risk associated with the business risks you identify in part (a), so introducing different risks in part (b) will not gain marks in an examination.

**Suggested ideas for a solution**

The business risks and the financial statement risks that might be identified are set out in the table below. The left-hand column identifies the words or phrases in the case study that should enable you to identify the risks.

<b>Words or phrase indicating a risk</b>	<b>Business risk indicated</b>	<b>Financial statement risk indicated</b>
<i>Standard design</i>	Operational risk is increased by standard design of each centre, because a problem with one facility at one centre is likely to be repeated at all the centres.	Asset values might be affected – for example, non-current assets might be overstated if they have been impaired by lack of use (e.g. saunas – see below). Asset impairment has probably not been recognised.
<i>each centre must have a licence to operate</i>	An operational risk exists, because a centre cannot operate if its licence is withdrawn.	Each centre's licence must be accounted for properly, i.e. capitalised.
<i>Fees are payable annually in advance</i>	Financial risk is increased by payments in advance because cash has to be available to fund services later when they are due.	Deferred income must be calculated correctly in the financial statements.
<i>serious accident in the sauna involving chemicals</i>	Serious accidents may prompt investigation by the local government authority, leading to fines or penalties or loss of licence.	Provisions should be recognised for any fines that might be pending. If any centre's licence is affected by such events, the licence may be impaired.
<i>revised guidelines</i>	Compliance risk that the fitness centres cannot meet the new guidelines	If failure to comply leads to punitive action by the local government authority, it may be necessary to make provisions for fines/penalties.

Words or phrase indicating a risk	Business risk indicated	Financial statement risk indicated
<i>many members have complained strongly</i>	Risk that falling membership will continue	Fees payable in advance are said to be non-refundable. This might be incorrect, and a provision might be required for refunds of fees.
<i>Three ... fitness centres are expected to have run at a loss</i>	Risk that more centres will become loss-making.	Possible need to consider the going concern status of the company, or at least to test the fitness centres for impairment as cash-generating units.
<i>construction behind schedule and costs to date far in excess of budget</i>	Risk that the new hydrotherapy pool will not attract the expected new members	The value of the asset should be considered. There might be a loss of value due to impairment even before it has opened for use.
<i>defer by at least one year the replacement of gym equipment</i>	Risk of more customer dissatisfaction and loss of members	Risk that depreciation might be charged for equipment that is already fully depreciated.

### 3 MATERIALITY

#### Section overview

- General principles
- Materiality thresholds
- ISA 320: Materiality in planning and performing an audit

#### 3.1 General principles

The IASB's *Framework for the preparation and presentation of financial statements* states that "information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements."

*ISA 320 Materiality in planning and performing an audit* deals with the auditor's responsibility to apply the concept of materiality when planning and performing his audit. The revised ISA makes it clear that materiality depends on the **size and nature** of an item judged in the surrounding circumstances.

It is important to appreciate that the **assessment of materiality** is always based on the **judgement of the auditor** applied to the circumstances of a particular case. There are guidelines on materiality – but no rules.

##### Materiality is relative

Materiality is a relative factor. What, and what amount will be material in the financial statements of one company may not be material in the financial statements of another.



##### Example:

An unrecorded sales invoice of ₦10,000 is unlikely to be material to the income statement/statement of comprehensive income of a multinational company with revenue of many millions of dollars. However, it would probably be considered material to a small company with annual revenue of, say, ₦300,000.

Despite this, such an error must still be considered carefully even in the context of a large company as one error could indicate the existence of others which could, in total, be material.

#### 3.2 Materiality thresholds

In order to deal with materiality on a consistent basis, most audit firms set their own '**materiality thresholds**'. Their audit staff are trained to use these thresholds to 'measure' whether or not an item is material. Materiality thresholds vary from one firm to another, but will typically fall within the following ranges:

Revenue	1% – 2%	An item of revenue is material if it is at least 1% or 2% of annual sales revenue.
Pre-tax profit	5% – 10%	An item is material if it is at least 5% or 10% of reported pre-tax profit.
Total assets	1% – 2%	A balance is material if it represents at least 1% or 2% of total assets.

The 'danger' of materiality thresholds is that they are used simply to 'measure' whether an item is material, without considering important other factors as well. Other factors that the auditor should consider in evaluating materiality may include the following:

- The nature of the item involved** – The valuations of some items in the financial statements are more subjective than others, and depend on estimation. The more subjective the item, the more flexible the auditor should be in assessing the materiality of possible misstatements. The auditor will have to take a very different view on materiality when considering a warranty provision (which is a subjective estimate), compared with the approach taken when auditing share capital, which is capable of precise measurement.
- The significance of the item** – Some items may be insignificant in terms of their monetary amount, but may nevertheless be of particular interest to the users of the financial statements. An example might be bonus payments to directors.
- The impact of the item on the view presented by the financial statements**. A small and apparently insignificant error or omission may be material if, by correcting it:
  - a reported profit is converted into a reported loss, or
  - the correction significantly alters the trend of profits (growth rate in profits) over the past few financial years.

### 3.3 ISA 320: Materiality in planning and performing an audit

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

- when planning and performing the audit, and
- when **evaluating the effect of misstatements** on the financial statements and therefore on his audit opinion (covered in a later chapter under ISA 450 *Evaluation of misstatements identified during the audit*).

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

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

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

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

## 4 COMPUTERS IN AUDITING

### Section overview

- Introduction
- Using computers to perform the audit
- Controls in computer-based information systems: general controls and application controls
- COBIT (Control Objectives for Information and Related Technologies)
- Microcomputers, on-line systems and EDI
- Computer-assisted audit techniques (CAATs)

#### 4.1 Introduction

Computer systems affect the audit process in two ways.

- The auditor may use computers to perform his auditwork.
- The client's accounting systems may be computer-based. If so, the auditor will need to consider:
  - the controls that are in place for the system (and whether these are effective), and
  - whether to use computer-assisted audit techniques (CAATs) to do some of the audit work.

Each of these should be considered at the planning stage.

#### 4.2 Using computers to perform the audit

It is usual for members of an audit team to take laptop computers with them to the client's premises, for use with the administration, documentation and performance of the audit assignment. Laptop computers may be used for tasks such as:

- audit administration and control (for example, preparing time sheets and audit work programmes)
- audit planning work (for example, for risk and materiality assessments)
- preparing audit working papers
- analytical procedures (including holding on file a record of statistics and financial ratios for the client for previous years)
- sampling software (if appropriate).

Using computers for the audit may also allow managers or partners to review the audit work that has been done without having to visit the client's premises.

Members of the audit team can e-mail papers to managers or partners back at the office. This saves time that would otherwise be wasted by senior managers and partners in travelling to and from the client's premises.

#### Controls over the auditors' computer systems

When the audit work is performed largely on computers, the auditor must have suitable controls in place. Essentially, these are the same controls that should apply in any computer application. Controls should be in place to ensure that:

- client data remains confidential and cannot be accessed by an unauthorised person
- audit work held on computer file cannot be lost
- an audit trail is created for the work the auditor has done, to assist the audit review and control process
- the programs operate in the way that they are expected to.

#### 4.3 Controls in computer-based information systems: general controls and application controls

In a computer-based system, the internal controls will consist of both manual procedures (such as physically locking a room) and procedures designed into computer programs (such as passwords).

Such controls fall into two categories:

- general controls, and
- application controls.

The auditor needs to be satisfied that these controls are effective.

##### General controls

**General controls** are controls over the environment in which the computer-based information system is designed, developed, operated and maintained.

The main categories of general control that an auditor would expect to find in a computer-based information system are summarised in the table below.

Control area	Controls
<b>Development of computer-based information systems and applications</b>	<ul style="list-style-type: none"> <li>▪ Appropriate standards should be established and enforced for designing, developing, programming and documenting each new system.</li> <li>▪ Suitable testing procedures should be carried out on each new system.</li> <li>▪ The design of a new system should be approved formally by the management of the system user.</li> <li>▪ There should be a segregation of duties between system designers and system testers (to reduce the risk of error or fraud)</li> <li>▪ There should be suitable staff training in the design and testing of systems.</li> </ul>
<b>Documentation and testing of program changes</b>	<ul style="list-style-type: none"> <li>▪ Formal testing procedures should be applied for any change to a current program.</li> <li>▪ There should be formal authorisation procedures for program changes.</li> <li>▪ There should be suitable staff training in making and testing program changes.</li> </ul>

Control area	Controls
<b>Prevention or detection of unauthorised program changes</b>	<ul style="list-style-type: none"> <li>▪ There should be a segregation of duties between programmers and computer system operators</li> <li>▪ All program changes must be fully documented.</li> <li>▪ Access to program files must be restricted</li> <li>▪ Program logs should be used to record access to program files and programs.</li> <li>▪ There should be anti-virus software and back-up copies of program files should be kept, to prevent or detect or deal with 'malicious' changes to programs.</li> </ul>
<b>Prevention of the use of incorrect programs or data files</b>	<ul style="list-style-type: none"> <li>▪ Standard operating procedures should be established, and operations should be performed by suitably-trained staff</li> <li>▪ The scheduling of 'jobs' for a computer centre should specify the program files and data files to be used.</li> <li>▪ There should be effective supervision of computer centre operations.</li> <li>▪ Reviews of operations should be carried out regularly by management</li> </ul>
<b>Prevention of unauthorised amendments to data files</b>	<ul style="list-style-type: none"> <li>▪ There must be restricted access to data files, limited to authorised personnel</li> <li>▪ Transaction logs should be kept of all uses of data files, and these should be reviewed by management</li> </ul>
<b>Ensuring continuity of operations</b>	<ul style="list-style-type: none"> <li>▪ Secure back-up copies should be kept of program files and data files</li> <li>▪ Measures should be implemented for the protection of equipment against fire, power failure and other hazards</li> <li>▪ Disaster recovery programmes should be in place, in the event of a major disaster that puts the main computer system out of action.</li> <li>▪ There should be suitable maintenance and service agreements for all major externally-acquired software.</li> </ul>

These general controls should apply to most or all of the entity's computer-based information system applications, not just to computerised accounting systems. If general controls are weak, it is unlikely that the processing undertaken by the system will be complete and accurate.

The auditor should review and test the general controls in order to reach a conclusion about their effectiveness. This will enable him to assess the control risk attached to the entity's computer-based information systems as a whole.

#### Application controls

It is also necessary for the auditor to identify and assess the application controls in each specific computer-based application, such as the inventory, receivables and payroll systems. The auditor must be satisfied that the application controls for a particular system are effective.

Application controls are specific controls over each specific computerised accounting application or system. The purpose of application controls is to provide assurance that:

- processed transactions have been properly authorised, and
- the processing of data is complete, accurate and timely.

In a manual processing system, internal controls vary according to the application. For example, internal controls over inventory are different from the controls over payroll processing. Similarly, application controls in a computer-based information system will vary depending on the nature of the application.

However, application controls for different computer applications share a number of common features, regardless of the particular application involved.

In particular, the auditor will place a high degree of emphasis on controls over **input**. For application controls to be effective, it is essential that input must be complete and accurate. If the input is not correct, the output from the application cannot be expected to be correct.

A list of application controls that might be found in a computer system is set out below.

Control area	Controls
<b>Input</b>	<p><b>Authorisation</b></p> <ul style="list-style-type: none"> <li>▪ Data for input should be authorised before input.</li> <li>▪ Data is input only by authorised personnel.</li> </ul> <p><b>Completeness</b></p> <p>There should be checks to ensure that all data has been processed. Checks might consist of:</p> <ul style="list-style-type: none"> <li>▪ Document counts (for example, counting the number of invoices)</li> <li>▪ Control totals</li> <li>▪ Checking output to input</li> <li>▪ Review of output against expected values (for example, is the total payroll cost broadly in line with expectations)</li> </ul> <p><b>Accuracy</b></p> <p>There should be some checks within the computer software on the validity of input data items (data validation checks). These may include:</p> <ul style="list-style-type: none"> <li>▪ Check digits for key code items, such as supplier codes, customer codes and employee identification numbers</li> <li>▪ Range checks (= a check on whether a particular value or figure is feasible and within a realistic range of values)</li> <li>▪ Existence checks (= a check on whether a particular code exists)</li> <li>▪ Review and reconciliation of output</li> <li>▪ Use of control totals</li> </ul>

Control area	Controls
<b>Processing</b>	<p>There should be checks that all input has been processed and that processing is complete. Checks might include:</p> <ul style="list-style-type: none"> <li>▪ Control totals</li> <li>▪ Batch totals (where the computer counts the number of transactions in a processed batch, and this is checked against a manual record of the number of items in the batch)</li> <li>▪ Manual review</li> <li>▪ On-screen warning that processing is not complete</li> </ul>
<b>Master files and standing data</b>	<ul style="list-style-type: none"> <li>▪ Management review of master files and standing data</li> <li>▪ Regular updates of master files</li> <li>▪ Record counts</li> </ul>

The auditor should review the application controls for each application, to establish whether they are effective 'on paper'. He should then carry out tests of controls to establish whether the application controls are operating effectively in practice.

#### 4.4 COBIT (Control Objectives for Information and Related Technologies)

##### Introduction

The existence of an accepted framework such as COBIT used for systems development by a client may provide additional assurance to the auditor in their assessment of the client's information system.

COBIT is an IT governance tool that has been of tremendous benefits to IT professionals and has contributed immensely to effective control of information systems. Linking information technology and control practices, COBIT consolidates and harmonises standards from prominent global sources into a critical resource for management control professionals and auditors. As such, COBIT represents an authoritative, up-to-date control framework, a set of generally accepted control objectives and a complementary product that enables the easy application of the Framework and Control Objectives, referred to as the Audit Guidelines.

COBIT applies to enterprise-wide information systems, including personal computers, mini-computers, mainframes and distributed processing environments. It is based on the philosophy that IT resources need to be managed by a set of naturally grouped processes in order to provide the pertinent and reliable information which an organisation needs to achieve its objectives.

With the addition of the management guidelines, COBIT now supports self-assessment of strategic organisational status, identification of actions to improve IT processes and monitoring of the performance of these IT processes. Since the first edition of COBIT was released in 1997 it has been sold and implemented in over 100 countries of the world.

COBIT has been developed as a generally applicable and accepted standard for good information technology (IT) security and control practices that provides a reference framework for management, users and information system audit as well as control and security practitioners.

### **The Purpose of COBIT**

The purpose of COBIT is to provide management and business process owners with an information technology (IT) governance model that helps in understanding and managing the risks associated with IT. COBIT helps to bridge the gaps between business risks, control needs and technical issues. It is a control model to meet the needs of IT governance and ensure the integrity of information and information system.

### **The Users of COBIT**

COBIT is used by those who have the primary responsibilities for business processes and technology; those who depend on technology for relevant and reliable information, as well as those providing quality, reliability and control of information technology.

### **Application of COBIT in Business process**

COBIT is business process oriented and therefore addresses itself in the first place to the owners of these processes. Generic business model refers to core processes such as procurement, operations, marketing, sales, etc., as well as support processes (human resources, administration, information technology). As a consequence, COBIT is not applied only by the IT department, but also by the business as a whole.

The above approach stems from the fact that in today's enterprises, the process owners are responsible for the performance of their processes of which IT has become an integral part. In other words, they are empowered, but also accountable.

As a consequence, the business process owners bear the final responsibility for the information technology as deployed within the confines of business processes. Of course, they will make use of services provided by specialised parties like the traditional IT department or the third party service provider. COBIT provides the business process owners with a framework which should enable them to control all the different activities underlying IT deployment. As a result, they can gain reasonable assurance that IT will contribute to the achievement of their business objectives. Moreover, COBIT provides the business process owners with a generic communication framework to facilitate understanding and clarity among the different parties involved in the delivery of IT services.

The addition of the Management Guidelines in the third edition of COBIT provides management with a new set of tools. These allow self-assessment in order to make choices for control implementation and improvements over IT, measure the achievement of goals and the proper performance of IT processes. The Management Guidelines include maturity models, critical success factors, key goal indicators and key performance indicators to support managerial decision making.

### **COBIT components**

COBIT, issued by the IT Governance Institute and now in its third edition, is increasingly internationally accepted as good practice for control over information, IT and related risks. Its guidance enables an enterprise to implement effective governance over the IT that is pervasive and intrinsic throughout the enterprise. In particular, COBIT's Management Guidelines component contains a framework which responds to management's need for control and measurability of IT by providing tools to assess and measure the enterprise's IT capability for the 34 COBIT IT processes.

The tools include:

- Performance measurement elements (outcome measures and performance drivers for all IT processes)
- A list of critical success factors that provides succinct, non-technical best practices for each IT process; and
- Maturity models to assist in benchmarking and decision-making for capability improvements.

COBIT comprises six specific components:

- Management guidelines;
- Executive summary;
- Framework;
- Control objectives;
- Audit guidelines; and
- Implementation tool set.

#### **Management guidelines**

To ensure a successful enterprise, one has to effectively manage the union between business processes and information systems. The Management guidelines are composed of:

- Maturity models, to help determine the stages and expectation levels of control and compare them against industry norms;
- Critical success factors, to identify the most important actions for achieving control over the IT processes; and
- Key goal indicators, to define target levels of performance; and key performance indicators, to measure whether an IT control process is meeting its objective.

These Management guidelines will help answer the questions of immediate concern to all those who have a stake in enterprise success.

#### **Executive summary**

Sound business decisions are based on timely, relevant and concise information. Specifically designed for time pressed senior executives and managers, COBIT includes an executive overview which provides thorough awareness and understanding of COBIT's key concepts and principles. Also included is a synopsis of the Framework providing a more detailed understanding of the concepts and principles, while identifying COBIT's four domains (Planning & Organisation, Acquisition & Implementation, Delivery and Support, and Monitoring) and 34 IT processes.

#### **Framework**

A successful organisation is built on a solid framework of data and information. The Framework explains how IT processes deliver the information that the business requires to achieve its objectives. This delivery is controlled through 34 high-level control objectives, one for each IT process, contained in the four domains. The Framework identifies which of the seven information criteria (effectiveness, efficiency, confidentiality, integrity, availability, compliance and reliability), as well as which IT resources (people, applications, technology,

facilities and data) are important for the IT processes to fully support the business objective.

#### **Control Objectives**

The key to maintaining profitability in a technologically changing environment is how well control is maintained. COBIT's Control Objectives provide the critical insight needed to delineate a clear policy and good practice for Information Technology controls. Included are the statements of desired results or purposes to be achieved by implementing the specific and detailed control objectives throughout the 34 Information Technology processes.

#### **Audit Guidelines**

To achieve desired goals and objectives one has to constantly and consistently audit one's procedures. Audit Guidelines outline and suggest actual activities to be performed corresponding to each of the 34 high level IT control objectives, while substantiating the risk of control objectives not being met. Audit Guidelines are an invaluable tool for information system auditors in providing management assurance and/or advice for improvement.

#### **Implementation tool set**

Implementation tool set contains:

- Management awareness and IT control diagnostics;
- Implementation guide FAQs;
- Case studies from organisations currently using COBIT; and
- Slide presentations that can be used to introduce COBIT into organisations.

The tool set is designed to facilitate the implementation of COBIT, relate lessons learned from organisations that quickly and successfully applied COBIT in their work environments, and lead management to ask about each COBIT process: Is this domain important for our business objectives? Is it well performed? Who does it and who is accountable? Are the processes and control formalised?

#### **4.5 Microcomputers, on-line systems and EDI**

Computer systems in many organisations are 'decentralised'. They are not large centralised mainframe computer systems, operated in a computer centre by specialist operating staff. Instead, the entity uses decentralised 'standalone' computers or network systems, which are managed and operated by individuals who are not IT specialists.

The use of decentralised systems is often efficient for the client, but may create additional problems for the auditor, who needs to be satisfied that the controls within the system are effective.

The following types of system may require special attention by the auditor:

- Microcomputer systems
- on-line systems
- electronic data interchange (EDI) systems.

### **Microcomputer systems**

'Microcomputer system' is not a precisely - defined term. It refers to a computer system in which the entity uses a number of stand-alone 'desktop' computers that are located throughout the organisation.

For the entity, a microcomputer system will often be more efficient and cost-effective than a centralised mainframe computer system, especially as the systems can normally be operated (and possibly programmed) by staff with little technical training in computers and IT.

The auditor may have some difficulty, however, in satisfying himself that the controls for the system are sufficient and effective. The problems for the auditor in checking the effectiveness of controls happen for the following reasons:

- The difficulty of ensuring adequate physical security of the equipment.
- Difficulties with ensuring the security of the data and storage media (disks, tapes, etc.).
- These systems may permit access to many individuals, some of whom are not authorised. It may be easy, for example, for an unauthorised person to gain access to a computer system when the authorised user is not at his or her desk. The problem of easy access therefore introduces problems of authorisation. There is the risk of unauthorised amendments to program or data files. The risks in this area can be minimised by restricting access to the computer system and to particular program files and data files through the use of passwords and usernames.
- Programs may be written or modified by the user (one of the potential attractions to the entity of the use of microcomputer systems) but this may cause control risks with respect to processing and the software. In an extreme case, the accounting data produced by a microcomputer may not be usable by the auditor.
- The auditor should want to see adequate documentation of the software systems. If this is not provided by the software supplier with the program, it would need to be written by the computer user.

### **On-line systems**

On-line systems are network computer systems that allow users direct access to centrally-held data and programs. Access to the central files is through remote terminals.

On-line systems offer a number of operational advantages to entities that use them.

- They permit the immediate entry of transactions from many different locations, instead of having to submit transactions to a central computer centre for processing. For example, if a retailing company operates an on-line system for sales, sales transaction data can be input immediately for centralised processing through terminals in each retail store.
- In the same way, centralised master files (such as master files for inventory) are updated immediately. This means that subsequent users of the system can use the up-to-date versions of master files.
- On-line systems allow users to make inquiries and obtain immediate responses, by having access to master files or reference files. (For example, users are able to give immediate answers to customers about prices of products or the current status of their order).

Again, although on-line systems are usually efficient and effective for the user, they create additional problems for the auditor who needs to assess the effectiveness of the system controls. There should be sufficient general controls and application controls to minimise the risks that arise from using on-line systems.

**General controls** in an on-line system could include the following:

- There must be effective controls over access to the system and its files. This is because in on-line systems, transactions are processed as soon as they are input.
- There should be controls written into the system software to prevent or detect unauthorised changes to programs.
- Transaction logs should be used to create an 'audit trail'. An **audit trail** refers to the ability of the auditor to trace a transaction through all its processing stages. An audit trail may not exist in paper form in computer systems. The computer program should therefore be written in such a way as to generate the audit trail for any transaction, on request.
- Firewalls should be used for systems that have access to the Internet. Firewalls are hardware or software devices that prevent unauthorised access to a system from an Internet user.

**Application controls** in an on-line system could include the following:

- Pre-processing authorisation (such as logging on to the system, and the use of user names and passwords).
- Data validation checks in the software, to check the completeness and accuracy of processing (such as checking that a product code has been entered with the correct number of digits).
- 'Balancing' – checking control totals of data submitted from remote terminals before and after processing.

### **Electronic data interchange (EDI) systems**

Electronic data interchange (EDI) systems are systems that allow the electronic transmission of business documents, such as invoices or payroll information, between different computer systems. The EDI system provides a form of 'translation' service, so that the data transmitted from one computer system is changed into a form that can be read by the other computer system, without any need for human intervention.

EDI systems may operate:

- within the organisation (for example, the sales department may use EDI to transfer copies of customer orders electronically to a separate computer system of the accounting department), or
- externally (for example, a company may use EDI to submit payroll data for processing to the computer system of a payroll agency, or may submit purchase orders for inventory electronically to the computer system of a supplier).

EDI systems can improve the operational efficiency of an entity, but they may generate the following problems for the auditor who has to assess the efficiency of the system controls:

- The lack of a paper audit trail.

- An increased level of dependency on the computer systems of the organisation and possibly the computer systems of other entities. Any failure or control weakness in one computer system may have an impact on the computer system that is being audited.
- There may be a risk of loss or corruption of data in the process of transmission.
- There will be security risks in the transmission of data.

Auditors should expect to find effective controls in place to minimise the risks inherent in EDI systems. Typically, controls will cover such matters as:

- controls over the transmission of data (such as the encryption of data before transmission, acknowledgement systems, and the use of authentication codes for senders of data);
- monitoring and checking of output;
- virus protection systems; and
- contingency plans and back-up arrangements.

#### 4.6 Computer-assisted audit techniques (CAATs)

CAATs can be defined as any technique that enables the auditor to use computer systems as a source of generating audit evidence. They involve the use of computer techniques by the auditor to obtain audit evidence.

- CAATs are often necessary in the audit of computer-based information systems because these systems may not provide an adequate audit trail.
- In addition, processing is 'invisible' because it is electronic. Therefore the auditor needs to 'get inside the computer' to check the completeness and accuracy of the processing. CAATs allow the auditor to achieve this.

Two commonly-used types of CAATs are:

- audit software, and
- test data.

##### **Audit software**

Audit software is computer programs used by the auditor to extract information from a client's computer-based information system, for use in the audit.

The main types of audit software include:

- interrogation programs, to access the client's files and records and extract data for auditing;
- interactive software, for use in interrogation of on-line computer systems
- 'resident code' or 'embedded software', to monitor and review transactions as they are being processed by the client's programs. This type of software is called **embedded audit facilities**.

The main use of audit software is in substantive audit testing.



#### Example:

Audit software is used to extract and analyse information in the entity's computer-based information systems for use in the audit work. Here are some examples.

- Account analysis: Audit software may be used to interrogate the client's data files for the general ledger, and extract from the files all items above ₦50,000 in the repairs expense account.
- Preparing an aged listing of receivables (an aged debtors list), if these are not already produced by the client as a matter of operational routine. The audit software can interrogate the trade receivables file, and produce a list and analysis in date order of unpaid invoices.
- Calculating ratios and making comparisons: Audit software can be used to assist the auditor with analytical procedures (which are described in a later chapter).

#### Test data

An auditor may use test data to process a sample of transactions through the client's computer-based information system, and compare the results (output) obtained from the processing with the pre-determined results that the auditor would expect.

Test data is used primarily for **tests of control**. The technique provides evidence that specific application controls are operating effectively in a given system.

One of the problems with using test data is that it can only give audit evidence about the computer system at the time the test data is processed. The test data cannot provide assurance that the system and its controls operate effectively at any other time. This problem can be addressed by the use of **embedded audit facilities**.

#### Embedded audit facilities

Embedded audit facilities may also be called 'resident audit software' or an 'integrated audit module'. It is audit software that is built into the client's computer system, either temporarily or permanently.

The purpose of embedded audit facilities is to allow the auditor to carry out tests at the time that transactions are being processed, in 'real time'.

Procedures are written into the entity's computer-based information system and these generate data for audit purposes every time the system is run. In order to obtain audit data without the risk of corrupting the client's operational data files with the test data, it is usual to establish an extra 'dummy' department. The test data results are allocated to this dummy department, and the test data is therefore kept separate from the client's operational data. Only the auditor should have access to the data stored in this dummy department.

Embedded audit facilities can be very useful for the auditor of on-line computer systems where:

- data is continually processed and master files are being continually updated; and/or
- it is difficult, if not impossible, for the system to provide a satisfactory audit trail for following transactions through the system.

An embedded audit facility may also print out details of the transactions it has monitored, or copy them to a computer file, so that the auditor can study the transactions.

#### **Disadvantages of CAATs**

CAATs give the auditor the ability to audit the processing of transactions in a computer-based information system. However, the value of using CAATs should be assessed on a cost-benefit basis. CAATs should only be used if the benefits from their use exceed the costs.

The costs related to the use of CAATs may include:

- purchasing or developing the programs
- keeping the programs up-to-date, for changes in hardware and software
- training audit staff in their use. CAATs are of no value unless auditors are properly trained in how to use them.
- obtaining time on the client's computer systems to run the CAATs.

#### **Advantages of CAATs**

CAATs also have many advantages (which is why many audit firms use them).

- They give auditors an ability to test the completeness and accuracy of the electronic processing itself (the computer software), rather than relying only on testing the accuracy and completeness of inputs and outputs.
- They give the auditor an ability to test a larger number of transactions in a relatively short amount of time: testing larger amounts of data reduces the overall audit risk.
- They allow the auditor to test the effectiveness of controls that are programmed into the computer software.

## 5 NOT-FOR-PROFIT ORGANISATIONS

### Section overview

- Auditing of not-for-profit organisations
- NFPOs: the audit approach
- Public sector audit

#### 5.1 Auditing of not-for-profit organisations

In any audit or review, it is important to understand the entity and its environment. A key aspect of an audit or review may be the objective that the entity is trying to achieve.

- In commercial organisations, the objective is to make a profit for the shareholders.
- In the case of not-for-profit organisations (NFPOs), the objective is very different. It is usually the provision of a service to society as a whole or to a group in society. Examples are charities, clubs and societies and publicly-owned organisations.
- The service provided by an NFPO will have to be provided within the constraints of the resources it has at its disposal. In other words, an NFPO will seek to achieve its objective as far as possible with the money and other resources available.

#### Example: Charity and public sector audits

A charity or government department is an example of an NFPO:

- They have certain defined beneficiaries, since they were established for the purpose of providing benefits to them – e.g. starving children (charity) or the public at large (public hospitals);
- They raise funds from the public – charity donations and government tax revenues; and
- They seek to spend those funds as effectively as possible to help the beneficiaries.

NFPOs may be required to have an audit performed under local law, or may choose to have an audit performed on a voluntary basis in order to add credibility to their financial statements.

The difference in the objectives of an NFPO, compared with the objectives of a commercial company, will influence the approach to the audit.

In addition, there may be specific auditing and reporting requirements set out in local law for certain types of NFPOs. This may also influence the audit work performed and the form and content of the opinion issued.

If the NFPO requests an audit to be performed on a voluntary basis, or requires a review to be carried out, the scope of the work and the nature of any report issued will be agreed in advance between the auditor and the NFPO.

## 5.2 NFPOs: the audit approach

The auditor should recognise the specific features of the NFPO. However, it is important to realise that the auditor is still performing an audit, and the overall **structure** of the audit of an NFPO will be similar to the audit of a commercial organisation. However, the detail of the audit will probably differ.

The main points to bear in mind with the audit of an NFPO are summarised below. These are general principles. They should be modified as appropriate to reflect the circumstances of each particular NFPO.

Audit area	Comments
<b>Planning</b>	Consider: <ul style="list-style-type: none"> <li>■ the objectives and scope of the audit work;</li> <li>■ any local regulations that apply;</li> <li>■ the environment in which the organisation operates;</li> <li>■ the form and content of the final financial statements and the audit opinion; and</li> <li>■ key audit areas, including risk.</li> </ul>
<b>Risk</b>	Carry out an audit risk analysis under the usual headings of inherent risk, control risk and detection risk: <ul style="list-style-type: none"> <li>■ inherent risk (reflecting the nature of the entity's activities and the environment);</li> <li>■ control risk (internal controls, and the risk that these may be inadequate: controls over cash collection and cash payments may be a key area for an NFPO such as a charity, because large amounts of cash may be collected from the public by volunteers); and</li> <li>■ detection risk (the risk that the auditor will fail to identify any material error or misstatement in performing the audit).</li> </ul>
<b>Internal control</b>	Key areas of internal control in an NFPO might include: <ul style="list-style-type: none"> <li>■ segregation of duties (although this may be difficult in a small NFPO with only a few employees);</li> <li>■ authorisation of spending;</li> <li>■ cash controls;</li> <li>■ controls over income (donations, cash collections, membership fees, grants); and</li> <li>■ the use of funds only for authorized purposes.</li> </ul>
<b>Audit evidence</b>	<ul style="list-style-type: none"> <li>■ A substantive testing approach (rather than a systems based approach) is likely to be necessary in a small NFPO, because of weaknesses in its internal control system.</li> <li>■ Key areas may include: <ul style="list-style-type: none"> <li>– the completeness of recording transactions, assets and liabilities; and</li> <li>– the possibility of misuse of funds.</li> </ul> </li> <li>■ Analytical procedures may be used to 'make sense' of the reported figures.</li> </ul>

Audit area	Comments
	<ul style="list-style-type: none"> <li>■ There should be a review of the final financial statements, including a review of the appropriateness of the accounting policies.</li> </ul>
<b>Reporting</b>	<ul style="list-style-type: none"> <li>■ If a report on an NFPO is required by law, the standard external auditor's report covered in a later chapter can be used.</li> <li>■ If the audit is performed on a voluntary basis, the report needs to reflect the agreed objective of the audit. However, it is good practice for the report to follow the general structure laid down by ISA 700: <ul style="list-style-type: none"> <li>– Title;</li> <li>– Addressee;</li> <li>– the auditor's opinion;</li> <li>– basis for opinion;</li> <li>– going concern &amp; KAMs (if appropriate);</li> <li>– responsibility for the financial statements;</li> <li>– auditor's responsibilities;</li> <li>– other reporting responsibilities; and</li> <li>– name, signature, address of auditor and date.</li> </ul> </li> </ul>

Other factors to consider include:

- Cash may be significant in small NFPOs and controls are likely to be limited;
- Income could be a risk area, particularly where money is donated or raised informally;
- There may be a limitation on the scope of the audit if obtaining audit evidence is a problem;
- There may be a lack of predictable income or identifiable relationship between expenditure and income which could make analytical review less appropriate;
- Restricted funds may exist where the organisation is only allowed to use certain funds for specific purposes; and
- There may be sensitivity to key statistics such as the proportion of revenue used in administration (particularly for a charity).

### 5.3 Public sector audit

As you have seen above the principles of an independent audit of a public sector entity performed in accordance with ISAs are the same as any other audit performed in accordance with ISAs. The key difference is the nature of the underlying entity being audited which will impact audit risk and audit approach.

The audit of public sector organisations is carried out by Supreme Audit Institutions (SAIs). The OECD has described a SAI as a government entity whose external audit role is established by the constitution or supreme law-making body. SAIs follow International Standards of Supreme Audit Institutions (ISSAIs) which

have been developed by INTOSAI (International Organisation of Supreme Audit Institutions). ISSAIs state the basic prerequisites for the proper functioning and professional conduct of SAIs and the fundamental principles in auditing of public entities.

Many countries establish quasi-autonomous non-governmental organisations (QUANGOs) which are tasked with auditing public sector entities. QUANGOs may or may not perform their work in accordance with ISAs and may or may not be independent in the full definition of the term per IFAC's (or ICAN's) code of ethics.

You will study public sector audit in more detail in paper *B5 Public Sector Accounting and Finance*.

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## 6 CHAPTER REVIEW

### Chapter review

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

- Describe how to plan an audit engagement
- Explain the various components of audit risk
- Discuss the principles and application of materiality
- Articulate the relevance of computers to auditing
- Describe and critically assess general and application computer controls

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### Quick quiz questions

- 1 Which of the following will be included in an Audit Planning Memorandum?
  - 1 Job timetable
  - 2 Last year's management letter
  - 3 This year's written representation letter
  - 4 This year's draft financial statements
  - A 1, 2 and 3 only
  - B 1, 3 and 4 only
  - C 2, 3 and 4 only
  - D 1, 2 and 4 only
- 2 In addition to the traditional benchmarks for materiality, what other issues should be considered in relation to materiality?
  - A Degree of approximation, critical points, offset and aggregation, directors' responsibilities
  - B Offset and aggregation, critical points, degree of approximation, losses or low profits
  - C Directors' responsibilities, critical points, losses or low profits, degree of approximation
  - D Degree of approximation, directors' responsibilities, offset and aggregation, losses or low profits
- 3 In the context of audit planning, financial statement risk consists of:
  - A control risk and detection risk
  - B business risk and audit risk
  - C inherent risk and control risk
  - D detection risk and business risk
- 4 Internal controls relating to the way in which IT systems are developed and operated are known as:
  - A development controls
  - B general controls
  - C embedded controls
  - D application controls

- 5 The two common categories of computer assisted audit techniques are:
- A Audit data and test solutions
  - B Bespoke system and test data
  - C Proprietary control software and check sums
  - D Audit software and test data

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**Quick quiz answers**

1 D

The Audit Planning Memorandum is prepared before detailed audit testing begins. It cannot contain this year's letters of representation which will not be prepared until near the end of the audit process.

2 B

Directors' responsibilities have little to do with materiality.

3 C

Financial statement risk consists of inherent risk and control risk. These are the risks of a material misstatement in the financial statements if not detected by the auditor. Audit risk is determined by financial statement risk and detection risk.

4 B

Application controls are specific controls relating to a particular IT system (application) whereas general controls are applied to the development and operation of all IT systems within an entity.

5 D

CHAPTER  
**8**

## **Audit evidence**

### **Contents**

- 1 Audit testing
- 2 Audit documentation: ISA 230
- 3 Related parties: ISA 550
- 4 Written representations: ISA 580
- 5 Using the work of an auditor's expert: ISA 620
- 6 The external auditor's reliance on the work of the internal auditor: ISA 610
- 7 The audit of accounting estimates: ISA 540
- 8 The audit of specific areas of the financial statements
- 9 Transaction cycles
- 10 Chapter review

## INTRODUCTION

### Competencies

#### Laws and regulations on audit and assurance engagements

- A2 Identify and make judgements on when it may be appropriate to refer a matter to a senior colleague or for third party advice or consultation.

#### Accepting professional engagements and managing assignments

- B2 (c) Identify and evaluate the extent to which assurance and audit functions within an entity can be used or relied upon.

#### Planning and undertaking audit work

- C1 (c) Analyse and evaluate the situations when third party expertise may be required (**ISA 620 - Using the Work of an Auditor's Expert**)

- C1 (j) Evaluate and apply analytical procedures that may be used to plan an audit or assurance engagement.

- C1 (l) Develop an audit plan, justifying judgements made on an audit or assurance engagement based on a business scenario, including considerations relating to:

- Reliance on internal audit, specialists and the work of other auditors
- Use of client's generated data, information and reports
- Tests of control, substantive and analytical procedures
- Visits to locations, branches and departments.

- C3 Evaluate and draw conclusions on the appropriateness of stated accounting treatments in the context of a given scenario for public or private sector based on national and international standards on auditing and international financial reporting standards (IFRS).

### Exam context

In this comprehensive chapter students will study much of what is required during the fieldwork stage of an audit. Whilst a number of ISAs are re-visited from earlier studies, students will now be exposed to the full cross-section of ISAs relevant to performing an audit, all of which are examinable at this level.

The chapter also incorporates specific guidance on testing the various transaction cycles such as revenue/receivables and purchases/payables.

At the end of this chapter, readers should be able to:

- Explain the fundamental requirements of audit testing in the context of ISAs 500, 520, 530 and 230
- Describe the requirements of a number of other fieldwork-driven standards including ISAs 501, 540, 580, 610 and 620
- Summarise the audit approach relevant to a number of key IASs and IFRSs
- Explain how to audit the various transaction cycles such as revenue/receivables and purchases/payables

## 1 AUDIT TESTING

### Section overview

- Gathering audit evidence
- ISA 500 and the financial statement assertions
- Directional testing
- Sampling: ISA 530
- Analytical procedures: ISA 520

#### 1.1 Gathering audit evidence

The **outcome** of an audit is a report, which usually expresses an opinion.

The contents of the report and the auditor's opinion may subsequently be challenged. If this happens, the auditor must be able to justify what he has written. In other words, the report and opinion must be **supportable** by the auditor, if challenged.

The auditor will therefore collect **evidence** on which to base the report and opinion.



##### Definition: Audit evidence

This is any information used by the auditor to arrive at the opinion on which his report is based. It includes information in the accounting records and other information.

The auditor carries out procedures known as '**audit tests**' in order to create this evidence. These tests could be:

- tests of controls**; and/or
- tests of detail** (tests of transactions and balances).

It is unlikely that the auditor's tests will be applied to all the transactions that have been undertaken by the entity during the financial period under audit. The audit evidence will typically be drawn from a **sample** of transactions.



##### Definition: Audit sampling

This is the application of audit procedures to less than 100% of the population of transactions and balances, such that all units have a chance of selection. Again, this is revised later in this section.

**Analytical procedures** are also carried out, but not typically on a sample basis. These are revised later in this section. Analytical procedures together with tests of detail are referred to as **substantive procedures**.

The tests, the evidence from the tests, and the conclusions that have been drawn must all be **documented** in the audit files.

## 1.2 ISA 500 and the financial statement assertions

ISA 500 *Audit evidence* sets out the **objective** of the auditor as being to design and perform audit procedures in such a way as to enable him to:

- obtain sufficient, appropriate audit evidence;
- in order to be able to draw reasonable conclusions; and
- on which to base his audit opinion.

Following on from this, the auditor is **required** by ISA 500 to **design and perform appropriate audit procedures for the purpose of obtaining sufficient, appropriate audit evidence**.

Other **requirements** of ISA 500 are as follows:

- Consider the **relevance and reliability** of the information to be used as audit evidence.
- If information to be used as audit evidence has been prepared using the work of a **management's expert**:
  - evaluate the competence, capabilities and objectivity of that expert;
  - obtain an understanding of the expert's work; and
  - evaluate the appropriateness of his report as audit evidence.
- When using **information produced by the entity** evaluate whether the information is sufficiently reliable (accurate, complete, precise and detailed).
- Use effective means of **selecting items for testing** (covered in detail later in this chapter under ISA 530 *Audit sampling*).
- If audit evidence from one source is **inconsistent** with that obtained from another source, or the auditor has **doubts over the reliability of evidence** – consider:
  - what additional audit procedures are needed; and
  - the effects on any other aspects of the audit.

### Use of an expert by management

When assessing the **objectivity of an expert employed by management**, issues for the auditor to consider would include whether:

- the expert has a financial interest in the audit client, for example a shareholding;
- the expert has a personal relationship with a senior manager in the audit client; and
- the fee paid for the expert's services was a fair commercial price.

When assessing **whether the work of management's expert provides sufficient and appropriate evidence** for audit purposes.

- The auditor should review the terms on which the expert was engaged by the audit client, such as the objective and scope of the expert's work and whether the expert was notified that his work may be relied on by the auditors.

- The auditor should obviously study the content of the expert's report and the conclusions that the expert reached. Any assumptions used by the expert may be significant (for example in making an asset valuation) and the auditor should compare those assumptions with his own understanding of the audit client's business.
- The auditor may also need to check the methods used by the expert. For example for the valuation of investment property, the method of valuation used should be consistent with the requirements of IAS 40.
- If the expert has been used to provide a valuation, the date of the valuation should be close to the end of the financial year of the audit client (so that it is up-to-date and current).

There may be additional evidence that the auditor could obtain to confirm the evidence provided by the expert. For example, if a property valuation expert has been used by the audit client to value a number of properties, the auditor may be able to obtain some additional evidence of the reliability of the valuations in a number of ways:

- By inspecting some of the properties to assess their condition;
- By checking the cost of similar assets acquired by the audit client during the financial year;
- For assets acquired during the year, by comparing their cost with the end-of-year valuation: unless there has been a large rise or fall in property values during the year, current valuation should be fairly close to original cost;
- By checking events after the reporting period: if any of the properties have been sold since the end of the year, their sale value should be compared with their end-of-year valuation. They ought to be similar amounts;
- By obtaining representations from management that the key assumptions used in arriving at estimated values are reasonable; and
- Use of fair value accounting may require more frequent use of experts by the auditor.

### Sufficient and appropriate audit evidence



#### Definition: Sufficient and appropriate

**Sufficient** relates to the **quantity** of evidence. There must be enough audit evidence to support the auditor's conclusion or opinion.

**Appropriate** relates to the **quality** (relevance and reliability) of the evidence.

The auditor will need to exercise his professional judgement on both of these aspects, in deciding whether there is enough evidence to support a conclusion and assessing the quality of each item of evidence:

- When is there enough evidence to support a conclusion?
- What is the quality of a given piece of evidence, and is this sufficient to justify the audit opinion?

The two characteristics of quantity and quality are also inter-related.

- An auditor may be able to reach a justifiable conclusion based on a smaller quantity of high-quality evidence,

- However, a larger quantity of lower quality evidence may be required to reach a justifiable conclusion.

Factors that may influence the sufficiency of audit evidence include:

- Materiality of the item being tested;
- Financial position of the client;
- Condition of the accounting and internal control system;
- Persuasiveness of the audit evidence obtained;
- Population of the item; and
- Level of audit risk involved.

#### The reliability of audit evidence

There are a number of general principles set out in ISA 500 to assist the auditor in assessing the reliability of audit evidence. These can be summarised as follows:

- Audit evidence is more reliable when it is obtained from independent sources outside the entity under audit.** As specified above, ISA 500 requires that the auditor should be satisfied as to the accuracy and reliability of any internal evidence used in reaching a conclusion. (Note that internally generated audit evidence is more reliable when the related controls are effective);
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.** For example, observation of the operation of a control by the auditor is more reliable than inquiry about the operation of that control;
- Audit evidence is more reliable when it exists in documentary form.** This could be paper, electronic or other medium. For example, a written record of a meeting made at the time is more reliable than a subsequent oral representation of the matters discussed; and
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies,** or documents that have been filmed, or otherwise transformed into electronic form. This is because the reliability of those other forms may depend on the controls over their preparation and maintenance.

#### Procedures for generating audit evidence

A number of audit testing procedures are available to the auditor as a means of generating audit evidence.

- More than one procedure may be used in collecting evidence in a particular area.
- Not all procedures may be appropriate to a given objective of the audit.

The auditor should select the most appropriate procedures in each situation.

There are seven main testing procedures for gathering audit evidence:

- Inspection;
- Observation;
- Inquiry;

- External confirmation;
- Recalculation;
- Reperformance; and
- Analytical procedures.

The table below explains the seven main procedures and gives examples of how they are used and applied.

Procedure	Explanation/application
Inspection (looking at an item)	<ul style="list-style-type: none"> <li>■ Of tangible assets</li> <li>■ Of entries in accounting records</li> <li>■ Of documents (e.g. invoices)</li> </ul>
Observation	<ul style="list-style-type: none"> <li>■ Watching a procedure (e.g. physical inventory counts, distribution of wages, opening of mail)</li> <li>■ Limited to the point in time when the observation takes place</li> <li>■ The person performing the procedure may act differently when being observed</li> </ul>
Inquiry	<ul style="list-style-type: none"> <li>■ Seeking information from knowledgeable persons inside or outside the entity,</li> <li>■ Evaluating responses to those inquiries, and</li> <li>■ Corroborating those responses with other audit evidence</li> </ul>
External confirmation	<ul style="list-style-type: none"> <li>■ A specific type of inquiry – seeking confirmation from a third party (e.g. a bank or trade receivable). This is specifically covered by ISA 505 <i>External confirmations</i>.</li> </ul>
Recalculation	<ul style="list-style-type: none"> <li>■ Checking the mathematical accuracy of documents or records (e.g. adding up the list of year-end trade receivables)</li> </ul>
Reperformance	<ul style="list-style-type: none"> <li>■ Independently carrying out procedures or controls, which were originally performed by the client (e.g. reperforming the aging of year-end trade receivables)</li> </ul>
Analytical procedures	<ul style="list-style-type: none"> <li>■ Evaluating and comparing financial and/or non-financial data for plausible relationships and investigating unexpected fluctuations</li> <li>■ For example, comparing last year's gross profit percentage to this year's and ensuring any change is in line with expectations</li> </ul>

#### The financial statement assertions

Modern auditing theory takes the view that the financial statements are made up of a number of '**assertions**' or representations. The auditor should therefore generate evidence designed to reach a conclusion about each of these assertions.

These assertions are set out in ISA 315 and fall into two categories:

- Assertions about **classes of transactions and events, and related disclosures** for the period under audit (i.e. income statement assertions)
- Assertions about **account balances and related disclosures** at the period end (i.e. statement of financial position assertions)

Assertions about **classes of transactions and events, and related disclosures**, are as follows:

- Occurrence:** Transactions and events that have been recorded or disclosed have occurred, and such transactions and events relate to the entity;
- Completeness:** All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included;
- Accuracy:** Amounts and other data relating to recorded transactions and events have been recorded appropriately, and all related disclosures have been appropriately measured and described;
- Cut-off:** Transactions and events have been recorded in the correct accounting period;
- Classification:** Transactions and events have been recorded in the proper accounts; and
- Presentation:** Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

Assertions about **account balances and related disclosures** are as follows:

- Existence:** Assets, liabilities and equity interests exist;
- Rights and obligations:** The entity holds or controls the rights to assets, and liabilities are those of the entity;
- Completeness:** All assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included;
- Accuracy, valuation and allocation:** Assets, liabilities and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded, and related disclosures have been appropriately measured and described;
- Classification:** Assets, liabilities and equity interests have been recorded in the proper accounts; and
- Presentation:** Assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

For each financial statement item being audited, the auditor should therefore generate evidence designed to reach a conclusion on the reliability of the appropriate assertions.

### 1.3 Directional testing

Directional testing is an audit approach, developed in the 1980s, to provide a framework for the conduct of an audit. Directional testing has a number of advantages. The main advantages are that:

- it helps the auditor to clarify the audit objectives.
- it focuses the audit work on areas of high audit risk.
- it links together the results of audit tests.

Directional testing has its foundation in the fundamental principle of double entry book-keeping whereby **for every debit entry there is a credit entry**.

If the trial balance balances, but a debit or a credit entry is misstated, there must be a second misstatement somewhere in the trial balance figures.

**Example:**

If non-current assets are overstated by ₦2m, but the trial balance balances, then one of the following errors must have happened to explain how the situation has arisen.

- Possibility 1. Another asset is understated by ₦2m.
- Possibility 2. Liabilities are overstated by ₦2m.
- Possibility 3. Income is overstated by ₦2m.
- Possibility 4. Expenditure is understated by ₦2m.
- Possibility 5. A combination of any as all Possibilities 1 – 4 has occurred, amounting to ₦2m.

#### The nature of directional testing

The following conclusions follow on from the points raised in the above example.

- By testing debit balances (in the client's accounting system) **directly for overstatement**, total credit balances will also be tested - **indirectly - for overstatement**.
- By testing credit balances **directly for understatement**, total debit balances will also be tested - **indirectly – for understatement**.

Directional testing is therefore based on the following approach to the audit.

- If all asset balances and expenses for the year (**debits**) are tested directly for **overstatement**, and
- all liability balances and income for the year (**credits**) are tested directly for **understatement**
- then misstatement in the opposite directions (overstatement of credit balances and understatement of debit balances) will be tested indirectly.

The main focus of directional testing is therefore:

- test debits for overstatement and
- test credits for understatement.

This is because:

- in the statement of financial position, assets are more likely to be overstated and liabilities are more likely to be understated
- a misappropriation or fraud will often result in an overstatement of an asset or expense. For example, the theft of cash may be 'hidden' fraudulently by writing it off, by means of the ledger entry: Cr Cash and Dr Expense.

#### Testing for overstatement of debit balances

A **test for overstatement** starts with the monetary amount recorded in the financial statements. The direction of testing is then '**backwards**' to its source. Such tests seek to confirm **existence**. For example, in testing purchases for overstatement, balances in the financial statements will be traced back to signed goods received notes as evidence that the goods were received.

#### Testing for understatement of credit balances

A **test for understatement** starts at the source and traces transactions '**forwards**' to the financial statements. These tests are aimed at ensuring the **completeness** (and accuracy) of recorded transactions and balances. For example, in testing sales for understatement, signed despatch notes are traced through to sales in the financial statements to check that the sale was recorded.

#### Example:

##### Testing trade receivables balances for over-statement/existence

A starting point for testing will be the entity's list of receivables balances (the list of customers owing money) as at the end of the reporting period. The auditor wants to check that these receivables do infact exist. One way of doing this is to write directly to customers on the list asking them to confirm the amount that they owe the entity.

Alternatively, if the auditor is checking documentation within the client entity, he can take a sample of receivables from the list of balances, and trace their existence back through the accounting records, from receivables ledger to sales day book (receivables day book) to invoice.

##### Testing trade payables balances for understatement/completeness

To test payables for completeness, there is no point in taking as a starting point the entity's list of payables balances – because this may not be complete, and the auditor is testing for completeness.

Instead, the auditor may write to regular suppliers who might possibly be year- end payables, based on the total amount of purchases from the supplier during the year. If the supplier is not on the list of trade payables or is listed as a payable for only a small amount, the auditor can ask the supplier to confirm this fact. This is often referred to as testing the '**reciprocal** population'.

Alternatively, if the auditor is checking documentation within the client entity, he may take as a starting point a sample of documents indicating that goods have been purchased or received – such as a sample of goods received notes – and then trace the purchase through the system from purchase invoice to purchases day book (payables day book) to payables ledger.

### 1.4 Sampling: ISA530

ISA 530 *Audit sampling* states that the objective of audit sampling is to give the auditor a **reasonable basis for his conclusion about the population from which the sample is drawn**. The auditor is not interested in the result from the sample itself – he is only interested in it as a basis for reaching a conclusion about the whole population under test.

However, there is always a risk that the auditor will reach a different conclusion based on the sample than he would have reached had he tested the entire population. This is referred to as **sampling risk**. To reduce this risk (and therefore detection risk) to a minimum the sample must be designed in such a way as to be **representative** of the whole population.

In setting his sample size the auditor will need to consider the **expected misstatement** (for tests of details) or **rate of deviation** (for tests of controls). This assessment will be based on his experience in this area from previous audits and on any related areas on the current audit. The results of the sample (projected for tests of detail) will be compared to **tolerable misstatement/rate of deviation**.

#### Factors to consider when selecting sample size

If an audit sampling exercise is to be effective – if sampling risk is to be reduced and therefore detection risk reduced – the sample must be designed in an appropriate way.

When designing a sample, the auditor is **required** by ISA 530 to:

- consider the purpose of the audit procedure and the population from which the sample will be drawn;
- determine a sample size sufficient to reduce sampling risk to an acceptably lowlevel; and
- select items for the sample in such a way that each sampling unit in the population has an equal chance of selection.

The auditor will therefore have to make a number of **key decisions**:

- the sampling approach to be used (statistical or non-statistical);
- the characteristics of the population from which the sample is to be drawn;
- the sample selection method;
- what constitutes a misstatement or deviation;
- the 'tolerable' misstatement or rate of deviation; and
- the 'expected' misstatement or rate of deviation.

All of the above decisions will influence the sample size required.

#### Method of audit sampling: statistical sampling and non-statistical sampling

ISA 530 distinguishes between statistical sampling and non-statistical sampling:

- Statistical sampling** is any sampling approach that involves random selection and applies probability theory to the evaluation of the sample results and the measurement of sampling risk.
- Non-statistical sampling** (also known as **judgemental sampling**) is any sampling technique not based on probability theory. Instead, it is based on a judgemental opinion by the auditor about the results of the sample.

### Specific method of sampling

The population is defined by ISA 530 as **the entire set of data from which a sample is to be selected and about which the auditor wishes to draw conclusions.**

The population from which a sample is to be drawn should be appropriate for the audit objective to be achieved, and the population should be complete. (In other words, all relevant items must be included in the population).

Each individual item in the population (trade receivables in the example above) is referred to as a **sampling unit**. It is important that all sampling units should be homogeneous, (have the same characteristics).

ISA 530 requires auditors to select a sample in such a way that each item in the population (each 'sampling unit') has an equal chance of being selected.

A wide range of sample selection methods is available to the auditor:

- Random sampling:** All items in the population have an equal chance of selection. This is typically achieved by the use of random numbers to select items for testing.
- Systematic sampling:** With systematic sampling, a random starting point is chosen from the population and then items are selected with a standard gap between them (for example, every 10th item). For example, suppose that a sample will be 10% of the items in a population and the items in the population can be arranged in a sequence, such as listed in invoice number order, or account number order or date order. A systematic sample would be to select one of the first 10 items in the list at random, and then to select every 10th item in the list for testing in order to obtain the 10% sample.
- Haphazard sampling:** The auditor selects the sample on an arbitrary basis, for example, choosing any 100 invoices from a file. This is not a scientifically valid method and the resulting sample may contain a degree of bias. It is therefore not recommended for use with statistical sampling techniques.

#### Definition: Tolerable misstatement

**Tolerable misstatement** is a monetary amount set by the auditor in order to address the risk that the total of individually immaterial misstatements may cause the financial statements to be materially misstated. It is the application of performance materiality (as discussed in a previous chapter) to a particular sampling procedure. A misstatement above "tolerable misstatement" would therefore be considered material.

#### Definition: Tolerable rate of deviation

Following on from the above, the **tolerable rate of deviation** is a rate of deviation from prescribed control procedures which the auditor is prepared to accept and still be able to conclude that the financial statements are materially correct

## 1.5 Analytical procedures: ISA520

It is important to remember two key points when dealing with analytical procedures.

- The evidence generated is 'supplementary' to evidence gained from other audit testing procedures.
- The basic objective of analytical procedures is to allow the auditor to assess whether the reported figures 'make sense' in the context of known business facts. If the analysis indicates that there are some figures or ratios that do not make sense (there are some 'anomalies'), these require further investigation by the auditor.

### The nature and purpose of analytical procedures

'Analytical procedures' are defined by ISA 520 *Analytical procedures* as "evaluations of financial information through analysis of plausible relationships among both financial and non-financial data."

The analysis usually considers both **comparisons** and **relationships**.

Financial information in the draft financial statements is often **compared with a benchmark**. For example, ratios, trends and relationships for the current financial year are compared with:

- prior periods (historical data)
- budgets and forecasts (future – oriented data)
- predictive estimates (in other words, estimates of the expense or income that might have been predicted, such as a prediction of the annual depreciation charge)
- (more rarely) industry averages (= ratios for business entities in the industry as a whole).

Typically, **relationships** are used in analytical procedures to analyse:

- items of financial information that are expected to adhere to a predicted pattern (such as gross profit margins: any significant change in this margin compared with the previous years should be investigated)
- relationships between financial and non-financial information that might be predictable (such as payroll costs per employee).

### Using analytical procedures in the audit process

Analytical procedures can be used at three stages in the audit process.

- They **must** be used **in planning** the nature, timing and extent of other audit procedures.
- They **may** be used **as a substantive procedure** when their use is more effective or efficient than detailed substantive tests of transactions and balances.
- They **must** be used **at the overall review stage**, to allow the auditor to conclude whether the financial statements as a whole are consistent with his knowledge of the business.

Analytical procedures are not concerned only with the analysis of trends. The auditor must use analytical procedures to reach a conclusion about the financial statements. It is not sufficient for the auditor to calculate and summarise ratios for

this year and previous years, and to record the trends over time. Analytical procedures are also concerned with:

- the **investigation** of changes away from expected trends, and
- the **corroboration** of explanations as to why these changes have happened when they were not expected to.

#### **Example: Analytical procedures**

An auditor has calculated the gross profit percentage for a client company. This year the gross profit is 25% of sales, but last year it was 20%. The auditor is not aware of any change in the nature of the client's business, and he had been expecting the gross profit percentage to remain constant, at about 20%.

The finance director of the client company gives the explanation that purchase prices have fallen in the past year or so, relative to sales prices. The auditor should not accept this explanation as a proper explanation without finding evidence to corroborate it.

It is possible that purchase prices have fallen in relation to sales prices. However, a possibility that the auditor needs to eliminate is that purchase prices have not fallen, but the client company's management have included an excessively high figure for closing inventory in the statement of financial position, in order to increase profits.

A closer investigation of purchase prices should confirm the finance director's explanation or leave the auditor with a suspicion that there is something unusual in the financial statements and that a proper explanation has yet to be found.

#### **The extent of use of analytical procedures**

Several factors should determine the extent to which the auditor can use analytical procedures as a form of audit evidence. ISA 520 **requires** the auditor to:

- Determine the suitability of particular substantive analytical procedures for given assertions – i.e. how effective they will be in detecting a particular type of material misstatement. This usually depends on the closeness of relationships between items of data. Analytical procedures are more appropriate when relationships are plausible and predictable. For example, there is normally a close relationship between sales commission and sales revenue, whereas the relationship between administration costs and sales revenue is less close and so less predictable.
- Develop an expectation of recorded amounts or ratios and evaluate whether that expectation is sufficiently precise to identify a misstatement. How effectively this can be done depends on factors such as:
  - the accuracy with which amounts can be predicted
  - the extent to which information can be disaggregated (e.g. sales split out by product line)
  - the availability of information.
- Evaluate the reliability of the data from which the expectation has been developed. If data is unreliable then it will be of little use. The auditor should consider such factors as:
  - the source of the information

- comparability of the information available (broad industry data may not be suitable for an entity with more specialized products)
  - the nature and relevance of the information available (budgets may not be suitable if they have been prepared as goals rather than expectations)
  - controls over the preparation of the data.
- Determine what level of difference from expected amounts is acceptable without further investigation (i.e. link to materiality).

#### Investigation of fluctuations

Fluctuations are significant changes in a financial ratio or a trend, compared with previous financial years.

When carrying out analytical procedures, the auditor is primarily concerned with identifying the unexpected and reasons to explain why anything unexpected has happened. If the unexpected has occurred and cannot be explained, further investigation by the auditor will be necessary.

Trends or deviations that do not fit with known business facts should be discussed with client staff and explanations must be obtained. It is often more useful to the auditor to discuss matters with several of the client's staff, who are responsible for non-financial as well as for financial operations.

Explanations must not be accepted at face value but should be corroborated by:

- other audit evidence, or
- the auditor's knowledge of the client and the industry in which it operates.

Therefore, if the auditor finds:

- fluctuations or relationships which are inconsistent with other information, or
- unacceptable levels of differences from expected amounts

then ISA 520 **requires** him to:

- make inquiries of management and verify management's responses, and
- perform other audit procedures as necessary.

## 2 AUDIT DOCUMENTATION: ISA230

### Section overview

- Audit documentation (audit working papers)
- Reasons for preparing sufficient and appropriate audit documentation
- Form, content and extent of audit documentation
- Computer-generated audit working papers
- Ownership, custody and confidentiality of audit working papers

#### 2.1 Audit documentation (audit working papers)

All audit work must be properly documented and held in the audit file (also known as audit working papers). This documentation provides a record of:

- the audit procedures performed
- audit evidence obtained, and
- the conclusions reached.

The documentation must provide:

- a sufficient and appropriate record of the basis for the audit report, and
- evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements.

ISA 230 requires the auditor to prepare documentation **on a timely basis**, sufficient to enable an experienced auditor **with no previous connection with that audit** to understand:

- the nature, timing and extent of the audit procedures performed
- the results of those procedures and the audit evidence obtained, and
- significant matters which arose during the audit and the conclusions reached thereon.

The auditor is also required to document:

- discussions of all significant matters
- how any inconsistencies with the final conclusion on significant matters were resolved
- and justify any departure from a basic principle or relevant procedure specified by an ISA.

#### 2.2 Reasons for preparing sufficient and appropriate audit documentation

Preparing sufficient and appropriate audit documentation **on a timely basis** helps to:

- enhance the quality of the audit, and
- facilitate the effective review and evaluation of the audit evidence obtained and conclusions reached, before the audit report is finalised.

**Documentation prepared at the time the work is performed is likely to be more accurate than documentation prepared later.**

Other purposes of audit documentation include the following.

- Assisting the audit team to plan and perform the audit.
- Assisting supervisors in directing and supervising audit work.
- Ensuring members of the audit team are accountable for their work.
- Keeping a record of matters of continuing significance to future audits.
- Enabling an experienced auditor, with no previous connection with that audit, to conduct quality control reviews or other inspections i.e. by understanding the work that has been performed and the conclusions that have been reached.

### 2.3 Form, content and extent of audit documentation

Audit documentation may be recorded on paper, or on electronic or other media. The audit documentation for a specific engagement is assembled in an **audit file**. The precise contents of the audit working papers varies, depending on the nature and size of the client and the complexity of the audit processes required to reach a conclusion but will include:

- Audit programs
- analyses
- summaries of significant matters
- letters of confirmation and representation
- checklists, and
- correspondence.

Traditionally, it has been normal practice to maintain two types of audit files, a permanent file and a current file.

#### Permanent file

The **permanent file** records information that is likely to be of significance to every annual audit of that client. Examples of such information might include the following.

- The legal constitution of the company.
- Other important legal documents such as loan agreements.
- A summary of the history, development and ownership of the business.
- A record of the accounting systems and procedures used by the client.
- Copies of the financial statements for the previous years, with key financial ratios and trends.

This information is of continuing significance, and it is therefore important that the auditor should review the contents of the permanent file regularly and update it as appropriate.

#### Current file

The **current file** contains information of relevance to the current year's audit. This will be the main evidence on which the conclusion for the current audit will be based. Examples of the contents of a current audit file include the following.

- The final financial statements and auditor's report.

- A summary of audit adjustments, including those not included in the final reported figures.
- Audit planning documentation.
- Audit control material (time budgets, review points, points for consideration by the engagement partner).
- Audit letters.
- For each 'audit area' (such as inventory, sales and payroll):
  - an audit plan (detailing the work to be done on that area)
  - details of items selected for testing, the tests performed, problems that were encountered (and how these problems were resolved) and the conclusion reached by the auditor on that area of operations/the financial statements
  - 'lead schedules': these give the figures for the audit area that will appear in the final financial statements.

All audit working papers should clearly show the following (where relevant) and for each audit area as appropriate:

- the name of the client
- the accounting date
- a file reference
- the name of the person preparing the working paper
- the date the paper was prepared
- the name of any person reviewing the work and the extent of such review
- the date of the review
- a key to/explanation of the audit ticks or symbols used in the working papers
- a listing of any errors or omissions identified
- the auditor's conclusion on the area

ISA 230 requires the auditor to assemble the **final audit file(s)** on a timely basis after the date of the audit report (ordinarily not more than 60 days). This usually excludes drafts of working papers or financial statements, or notes that reflect incomplete or preliminary thinking. After the assembly of the final audit file has been completed, the auditor **must not delete or discard audit documentation** before the end of its retention period (see below).

If it does become necessary to modify existing or add new documentation after this stage, the auditor must document:

- when and by whom the modifications were made
- the reasons for making them.

If exceptional circumstances arise after the date of the audit report, such that the auditor:

- has to perform new or additional procedures, or
- reaches new conclusions

The auditor must document:

- the circumstances
- the new or additional procedures performed, audit evidence obtained, conclusions reached and their effect on the auditor's report, and
- when and by whom the resulting changes to audit documentation were made and who reviewed them.

#### 2.4 Computer-generated audit working papers

Auditors often use computer software (with laptop computers) to improve the efficiency of preparing audit working papers. These software packages can be used to help the auditor to prepare:

- analysis schedules (especially where the audit firm uses standardised working papers)
- lead schedules, and
- draft financial statements.

These schedules and statements can usually be cross-referenced and updated automatically as the audit proceeds, to allow for adjustments that the auditor makes.

The advantages of these computer software packages for auditors are as follows.

- The working papers are neat, easy to read and in a standard format.
- There is a lower risk of error by the auditor in processing adjustments.
- The audit review process by senior managers or the audit partner can be carried out remotely, without the necessity for the manager or partner to visit the client's premises to carry out there view.

The automatic processing of adjustments by the auditor, using software, may result in significant savings in time (and cost).

#### 2.5 Ownership, custody and confidentiality of audit working papers

The audit firm has ownership of the audit working papers. The papers are not a part of the client's accounting records and do not belong to the client.

The auditor needs to decide how long to keep the audit files. ISQC1 requires a minimum period of **five years** from the date of the audit report, or group audit report if later (and relevant).

Auditing standards require the auditor to ensure that working papers are kept safe and that their contents are kept confidential. Confidential information should only be made available to third parties in accordance with ethical guidelines.

### 3 RELATED PARTIES: ISA 550

#### Section overview

- Related parties and related party transactions
- The impact on the audit of related party relationships and transactions
- The requirements of ISA 550

#### 3.1 Related parties and related party transactions

**Related parties** are individuals or organisations that might have, or might be expected to have, an undue influence on the company that is being audited. Examples of related parties include:

- the directors and key management of a company
- their families
- other companies controlled by directors, key managers and members of their close family
- other companies in the same group.

Related party transactions are material transactions between the client company and a related party of the company.

It is the responsibility of the client company's management to record and disclose all material **related party transactions**, because these transactions may be carried out on more favourable terms than similar transactions with an independent third party.

The approach required by IAS 24 *Related party disclosures* is to disclose the relevant amounts of related party transactions and the nature of the related party relationships, so that the users of the financial statements can decide for themselves whether these transactions might have resulted in a manipulation or distortion of the financial statements.

ISA 550 *Related parties* deals with the auditor's responsibilities in respect of related party transactions. It was revised (and redrafted) in July 2008 for two main reasons.

- The increased public attention given to accounting for related party relationships, because a number of major corporate scandals (such as Enron in the US) have involved related parties.
- The previous version of ISA 550 was mainly procedural in nature and did not discuss the risks of material misstatement that may arise from the existence of related party relationships and transactions.

The requirements of ISA 550 are discussed below.

#### 3.2 The impact on the audit of related party relationships and transactions

Although many related party transactions are in the normal course of business and therefore may carry no higher a risk of material misstatement than ordinary transactions, in some circumstances related party transactions may lead to higher risks. For example:

- related parties may operate through complex structures and relationships and the resulting transactions may therefore also be complex

- accounting systems may not be effective at identifying and summarising related party transactions and balances
- related party transactions may not be conducted on normal market terms – some may even be conducted with nil consideration.

The **objectives** of the auditor with regard to ISA 550 are to obtain:

- an **understanding** of the entity's related party relationships and transactions, and
- sufficient appropriate audit evidence about whether related party relationships and transactions have been **appropriately identified, accounted for and disclosed** in the financial statements.

The understanding must be sufficient for the auditor to be able to:

- recognise **fraud risk factors** arising from related party relationships and transactions
- conclude whether the financial statements achieve **fair presentation** in respect of related party relationships and transactions.

There is an increased risk of fraud in this area as related party relationships may present a greater opportunity for collusion, concealment or manipulation by management. It is therefore particularly important that the auditor approaches this area of the audit with **professional scepticism**.

### 3.3 The requirements of ISA 550

Most material misstatements linked to related party transactions arise from failure by the management of the client company to disclose related party relationships and transactions to the auditor.

ISA 550 therefore sets out a minimum set of risk assessment procedures specifically directed towards the identification of related party relationships and transactions that have not been identified or disclosed by management.

#### Risk assessment procedures

As part of the risk assessment procedures required by ISAs 240 and 315 the auditor is required to perform the following procedures in order to **understand the entity's related party relationships and transactions**:

- Consider the risk of material misstatement due to fraud or error arising from related party relationships and transactions.
- Make inquiries of management in respect of:
  - the identity of related parties
  - the nature of relationships with those related parties
  - the nature of any transactions entered into with those parties during the period.
- Obtain an understanding of the internal controls in operation over:
  - the identification of, accounting for and disclosure of related party relationships and transactions
  - the authorisation and approval of significant related party transactions
  - the authorisation and approval of significant transactions outside the normal course of business.

### Identifying related parties and related party transactions

In making inquiries of management in respect of the identity of related parties, the auditor will obtain a list of related parties from the directors and consider if this list is complete. **Tests for completeness** could include the following:

- Review working papers for previous years, to look for names of known related parties.
- Review the company's procedures for identifying related parties.
- Inquire about the relationships between directors and other entities (for example, does any director own another company, and have there been any transactions between that company and the client company?)
- Review shareholder records for the names of major shareholders.
- Review minutes of shareholder meetings (general meetings of the company).
- Ask any other audit firms involved in the audit about related parties (if the audit is the audit of a group of companies and more than one firm of auditors is involved). Or ask previous auditors of the company about their knowledge of related parties.

The auditor may have difficulty in obtaining a complete list of related parties. This is because their main source of information about related parties is the client's management, who may wish to keep related party relationships hidden. Particular problem areas where the disclosure of related parties may be incomplete are:

- close family relationships
- where the related party is another business entity which is owned or influenced by a director of the client company: however two companies are not necessarily related parties just because the same individual is a director or shareholder in both – the key issue is whether the individual is in a position of influence in both companies.

The auditor may also have difficulty in identifying all related party transactions that have occurred, unless the client entity has recorded them separately.

Related party transactions may be 'hidden' within all the other transactions recorded in the accounts of the entity.

During the audit the auditor must remain alert, **when inspecting records or documents**, for information which might indicate the existence of previously unidentified or undisclosed related party relationships or related party transactions. The auditor is also specifically required to inspect the following:

- Any bank and legal confirmations obtained as part of his audit work.
- Minutes of shareholder and management meetings.
- Any other records or documents the auditor considers necessary in the specific circumstances.

If the auditor identifies **significant transactions outside the entity's normal course of business**, he must inquire as to the nature of these transactions and whether related parties could be involved. This is because these carry a higher risk of involving related parties who have previously been unidentified or undisclosed. ISA 550 states that any significant related party transactions outside the entity's normal course of business must be treated as giving rise to significant risks of material misstatement.

The whole audit team should be made aware of information obtained about the entity's related parties so that they can identify any previously undisclosed transactions with related parties.

If any fraud risk factors are found these must be considered when the auditor identifies and assesses the risks of material misstatement due to fraud in accordance with ISA 240. A key fraud risk factor identified by ISA 550 is the existence of a party who exerts **dominant influence** over the entity. Any such party (an individual or a company) is likely to be able to override the views of the entity's management and force the entity to enter into a transaction in which the dominant party has an interest.

Indicators that a person or entity might be a dominant party include:

- the party vetoing significant business decisions of the entity
- significant transactions being referred to the party for final approval
- little or no debate among management in respect of business proposals made by the party
- transactions involving the party (or its close family members) are rarely independently reviewed or approved.

#### **Responses to the risks of material misstatement**

As discussed in a previous chapter, the auditor is required by ISA 330 to respond to assessed risks. In the context of the assessed risks of material misstatement arising from related party relationships and transactions ISA 550 requires the following audit procedures.

If the auditor discovers previously unidentified or undisclosed related parties or (significant) related party transactions he must:

- Determine whether the underlying circumstances confirm the existence of those relationships or transactions.
- Communicate the relevant information to the audit team.
- Request management to identify all transactions with the newly identified related parties.
- Inquire as to why the entity's system failed to identify or disclose these related party relationships or transactions.
- Perform appropriate substantive procedures on the newly identified related parties or significant related party transactions.
- Reconsider the risk of there being unidentified or undisclosed related parties or (significant) related party transactions and perform additional procedures as necessary.
- If the non-disclosure appears intentional, evaluate the implications for the audit.

If the auditor discovers significant related party transactions outside the entity's normal course of business, he must:

- Inspect the underlying contracts or agreements to evaluate whether:
  - the contracts etc. were entered into in order to engage in fraudulent financial reporting or to hide the misappropriation of assets (a lack of business rationale might indicate this)
  - the terms of the contracts etc. are consistent with management's explanations, and
  - the transactions have been properly accounted for and disclosed.
- Obtain evidence that the transactions were properly authorised.

If management has made a statement in the notes to the financial statements that a related party transaction was made on the same terms as an arm's length transaction, the auditor must obtain evidence to support this assertion.

#### **Materiality of related party transactions**

ISA 450 *Evaluation of misstatements identified during the audit*, which is covered in a later chapter, requires the auditor to consider both the **size and the nature** of a misstatement, and the **particular circumstances of its occurrence**, when evaluating whether a misstatement is material.

In the context of related party transactions, this means that much smaller transactions in monetary terms may be material as the significance of the transaction to the users of the financial statements may not depend solely on the recorded amount of the transaction but also on the nature of the related party relationship. It may be tempting to assume that materiality means 'large', but in the case of related party transactions, a transaction could be material if it has a value as low as ₦0 (for example, a transaction involving the sale of the company's assets to a related party for a very low price).

#### **Other requirements**

**Written representations** must always be obtained by the auditor from the directors about related parties and related party transactions. The directors are in the best position to know the identities of any related parties. The written representation from the directors must cover:

- the completeness of the information that has been provided about the identity of related parties and related party relationships and transactions, and
- the adequacy of accounting for and disclosure of such related party relationships and transactions in the financial statements.

Unless all of those charged with governance are involved in managing the entity, the auditor **must communicate to those charged with governance** significant matters arising during the audit in connection with the entity's related parties.

The names of all identified related parties and the nature of the related party relationships must be **documented**.



### Example: Audit matters and audit evidence

The draft statement of financial position of ABC Company includes an amount of ₦30,000 owed by DE Company. The total assets of ABC Company are ₦10 million.

The auditor has obtained the following audit evidence:

- DE Company is controlled by the chairman of ABC Company, who is its majority shareholder.
- The draft financial statements of ABC Company do not provide any disclosures about the ₦30,000 transaction, on the grounds that it is immaterial.
- There is no information about the nature of the transaction, but the ₦30,000 had been included in receivables at the end of the previous financial year.

#### Required

What further measures should the auditor take?



### Answer

The auditor should first establish whether DE Company is a related party of ABC Company. From the information available it would seem that it is a related party, because the chairman of ABC Company, as a majority shareholder in DE Company, would appear to be in a position of influence in both companies.

Although the amount receivable is not material in terms of value (in relation to the value of total assets of ABC), the materiality of related party transactions should not be judged only on the basis of value. The nature of the transaction is also relevant for judging materiality. The auditor needs to obtain more information. The chairman should be asked to provide more details. In addition, the auditor should review the written terms of the transaction (if there are any) and should obtain a written representation from the chairman about the nature of his influence over DE Company, whether the amount receivable by ABC Company is likely to be recoverable and when it is likely to be paid. The auditor should also review board minutes of ABC Company for any recorded discussions by the board of the transaction with DE Company.

If the auditor takes the view that the transaction is a related party transaction, he should notify management of the need for disclosure in the financial statements. Disclosure is required of the nature and amount of the transaction, the amount of any balances (and details of any security given) and any allowances that have been made for an irrecoverable amount. Since the amount was receivable one year ago, the auditor should also consider the expected date of payment, and whether the balance is more in the nature of a long-term loan receivable than a current asset.

## 4 WRITTEN REPRESENTATIONS: ISA 580

### Section overview

- Definition and objectives
- Written representations as audit evidence
- Written representations about management's responsibilities
- Form and contents of the letter of representation
- Refusal to provide requested written representations

#### 4.1 Definition and objectives

ISA 580 defines a written representation as a written statement by management provided to confirm certain matters or to support other audit evidence.

The **objectives** of the auditor in this area, per ISA 580, are to:

- obtain written representations from management that it has fulfilled its responsibilities in respect of the financial statements and the audit
- obtain written representations as appropriate to support other audit evidence
- respond appropriately to written representations provided by management or if management refuse to provide the written representations requested.

ISA 580 requires the auditor to obtain appropriate written representations from management (often referred to as "**management representations**") in the form of a **letter of representation**, addressed to the auditor.

These written representations may be an important source of audit evidence.

#### 4.2 Written representations as audit evidence

If the auditor considers that written representations are needed **to support other audit evidence**, he must request such other written representations.

During the course of the audit, management will make many representations to the auditor. Some of these will be unsolicited but some will be given in response to specific inquiries from the auditor. The auditor will have recorded such verbal discussions with management in the audit working papers. However, verbal evidence is not strong audit evidence. In order to improve the quality of this evidence, the auditor will ask for any significant discussions to be confirmed in writing.

Such representations are likely to be needed:

- to support the auditor's understanding of management's intention or judgment (for example, in respect of future plans for the business or a specific matter such as the net realisable value of inventory), or
- in respect of the completeness of a specific item (for example, that all liabilities have been provided for).

However, although such written representations provide necessary audit evidence, **they do not provide sufficient appropriate evidence on their own**.

If a written representation is contradicted by other audit evidence, the auditor should:

- consider whether his risk assessment of that area is still appropriate
- consider whether additional audit procedures are needed
- if he has concerns about the integrity of management, document those concerns and consider withdrawing from the audit.

The auditor is also required by specific other ISAs to request certain other written representations. These requirements are illustrated in the example letter set out below.

#### 4.3 Written representations about management's responsibilities

The auditor is also required by ISA 580 to obtain certain other written representations from management. In these representations, management acknowledges that:

- it has fulfilled its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
- it has provided the auditor with all relevant information
- all transactions have been recorded and are reflected in the financial statements.

Again, these points are illustrated in the example letter set out below.

#### 4.4 Form and contents of the letter of representation

The letter of representation is:

- usually drafted by the auditor (as he knows the areas on which he requires written representations)
- addressed to the auditor
- dated as near as practicable (but not after) the date of the audit report.

The following example of a letter of representation shows the minimum contents of such a letter. However, remember that the auditor may also need to request management to provide written representations about specific assertions in the financial statements.

**Example of a letter of representation**

(Entity Letterhead)

(To Auditor)

(Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Ltd for the year ended 31 December 31 20X1 for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or give a true and fair view) in accordance with International Financial Reporting Standards.

We confirm that (*to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*):

### **Financial statements**

We have fulfilled our responsibilities for the preparation and presentation of the financial statements as set out in the terms of the audit engagement dated..... and, in particular, the financial statements are fairly presented (or give a true and fair view) in accordance with International Financial Reporting Standards.

Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable. (ISA 540).

Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of International Financial Reporting Standards. (ISA 550).

All events subsequent to the date of the financial statements and for which International Financial Reporting Standards require adjustment or disclosure have been adjusted or disclosed. (ISA 560).

The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (ISA 450)

### **Information provided**

We have provided you with:

- all information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements
- additional information that you have requested from us; and
- unrestricted access to those within the entity.

All transactions have been recorded in the accounting records and are reflected in the financial statements.

We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (ISA 240).

We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:

- management
- employees who have significant roles in internal control; or
- others where the fraud could have a material effect on the financial statements. (ISA240)

We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (ISA 240)

We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements. (ISA 250)

We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (ISA 550)

#### 4.5 Refusal to provide requested written representations

If management refuse to provide requested written representations the auditor must:

- discuss the matter with management
- re-evaluate the integrity of management and reconsider the impact on other representations and audit evidence, and
- take appropriate action, including considering the effect on the audit report.

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## 5 USING THE WORK OF AN AUDITOR'S EXPERT: ISA 620

### Section overview

- Definition of an expert
- Assessing the need for an expert
- Assessing the work of an expert

#### 5.1 Definition of an expert



##### Definition: Auditor's expert

The term 'expert' is used herein the sense of an individual or an organisation that possesses skills, knowledge and experience in **fields other than accounting or auditing**

The auditor may use the work of an expert to provide knowledge relevant to the audit, which the audit firm itself does not possess. ISA 620 *Using the work of an auditor's expert* gives a number of examples where experts may be used by an auditor. These include:

- Legal opinions
- specialist valuation areas, such as property or pension liabilities
- the analysis of complex or unusual tax compliance issues.

Note that the ISA covers the work of **the auditor's** expert – the expert is employed by the auditor, not by the entity. The situation where management use the work of an expert was covered above, under ISA 500.

The **objective** of ISA 620 is to allow the auditor to:

- decide whether to use the work of an expert, and
- assess whether that work is adequate.

#### 5.2 Assessing the need for an expert

There is a cost attached to the use of an expert by the auditors. The expert will charge a fee for the professional service he provides. The use of an expert should therefore be evaluated on a cost/benefit basis.

When deciding whether he needs to use an expert to assist him in obtaining sufficient appropriate evidence, the auditor should consider such factors as:

- the nature, significance and complexity of the matter
- the risk of material misstatement
- the availability of alternative sources of audit evidence.

### 5.3 Assessing the work of an expert

ISA 620 **requires** the auditor to apply the procedures set out below when using the work of an expert. The auditor shall:

- obtain an understanding of the expert's field of expertise, sufficient to allow the auditor to determine the nature, scope and objectives of the expert's work and evaluate the adequacy of that work
- agree terms of engagement with the expert, including:
  - the nature, scope and objectives of the expert's work
  - the respective responsibilities of the expert and the auditor
  - the form of the expert's report
  - confidentiality requirements
- evaluate the adequacy of the expert's work, including the:
  - reasonableness of the expert's conclusions
  - consistency of those conclusions with other audit evidence
  - reasonableness of significant assumptions and methods used
  - relevance, completeness and accuracy of source data.

Generally, the auditor is assessing whether the expert's work constitutes sufficient and appropriate audit evidence.

If the auditor decides that the work of the expert is not adequate, he is **required** to:

- agree additional work with the expert, or
- perform other appropriate additional audit procedures.

The auditor has sole responsibility for the audit opinion issued and this is not reduced in any way by his use of an expert. Therefore **he should not refer in his report to the use of an expert**, unless that is required by law or regulation. Even then, or if the auditor refers to the expert's work in his report because it is relevant to an understanding of a modified opinion, then he must make it clear that such a reference does not reduce his responsibility for that opinion in any way.

This approach reinforces the point made earlier, that the auditor remains fully responsible for the report produced, even if evidence on which it is based was produced by others. The auditor therefore cannot simply accept work performed by experts. That work must be evaluated in the same way as other audit evidence is evaluated.

The competence, capabilities and objectivity of an expert may be assessed in one or more of the following ways:

- Personal experience with previous work of that expert;
- Discussions with that expert;
- Discussions with other auditors or others who are familiar with that expert's work; and
- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.

- Published papers or books written by that expert.

The objectivity of the expert is probably more of an issue when the expert has been employed by the audit client, as discussed earlier in this chapter in section 1.2 regarding using the work of management's expert.

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## 6 THE EXTERNAL AUDITOR'S RELIANCE ON THE WORK OF THE INTERNAL AUDITOR: ISA 610

### Section overview

- Reliance on internal audit: the external auditor's problem
- ISA 610: Using the work of internal auditors

#### 6.1 Reliance on internal audit: the external auditor's problem

In many instances the work of the external auditors and internal auditors may overlap, particularly when the internal audit department carry out financial audits. In principle, the external auditors may be able to reduce the amount of testing and checking they carry out for the external audit, by relying on work that has already been carried out by the internal auditors. Reliance by the external auditor on the work of the internal auditors, where it is appropriate to do so, should lead to a more efficient and cost-effective audit.

However, the external auditor has a problem. The external auditor is responsible for his opinion on the financial statements, **even if he has relied on the work of others** such as internal auditors and external experts. The responsibility for relying on work done by the internal auditors rests entirely with the external auditors.

The external auditors must therefore be satisfied that they can rely on the work of the internal auditors to support the external audit opinion. The external auditors must therefore decide whether to rely on work done by the internal auditors, and if so, in what respect?

#### 6.2 ISA 610: Using the work of internal auditors

ISA 610 provides guidance to the external auditor who has decided that the entity's internal audit function is likely to be relevant to his audit. The **objectives** of the external auditor are then to decide:

- whether and to what extent to use specific work of the internal auditors
- if so, whether such work is adequate for the purposes of the external audit.

To determine whether such work is adequate for his purposes, the external auditor is **required to evaluate** the internal audit function and its procedures. A decision can then be taken as to whether the work of the internal auditors can be used as part of the evidence on which the external audit opinion will be based.

The following factors should be considered by the external auditors in making the assessment of internal audit:

- The status of the internal audit department within the entity. In particular, the **objectivity** of the internal audit department is important. The external auditors will be more willing to rely on the internal auditors if the internal audit department has a considerable degree of operational independence – for example, in deciding the nature of the audit work it will carry out, and in reporting to an 'independent' senior person or body within the entity, such as the audit committee (rather than the finance director). The external auditor will also need to consider the scope of the internal audit work and any restrictions placed by senior management on the scope of its work and whether management act on recommendations in internal audit reports.

management ignore recommendations in internal audit reports, the external auditors cannot have much confidence in the ability of internal audit to ensure the effectiveness of internal control.

- The **technical competence** and **due professional care** of the internal auditors. The external auditors must be satisfied that the internal audit staff have sufficient technical competence and take a professional approach towards their work.
- There will need to be **effective communication** between the external and internal auditors with meetings held at appropriate intervals and each notifying the other of any significant matters that might affect the other's work.

In addition to the **general** assessment of the internal audit, ISA 610 also requires the external auditor to **evaluate each specific piece of work** performed by internal audit before it is used as external audit evidence.

To determine the **planned effect** of the work of internal audit on the nature, timing and extent of the external auditor's procedures, the external auditor is **required** to consider:

- the nature and scope of specific work performed or to be performed by internal audit
- the assessed risks of material misstatement at the account balance/transaction level
- the degree of subjectivity involved in the evaluation of evidence gathered by internal audit.

Because the external auditor is fully responsible for the audit opinion, he will need to test the work performed by the internal auditors. **Before using specific work** of internal audit the external auditor is **required** to evaluate whether:

- the work was performed by internal auditors with adequate technical training and proficiency
- the work was properly supervised, reviewed and documented
- adequate audit evidence was obtained
- appropriate conclusions were reached, consistent with any reports prepared
- any exceptions or unusual matters were properly resolved.

Procedures to achieve this might include:

- examining items already examined by internal audit
- examining other similar items
- observing procedures performed by internal audit.

The external auditor's evaluation of the internal audit function and its work should be fully documented in the external auditor's working papers.

## 7 THE AUDIT OF ACCOUNTING ESTIMATES: ISA 540

### Section overview

- The nature of accounting estimates and the audit problem
- ISA 540: Auditing accounting estimates
- IAASB Alert: Challenges in auditing fair value accounting estimates in the current market environment

#### 7.1 The nature of accounting estimates and the audit problem

In the financial statements, estimated figures are used in situations where it is not practical or not possible to obtain a more precise measurement of an item. ISA 540 defines an audit estimate as: 'an approximation of a monetary amount in the absence of a precise means of measurement.' Accruals, prepayments and depreciation are all examples of areas where estimates are widely used. Other examples are the estimation of deferred tax and provisions for the settlement of unfinished legal disputes.

Estimates are made for the financial statements by the management of the entity, using their judgement. The audit problem is therefore fairly clear. How does the auditor satisfy himself that the estimates made by management for inclusion in the financial statements are reasonable? The audit risk can be high.

#### 7.2 ISA 540: Auditing accounting estimates

ISA 540 *Auditing accounting estimates, including fair value accounting estimates, and related disclosures* is concerned with the audit of all accounting estimates, including those involving fair values. It requires auditors to obtain sufficient appropriate audit evidence as to whether:

- accounting estimates (whether recognised or disclosed in the financial statements) are reasonable, and
- whether the related disclosures are adequate.

Because of the number of major corporate scandals in recent years about aggressive 'earnings management', ISA 540 (revised and redrafted in accordance with the IAASB's clarity project) introduces requirements for greater rigour and scepticism in the audit of accounting estimates. It encompasses a risk-based approach, focusing on those estimates that have **high estimation uncertainty**.

ISA 540 gives the following examples of accounting estimates.

- Allowance for doubtful accounts
- Inventory obsolescence
- Warranty obligations
- Depreciation method or asset useful life
- Costs arising from litigation settlements and judgments
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability
- Outcome of long-term contracts

Additional examples of situations where fair value accounting estimates may be required include:

- complex financial instruments, which are not traded in an active and open market
- share-based payments
- property or equipment held for disposal
- certain assets or liabilities acquired in a business combination, including goodwill and intangible assets
- transactions involving the exchange of assets or liabilities.

Audit evidence relating to such estimates is often of relatively poor quality, because of the nature of the items involved. This means that the auditor will require a higher volume of this lower quality evidence, **particularly where the estimated item may be material, or the audit risk is relatively high.**

#### **Accounting estimates: auditing procedures**

As part of his **risk assessment procedures** ISA 540 requires the auditor to obtain an understanding of the following.

- The requirements of the applicable financial reporting framework (for example, international accounting standards) in respect of accounting estimates, including related disclosures.
- How management identify transactions or events that could result in an accounting estimate being recognised or disclosed in the financial statements.
- The nature of the estimates. In the case of a liability, this involves obtaining an understanding of the obligation for which an estimate is needed: for example in the case of a provision for costs of warranties or guarantees, what are the terms of the warranties or guarantees that have been given by the client to its customers?
- The auditor should also review the procedures used by management to make their estimates, including:
  - the method used for estimating (for example in deciding the estimated useful lives of non-current assets)
  - relevant controls
  - the use of experts
  - the underlying assumptions
  - whether there ought to have been any change in the method used since the prior period
  - whether and how management has assessed the effect of estimation uncertainty.
- If possible, the auditor should check the amount of an estimate against other known facts, to assess whether the estimated amount seems reasonable.

The auditor should also:

- review the outcome of accounting estimates included in the previous period's financial statements (to assess their reliability) and consider changes in the estimate from one year-end to the next.
- evaluate the degree of estimation uncertainty associated with each current period estimate and, if the risk is high, whether this gives rise to significant risks.

Having assessed the risks of material misstatement the auditor must then determine:

- whether management has properly applied the requirements of the applicable financial reporting framework, and
- whether the methods used for making the estimates are appropriate and have been consistently applied (or whether any change in method since the previous period is appropriate).

In response to the assessed risks of material misstatement the auditor must then perform one or more of the following procedures.

- Determine whether events up to the date of the auditor's report provide sufficient audit evidence in respect of the estimate. The auditor should review events after the reporting date, and if possible, find evidence to confirm the validity of the estimates.
- Test how management made the estimate and the data on which it is based, considering the method used and assumptions made.
- Test the controls over management's procedures for making estimates and carry out appropriate substantive procedures.
- Develop his own estimate or range of estimates and compare to management's figure, evaluating any significant differences.

**The auditor is also required to:**

- consider the need for expert evidence
- obtain written representations from management, and
- document the basis for his conclusions and any indications of management bias.

The following examples of indicators of possible management bias in estimates are given in the ISA.

- Changes in an accounting estimate, or the method for making it, where this is a subjective assessment.
- Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
- Selection or construction of significant assumptions that yield an estimate which favours management objectives.
- Selection of an unduly optimistic or pessimistic estimate.

### Auditing of fair value measurements

Issues relating to the audit of fair value measurements are similar to those for the audit of accounting estimates (and both are covered by ISA540). Balances of items measured at fair value, such as property and financial instruments, are often significant items in the statement of financial position.

The auditor needs to recognise the audit risk in fair value measurements:

- Inherent risk:** Many fair value measurements are largely subjective and imprecise, and there is unavoidable inherent risk in their measurement. Valuation models may be used, but these are often complex and may be unreliable (for example, in the case of non-marketable financial instruments, or models to assess the amount of liabilities to a company's pension fund). The inherent risk is much less when an open market exists for the items measured at fair value.
- Control risk:** There is some risk that the entity's systems may fail to prevent or detect valuation errors. Fair value measurements are often made by external experts, outside the normal course of routine business operations, and the controls over the valuation process are therefore likely to be weak.
- Detection risk:** The auditor should try to minimise detection risk, but the auditor may lack the knowledge and expertise to verify fair value measurements. This means that the auditor may need to rely on the work of an external expert, increasing the risk that errors in fair value measurements will not be discovered.

### 7.3 IAASB Alert: Challenges in auditing fair value accounting estimates in the current market environment

The IAASB issued an alert in October 2008 to assist auditors by highlighting areas within the International Standards on Auditing (ISAs) that are particularly relevant in the audit of fair value accounting estimates in times of market uncertainty. It was prepared in light of difficulties in the credit markets and therefore focused on financial instruments.

The alert also refers to related issues concerning whether an entity has the ability to continue as a going concern.

The alert is relevant to audits of all entities that have investments in financial instruments, especially those in illiquid markets.

#### Key matters highlighted in the alert

- Challenges faced in accounting on the basis of fair value;
- Requirements and guidance in standards that are particularly relevant to fair values;
- Other considerations in audits of fair value accounting estimates;
- Initiatives of the International Accounting Standards Board; and
- Recent revisions to extant standards on auditing accounting estimates and fair value measurements and disclosures which, while not yet effective, may be helpful to auditors.

## 8 THE AUDIT OF SPECIFIC AREAS OF THE FINANCIAL STATEMENTS

### Section overview

- Introduction
- Auditor's checklist for specific IASs and IFRSs
- ISA 501: Audit evidence – specific considerations for selected items (litigation and claims)
- Conclusion: audit papers, audit procedures and audit matters

#### 8.1 Introduction

In your examination, you will be required to apply the general principles of obtaining audit evidence to specific areas of the financial statements that are regulated by one or more of the international accounting standards.

In order to deal with exam questions of this type you need to know the details of the relevant IFRS or IAS. You will then need to consider:

- Materiality: is the item material for the financial statements?
- Key requirements of the IFRS or IAS: what does the auditor need to test to ensure compliance?
- How to obtain suitable audit evidence to check compliance with the accounting standard.

The main areas that you may be required to consider in the examination are set out below, as a checklist of the main issues that the auditor should consider when gathering audit evidence.

#### 8.2 Auditor's checklist for specific IASs and IFRSs

##### IAS 1: Presentation of financial statements

- Has the **going concern basis** been adopted? Is the going concern basis appropriate?
- If the directors of the client company have decided that the going concern basis is not appropriate, have the relevant disclosures been made?
- If there is uncertainty about the going concern status of the company, have the relevant disclosures been made?
- Has the **accruals concept** been complied with?
- Is there consistency in the presentation and classification of items in the financial statements, between the current and previous financial periods?
- Has each material class of items been separately presented in the financial statements?
- Has **offsetting** (of assets and liabilities, or income and expense) been applied only as permitted by an accounting standard?
- Has an **appropriate format** been adopted for the statement of financial position, income statement/statement of comprehensive income and statement of changes in equity?
- Are appropriate disclosure notes included?

#### **IAS 2: Inventories**

- Has inventory been consistently valued at the **lower of cost and net realisable value**, on an item-by-item basis?
- Has an **acceptable costing method** been used for inventory? (Remember that LIFO is not permitted by IAS2.)
- Has inventory been **counted accurately**? (What is the evidence for this?)
- Has an appropriate method been used for the treatment of **overheads**?

#### **IAS 7: Statement of cash flows**

- Is the presentation of the statement of cash flows in accordance with the requirements of IAS 7?

#### **IAS 8: Accounting policies, changes in accounting estimates and errors**

- Have appropriate accounting policies been selected and consistently applied?
- Have any changes in accounting policy permitted under IAS 8 been correctly accounted for as prior period adjustments?
- Have fundamental errors in prior period financial statements been accounted for as prior period adjustments?
- Have changes in accounting estimates been reflected on a prospective basis?

#### **IAS 10: Events after the reporting period**

- Has the definition of events after the reporting period (as defined by IAS 10) been properly applied?
- Is there a correct distinction between adjusting and non-adjusting events after the reporting period?
- Have adjustments been made correctly for **adjusting events**, in accordance with the appropriate IAS/IFRS?
- Have **non-adjusting events** been adequately disclosed?

#### **IAS 12: Income taxes**

- Has the income tax liability been correctly calculated and disclosed?
- Has deferred tax been recognised in respect of all material temporary differences in accordance with IAS 12 guidance?
- Has an **appropriate rate of tax** been used in measuring the amount of the **deferred tax** liability (asset)?
- Are deferred tax assets recoverable?

#### **IAS 16: Property, plant and equipment**

- Has the **cost** of property, plant and equipment been determined in accordance with IAS 16?
- Has cost been correctly allocated to components of an asset in accordance with IAS 16?
- Has **post-acquisition expenditure** on property, plant and equipment been properly analysed between capital expenditure and revenue expenditure?

- Has **depreciation** been properly calculated and accounted for?
- Have **asset valuations** been performed in accordance with IAS 16 and accounted for correctly?
- Have disposals and the resulting **gain or loss on disposal** been properly calculated and recorded?

#### **IAS 19: Employee benefits**

- Have appropriate liabilities been recognised correctly when employees have provided service in exchange for employee benefits to be paid in the future?
- Has the expense of the entity consuming the economic benefit arising from service provided by employees in exchange for employee benefits been recognised correctly?

#### **IAS 20: Accounting for government grants and disclosure of government assistance**

- Have revenue-based grants been credited to the income statement/statement of comprehensive income at the same time as the related expense?
- Have capital-based grants been accounted for in accordance with IAS 20? The grant should either (1) be credited to the asset account, with depreciation then on the net cost of the asset, or (2) carried as a deferred credit which is then amortised to the income statement/statement of comprehensive income over the life of the asset.

#### **IAS 21: The effects of changes in foreign exchange rates**

- Have appropriate exchange rates been used in generating exchange differences and translating from functional to presentation currencies?
- Have exchange differences on settlement of monetary items been correctly calculated and classified within the income statement?
- Have exchange differences on foreign currency monetary items in the statement of financial position at year-end been correctly calculated and allocated within the income statement (or other comprehensive income if the asset/liability is a designated hedge)?
- Have exchange differences on non-monetary foreign currency assets/liabilities carried at fair value at year-end been correctly calculated and allocated within other comprehensive income?
- Have appropriate exchange rates been used?

#### **IAS 23: Borrowing costs**

- Have borrowing costs been recognised as an expense in the period in which they are incurred?
- If borrowing costs have been capitalised, are they directly attributable to the acquisition, construction or production of a qualifying asset?
- Have appropriate disclosures been made of the accounting policy, the amount of capitalised borrowing costs in the period and the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation?

#### **IAS 24: Related party disclosures**

- Have necessary disclosures been made to draw attention to the possibility that the company's financial position or profit/loss has been affected by related parties and related party transactions?

#### **IAS 26: Accounting and Reporting by Retirement Benefit Plans**

- Has a suitable valuation method been used to **value plan assets**? Inputs to the valuation model will need to be identified - maximising the use of observable (therefore verifiable) inputs, and minimising the use of unobservable inputs.
- Has there been consistent use of either the current salary levels or projected salary levels in forecasting **actuarial present value of promised retirement benefits**?
- Is the most recent actuarial valuation sufficiently up-to-date to use as a basis for calculating the **actuarial present value of promised retirement benefits**?
- Has the reputation, independence and competence of the actuaries been confirmed?
- Is the chosen discount rate an appropriate measure of current economic circumstances – interest rates generally, liquidity premia, other premia?

#### **IAS 29: Financial reporting in hyperinflationary economies**

- Does the entity's functional currency satisfy IAS 29's definition of hyper inflationary?
- Have the financial statements been correctly restated into 'measuring units' at the reporting date including **non-monetary** assets/liabilities and income/expense items?
- Has the gain or loss on **monetary items** been calculated accurately and classified appropriately within the income statement?
- For group audits does the parent company retain a sufficient level of **control** (for a subsidiary) or significant influence (for an associate) to satisfy the accounting treatment applied?
- Does the hyperinflationary entity remain a **going concern**?

#### **IAS 32: Financial instruments: Presentation and IFRS 7: Financial instruments: Disclosures**

- Have financial instruments (liabilities) been **properly classified as debt or equity** based on their substance?
- Have **compound instruments** been properly analysed into their debt and equity elements?
- Have payments to the providers of capital been correctly classified as borrowing cost or dividend in accordance with the classification of the instrument to which they relate?
- Have **appropriate disclosures** been made of risk exposures, risk management and hedging policies?

**IAS 33: Earnings per share**

- Has the **basic earnings per share** been correctly calculated and disclosed for the current and prior reporting period?
- Has **diluted earnings per share** been properly calculated and disclosed where relevant?

**IAS 34: Interim financial reporting**

- Have the interim financial reports been prepared in accordance with local requirements as well as IAS 34?
- Do the contents comply with the minimum requirements of IAS 34?
- Are appropriate disclosures included in notes to the interim statements?

**IAS 36: Impairment of assets**

- Have the directors identified events that may indicate that an impairment review is necessary?
- Have **recoverable amounts** been calculated in accordance with IAS 36?
- Where appropriate, have **cash-generating units** been identified?
- If an impairment loss has been recognised, has the loss been allocated to assets and recorded correctly?

**IAS 37: Provisions, contingent liabilities and contingent assets**

- Have all necessary provisions been recorded?
- Have contingent liabilities/ contingent assets been disclosed as required by IAS 37?
- As discussed in more detail below, ISA 501 *Audit evidence – specific considerations for selected items* covers contingencies relating to litigation and legal claims. This typically represents the major part of audit work on contingencies.

**IAS 38: Intangible assets**

- Have **purchased intangible assets** been recognised and measured in accordance with IAS 38?
- Have the **useful lives** of intangible assets been estimated in a reasonable way?
- Is there evidence to support the non-depreciation of **intangibles with an indefinite useful life**?
- Have intangible assets been subject to **annual impairment reviews**?

**IAS 39: Financial instruments: recognition and measurement**

- Have financial instruments been recognised and measured in accordance with IAS 39?

**IAS 40: Investment property**

- Has the company adopted the cost model or the fair value model?
- If the cost model has been adopted, have the principles of IAS 16 been complied with?

- If the fair value model has been adopted, have annual valuations been performed and the gain or loss correctly accounted for?

#### **IAS 41: Agriculture**

- Have changes in fair value less point-of-sale costs in respect of biological assets been included in the profit and loss in the period in which they arose?
- Have government grants relating to biological assets been recognised only when they become receivable and measured as fair value less estimated point-of-sale costs?

#### **IFRS 1: First-time adoption of International Financial Reporting Standards**

- Has the company followed the specific Nigerian guidance issued by the FRC in respect of the IFRS 1 guidance on exemptions and exceptions from full retrospective restatement on first time adoption?
- Has the company adopted a set of accounting policies that are appropriate and in compliance with IFRSs?
- Have all assets and liabilities recognised under IFRS been properly recognised and classified?
- Have all assets and liabilities not recognised under IFRS been removed from the financial statements?

#### **IFRS 2: Share-based payments**

- Is the calculation of share-based payments correct? (Check the number of employees granted share options and the number of options per employee; the official date for the grant of the options; the length of the vesting period; the required performance conditions attached to the options.)
- Has the cost of the share-based payments been spread fairly over the vesting period?
- Are the assumptions used to predict the level of staff turnover reasonable, based on available evidence? (If not, what assumptions would be reasonable?) The assumption about staff turnover affects the estimated cost of the share-based payments.
- Is the estimate of the fair value of the equity instrument reasonable, and is it consistent with any valuation provided by an external expert (such as a chartered financial analyst)?

#### **IFRS 5: Non-current assets held for sale and discontinued operations**

- Has the **definition of discontinued operations** in IFRS 5 been properly applied?
- Have the results of discontinued operations been properly quantified and disclosed?
- Has the **definition of assets held for sale** contained in IFRS 5 been properly applied?
- Have assets held for sale been properly valued and disclosed?

**IFRS 6: Exploration for evaluation of mineral resources**

- Where a company has recognised assets as a result of exploration and evaluation expenditures, and facts and circumstances suggest that the carrying value may exceed the recoverable amount, has an impairment test of those assets been carried out?
- Has any impairment loss been measured, presented and disclosed in accordance with IAS 36?
- Has the entity disclosed information that identifies and explains the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources?

**IFRS 8: Operating segments**

- Have the criteria for reportable segments been properly applied?
- Has all the required information been disclosed?

**IFRS 9: Financial instruments**

- Have financial instruments been recognised and measured in accordance with IFRS 9?

**IFRS 13: Fair value measurement**

- Has the correct identification of a **principal market**, or in its absence, the most advantageous market been made?
- Is the observed transaction “orderly”, and does it therefore provide **relevant evidence**?
- Has the “**highest and best use**” for non-financial assets been identified?

**IFRS 14: Regulatory deferral accounts**

- Does the entity have activities that put it in scope of IFRS 14, and therefore which enable it to carry “**regulatory deferral balances**” that otherwise do not meet the definitions of assets and liabilities under the IASB Conceptual Framework?

**IFRS 15: Revenue from contracts with customers**

- Does a **contract** with a customer exist?
- Whether **modifications** to an existing contract require to be treated as an entirely new contract, or as an amendment to an existing contract and possible “catch-up” adjustments?
- What are the **performance obligations** in the contract, and are there “distinct” goods or services?
- Whether a contract includes a significant financing effect, requiring the use of **discounting**?
- Whether or not a contract is **performed** “at an instant” or “**over a period of time**”?

**IFRS 16: Leases**

- Are the **portfolio groupings** of leases that share similar characteristics appropriate?

- The entity must demonstrate that the application of the Standard to a portfolio is done on the basis of a reasonable expectation that the effects of so doing would not differ materially from the application of the rules to individual leases. This will require the entity to construct representative samples and evaluation for them to support their assertion. Has the auditor examined these, perhaps forming their own samples, in order to conclude whether the materiality of any difference is acceptable?
- Are those previous determinations of "arrangements" (contracts) that whilst not legally a lease, are nevertheless in substance, a lease, still applicable under IFRS 16?
- There is a preference for discounting using the interest rate implicit in the lease, but as an alternative, if the interest rate implicit is not determinable, then the lessee's incremental borrowing rate is used. Has any such rate taken into account not just an observable current interest rate, but also adjusted for factors unique to the lease (e.g. the lessee's credit standing, the amount being borrowed, the term of the borrowing, the quality of any collateral, etc)?

#### IFRS 17: Insurance Contracts

- Have the scope requirements been applied correctly?
- Has the level of aggregation of contracts into portfolios and sub-groups been checked as this will affect the application of the requirements of the Standard in a highly material manner?
- Have the skills, qualifications and reputation of the actuary been taken into account?

### 8.3 ISA 501: Audit evidence – specific considerations for selected items (litigation and claims)

One section of ISA 501: *Audit evidence – specific considerations for selected items* addresses the audit of litigation and claims. ISA 501 states that the auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

- a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
- b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and  
Reviewing legal expense accounts

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other ISAs, seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor.

If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.

The auditor shall modify the opinion in the auditor's report in accordance with ISA 705 if:

- management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding; and
- the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures.

#### 8.4 Conclusion: audit papers, audit procedures and audit matters

It is highly probable that a question in your examination will ask you to describe the audit procedures in relation to a specific issue in the financial statements or to comment on audit matters that should be considered in relation to a particular item. The question might also ask about the audit evidence you would expect to see on file in respect of these procedures and matters.

A question may therefore ask any of the following:

- What audit procedures** should be carried out in respect of...? An audit procedure is **an action**; for example 'discuss with management' or 'vouch to invoice'.
- What audit evidence** would you expect to see in relation to...? Audit evidence will be **an item or record**; for example a copy of the relevant sales contract. Remember that discussions with managers about significant matters should be included in the documentation in the audit working papers, as audit evidence.
- What matters** would you consider in respect of...? Relevant matters to consider will include (1) materiality (2) risk and (3) the requirements of any particular accounting or auditing standards.

##### Example: Audit procedures

Your audit firm is carrying out the audit of ABC Company, which owns the well-known Halberd brand name for fashion clothes. The brand name was purchased three years ago and is being amortised.

What audit procedures might be carried out in respect of the **useful life** of the Halberd brand name?



### Answer

#### **Tutorial note**

You need to identify a suitable audit procedure. Vouching cost to original purchase documents would not be relevant to this question. Instead, it is important to consider how to audit the period over which the brand is being amortised.

#### **Ideas for a solution**

Relevant procedures would be as follows.

- Compare the useful life attributed to the Halberd brand with the useful life of brands of other business entities in the industry.
- Review the annual marketing spend on the brand.
- Review planned future expenditure on the brand, to see if its value is likely to be maintained.
- Review the results of management's impairment test on the brand.



#### **Example: Provisions and audit evidence**

Bitton is a limited liability company. It manufactures and installs drilling equipment. Its charges for installing equipment were raised by 30% with effect from 1 January in the financial year just ended (to 31 December Year 9). The increase in installation charges was made to allow for the fact that from 1 January, Bitton have a warranty to re-install any of its drilling equipment that did not perform to specification, due to a fault in the equipment or an error in the installation. The warranty is given for a two-year period.

The notes to the financial statements contain the following statements.

'The company guarantees the installation of all its equipment since 1 January Year 9. No provision for the guarantees has been recognized since the amount of the obligation cannot be measured with sufficient reliability.'

Installation fees for the year to 31 December Year 9 amounted to ₦7.6million of which ₦2.1million related to the three months to 31 December Year 9.'

#### **Required:**

As auditor of Bitton for the year to 31 December Year 9:

- (a) State the matters that should be considered in respect of the warranties
- (b) State the audit evidence that you would require in respect of these matters.

**Answer****Matters to consider** are as follows:

- The requirements of IAS 37 and whether a warranty provision was required based on the given facts
- The materiality of a best estimate of a warranty provision
- Whether the audit report would have to be modified if changes were not made

Possible **audit evidence** includes the following:

- The warranty terms offered to customers
- Management's costings in respect of the warranties
- Schedules of installations (from which warranties arose) during the relevant period
- Letters of complaint from customers indicating the level of warranties used
- Costs of reinstallations from job cards.

**Example: Development costs and audit evidence**

Extracts from the draft financial statements of a company are as follows.

	₦000
Statement of financial position extract	
Development costs	
At cost	3,400
Less: Accumulated amortisation	<u>(1,850)</u>
	1,550
Total assets of the company	20,400
Development costs capitalised during the year	700
Income statement extracts	
Revenue	5,600
Research costs	180
Amortisation of development costs	900
Profit before tax	2,800

**Required**

What audit evidence should be obtained to check:

- (a) that capitalised development costs are properly recognised
- (b) the validity of the amortisation rate for development costs?



### Answer

#### Materiality

The carrying value of the development costs is 7.6% of total assets and the item is therefore material.

Development costs capitalised during the year were ₦700,000. If these had been written off instead, profit would have been ₦2,100,000 or 25% lower than reported. This is also a material amount.

The total spending during the year on research and development costs was ₦880,000 ( $\text{₦}180,000 + \text{₦}700,000$ ). This is 15.7% of sales revenue: this too is material.

The auditor therefore should obtain sufficient appropriate audit evidence to support the accounting treatment and the valuation of development costs (and R&D expenses).

### IAS 38 requirements

IAS 38 specifies the conditions that must exist for development costs to be capitalised. Briefly, these are:

- Intention to complete the development and either use or sell the developed item
- Technical feasibility of completing the development and the ability of the entity to use the developed item or sell it
- Ability to create future economic benefits
- Availability of technical, financial and other resources to complete the development
- Ability to measure the costs attributable to the intangible asset.

The audit risk is that development costs have been capitalised when not all of the criteria for capitalisation have been met. The auditor should therefore obtain audit evidence to confirm that each criterion has been met. For example, in order to test the technical feasibility, the auditor should look at test results of the project to date.

To assess the amortisation rates used for development costs already capitalised, the auditor might look for evidence from market research about the likely demand for the item. In the case of development of a new product, the auditor can look at actual sales since the product launch and discuss with management whether these appear to support the estimated amortisation period for the development costs.



**Example: Deferred tax asset and audit evidence**

In its draft financial statements, a company has included a deferred tax asset of ₦5 million. This relates to unused tax losses that have accumulated during the past three years. Management are confident that there will be sufficient future operating profits to claim the benefit of the tax losses in full in future years.

The auditor should assess whether it is appropriate to include a deferred tax asset in the financial statements, and so needs evidence about whether the tax losses will be recoverable.

- He should start by checking whether the amount is reliable. He should obtain a copy of the client's tax computations and should agree the figures in the calculation to the accounting records.
- He should also review any correspondence about tax that may exist.
- He needs to make an assessment about whether the tax losses will be recoverable, by obtaining forecasts from the client of future profitability. The assumptions used in the forecast should be assessed for reasonableness in the context of the auditor's understanding of the client's business.
- If the forecasts of future profitability are reasonable, the auditor should assess how long it will be before the losses are recovered in full. This period should be checked against tax regulations, to confirm that there is no statutory limit on carrying forward tax losses.

## 9 TRANSACTIONCYCLES

### Section overview

- Introduction
- Revenue and receivables
- Purchases and payables
- Payroll
- Bank and cash
- Inventories
- Non-current assets

#### 9.1 Introduction

For your examination, you may be expected to apply your auditing knowledge to the main transaction cycles of an entity. These are:

- the revenue (sales) and receivables cycle
- the purchases and payables cycle
- the payroll cycle.

You may also be required to show an understanding of controls and audit tests in relation to:

- bank and cash transactions
- inventory
- non-current assets.

This section of the chapter provides you with checklists, for each of these audit areas. The checklists set out:

- the control objectives
- the key internal controls
- tests of control that might be applied
- substantive tests that might be carried out (usually on a sample basis).

If you are not familiar with the items in the checklists, you should revise tests of control and substantive testing in your study material for basic audit and assurance.

## 9.2 Revenue and receivables

Control objectives	Key controls	Tests of control	Substantive tests
<ul style="list-style-type: none"> <li>■ There must be proper authorisation and recording of customer orders, goods returned and allowances (discounts) given.</li> <li>■ Revenue must be recorded for all goods or services delivered.</li> <li>■ All documents and records must be recorded accurately.</li> <li>■ A policy should be established for the collection of receivables.</li> </ul>	<ul style="list-style-type: none"> <li>■ Segregation of duties (order acceptance/ despatch/ invoicing.)</li> <li>■ Check that a customer's order is within the customer's credit limit.</li> <li>■ Authorisation of orders.</li> <li>■ Use of pre-numbered sales order forms.</li> <li>■ Despatch notes should be pre-numbered and matched with sales orders and invoices.</li> <li>■ Authorisation of despatches afterchecking.</li> <li>■ Invoices should be authorised for sending to customers, after checking them for accuracy and against sales orders and despatch notes.</li> <li>■ Invoices should be recorded promptly in the sales ledger. Batching of invoices for input and batch totals may be used as a control.</li> <li>■ Sales returns and allowances (discounts) should be checked and authorised.</li> </ul>	<ul style="list-style-type: none"> <li>■ Sequence checks on all documents.</li> <li>■ Check on evidence of authorisation at each stage in the cycle.</li> <li>■ Check for evidence that the arithmetic/ calculations in all documents and records have been checked.</li> <li>■ Check that documents have been matched, where appropriate.</li> <li>■ Check that control account reconciliations have been performed and reviewed, with appropriate adjustments being made to the records.</li> </ul>	<ul style="list-style-type: none"> <li>■ Check the accuracy of the arithmetic in books of prime entry.</li> <li>■ Check entries in books of prime entry back to the source documents.</li> <li>■ Check the accuracy of postings to ledgers.</li> <li>■ Check invoices and credit notes for accuracy in the arithmetic and pricing.</li> <li>■ Check that inventory records have been correctly updated for despatches of goods to customers.</li> <li>■ Review control account reconciliations.</li> <li>■ Test the sales cut-off.</li> <li>■ Apply analytical procedures, such as trend analysis for sales, and gross profit margin.</li> </ul>

Control objectives	Key controls	Tests of control	Substantive tests
	<ul style="list-style-type: none"><li>■ Credit notes must be recorded accurately.</li><li>■ The control account for receivables in the main ledger should be reconciled regularly with account balances in the receivables ledger.</li><li>■ Statements should be sent regularly (monthly) to credit customers.</li><li>■ Debt collection procedures should be followed systematically, in accordance with debt collection policy.</li><li>■ Writing off any bad debts must be authorised.</li></ul>		

### 9.3 Purchases and payables

Control objectives	Key controls	Tests of control	Substantive tests
Goods and services are purchased: <ul style="list-style-type: none"><li>■ with proper authority</li><li>■ under proper procedures</li><li>■ for the business</li><li>■ from authorised suppliers</li><li>■ and are inspected for description, quantity and quality.</li></ul>	<ul style="list-style-type: none"><li>■ Segregation of duties (ordering, receipt of goods, recording invoices, payment).</li><li>■ Use of official pre-numbered documentation (purchase orders).</li><li>■ Appropriate authorisation procedures should be used for orders and payments.</li></ul>	<ul style="list-style-type: none"><li>■ Sequence checks on all documents (purchase orders, goods received notes).</li><li>■ Check on evidence of authorisation at each stage in the purchasing cycle.</li><li>■ Check for evidence that the arithmetic/calculations in all documents and records have been checked.</li></ul>	<ul style="list-style-type: none"><li>■ Check the accuracy of the arithmetic in books of prime entry.</li><li>■ Check entries in books of prime entry back to the source documents.</li><li>■ Check the accuracy of postings to ledgers.</li></ul>
Before being recorded purchase invoices are: <ul style="list-style-type: none"><li>■ authorised</li><li>■ checked for arithmetic accuracy and pricing</li><li>■ checked against supporting documentation (for example, purchase orders).</li></ul> Completeness and accuracy of recording.	<ul style="list-style-type: none"><li>■ There is a policy for re-ordering regular items of inventory.</li><li>■ Goods received notes (GRNs) are used, and signed, as evidence that the quantity, quality and description of all goods received have been checked.</li><li>■ Matching of documents (purchase requisitions, purchase orders, GRNs and purchase invoices).</li></ul>	<ul style="list-style-type: none"><li>■ Check that documents have been matched where appropriate.</li><li>■ Check that control account reconciliations have been performed and reviewed, with appropriate adjustments being made to the records.</li></ul> <p><i>Note that these tests of control are essentially the same as for the revenue/sales and receivables cycle.</i></p>	<ul style="list-style-type: none"><li>■ Check invoices and credit notes for accuracy in arithmetic and pricing.</li><li>■ Check that inventory records have been correctly updated for receipts of goods from suppliers.</li><li>■ Review control account reconciliations.</li><li>■ Test purchases cut-off.</li><li>■ Apply analytical procedures.</li></ul>

Control objectives	Key controls	Tests of control	Substantive tests
	<ul style="list-style-type: none"> <li>■ Procedures should exist for analysing purchase invoices and recording them in the correct expense or asset accounts.</li> <li>■ Use of control accounts and batch totals to ensure completeness and accuracy of processing.</li> <li>■ Accurate records should be kept of purchases returns, and these should be matched with credit notes from the supplier.</li> </ul>		Review other audit areas and prior year working papers for evidence of possible unrecorded liabilities.

#### 9.4 Payroll

Control objectives	Key controls	Tests of control	Substantive tests
<ul style="list-style-type: none"> <li>■ Gross pay is calculated at the correct rates.</li> <li>■ Employees are paid only for workdone.</li> </ul>	<ul style="list-style-type: none"> <li>■ Segregation of duties (establishing pay rates, calculating pay, recording pay).</li> <li>■ Maintenance of up-to-date personnel records.</li> <li>■ Authorisation of joiners and leavers, pay rates, overtime, voluntary deductions from pay.</li> </ul>	<p>Check:</p> <ul style="list-style-type: none"> <li>■ that payroll information is reconciled between periods and any changes between periods are explained</li> <li>■ entries in the wages control account, if used</li> </ul>	<p>Check:</p> <ul style="list-style-type: none"> <li>■ the accuracy of the arithmetic in payroll calculations and payroll records</li> <li>■ postings to ledger accounts</li> <li>■ that correct pay rates are used</li> </ul>

Control objectives	Key controls	Tests of control	Substantive tests
<ul style="list-style-type: none"> <li>■ Gross pay, net pay and deductions are recorded completely and accurately in the payroll, cash records and ledger accounts.</li> <li>■ The correct employees are paid the correct amounts.</li> <li>■ The correct amount of deductions are paid to the tax authorities and other authorities.</li> </ul>	<ul style="list-style-type: none"> <li>■ Regular management review of overall cost of payroll.</li> <li>■ Establishment of standard procedures, timetables and systems for processing payroll.</li> <li>■ Approval of payroll, once prepared.</li> <li>■ Use of a control account for payroll expenses/liabilities.</li> <li>■ Safe custody of cash, where employees are paid in cash.</li> <li>■ Verification of the identity of employees, when payment is in cash.</li> <li>■ Signature received for pay, when payment is in cash.</li> <li>■ Custody and investigation of unclaimed pay packets, when payment is in cash.</li> <li>■ Use of a separate bank account for payroll.</li> </ul>	<ul style="list-style-type: none"> <li>■ the accuracy and completeness of ledger account entries</li> <li>■ the accuracy of the arithmetic in payroll records</li> <li>■ that the payroll records agree with cash/bank records</li> <li>■ Agree payroll amounts to bank records</li> <li>■ Review payroll for unusual amounts.</li> </ul> <p>When employees are paid in cash:</p> <ul style="list-style-type: none"> <li>■ check that unclaimed wages are kept safe and reasons for not claiming wages are explained</li> <li>■ attend and observe a distribution of pay</li> <li>■ compare names on payroll to names on pay packets</li> <li>■ examine signed receipts for pay.</li> </ul>	<ul style="list-style-type: none"> <li>■ that correct, authorised rates are used for statutory deductions (such as tax) and voluntary deductions</li> <li>■ that overtime, bonuses and similar payments have been properly authorised</li> <li>■ that joiners are properly authorised</li> <li>■ that employees have not been paid for periods before they join or after they leave</li> <li>■ the pay for hours worked or output produced should be checked against the authorised documentation</li> <li>■ that payments of deductions have been made to the appropriate authorities</li> <li>■ the signed receipts for wages paid in cash.</li> </ul>

Control objectives	Key controls	Tests of control	Substantive tests
	<ul style="list-style-type: none"> <li>■ Authorisation of cheques/bank transfers, when employees are paid by these methods.</li> </ul>	<ul style="list-style-type: none"> <li>■ check that no employee receives more than one pay packet.</li> </ul>	<ul style="list-style-type: none"> <li>■ that the correct entries have been made in the wages control account.</li> </ul> <p><i>Also:</i></p> <ul style="list-style-type: none"> <li>■ Verify the existence of a sample of employees on the payroll.</li> <li>■ When wages are paid in cash, observe the distribution of paypackets.</li> <li>■ Carry out analytical procedures, such as trend analysis, average pay per employee.</li> </ul>

## 9.5 Bank and cash

Control objectives	Key controls	Tests of control	Substantive tests	
<b>Bank</b>	<ul style="list-style-type: none"> <li>■ All money belonging to the company is received and is promptly and accurately recorded.</li> <li>■ All payments are properly authorised and are promptly and accurately recorded.</li> </ul>	<ul style="list-style-type: none"> <li>■ Segregation of duties.</li> <li>■ Listing and prompt recording and banking of all receipts.</li> <li>■ Authorisation for all payments.</li> <li>■ Regular reconciliations are performed and reviewed.</li> <li>■ There are sufficient physical custody controls over cheques and cash.</li> </ul>	<ul style="list-style-type: none"> <li>■ Review bank reconciliations for unusual items and evidence of management review of statements.</li> <li>■ Review cash book for unusual entries.</li> <li>■ Check additions in cash book and entries in ledgers.</li> <li>■ Review payments for evidence of authorisation.</li> </ul>	<ul style="list-style-type: none"> <li>■ Send bank confirmation letter(s).</li> <li>■ Check or prepare bank reconciliation statement.</li> <li>■ Assess audit significance of other information in the reply from the bank.</li> <li>■ Review large or round-sum amounts just before and just after the reporting period.</li> <li>■ Carry out analytical procedures.</li> </ul>

Control objectives	Key controls	Tests of control	Substantive tests
<b>Cash</b> As for bank above.	As for bank above.	<ul style="list-style-type: none"> <li>■ Observe that procedures for opening mail and handling cash are being followed.</li> <li>■ Check amounts recorded as receipts against remittance advices from customers.</li> <li>■ Check the amounts in receipt books or on till rolls against paying-in slips (paying in cash to the bank), the cash book and bank statements.</li> <li>■ Check whether cash is banked daily.</li> <li>■ Check payments out of cash takings, if any.</li> <li>■ Check petty cash payments for authorisation.</li> <li>■ Check the documents that support any cash payments (for example, receipts).</li> </ul>	<ul style="list-style-type: none"> <li>■ Attend/carry out cash counts.</li> <li>■ Check that postings are made correctly to ledger accounts.</li> <li>■ Analytical procedures.</li> </ul>

## 9.6 Inventories

Many of the points listed above in relation to the purchases cycle (for example, in relation to the receipt of goods) and the sales cycle (for example, in relation to the despatch of goods) should also apply to the inventory system. For example, the requirement for authorisation procedures and segregation of duties are the same. The table below focuses on additional points.

Control objectives	Key controls	Tests of control	Substantive tests
<ul style="list-style-type: none"> <li>■ Inventory in the inventory records should represent inventory that physically exists.</li> <li>■ Inventory is valued at the lower of cost and net realisable value(NRV).</li> <li>■ Inventory quantities are maintained at a level suitable to the business.</li> </ul>	<ul style="list-style-type: none"> <li>■ There should be regular inventory counts, with reconciliations of physical counts to inventory records. Differences should be explained.</li> <li>■ Reviews of inventory for items where NRV may be below cost.</li> <li>■ Accurate, up-to-date inventory records are maintained.</li> <li>■ Inventory cut-off procedures are in place.</li> <li>■ Appropriate physical custody procedures should be in place.</li> </ul>	<ul style="list-style-type: none"> <li>■ Review and observe inventory counting procedures.</li> <li>■ Check that any necessary changes to inventory records are made.</li> <li>■ Check that NRV reviews are performed.</li> <li>■ Confirm that cut-off procedures are operating.</li> <li>■ Review inventory levels for adequacy.</li> <li>■ Check that physical custody procedures are operational (= applied in practice).</li> </ul>	<ul style="list-style-type: none"> <li>■ Attend inventory count: <ul style="list-style-type: none"> <li>- observe procedures</li> <li>- record test counts</li> <li>- record cut-off information.</li> </ul> </li> <li>■ Check inventory valuation, at lower of cost and NRV.</li> <li>■ Check inventory cut-off.</li> <li>■ Perform appropriate analytical review procedures.</li> <li>■ Confirm the existence of inventory held at outside locations.</li> <li>■ Check the treatment of inventory held on the client's premises but owned by a third party.</li> </ul>

### 9.7 Non-current assets

Again, some of the controls and tests that are listed above (for example, the requirement that purchases/expenditure should be properly authorised) are also relevant here. The table below lists additional points.

Control objectives	Key controls	Tests of control	Substantive tests
<ul style="list-style-type: none"> <li>■ Records of non-current assets should be complete and correct.</li> <li>■ There should be adequate controls for the safe custody of non-current assets.</li> <li>■ Depreciation, revaluations and disposals must be dealt with correctly.</li> </ul>	<ul style="list-style-type: none"> <li>■ Use of authorised capital expenditure budgets and project evaluation techniques, if appropriate.</li> <li>■ Use of a non-current asset register, that is regularly checked and reconciled to the non-current asset accounts in the main ledger.</li> <li>■ Impairment reviews are performed as necessary.</li> </ul>	<ul style="list-style-type: none"> <li>■ Check for the proper authorisation of additions and disposals.</li> <li>■ Check reconciliations of ledger balances with the non-current asset register.</li> </ul>	<ul style="list-style-type: none"> <li>■ Review the movement in non-current assets for the period.</li> <li>■ Check additions, and the calculations of depreciation and gain or loss on disposals.</li> <li>■ Physically verify a sample of additions.</li> <li>■ Trace proceeds for disposals to cash records.</li> <li>■ Review for unrecorded disposals.</li> <li>■ Review evidence relating to any asset revaluations during the period.</li> </ul>

## 10 CHAPTER REVIEW

### Chapter review

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

- Explain the fundamental requirements of audit testing in the context of ISAs 500, 520, 530 and 230
- Describe the requirements of a number of other fieldwork-driven standards including ISAs 501, 540, 580, 610 and 620
- Summarise the audit approach relevant to a number of key IASs and IFRSs
- Explain how to audit the various transaction cycles such as revenue/receivables and purchases/payables

### Quick quiz questions

- 1 Which financial statement assertions are tested by directional testing?
  - A Accuracy and valuation
  - B Accuracy and existence
  - C Completeness and existence
  - D Accuracy and completeness
  
- 2 Which of the following statements about written representations is INCORRECT?
  - A Too many representations can be seen to be a perceived lack of integrity
  - B They should only be used when all substantive procedures have been exhausted
  - C Auditor may request a written representation at any time during the audit
  - D If management are willing to provide a written representation it may lead to a qualified audit opinion on the grounds of disagreement.
  
- 3 Audit evidence must be:
  - A sufficient and appropriate
  - B complete and relevant
  - C qualitative and quantitative
  - D strategic and operational
  
- 4 Audit tests on assets will focus on which financial statement assertions most?
  - A occurrence, valuation, classification
  - B completeness, existence, cut-off
  - C rights and obligations, completeness, accuracy
  - D existence, rights and obligations, valuation
  
- 5 When are analytical procedures UNLIKELY to be a reliable source of audit evidence?
  - A when internal controls are strong
  - B when the analysis is applied only to material balances and transactions
  - C when there are reliable benchmarks
  - D when the relationships between items in the financial statements are predictable

### Quick quizanswers

1 C

Directional testing tests debit balances for existence, and credits balances for completeness.

2 D

If management request that a matter is true, but the auditor believes that it is false, this could lead to a qualified audit opinion on the grounds of disagreement.

3 A

4 D

5 B

In the other three situations, analytical procedures are likely to be a reliable source of audit evidence.

CHAPTER  
**9**

## Evaluation and review

### Contents

- 1 The review stage of the audit
- 2 Opening balances and prior period comparatives:  
ISAs 510 and 710
- 3 Subsequent events: ISA 560
- 4 Going concern: ISA 570
- 5 Chapter review

## INTRODUCTION

### Competencies

#### Planning and undertaking audit work

- C3** Evaluate and draw conclusions on the appropriateness of stated accounting treatments in the context of a given scenario for public or private sector based on national and international standards on auditing and international financial reporting standards(IFRS).

#### Drawing conclusions and reporting

- D1 (a)** Analyse, evaluate and propose how issues identified during the course of an assignment may be raised and dealt with in communication with management, directors and those charged with governance, including actions taken when issues cannot be agreed.
- D1 (b)** Identify, explain and apply procedures that may be used and considerations relating to the identification of subsequent events that may require adjustments or disclosures.
- D1 (c)** Identify, apply and explain procedures that may be used and considerations relating to the identification of risk issues that require disclosures.
- D1 (d)** Evaluate and apply quantitative and qualitative judgments based on the results of tests and evidence obtained.

### Exam context

So far students have largely focused on the planning and fieldwork stages of the audit. This section introduces the student in some depth to the completing phase of the audit incorporating a number of new ISAs.

At the end of this chapter, readers should be able to:

- Describe the process and considerations for evaluating misstatements per ISA450
- Audit opening balances and prior period comparatives in compliance with ISAs 510 and 710
- Explain how to audit subsequent events in accordance with ISA560
- Summarise the concept of going concern and describe how to apply and comply with ISA570

## 1 THE REVIEW STAGE OF THE AUDIT

### Section overview

- The need for a review
- Evaluation of misstatements: ISA 450
- Other areas for evaluation and review

#### 1.1 The need for a review

Having carried out tests of control and an appropriate amount of substantive testing, the auditor has reached the stage in the audit where he should carry out a review and an evaluation of the evidence he has gathered.

- The auditor should back up his detailed testing of controls, transactions and balances with a broader review of other information and events that may have an impact on the information presented in the financial statements.
- Analytical procedures** are also used at this review stage, as a final check that the information contained in the draft financial statements 'makes sense'.

#### 1.2 Evaluation of misstatements: ISA 450

It is also at this stage of the audit that the auditor will make an overall evaluation of the level of errors he has found in the financial statements. Errors found in individual areas (such as receivables, or inventory) will be summarised and totalled.

The total amount of the errors will be compared with the **materiality thresholds** that were set at the planning stage. This will allow the auditor to reach a conclusion as to whether the financial statements are materially 'correct' – one aspect of whether the financial statements show a true and fair view.

This area is covered by ISA 450 *Evaluation of misstatements identified during the audit*. The **objective** of the auditor in this area, per ISA 450, is to evaluate the effect of:

- identified misstatements on the audit, and
- any uncorrected misstatements on the financial statements.

A **misstatement** could be in relation to the amount, classification, presentation or disclosure of an item.

ISA 450 **requires** the auditor to carry out the following procedures:

- Accumulate all misstatements found during the audit, unless they are clearly trivial.
- If the total of misstatements identified during the audit approach (or could approach) materiality, decide if the overall audit strategy and audit plan need to be revised.
- Communicate all misstatements found during the audit to an appropriate level of management and request that the misstatements be corrected.
- If management refuse to correct the misstatements obtain the reasons for this and take those reasons into account when evaluating whether the financial statements as a whole are free from material misstatement.

- Prior to evaluating the effect of uncorrected misstatements reassess materiality per ISA 320.
- Decide whether uncorrected misstatements are material, individually, or when added together. In making this assessment the auditor should take into account the size, nature and circumstances of the misstatements and the effect of any uncorrected misstatements from prior periods.
- Communicate to those charged with governance the effect that uncorrected misstatements may have on the audit report.
- Request a written representation from management as to whether they believe the effect of uncorrected misstatements are immaterial, individually, or in total (see example letter in the previous chapter).
- Document:
  - the amount below which misstatements would be regarded as clearly trivial
  - all misstatements accumulated during the audit and whether they have been corrected
  - his conclusion as to whether uncorrected misstatements are material, individually, or in total.

### 1.3 Other areas for evaluation and review

However, there are also a number of other specific areas which form part of the overall evaluation and review process, including the auditor's work on:

- opening balances and comparative figures
- other information published with the audited financial statements
- subsequent events
- going concern basis.

## 2 OPENING BALANCES AND PRIOR PERIOD COMPARATIVES: ISAS 510 AND 710

### Section overview

- Opening balances and comparatives
- ISA 510: Initial audit engagements – opening balances
- ISA 710: Comparative information – corresponding figures and comparative financial statements

#### 2.1 Opening balances and comparatives

The auditor's work on this area is regulated by *ISA 510 Initial audit engagements – opening balances* and *ISA 710 Comparative information – corresponding figures and comparative financial statements*.

In most countries, the financial statements of companies must include comparative figures for the previous year. To reach the conclusion that the financial statements present a true and fair view, the auditor therefore needs to be confident that:

- opening balances brought forward in the accounting records agree with the audited figures reported in the prior year financial statements
- accounting policies have been applied consistently over the current financial year and prior years
- there is consistency of classification and disclosure between the current financial year and prior years.

Where the current auditor performed the audit in the previous year and issued an 'unmodified' opinion, it should be a straightforward exercise for the auditor to confirm that points listed above have all been complied with.

A different situation arises when an audit firm is carrying out an audit of a client for the first time.

For example, an auditor may be appointed to carry out his first audit of the financial statements for the year to 31 December 20X4. To do this, the auditor cannot ignore the opening statement of financial position, as at 31 December 20X3.

- The figures in the closing statement of financial position for the previous period will be presented as prior period comparative figures in the 20X4 financial statements. The new auditor is therefore giving an audit opinion on published financial statements that include the previous year's closing balances.
- Errors in the opening balances may affect the figures for the current financial period. For example, if opening inventory is misstated and is over-valued, the cost of sales in the current period may also be misstated (too high).

## 2.2 ISA 510: Initial audit engagements – opening balances

ISA 510 provides guidance on the auditor's responsibilities in relation to opening balances where:

- the financial statements for the prior period were not audited, or
- the financial statements for the prior period were audited by another auditor (referred to as the **predecessor auditor**).

The **objective** of the auditor when considering such an initial audit engagement is to obtain sufficient appropriate audit evidence about whether:

- the **opening balances contain misstatements** that materially affect the current period's financial statements, and
- appropriate accounting policies** reflected in the opening balances have been **consistently applied** in the current period (or a change of accounting policy has been properly accounted for and disclosed).

The following **audit procedures** are **required**:

- Read the most recent financial statements and audit report, if any, for information relevant to opening balances.
- Check that the prior period's closing balances have been correctly brought forward.
- Check that opening balances reflect appropriate accounting policies.
- One or more of the following procedures:
  - Where the prior period financial statements were audited, review the predecessor auditor's working papers to obtain evidence re opening balances.
  - Consider whether audit procedures carried out in the current period provide evidence on some of the opening balances. For example, cash received from customers in the current period gives evidence of the existence of a receivable at the opening date.
  - Carry out specific audit procedures to obtain evidence re opening balances. A review of the audit report on the financial statements for the previous period.
- If evidence is found that opening balances could contain material misstatements affecting the current period's financial statements, perform appropriate additional procedures to assess the effect, and
- if such misstatements do exist, communicate this to those charged with governance in accordance with ISA 450.
- Check that the accounting policies reflected in the opening balances have been consistently applied in the current period (or a change of accounting policy has been properly accounted for and disclosed).

### 2.3 ISA 710: Comparative information – corresponding figures and comparative financial statements

ISA 710 Comparative information – corresponding figures and comparative financial statements also relates to a similar area of the audit work. It deals with audit work on corresponding amounts and other comparative information for the preceding financial reporting period. The considerations in ISA 710 apply to all external audit engagements, whereas ISA 510 focuses particularly on new audit engagements and opening balances (comparative statement of financial position figures).

Audit procedures carried out on comparative figures are significantly less than those carried out on the current year figures. They are normally limited to ensuring that comparative figures have been:

- correctly reported as required by the applicable financial reporting framework, and
- appropriately classified.

ISA 710 therefore **requires** the auditor to evaluate whether:

- the comparative information agrees with the previous period, or, where appropriate has been restated, and
- accounting policies have been consistently applied in the two periods**, or, if there have been changes in accounting policies, whether those changes have been properly dealt with.

In addition, he is **required** to:

- perform appropriate additional procedures if he becomes aware of a possible material misstatement in the comparative information whilst performing the current period audit
- obtain written representations which cover all periods referred to in his opinion.

The task set by ISA 710 should not present any problems where the auditor:

- also audited the client's financial statements in the previous financial period, and
- issued an audit report on those financial statements stating that they showed a true and fair view.

If he did not audit the prior period financial statements, then he should also follow the guidance set out in ISA 510 (see above).

The audit opinion should not normally refer to the corresponding figures, unless particular circumstances apply. These circumstances are considered in a later chapter.

### 3 SUBSEQUENT EVENTS: ISA 560

#### Section overview

- IAS 10 and ISA 560
- Audit work to check compliance with IAS 10
- Events occurring after the reporting period and up to the date of the audit report
- Facts discovered after the date of the audit report and before the financial statements are issued
- Facts discovered after the financial statements have been issued

#### 3.1 IAS 10 and ISA 560

It is not possible to prepare financial statements that present a true and fair view by considering only those events and transactions that take place before the date at which the statement of financial position is prepared. Material events that occur after the reporting period should also be considered when preparing the financial statements for the year.

##### Purpose of IAS 10

IAS 10 - Events after the reporting period has two main objectives:

- to specify when an entity should adjust its financial statements for events that occur after the reporting period, but before the financial statements are authorised for issue, and
- to specify the disclosures that should be given about events that have occurred after the reporting period but before the financial statements were authorised for issue.

**Events after the reporting period** are defined in IAS 10 as 'those events, favourable and unfavourable that occur between the end of the reporting period and the date when the financial statements are authorised for issue.' There are two types of events after the reporting period:

- Adjusting events. These are events that provide evidence of conditions that already existed at the end of the reporting period.
- Non-adjusting events. These are events that have occurred due to conditions arising after the reporting period.

##### Accounting for adjusting events after the reporting period

IAS 10 states that if an entity obtains information about an adjusting event after the reporting period, it should update the financial statements to allow for this new information.

'An entity shall adjust the amounts recognised in its financial statements to reflect adjusting events after the reporting period.'

IAS 10 gives the following examples of **adjusting events**:

- The settlement after the reporting period of a court case, confirming that the entity had a present obligation as at the end of the reporting period as a consequence of the case.
- The receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period.

- The determination after the reporting period of the purchase cost of an asset, where the asset had already been purchased at the end of the reporting period, but the purchase price had not been finally agreed or decided.
- The discovery of fraud or errors showing that the financial statements are incorrect

#### **Disclosures for non-adjusting events after the reporting period**

Non-adjusting events after the reporting period are treated differently. A non-adjusting event relates to conditions that did not exist at the end of the reporting period; therefore the financial statements must not be updated to include the effects of the event. IAS 10 states quite firmly: 'An entity shall **not** adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period'.

However, IAS 10 goes on to say that if a non-adjusting event is **material**, a failure by the entity to provide a disclosure about it could influence the economic decisions taken by users of the financial statements. For **material non-adjusting events** IAS 10 therefore requires disclosure of:

- the nature of the event, and
- an estimate of its financial effect, or a statement that such an estimate cannot be made.

This information should be disclosed in a note to the financial statements. IAS 10 gives the following examples of **non-adjusting events**:

- A fall in value of an asset after the reporting period, such as a large fall in the market value of some investments owned by the entity, between the end of the reporting period and the date the financial statements are authorised for issue.
- The acquisition or disposal of a major subsidiary.
- The formal announcement of a plan to discontinue a major operation.
- Announcing or commencing the implementation of a major restructuring.
- The destruction of a major plant by a fire after the reporting period.

#### **The role of the auditor: ISA 560**

The work of the external auditor in this area is covered by ISA 560 *Subsequent events*. The objectives of the auditor, per ISA 560, are to:

- obtain sufficient, appropriate evidence about whether events occurring between the date of the financial statements and the date of the audit report are appropriately reflected in those financial statements, and
- respond appropriately to facts that became known to him after the date of the audit report that, had they been known to him at that date, may have caused him to amend his report.

This means that audit procedures must be planned and performed so as to consider all significant transactions occurring after the reporting period. This means that the audit work does not stop with events only up to the end of the reporting period. There are two key dates after the reporting period: the date of the audit report and the date that the financial statements are issued.

- Before** the issue of the audit report, the auditor should **actively look for** significant subsequent events.
- After** the issue of the audit report (and up to the time that the financial statements are issued), the auditor has to consider the impact of any significant subsequent events **that come to his attention**. However, he does not have to look for these events actively.

### 3.2 Audit work to check compliance with IAS 10

Audit work to check compliance with IAS 10 can be divided into three phases:

- from the end of the reporting period to the date of the audit report
- from the date of audit report to the date that the financial statements are issued
- after the financial statements have been issued.

### 3.3 Events occurring after the reporting period and up to the date of the audit report

Between the end of the reporting period and the date of the audit report, the auditor is required to obtain sufficient appropriate evidence that all events that require adjustment or disclosure in the financial statements:

- have been identified, and
- are suitably reported in the financial statements.

#### Normal audit verification work

The auditor may find sufficient evidence of subsequent events in the course of normal audit verification work. Where this is the case he is not required to perform additional audit procedures. Such normal audit verification work will include looking at sales, invoices and cash transactions after the year-end in order to verify items in the statement of financial position at the year end. For example:

- The audit of receivables will consider whether receivables at the end of the reporting period are collectable. Cash receipts after the year-end may indicate a significant non-payment, suggesting the need to write off a debt as 'bad'.
- The audit of inventory procedures includes a review of the net realisable value of inventory. Sales of inventory after the year-end may indicate that some inventory in the statement of financial position is over-valued (because subsequent events have shown that its NRV was less than cost).
- A search for unrecorded liabilities may discover the existence of some unrecorded liabilities, from invoices received after the reporting period but relating to the period covered by the financial statements.
- A review of the entity's cash position at the end of the reporting period may find that a cheque from a customer, recorded as part of the bank balances, was dishonoured after the reporting period.

### Procedures aimed specifically at identifying subsequent events

The auditor should also actively look for 'subsequent events', up to the time that he prepares the audit report. Taking into account his risk assessment of this area, he should:

- obtain an understanding of management's procedures for identifying subsequent events
- inquire of management as to whether any subsequent events have occurred which might affect the financial statements
- read the entity's latest subsequent financial statements
- read minutes of shareholders' meetings, meetings of the board of directors and senior management meetings held after the date of the financial statements and inquire about matters discussed at any such meetings where minutes are not yet available
- obtain written representations in respect of subsequent events.

### 3.4 Facts discovered after the date of the audit report and before the financial statements are issued

Even after the date on which the audit report is signed, the auditor retains some degree of responsibility for **events of which he becomes aware**, up to the time that the financial statements are issued. He is not required, during this period, to actively look for subsequent events. His level of responsibility is therefore much reduced compared with the period before the signing of the audit report.

If the auditor becomes aware of a fact that, had it been known to him at the date of the report, may have caused him to amend his report then he must:

- discuss the matter with management,
- determine whether the financial statements need amending, and
- inquire how management intend to address the matter in the financial statements.

If the financial statements are amended, the auditor is required to:

- carry out the necessary audit procedures on the amendment(s), and
- extend his review of subsequent events up to the date of the new audit report.

{In some jurisdictions management are not prevented from restricting their amendments to the effects of the subsequent event. In such cases ISA 560 permits the auditor to restrict his extended review of subsequent events to that amendment only. In such a case the auditor must draw attention to this restriction in an **emphasis of matter paragraph** or **other matter paragraph** (covered in a later chapter)}.

If management do not amend the financial statements for the subsequent event, but the auditor feels that an amendment should be made, the auditor should take the following action.

- If the audit report has not yet been provided to the entity, modify his opinion as appropriate.

- If the audit report has been provided to the entity:
  - instruct management not to issue the financial statements before the necessary amendments have been made
  - if they do so, take appropriate action to prevent reliance on the audit report, after taking legal advice.

### 3.5 Facts discovered after the financial statements have been issued

As above, the auditor has no obligation to perform audit procedures or make inquiries regarding the financial statements after they have been issued.

However, if he becomes aware of a fact that, **had it been known to him at the date of his audit report, may have caused him to amend his report** then he should:

- discuss the matter with management
- determine how the financial statements need amending, and
- inquire how management intend to address the matter in the financial statements.

If the financial statements are amended, the auditor is required to:

- carry out the necessary audit procedures on the amendment
- extend his review of subsequent events up to the date of the new audit report (as above)
- review the steps taken by management to inform anyone who received the original financial statements and audit report of the situation
- issue a new audit report, containing an **emphasis of matter paragraph** or **other matter paragraph** (covered in a later chapter). This should refer to a note in the revised financial statements that explains in more detail the reason for the re-issue of the financial statements.

As usual, in the real examination, you are likely to be asked to **apply** your knowledge to a given scenario.



#### Example: Subsequent events

You are the auditor in charge of the audit of Hindsight, which has a 30 June year end. The subsequent events review for the year ended 30 June Year 5 revealed that, on 1 August Year 5, a receiver was appointed at a major customer. At 30 June Year 5 that customer owed ₦200,000 and goods costing ₦300,000 made to that customer's specification were held in inventory. Both these amounts are material.

#### Required:

List the matters to which you would direct your attention in respect of the above in relation to the audit for the year ended 30 June Year 5, if the audit report on the financial statements has not yet been written

- Check that the directors are willing to adjust the financial statements for this adjusting event after the reporting period.
- Establish whether any cash has been received from this customer since the year end.
- Review any correspondence from the receiver to establish to what extent the outstanding debt will be recovered.

- Consider whether the goods held in inventory are now valued at the lower of cost and NRV, given that these goods were made to the customer's specification. This may depend on whether or not those goods can be sold to a different customer.
- In the light of the above, consider whether any write-downs proposed by the directors to receivables and/or inventory are reasonable.
- If they are not, or if the directors refuse to adjust the financial statements, consider the impact on the audit report.

**Note**

If the event occurs after the date of the audit report but before the financial statements are issued, the auditor should discuss the matter with the directors of the client entity and ask what they propose to do.

- If the directors intend to amend the financial statements to include or report the event, the auditor should re-write the audit report accordingly and give it a new date.
- If the directors say that they do not intend to amend the financial statements, the auditor must consider the most appropriate course of action. If it is too late to re-write the audit report the auditor should consider communicating with the shareholders in another way; for example, by asking to speak at the annual general meeting of the entity (which is the auditor's right).

In the longer term, the auditor should also consider resigning from the audit, but this would not be appropriate as an immediate response to the problem. The immediate requirement is to convey the auditor's opinion to the shareholders.

## 4 GOING CONCERN: ISA 570

### Section overview

- Introduction
- Going concern: duties of the directors
- Going concern: duties of the auditor (ISA 570)
- IAASB Alert: Audit Considerations in Respect of Going Concern in the Current Economic Environment

#### 4.1 Introduction

The going concern assumption (also known as the going concern basis of accounting) means that the income statement/statement of comprehensive income and statement of financial position are prepared **on the assumption that the entity will continue in operational existence for the foreseeable future.**

If the entity is **not** a going concern, there will be significant implications for the financial statements. For example:

- the distinction between 'current' and 'non-current' for both assets and liabilities ceases to have any meaning: all assets and liabilities become 'current'
- all assets must be carried in the statement of financial position at their net realisable value, and
- there may be additional liabilities.

The auditor needs to be satisfied that the going concern assumption is appropriate to the financial statements under audit. This will involve an investigation of the financial and operating position of the client before the end of the reporting period. If this review indicates that the going concern assumption may not be appropriate, further investigation will be needed.

#### 4.2 Going concern: duties of the directors

In preparing the financial statements, the directors must satisfy themselves (in accordance with IAS 1) that the going concern basis is appropriate. In some countries, there is a requirement for large companies (listed companies) to disclose the fact that, in the opinion of the directors, the company **is** a going concern.

It is therefore the responsibility of management to make the going concern assessment.

#### 4.3 Going concern: duties of the auditor (ISA 570)

The work of the external auditor on the going concern status of an entity is covered by ISA 570 *Going concern*. Key points from ISA 570 are set out below.

The **objectives** of the auditor in this area, according to ISA 570, are to:

- obtain sufficient appropriate evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements

- conclude whether a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern, and
- determine the implications for the audit report (covered in a later chapter).

This is a subjective area where judgement is usually required to assess the uncertainties surrounding the assumptions that were made by management in reaching their conclusion about the going concern status of the entity.

**ISA 570** requires that the auditor must perform **risk assessment procedures** to consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

If management has already performed such an assessment, the auditor must:

- discuss this assessment with management
- determine whether the assessment identified any relevant events or conditions, and, if so
- determine management's plans to address them.

If management has not yet performed such an assessment, the auditor must:

- discuss with management the basis for the intended use of the going concern assumption, and
- inquire of them whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern.

In evaluating management's assessment the auditor must consider the same time period. If management looked less than 12 months into the future, the auditor should ask management to make a re-assessment looking at least 12 months into the future. The auditor must also inquire if management is aware of any relevant events or conditions beyond this time period.

#### **Factors that raise questions about the going concern assumption**

The auditor should remain alert throughout the audit process for factors or events that may indicate that the going concern status could be questionable/doubtful.

ISA 570 gives a number of examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption:

##### **Financial**

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.

- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

#### **Operating**

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labour difficulties (e.g. riot, strike or conflict).
- Shortages of important supplies.
- Emergence of a highly successful competitor.

#### **Other**

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

#### **Going concern assumption: audit procedures**

Where events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern the auditor must obtain sufficient appropriate evidence to determine whether in fact a material going concern uncertainty does exist. He does this by performing **additional audit procedures**.

- Discussion with management:** Management should be asked to explain the reasons why they consider the going concern assumption to be valid. They should also be asked about their future plans for the business. If the entity is expecting to make a loss next year, the possible implications of this for the going concern assumption should be discussed extensively.
- Obtain a cash flow forecast:** A cash flow forecast should be obtained from the entity and this should also be discussed with management. The assumptions in the forecast should be checked and, if appropriate, challenged. If there is a forecast of a cash shortage, the auditor should discuss with management their plans for obtaining the additional financing that will be required.
- Review the sales order book:** If this indicates a decline in sales orders, the issue should be discussed with management.
- Review ageing receivables:** Check a list of ageing receivables and assess the average time to pay. If customers are taking longer to pay, this may have adverse implications for operational cashflow.
- Consider whether planned capital expenditure by the entity may be insufficient to support the business as a going concern in the future.

- If a key senior employee has left the business entity in the recent past, the possible implications (for example, the possibility of losing key customers with the loss of the key employee) should be discussed.
- Litigation:** If the company is involved in continuing litigation, and faces the possibility of having to pay a large amount of money to settle the dispute, the implications should be discussed.
- Information from the client entity's bank:** If the client entity is expecting to rely on continuing financial support from its bank (for example, a continuation of its bank overdraft facility) the bank should be asked to confirm that the finance will remain available.
- After discussing the issues with management, the auditor should obtain a **letter of representation from management** confirming their opinion that the entity is a going concern.

The financial statements are the responsibility of management, and if the auditor considers that the going concern assumption is invalid whereas management consider it to be valid, the options available to the auditor are to:

- discuss the matter with management, having carried out audit procedures to obtain more evidence;
- try to persuade management to change their mind and prepare the financial statements on a different basis (a break up basis); and
- if management does not agree to change its view, consider making a qualified audit report.

Unless all those charged with governance are also involved in managing the entity, the auditor must **communicate to those charged with governance** any events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Such communication must include the following:

- Whether the events or conditions constitute a material uncertainty.
- Whether the use of the going concern assumption is appropriate.
- Whether the related disclosures in the financial statements are adequate.

If there is a **significant delay in the approval of the financial statements**, which the auditor believes is due to events or conditions related to the going concern assessment, he must:

- perform the additional audit procedures listed above
- consider the effect of this delay on his conclusions.

The audit work relating to the going concern status is summarised below.

Audit stage	Audit procedures
Planning and assessment	<ul style="list-style-type: none"> <li>■ Consider whether circumstances exist which cast doubt on the going concern status.</li> <li>■ If management have already carried out their assessment, review and evaluate that assessment.</li> <li>■ Review management's plans to deal with any problems identified.</li> <li>■ If the auditor has identified problems not identified by management, ask management to prepare appropriate plans which the auditor then reviews.</li> <li>■ Seek written representation regarding the plans/going concern status.</li> <li>■ Assess whether there are any material uncertainties relating to the going concern status of the entity.</li> </ul>
Detailed audit procedures to assess the going concern status	<p>These might include the following:</p> <ul style="list-style-type: none"> <li>■ Reviewing cash flow, profit and funding forecasts, normally for at least one year from the end of the reporting period.</li> <li>■ Analysing interim or management accounts.</li> <li>■ Reviewing loan agreements and other relationships with providers of finance.</li> <li>■ Reviewing minutes of board meetings.</li> <li>■ Reviewing current and future order levels and relationships with customers.</li> <li>■ Reviewing operating plans and the availability of future resources.</li> </ul>

The impact of the going concern status on the audit report is dealt with in a later chapter.

#### 4.4 IAASB Alert: Audit Considerations in Respect of Going Concern in the Current Economic Environment

The IAASB issued an alert in January 2009 to raise auditors' awareness about matters relevant to the consideration of the use of the going concern assumption in the preparation of the financial statements in the current environment. In particular, management, those charged with governance and auditors alike will be faced with the challenge of evaluating the effect of the credit crisis and economic downturn on an entity's ability to continue as a going concern and whether these effects on the entity ought to be described, or otherwise reflected, in the financial statements.

##### Key matters highlighted in the alert

- The going concern assumption is a fundamental principle in the preparation of financial statements.

- The assessment of an entity's ability to continue as a going concern is the responsibility of the entity's management.
- The appropriateness of the use of the going concern assumption is a matter for the auditor to consider on every audit engagement.
- International Standard on Auditing (ISA) 570, "Going Concern", establishes the relevant requirements and guidance with regard to the auditor's consideration of the appropriateness of management's use of the going concern assumption and auditor reporting.
- The credit crisis and economic downturn have led to a lack of available credit to entities of all sizes, which may affect an entity's ability to continue as a going concern; this and other factors may be relevant in the auditor's evaluation of forecasts prepared by management to support its going concern assessment.
- The extent of disclosures in the financial statements is driven by management's assessment of an entity's ability to continue as a going concern, coupled with the disclosure requirements of the applicable financial reporting framework.

## 5 CHAPTER REVIEW

### Chapter review

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

- Describe the process and considerations for evaluating misstatements per ISA 450
- Audit opening balances and prior period comparatives in compliance with ISAs 510 and 710
- Explain how to audit subsequent events in accordance with ISA 560
- Summarise the concept of going concern and describe how to apply and comply with ISA 570

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### Quick quiz questions

- 1 Which of the following items might affect the going concern assumption?
  - 1 Use of short-term finance for non-current assets
  - 2 Reliance on a single product
  - 3 Lack of market competition
  - 4 A high gearing ratio

A 1, 2 and 3 only  
B 1, 3 and 4 only  
C 2, 3 and 4 only  
D 1, 2 and 4 only
- 2 Which of the following periods are considered in the auditing standard ISA 560: 'Subsequent events'?
  - 1 Up to the date of the audit report
  - 2 After the date of the audit report but before the financial statements are issued
  - 3 After the financial statements have been issued

A Period 1 only  
B Periods 1 and 2 only  
C Period 2 only  
D Periods 1, 2 and 3
- 3 Which of the following statements is INCORRECT?
  - A The audit of opening balances and prior period comparatives should be straightforward except in the audit of a new audit client.
  - B When other information is published with the financial statements, the auditor should check that this information is not inconsistent with information in the financial statements.
  - C When other information published with the financial statements contains a significant misstatement of fact that does not relate to information in the financial statements, the auditor is not required to do anything.
  - D Before the audit report is issued, the auditors must look actively for significant subsequent events.

- 4 If, after the financial statements have been issued, an auditor became aware of a fact that, had it been known earlier, might have affected the audit report, which of the following measures should the auditor take?
- 1 Management should be asked to issue amended financial statements
  - 2 The amendments should be audited
  - 3 The auditor should extend the review of subsequent events up to the date of the revised audit report
  - 4 The auditor should issue a new unmodified audit report.
- A 1 only  
B 1 and 2 only  
C 1, 2 and 3 only  
D 1, 2, 3 and 4
- 5 Who is responsible for making the going concern assessment?
- A Management of the client company only
  - B Audit committee
  - C The auditor only
  - D Management of the client and the auditor

### Quick quiz answers

1 D

Lack of market competition should assist the company, not endanger its going concern status.

2 D

ISA 560 'Subsequent events' deals with the auditor's responsibilities in all three periods stated in the question.

3 C

Even though the information has not been audited and has no direct bearing on the financial statements, there is often a perception amongst users of financial statements that the auditors have approved all the published information. The auditor should therefore discuss the incorrect information with management of the client and advise them to obtain legal advice (about their potential liability if they do nothing to correct the error).

4 C

The auditor should issue a new audit report to go with the amended financial statements, but the report should be modified to include an emphasis of matter paragraph.

5 A

Management is responsible for making the going concern assessment. The auditor is then required to assess the appropriateness of management's assessment.

CHAPTER  
**10**

## **Group audits**

### **Contents**

- 1 Introduction to group audits
- 2 Group audits: preliminaries
- 3 Working with component auditors
- 4 Auditing the consolidation process
- 5 Documentation and communication with management and those charged with governance
- 6 Chapter review

## INTRODUCTION

### Competencies

#### Planning and undertaking audit work

- C1 (I)** Develop an audit plan, justifying judgements made on an audit or assurance engagement based on a business scenario, including considerations relating to:
- C1(I)iii** Reliance on internal audit, specialists and the work of other auditors
- C1(I)vi** Visits to locations, branches and departments.
- C 4 (b) i** Explain the term joint audit.
- C 4 (b) ii** Develop a plan for a joint audit.
- C 4 (b) iii** Identify circumstances under which a joint audit occurs.
- C 4 (b) iv** Describe the factors to consider in sharing audit work in joint audits.
- C 4 (b) v** Advise management on the merits and demerits of joint audits.
- C 4 (b) vi** Advise on matters to consider by firms engaging in joint audits.

#### Exam context

Group audit can be complex and confusing. Regulators often identify group audit in their quality inspections as an area that needs improving. With this in mind a whole chapter is dedicated to group audit in compliance with the revised ISA 600.

At the end of this chapter, readers should be able to:

- Summarise the core components and considerations of group audit
- Describe how component auditors are used and the various communications that they will partake in
- Explain the responsibilities and tasks involved in performing a group audit in compliance with ISA 600 including planning, performing and reporting.
- Explain what a joint audit is and when it may be necessary
- Discuss the benefits and drawbacks of a joint audit
- Discuss practical considerations when undertaking a joint audit

## 1 INTRODUCTION TO GROUP AUDITS

### Section overview

- Introduction
- Group audits and the audit of individual group companies
- Possible problems with group audits
- Terminology in group audits

#### 1.1 Introduction

A group audit is the audit of group financial statements. For this topic, you need to be aware of the requirements of the following accounting standards:

- IFRS 3 Business combinations
- IFRS 10 Consolidated financial statements
- IFRS 11 Joint arrangements
- IFRS 12 Disclosure of interests in other entities
- IAS 27 (revised) Separate financial statements
- IAS 28 Investments in associates and joint ventures

In addition, IAS 24 - Related party disclosures is also of particular relevance because companies within a group are related parties.

#### 1.2 Group audits and the audit of individual group companies

Much of the basic audit work for groups of companies consists of auditing the financial statements of the individual companies in the group. The parent company and subsidiaries are referred to (for audit purposes) as the '**components**' of the group.

The audit work on the financial statements of the components of a group will follow normal auditing principles and practice.

This chapter is concerned with the **additional** audit considerations that arise in connection with the preparation of the group financial statements.

#### 1.3 Possible problems with group audits

The organisation and planning of a group audit is usually more complex than the planning of the audit of a single company, for the following reasons:

- Groups may include a large number of companies. Some group companies may be foreign subsidiaries that report in their own currency and perhaps use their national accounting practices to prepare their financial statements, rather than international financial reporting standards.
- Some companies in the group may have a different year-end accounting date from other companies.
- It will be necessary to make or audit adjustments that are made to the financial statements of individual group companies, for consolidation purposes.

- Some group companies may be audited by an audit firm that is not the auditor of the parent company.

#### 1.4 Terminology in group audits

Some special terms from ISA 600 (see below) are used for group audits.

##### **Definition: Group engagement team**

The group engagement team is the audit team responsible for the audit of the group financial statements (and will usually also be the audit team responsible for the audit of the parent company). ISA 600 infact refers to the '**group audit**', the '**group engagement partner**' and the '**group engagement team**' whilst a number of other ISAs use the term '**group auditor**' as a synonym for group engagement team.

The group engagement team will:

- establish the overall group audit strategy
- communicate with component auditors (see below)
- perform work on the consolidation process, and
- evaluate the conclusions drawn from the audit evidence obtained in order to form an opinion on the group financial statements.

Each of the above stages is considered in more detail in the remainder of this chapter.

##### **Definition: Component auditor**

A component auditor is an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit. Forexample, the audit of an individual subsidiary, associate or joint venture may be performed by Audit firm A, when the group auditor is Audit firm B. Audit firm A is a 'component auditor'

##### **Definition: Component**

A component is an entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.

## 2 GROUP AUDITS: PRELIMINARIES

### Section overview

- The relationship between the group auditor and component auditors
- Accepting an appointment as group auditor
- Understanding the group, its components and component auditors
- Materiality
- Planning and controlling a group audit

#### 2.1 The relationship between the group auditor and component auditors

ISA 600 regulates situations where group financial statements include financial information of components that are audited by other audit firms. The group auditor is required to determine how the work of the component auditors will affect the audit of the group financial statements.

The group engagement partner is responsible for:

- the direction, supervision and performance of the group audit, and
- issuing an appropriate group auditor's report.

The group auditor is **solely responsible** for the auditor's report on the group financial statements (although ISA 600 does not in fact use this term). The group audit report does **not** therefore refer to any component auditors, unless such a reference is required by local law. If it is required, the group audit report must indicate that such a reference does not reduce the group auditor's responsibility for the opinion on the group financial statements.

Because of this sole responsibility, ISA 600 contains very specific guidance on:

- the direction that the group auditor should give to the group audit, and
- the group auditor's involvement in the work of component auditors.

#### 2.2 Accepting an appointment as group auditor

It is normal practice for the auditor of the parent company to act as the group auditor. However, this is 'technically' a separate appointment. As in the case of all appointments, the audit firm should consider whether it is in a position to accept the appointment as group auditor.

Before accepting appointment as group auditor, the audit firm should ensure that all the procedures relating to acceptance of an engagement per ISA 220 are met and that they have a 'reasonable expectation' of obtaining sufficient appropriate audit evidence about the consolidation process and the financial information of components to reduce audit risk to an acceptable level.

The firm does this by obtaining an understanding of the group and its components and their environment sufficient to determine:

- which components are significant to the group
- which significant components are audited by others, and
- whether as group auditor, the firm will be able to be sufficiently involved in the audit of significant components to obtain sufficient appropriate evidence about them.

If the group auditor is not able to be involved in the audit of a significant component, then it is unlikely that the group auditor can obtain sufficient appropriate evidence in respect of that component and it should not accept (or should resign from) the engagement. If the auditor is prevented from resigning from the engagement by the law, he should issue a disclaimer of opinion on the group financial statements.



**Definition: Significant components** Significant

components are those that:

- Are of individual significance to the group (i.e. individually material in a group context), or
- Have been identified as likely to include significant risks of material misstatement of the group financial statements.

### 2.3 Understanding the group, its components and the component auditors

In accordance with ISA 315, the group auditor must identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment. This will mean:

- enhancing the understanding of the group, its components and their environments, obtained at the acceptance or continuation stage, and
- obtaining an understanding of the consolidation process, including the instructions issued by management to its components.

This will enable the group auditor to confirm or revise its initial assessment of components which are likely to be significant.-

When the group auditor plans to request a component auditor to perform work on the financial information of a component, he must assess the following issues:

- Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit (in particular that he is independent).
- The component auditor's professional competence.
- Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence.
- Whether the component auditor operates in a regulatory environment that actively oversees auditors.

The group auditor cannot simply rely on the work performed by the component auditor without assessing the likely quality of that work.

If the component auditor is not independent or there are serious concerns about any of the other matters above, the group auditor will need to obtain evidence relating to the financial information of the component **without** requesting the component auditor to perform any work.

### 2.4 Materiality

The group auditor will need to set:

- group materiality for the group financial statements as a whole, and

- component materiality for those components where component auditors will perform an audit or a review for the purposes of the group audit.

Component materiality will usually be lower than group materiality. If a component has been audited in its own right (because of local laws or regulations) and the group auditor decides to use that audit to provide audit evidence for the group audit, the materiality threshold used on that audit will need to be assessed. If the threshold was too high, then additional work may be needed.

## 2.5 Planning and controlling a group audit

The principles and guidelines for planning and controlling a group audit are similar to those for the audit of an individual company. However, additional considerations arise, in regard to the complexities of a group audit.

These additional considerations will require the group auditor to do the following:

- Familiarise himself with the client's procedures for preparing group financial statements (for example, the client may use standard consolidation schedules).
- Ascertain the client's timetable for the preparation of the group financial statements.
- Establish an audit strategy and audit plan for the entire group audit, including the audit of components. This should include:
  - staffing requirements for the group audit
  - a timetable for the audit of the company financial statements and the group financial statements
  - an action plan for possible problem areas (for example, foreign subsidiaries)
  - arrangements for communication and co-operation with component auditors.

### 3 WORKING WITH COMPONENT AUDITORS

#### Section overview

- Determining the type of work to be performed on components
- Communication with component auditors
- Involvement of the group auditor in work performed by component auditors
- Joint auditors

#### 3.1 Determining the type of work to be performed on components

Where a component is **of individual financial significance** to the group, the group auditor or a component auditor must perform an audit using component materiality.

Where a component is **significant because of likely significant risk of material misstatement**, the group auditor or a component auditor must perform one or more of the following.

- An audit using component materiality.
- An audit of one or more account balances, classes of transactions or disclosures (depending on where the risk of material misstatement lies).
- Specified audit procedures to address the risk of material misstatement.

For **non-significant components** the group auditor should perform analytical procedures at a group level.

If the group auditor does not consider that sufficient appropriate audit evidence will be obtained from the sum of the above work then additional work should be performed on non-significant components (similar to that for significant components). The selection of such components should be varied from year to year.

#### 3.2 Communication with component auditors

If there is not effective communication between the group auditor and the component auditor, there is a risk that the group auditor may not obtain sufficient appropriate audit evidence on which to base the group audit opinion.

It is therefore vital that there is **clear and timely two-way communication** between the group auditor and the component auditor. The group auditor's requirements are usually communicated in a **letter of instruction**. The component auditor's communication with the group auditor will usually be in the form of a **memorandum or report of work performed**.

However, such communication may not necessarily be in writing. For example, the group engagement team may visit the component auditor to discuss identified significant risks or review relevant parts of the component auditor's audit documentation. In such cases, matters must be properly documented in accordance with ISA 230.

In co-operating with the group auditor, the component auditor will provide the group engagement team with access to relevant audit documentation provided this is not prohibited by law or regulation.

The group auditor's **letter of instruction** to the component auditor should set out:

- the work required
- the use to be made of that work, and
- the form and content of the component auditor's communication with the group engagement team.

It should also include:

- a request for co-operation
- ethical requirements
- component materiality
- identified significant risks
- a list of known related parties.

The component auditor's **report of work performed** should include:

- a statement of compliance with ethical and group auditor requirements
- identification of the financial information on which the component auditor is reporting
- any instances of non-compliance with laws and/or regulations which could lead to a material misstatement of the group financial statements
- a list of uncorrected misstatements of the financial information of the component
- indicators of possible management bias
- any identified material weaknesses in internal control
- any other significant matters the component auditor expects to communicate to those charged with governance of the component
- any other matters that may be relevant to the group audit
- the component auditor's overall findings, conclusions or opinion.

#### **Example: Group audit instructions**

The example below illustrates the sort of group audit instructions that might be sent to a component auditor.

##### **Group audit instructions**

*[Group auditor letterhead]*

*[Date]*

To component auditor

This letter refers to our audit of the group financial statements of [name of parent] for the year ended [date] for the purpose of expressing an opinion on whether the group financial statements present fairly, in all material respects (*give a true and fair view of*) the financial position of the group as at [date] and (of) its financial performance and cash flows for the year then ended in accordance with [indicate applicable financial reporting framework].

Please find the duties and responsibilities of the component auditor of [name of component] set out below:

- The work to be performed shall include: *[set out work to be performed by the component auditor]*
- The use to be made of that work shall include: *[set out use to be made]*
- The form and content of the component auditor's communication with the group engagement team shall comprise:
  - Confirmation as component auditor that you will co-operate with the group engagement team. Such confirmation is to be received by *[insert date]*;
  - *[set out other communication requirements]*
- The ethical requirements that are relevant to the group audit and in particular independence requirements are as follows: *[set out ethical requirements]*
- Component materiality and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements is *[set out component materiality and clearly trivial threshold]*
- Identified significant risks of material misstatement of the group financial statements, due to fraud or error that are relevant to the work of the component auditor comprise *[set out significant risks of material misstatement]*
- The group engagement team requests the component auditor to communicate any other identified significant risks of material misstatement and the component auditor's responses to such risks
- A list of related parties prepared by group management and any other related parties of which the group engagement team is aware is attached herewith *[attach list of related parties]*.
- Component auditors are requested to communicate any other related parties not previously identified.

In addition to the above, the group auditor requests the component auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit by *[insert date]*. These include:

- Whether the component auditor has complied with ethical requirements that are relevant to the group audit, including independence and professional competence
- Whether the component auditor has complied with the group engagement team's requirements
- Identification of the financial information of the component on which the component auditor is reporting
- Information on instances of non-compliance with laws and

regulations that could give rise to material misstatement of the group financial statements

- A list of uncorrected misstatements of the financial information of the component (the list need not include items that are below the threshold for clearly trivial misstatements)
- Indicators of possible management bias
- Description of any identified significant deficiencies in internal control at the component level
- Other significant matters that the component auditor communicated or expects to communicate to those charged with governance of the component, including fraud or suspected fraud involving component management, employees who have significant roles in internal control at the component level or others where the fraud resulted in a material misstatement of the financial information of the component.
- Any other matters that may be relevant to the group auditor that the component auditor wishes to draw to the attention of the group engagement team, including exceptions noted in the written representations that the component auditor requested from component management
- The component auditor's overall finding, conclusions or opinion.

The timetable agreed with those charged with governance of the group is as follows: *[insert dates]*.

We look forward to receiving your confirmation.

*[Group auditor's*

*signature] [Date]*

*[Group auditor's address]*

#### **Example: Component auditor's confirmation**

*ISA 600 includes an example of a component auditor's confirmation as set out below.*

##### **Component auditor confirmation**

*[Component auditor letterhead]*

*[Date]*

To Group Engagement Partner

This letter is provided in connection with your audit of the group financial statements of *[name of parent]* for the year ended *[date]* for the purpose of expressing an opinion on whether the group financial statements present fairly, in all material respects (*give a true and fair view of*) the financial position of the group as at *[date]* and (of) its financial performance and cash flows for the year then ended in accordance with *[indicate applicable financial reporting framework]*.

We acknowledge receipt of your instructions dated [date], requesting us to perform the specified work on the financial information of [name of component] for the year ended [date].

We confirm that:

1. We will be able to comply with the instructions. We advise you that we will not be able to comply with the following instructions [specify instructions] for the following reasons [specify reasons].
2. The instructions are clear, and we understand them. We would appreciate it if you could clarify the following instructions [specify instructions].
3. We will cooperate with you and provide you with access to relevant audit documentation.

We acknowledge that:

1. The financial information of [name of component] will be included in the group financial statements of [name of parent].
2. You may consider it necessary to be involved in the work you have requested us to perform on the financial information of [name of component] for the year ended [date].
3. You intend to evaluate and, if considered appropriate, use our work for the audit of the group financial statements of [name of parent].

In connection with the work that we will perform on the financial information of [name of component], a [describe component, for example, wholly-owned subsidiary, subsidiary, joint venture, investee accounted for by the equity or cost methods of accounting] of [name of parent], we confirm the following:

1. We have an understanding of [indicate relevant ethical requirements] that is sufficient to fulfil our responsibilities in the audit of the group financial statements, and will comply therewith. In particular, and with respect to [name of parent] and the other components in the group, we are independent within the meaning of [indicate relevant ethical requirements] and comply with the applicable requirements of [refer to rules] promulgated by [name of regulatory agency].
2. We have an understanding of International Standards on Auditing and [indicate other national standards applicable to the audit of the group financial statements] that is sufficient to fulfil our responsibilities in the audit of the group financial statements and will conduct our work on the financial information of [name of component] for the year ended [date] in accordance with those standards.
3. We possess the special skills (for example, industry specific knowledge) necessary to perform the work on the financial information of the particular component.

4. We have an understanding of [*indicate applicable financial reporting framework or group financial reporting procedures manual*] that is sufficient to fulfil our responsibilities in the audit of the group financial statements.

We will inform you of any changes in the above representations during the course of our work on the financial information of [*name of component*].

[Auditor's

*signature]* [Date]

[Auditor's address]

### 3.3 Involvement of the group auditor in the work performed by component auditors

It is the group auditor's responsibility to decide what work is to be performed on the financial information of the component by the component auditor.

The group auditor then has to decide the extent of his involvement in that work. For **significant components** he must, as a minimum:

- discuss with component management or the component auditor the business activities of the component that are significant to the group
- discuss with the component auditor the risk of material misstatement of the financial information of the component, and
- review the component auditor's documentation of identified significant risks of material misstatement of the group financial statements.

Where significant risks of material misstatement of the group financial statements have been identified at a component the group auditor should:

- evaluate the further audit procedures to be performed to address such risks, and
- consider whether it is necessary to be involved in those procedures.

Such involvement might include:

- meeting with component management/auditors to obtain an understanding of the component
- reviewing the component auditor's overall audit strategy and plan
- performing risk assessment procedures at the component
- designing and/or performing further audit procedures
- participating in closing/other key meetings between component auditors/management
- reviewing other relevant parts of the component auditor's documentation.

For **other components**, the extent of the group auditor's involvement will depend on his understanding of that component auditor. If he has concerns about that particular component auditor's competence, or a lack of local regulation, he may decide that he needs to be involved in that component auditor's risk assessment.

**In all cases** the group auditor is required to evaluate the report of the work performed by the other auditor. If, after such evaluation and after discussion with

the component auditor/management, the group auditor concludes that the work is insufficient he should:

- determine what additional procedures are needed, and
- whether such procedures should be performed by the component auditor or himself.

### 3.4 Joint auditors

A joint audit involves two (or more) audit firms being appointed to audit the financial statements of an entity. The joint audit provides a joint opinion on the financial statements of the company.

Joint audits may occur in other situations, but they are commonly found in group audits. In particular when a group acquires a new subsidiary, it is not unusual to appoint the group's auditors jointly with the subsidiary's existing auditors, at least for a period of time after the acquisition.

Additionally, in some countries joint audits are mandatory in certain situations, for example for audits of listed companies which produce consolidated financial statements in France. This practice is thought to increase competition between audit firms and reduce the dominance of the Big 4.

**Joint audit** should not be confused with **shared audit**. Whilst shared audits also involve more than one auditor, the overall responsibility for signing the shared audit report lies with a single firm. Joint audit requires the signature of multiple firms on the joint audit report.

#### Advantages of joint audits

The reasons why joint auditors might be appointed include the following issues:

- The client company may be so large that it requires the services of more than one firm of auditors.
- After the acquisition of a large subsidiary, using joint auditors may help the transition process while the group auditors become familiar with the new subsidiary. The 'old' auditors should be familiar with the business of the subsidiary and should pass their knowledge over to the parent company auditors. For the parent company auditors, this should accelerate the process of getting to know the business of the new subsidiary.
- Joint auditors may provide a higher level of technical expertise than either audit firm could provide individually.
- Improved geographical coverage may be obtained for the audit, where each of the joint auditors on its own does not have offices that cover all the geographical locations of the component companies in the group.
- It has been suggested that two medium-sized accountancy firms might 'join forces' and tender for the audit of a company for which the auditors would normally be one of the 'Big 4' accountancy firms. This is possibly a way in which medium-sized firms might try to 'break the monopoly' of the Big 4 on large company audits.

### Disadvantages of joint audits

Possible disadvantages of joint audits include the following:

- The extra cost to the client. It is likely to cost more to use two accountancy firms than to use one.
- Possible inconsistencies between the two joint auditors in the audit methods that they use. If so, there may be problems in reaching agreement on whose audit method to use.
- The possible difficulty the two firms may have in agreeing the division of work.
- Additional problems that will arise in monitoring and controlling the audit work of two different firms.
- The two firms may find it difficult to work well together, and each firm may try to become the leading firm in the joint audit.
- If there is a claim against the auditors for negligence in the conduct of the audit, there may be some difficulty in identifying which of the joint auditors is potentially liable.
- Costs may be higher due to the involvement of multiple audit firms.

### Performing joint audits

The key to a successful joint audit is good communication between the firms, including **joint planning meetings** and **regular discussions** between the firms at all key stages of the audit process. The meetings and discussions should be **fully documented**.

Audit firms performing joint audits will have a number of factors to consider including the following.

- Each audit firm will need to consider if the other firm is independent and competent as they will be providing a joint opinion.
- The two audit firms will need to agree on a joint audit strategy.
- The joint auditors will need to agree how to co-ordinate their work. This may be difficult if each firm follows different methodologies.
- Ideally there will be no duplication of work as this increases costs for the audit client. However, there may be some key areas where this occurs e.g. both firms wish to perform risk assessment procedures.
- The audit firms will need to agree how to allocate the audit work. Ideally, one firm will not be dominant, for example, performing 90% of the work. The split of work can be based on a number of factors including:
  - number of hours work performed;
  - the relevant experience of each audit firm;
  - geographical location of the audit firms in relation to the client premises; and
  - audit client business sectors.
- The audit firms will wish to review each other's work as they are both responsible for the audit opinion. It may be difficult to resolve situations where the firms have a difference of opinion or feel that the work carried out is not sufficient and appropriate.

## 4 AUDITING THE CONSOLIDATION PROCESS

### Section overview

- Role of the group auditor with regard to consolidation
- The main audit procedures relating to consolidation
- Subsequent events

#### 4.1 Role of the group auditor with regard to consolidation

As discussed above, ISA 600 requires the group auditor to obtain an understanding of the consolidation process, including the instructions issued by management to its components. This will allow an assessment of the risks involved in the consolidation process.

The group auditor will want to confirm that the following actions have been taken correctly by the client group:

- There has been a full and accurate transfer of information from the individual financial statements of the components of the group to the final consolidated financial statements.
- Appropriate consolidation adjustments have been made.

However, the amount and type of detailed audit procedures to be carried out will depend on the group auditor's assessment of risk in this area.

#### 4.2 The main audit procedures relating to consolidation

The table below sets out the main audit procedures that could be performed in relation to the consolidation process i.e. preparing the consolidated financial statements from the financial statements of the individual components in the group.

Topic	Audit procedures
Clerical accuracy	<ul style="list-style-type: none"> <li>■ Confirm that figures have been transferred accurately from the financial statements of the components (individual companies in the group) to the consolidation schedules.</li> <li>■ Check the arithmetical accuracy of all consolidation calculations, such as the consolidation total balances and total transaction values.</li> </ul>
Status of investments	<ul style="list-style-type: none"> <li>■ Confirm that the parent company has correctly classified investments as a subsidiary, associate, joint venture or simple investment, in accordance with standard accounting practice.</li> <li>■ Confirm that the appropriate accounting treatment has been adopted for each of these classifications of investment in the group accounts.</li> </ul>

Topic	Auditprocedures
<b>Changes in the group</b>	<ul style="list-style-type: none"> <li>■ For acquisitions: confirm fair values, the calculation of purchased goodwill and accounting treatment in accordance with IFRS 3 and any other relevant standards.</li> <li>■ Where there has been an acquisition during the year involving deferred consideration as part-payment, check that the amount of the deferred consideration has been included in the cost of the acquisition at discounted present value, using a current pre-tax cost of capital as the discount rate. (Note: The cost of the acquisition affects the amount of the purchased goodwill.)</li> <li>■ Where there has been an acquisition during the year involving a possible contingent consideration as part-payment, check the reasonableness of the assumption that the recent value of the contingent consideration should be included in the cost of the acquisition.</li> <li>■ For disposals: confirm the sale proceeds, and the calculation of the gain or loss on sale.</li> <li>■ Check that the correct accounting treatments of items are applied in the consolidated income statement/statement of comprehensive income and the consolidated. For example, when a subsidiary has been acquired during the year, check that the calculation of pre-acquisition and post-acquisition profit is correct.</li> </ul>
<b>Consolidation adjustments*</b>	<ul style="list-style-type: none"> <li>■ Reconcile the inter-company transactions and balances (or review the reconciliation of the inter-company transactions and balances that has been made by the client's staff).</li> <li>■ Confirm the inter-company balances.</li> <li>■ Check calculations of the adjustments for unrealised profit.</li> <li>■ Check the calculations and disclosure of non-controlling interests.</li> <li>■ Check the accounting treatment of inter-company dividends and other dividends.</li> </ul>

Topic	Auditprocedures
<b>Loss-making investments</b>	<ul style="list-style-type: none"> <li>■ Consider whether any goodwill on acquisition has suffered an impairment.</li> <li>■ Consider whether a write down of the investment in the books of the parent company is needed.</li> <li>■ If a subsidiary makes losses consistently, its going concern status may be in question.</li> <li>■ However, the group may take a formal decision to provide financial support to the subsidiary. This decision, in effect, would protect the going concern status of the subsidiary, even if it is making losses. In such a situation, the group auditor will normally request a 'comfort letter' (or 'support letter') to this effect from the directors of the parent company.</li> </ul>
<b>Relatedparties</b>	<ul style="list-style-type: none"> <li>■ Ensure the provisions of IAS 24 are complied with.</li> <li>■ (Most components of the group will be 'related' to most other components).</li> </ul>
<b>Reporting</b>	<ul style="list-style-type: none"> <li>■ Reach a conclusion about whether the group financial statements present a true and fair view.</li> <li>■ (The principles relating to group audit reports are dealt with in a later chapter).</li> </ul>

**\*(Note:** Consolidation adjustments are adjustments that are made after the financial statements of the individual group companies have been prepared. The adjustments are needed to consolidate the financial statements of the individual companies into a single set of group financial statements. Consolidation adjustments may therefore include adjustments to the financial statements of individual group companies, to achieve consistency of accounting policies. There are also adjustments for inter-group balances and closing inventory from intra-group sales, for goodwill impairment, and so on.)

#### 4.3 Subsequent events

The subsequent events review will need to include procedures to identify events at components that occur between the dates of the components' financial information and the date of the **group** audit report. These procedures could be carried out by the group auditor or by component auditors.

## 5 DOCUMENTATION AND COMMUNICATION WITH MANAGEMENT AND THOSE CHARGED WITH GOVERNANCE

### Section overview

- Documentation
- Communication with group management
- Communication with those charged with governance of the group

#### 5.1 Documentation

In addition to meeting the requirements of ISA 230 *Audit documentation* the group auditor must also document the following matters.

- An analysis of components, identifying significant components.
- The type of work performed on the financial information of components.
- The extent of the group auditor's involvement in the work performed by component auditors on significant components.
- Written communications between the group auditor and component auditors concerning the group auditor's requirements.

#### 5.2 Communication with group management

The group auditor should make group management aware, on a timely basis, of the following matters.

- Material weaknesses in the design or operating efficiency of group-wide controls.
- Material weaknesses which are significant to the group that the group auditor has identified at components.
- Material weaknesses which are significant to the group that component auditors have identified at components and have brought to the attention of the group auditor.
- Any fraud or suspected fraud identified by the group or component auditors.

The distinction between management and "those charged with governance" (see below), who could in fact be the same, is covered in a later chapter.

#### 5.3 Communication with those charged with governance of the group

In addition to the matters required to be communicated within ISA 260 *Communication with those charged with governance*, ISA 600 requires the group auditor to communicate the following matters to those charged with the governance of the group:

- The type of work to be performed on the financial information of components.
- The group auditor's planned involvement in the work to be performed by component auditors.
- Any concerns over the quality of any component auditor's work.
- Any limitations on the group audit (e.g. a lack of access to information).

- Any fraud or suspected fraud involving group management, component management, or employees with significant roles in group-wide controls where the fraud resulted in a material misstatement of the group financial statements.

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## 6 CHAPTER REVIEW

### Chapter review

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

- Summarise the core components and considerations of group audit
- Describe how component auditors are used and the various communications that they will partake in
- Explain the responsibilities and tasks involved in performing a group audit in compliance with ISA 600 including planning, performing and reporting.
- Explain what a joint audit is and when it may be necessary
- Discuss the benefits and drawbacks of a joint audit
- Discuss practical considerations when undertaking a joint audit

### Quick quiz questions

- 1 What is the preferred treatment of goodwill arising on consolidation under IFRS?
  - A Write off against reserves
  - B Capitalise and test for impairment when impairment indications arise
  - C Carry on the balance sheet indefinitely
  - D Capitalise and test for impairment annually
  
- 2 Which of the following statements is correct?
  - A Responsibility for a group audit is shared by the group auditor and any component auditors.
  - B An audit firm may accept an engagement as group auditor even if it is insufficiently involved in the audit of significant components to obtain audit evidence about them.
  - C A group auditor may rely on the work done by a component auditor without the need to assess its quality.
  - D The group auditor sets the group materiality level for the financial statements as a whole and component materiality levels for components audited by component auditors.
  
- 3 Which of the following statements about the group engagement partner in a group audit is INCORRECT?
  - A The group engagement auditor is responsible for the opinion on the group financial statements as a whole.
  - B The group engagement auditor can demand information and explanations from the component auditor.
  - C The group engagement auditor needs to consider the materiality of the portion of the group audited by him.
  - D The group engagement auditor can demand co-terminous year-ends for all group companies.
  
- 4 Which of the following statements is correct?
  - A A component auditor should provide the group auditor with access to its relevant auditing documentation.
  - B A component auditor should provide the group auditor with a report of work performed unless the group auditor specifically states that this is not necessary.
  - C When there is a joint audit, one of the firms must act as the senior firm in the audit.
  - D When a component within a group is significant, the audit of the component should use group materiality.

- 5 In a group audit, which of the following should be included in the main audit procedures in relation to the consolidation process?
- 1 Clerical accuracy
  - 2 Consolidation adjustments
  - 3 status of investments
- A 1 and 2 only
- B 1 and 3 only
- C 2 and 3 only
- D 1, 2 and 3

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### Quick quiz answers

1 D

Under IFRS 3, goodwill arising on consolidation ((purchased goodwill) should be capitalised in the consolidated statement of financial position and tested annually for impairment.

2 D

The group auditor has the full responsibility for the group audit. It must therefore assess the quality of the work of any component auditors.

3 D

It is up to the parent company to decide on the year-ends of group companies. Some subsidiaries may operate in countries that specify by law the year-ends that must be used, so it is not always possible for all group companies to use the same year-ends.

4 A

A component auditor should always provide the group auditor with a report of work performed. When a component within a group is significant, the audit of the component should use the component materiality.

5 D

There should be a check that the client has made the consolidation calculations accurately and that all the consolidation adjustments have been made (for inter-company balances, unrealised profit in closing inventory etc.). The status of investments should also be checked, to verify that entities within the group are correctly classified as subsidiaries or associates.

CHAPTER  
**11**

## **Audit-related services**

### **Contents**

- 1 Review engagements
- 2 Agreed-upon procedures
- 3 Compilation engagements
- 4 Investigations
- 5 Liquidation and bankruptcy
- 6 Chapter review

## INTRODUCTION

### Competencies

#### Planning and undertaking audit work

- C 4(c) i Identify and discuss various circumstances under which an investigation may be conducted.
- C 4(c) ii Differentiate between investigation and statutory audit.
- C 4(c) iii Analyse and evaluate various stages involved in conducting investigations.
- C 4(c) iv Write an appropriate report on each investigation.
- C 4(c) v Discuss the nature and methods of investigation relating to liquidation and bankruptcy.
- C 4(d) i Differentiate between due diligence and external audit.
- C 4(d) ii Describe the procedures involved in carrying out due diligence.
- C 4(d) iii Write a report on the outcome of a due diligence assignment.

#### Drawing conclusions and reporting

- D2 (h) Draft extracts of suitable audit, assurance and management reports based on a given scenario in accordance with Nigerian laws and international standards on auditing.
- D2 (j) Evaluate and apply suitable judgments on when it may be appropriate to withhold an opinion, withdraw an opinion or take other such appropriate actions on an audit or assurance engagement.

### Exam context

With the trend towards increased audit exemption leading to fewer mandatory audits being performed, there is an ever increasing market opportunity to offer non-audit services. This is the first of two chapters that focus on such non-audit engagements.

In this chapter students will learn how to perform review engagements in accordance with ISREs 2400 and 2410. Students will also learn how to perform related services engagements such as agreed-upon procedures and compilation engagements in accordance with ISRS 4400 and 4410.

At the end of this chapter, readers should be able to:

- Describe the objectives and conduct of review engagements in accordance with ISRE 2400 and 2410
- Describe the objectives and conduct of related services engagements in accordance with ISRS 4400 and 4410
- Discuss when an investigation is necessary, and the stages involved
- Explain the basic principles of company liquidation and bankruptcy

## 1 REVIEW ENGAGEMENTS

### Section overview

- The distinction between audit and audit-related services
- Types of review engagement
- Due diligence engagements
- International Standard on Review Engagements (ISRE)2400
- Reporting at the end of a review engagement
- International Standard on Review Engagements (ISRE)2410
- Procedures for the review of interim financial information
- Reporting on the review of interim financial information

#### 1.1 The distinction between audit and audit – related services

An **audit** is a form of **assurance engagement**. The objective of an audit is to enable the auditor to form an opinion as to whether the financial statements of an entity give a ‘true and fair view’.

An audit is designed to provide a high level of assurance to the users of the financial statements.

In contrast, **audit-related services** do not provide the same high level of assurance, and in some cases do not provide any assurance. Audit-related services include engagements such as:

- Reviews of data.** Reviews of data are checks carried out on information prepared by another person. They provide a **moderate** level of assurance that the information under review is free of material misstatement.
- Agreed-upon procedures.** This is an engagement where the party hiring the practitioner specifies the procedures that the practitioner should follow when performing the assignment.
- Compilations.** The practitioner is engaged to prepare information, rather than to audit information prepared by someone else. For example, an accountancy firm may be engaged to prepare a tax computation for a client.

#### 1.2 Types of review engagement

In a review engagement, the practitioner is engaged to review financial information or other information, but not to audit it.

The work performed in a review engagement is less detailed than the work for an audit. As a result, the level of assurance provided is **limited** rather than high (as in the case of an audit).

A distinction is made between two types of review engagement:

- an attestation engagement, and
- a direct reporting engagement.

### Attestation engagement

To **attest** to something means to affirm it or vouch for it. In an attestation engagement, a practitioner is engaged to attest to something. For example, a practitioner might be engaged to attest to the fact that certain procedures within an entity have been performed in a prescribed way. The practitioner will not comment on the quality of the procedures, but will simply attest to the fact that they have been performed.

### Direct reporting engagement

In a direct reporting engagement, a practitioner is engaged to provide a special report on some aspect of the client's affairs.

- The report will provide an expression of opinion (usually providing limited or **negative assurance**) that is made in accordance with the agreed terms of the engagement
- The report is prepared after the practitioner has carried out an independent examination of financial information or other information that has been prepared for use by another party.

### 1.3 Due diligence engagements

One of the most common forms of direct reporting engagement is '**due diligence**' work. This term refers to any engagement where the practitioner is engaged to make inquiries into the accounts, organisation or activities of an entity.

Due diligence work is most commonly referred to in the context of mergers and takeovers. The work involves obtaining information about the target company, prior to the takeover (or merger). The objective should be to find out everything that may be relevant about the target company's operations, financial performance, financial position and future prospects. In addition, information should also be gathered about the business environment in which the target company operates.

The practitioner will also interview the senior management of the target company, and other key employees and possibly external third parties. Due diligence work does **not** involve tests of controls (unless the client specifically asks for this), nor does it involve substantive testing. Due diligence work is **not** a form of audit work.

The main objective of due diligence is therefore often to provide information that will allow the client to:

- decide whether a takeover or merger is actually desirable, and
- if so, whether the proposed cost of the acquisition is reasonable.

An adverse or critical due diligence report may therefore result in:

- abandoning a proposed takeover or merger, or
- reducing the offer price for the acquisition.

### Items to investigate in a due diligence exercise

**Financial performance and financial position:** The practitioner will look at the available historical financial information about the target company, such as its financial statements for the past few years. Ratio analysis will often be used to make an assessment. The practitioner will also look at the target company's management accounts, budgets and profit/cash flow forecasts, and at any current business plan.

**Operational issues:** The practitioner should also look for any operational issues in the target company that may raise questions about its value. For example, the target company might have important contracts with major customers, and the practitioner should try to find out when these contracts reach their termination date and what the probability that the contracts will be renewed is. Other operational problems may be discovered, such as a high rate of labour turnover, or high costs incurred in meeting warranties or guarantees to customers.

**Management representations:** Management of the takeover target may have provided representations to the potential buyer. For example, they might have given a written assurance that the target company is not subject to any tax investigation or potential litigation. Due diligence work should seek to establish that these representations appear to be correct.

**Identification of assets:** A takeover usually results in purchased goodwill in the consolidated accounts. However the takeover target may have several intangible assets that do not appear in its statement of financial position (because they were internally-generated assets) but which should be recognised for the purpose of consolidation. Examples are internally-generated patent rights, customer lists and databases and brand names. These should be identified and valued, for inclusion in the consolidated statement of financial position after the acquisition. It is also useful for the management of the potential buyer to be aware of the nature and estimated value of the intangible assets that they would be acquiring.

**Benefits and costs of a takeover:** Due diligence may also include an attempt to estimate the future benefits of the takeover, such as cost savings from synergies such as economies of scale. Any 'one off' expenses such as redundancy costs and reorganisation costs will have to be estimated – by the potential buyer if not by the due diligence process.

### Benefits of using an audit firm for due diligence

There is no reason why an accountancy firm, such as the firm's auditors, should not be engaged to carry out due diligence. Management could do some or all the work themselves. However, using an accountancy firm to do the work has two potential benefits:

- Hiring an accountancy firm to do the work saves management time for the potential buyer. In addition, the practitioners assigned to the due diligence work should have suitable experience in this type of work. For large takeovers, the amount of time and resources required to carry out proper due diligence can be substantial.
- Using a professional firm to do due diligence may help to reassure shareholders in the potential buyer (or investors who will be asked to provide loan finance for the takeover) that the acquisition has been properly evaluated

### Due diligence reports

The format and content of a due diligence report will be agreed in advance with the client and detailed in the engagement letter. Note that there is no set format for a due diligence report given in the standards but they generally follow a similar structure.

- Introduction/executive summary:** This section provides a brief summary of the target company to the client and highlights any areas of concern.
- Main section of report:** The content and order of this section will be agreed with the client in advance and could include areas such as:
  - analysis of audited financial statements going back several years;
  - any audit issues in the past;
  - legal issues, such as potential litigation;
  - corporate governance analysis;
  - SWOT analysis;
  - any financial obligations, such as loans or leases;
  - details of key suppliers and customers;
  - details of key employment matters such as pensions, redundancy obligations; and
  - key employees.
- Appendices:** This section will contain the detailed documentation used to compile the main section of report e.g. copies of financial statements, copies of lease contracts or loan terms.

## 1.4 International Standard on Review Engagements (ISRE) 2400

### Objectives of ISRE 2400

ISRE 2400 - *Engagements to review historical financial statements* states the objectives of a review of financial statements are to:

- "Obtain limited assurance, primarily by performing inquiry and analytical procedures, about whether the financial statements as a whole are free from material misstatement, thereby enabling the practitioner to express a conclusion on whether anything has come to the practitioner's attention that causes the practitioner to believe the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- Report on the financial statements as a whole and communicate, as required by this ISRE."

A review requires less evidence than an audit. Because a review engagement provides a lesser form of assurance than an audit (limited rather than reasonable assurance), the work for the review will usually be limited to analytical review and other review procedures. Detailed verification work (for example, substantive tests) will not usually be carried out. This will usually mean that fewer accountancy staff, but more experienced staff, will be required for a review engagement than for an audit.

### Principles to apply to review engagements

ISRE 2400 sets out the following general principles that should be applied to a review engagement. The practitioner shall:

- comply with relevant codes of ethics
- plan and perform the work with an attitude of **professional scepticism**, recognising that material misstatements may exist in the information that is subject to review
- obtain **sufficient and appropriate evidence**, primarily through inquiry and analytical procedures.
- exercise professional judgement

The actual terms of a review engagement shall be agreed with the client, and set out in an **engagement letter**.

### Procedures for a review of financial statements

Procedures for the review of financial statements will usually include the following:

- Determine materiality for the financial statements as a whole.
- The practitioner shall obtain an understanding of the entity's business and the industry in which it operates.
- The practitioner shall make inquiries into:
  - the entity's accounting policies, practices and procedures, including the preparation of financial statements
  - material assertions in the financial statements that are subject to the review

- decisions taken at board meetings and other meetings of the entity that may affect the financial statements
  - the completeness of the accounting records that were used to prepare the financial statements.
- The practitioner will use analytical procedures. These should be designed to identify unusual relationships between items in the financial statements, and individual items that appear unusual. Analytical procedures would include:
- comparing the financial statements under review with financial statements for prior periods
  - comparing the financial statements with the anticipated results and financial position of the entity
  - a study of the relationships between elements in the financial statements that should be expected to conform to a predictable pattern (based on the entity's past experience or normal ratios/relationships for the industry as a whole).
- Other procedures that will usually be carried out in a review of financial statements include:
- discussions with the company's auditors
  - obtaining written representations from management
  - considering the appropriateness of the accounting policies employed by the entity
  - making inquiries into subsequent events (after the date of the statement of financial position)
  - making a review of the statements as a whole.
  - remaining alert for related party relationships and transactions and discussing these with management if they are identified
  - if fraud or NOCLAR is suspected, the practitioner must communicate this to management or those charged with governance (if appropriate), consider the effect on the financial statements (using management's assessment if this exists) and determine whether there is a need to report to an outside party.
  - review of management's assessment of the entity to continue as a going concern

If the practitioner finds information indicating that misstatements might exist in the financial statements, the scope of the work shall be extended.

### 1.5 Reporting at the end of a review engagement

The outcome of a review engagement will be a report from the practitioner. The report will be in one of two main forms, depending on whether:

- no matters have come to the attention of the practitioner, which indicate that a true and fair view is not presented
- some matters have come to the attention of the practitioner, indicating that a true and fair view might not be presented.

**No matters have come to the attention of the auditor**

In this situation the auditor will issue a report giving a clear expression of limited assurance. An example of such a report, based on ISRE 2400, is below.

**INDEPENDENT PRACTITIONER'S REVIEW REPORT**

*[Appropriate Addressee]*

**Report on the Financial Statements**

We have reviewed the accompanying financial statements of ABC Company, which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

**Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the International Financial Reporting Standard for Small and Medium-sized Entities, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

**Practitioner's Responsibility**

Our responsibility is to express a conclusion on the accompanying financial statements. We conducted our review in accordance with International Standard on Review Engagements (ISRE) 2400 (Revised), Engagements to Review Historical Financial Statements. ISRE 2400 (Revised) requires us to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects in accordance with the applicable financial reporting framework. This Standard also requires us to comply with relevant ethical requirements.

A review of financial statements in accordance with ISRE 2400 (Revised) is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with International Standards on Auditing. Accordingly, we do not express an audit opinion on these financial statements.

**Conclusion**

Based on our review, nothing has come to our attention that causes us to believe that these financial statements do not present fairly, in all material respects, (or do not give a true and fair view of) the financial position of ABC Company as at December 31, 20X1, and (of) its financial performance and cash flows for the year then ended, in accordance with the International Financial Reporting Standard for Small and Medium-sized Entities.

**Report on Other Legal and Regulatory Requirements**

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

*[Practitioner's signature]*

*[Date of the practitioner's report]*

*[Practitioner's address]*

### Where such matters have come to the practitioner's attention

When matters have come to the practitioner's attention, suggesting that a material misstatement or inability to obtain sufficient appropriate audit evidence exists, the reporting requirements are similar to those in ISA 705 for qualified external auditor's reports. The auditor will need to:

- describe the matters involved
- assess the impact of the matter, as either material or pervasive
- distinguish between 'material misstatement' and 'limitation on scope' when presenting the opinion in the report.

The following example of a report dealing with a material but not pervasive misstatement is based on ISRE 2400:

#### INDEPENDENT PRACTITIONER'S REVIEW REPORT

[Appropriate Addressee]

(First three sections as for the previous unqualified report.)

#### Basis for Qualified Conclusion

The company's inventories are carried in the statement of financial position at xxx. Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from the requirements of the Financial Reporting Framework (XYZ Law) of Jurisdiction X. The company's records indicate that, had management stated the inventories at the lower of cost and net realisable value, an amount of xxx would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

#### Qualified Conclusion

Based on our review, except for the effects of the matter described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the financial statements of ABC Company are not prepared, in all material respects, in accordance with the Financial Reporting Framework (XYZ Law) of Jurisdiction X.

#### Report on Other Legal and Regulatory Requirements

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

[Practitioner's signature]

[Date of the practitioner's report]

[Practitioner's address]

## 1.6 International Standard on Review Engagements (ISRE) 2410

*ISRE 2410 Review of interim financial information performed by the independent auditor of the entity* deals with a more specific topic than ISRE 2400. It deals with the review carried out by a company's external auditors of the interim financial statements (mid-year financial statements), where companies are required to produce interim statements. The interim financial statements are not subject to a full audit; however, they are subject to a review.

On the whole general auditing principles apply to this type of review, as set out below.

The auditing firm that reviews **interim financial information (IFI)** is normally the external auditor for the end-of-year accounts. The audit firm should:

- comply with the same ethical requirements as it does for the main audit
- implement appropriate quality control procedures
- plan and perform the review with an attitude of professional scepticism
- agree the terms of engagement with the client in an engagement letter
- prepare documentation sufficient to support the auditor's review conclusions and to provide evidence that the review was conducted in accordance with ISRE 2410.

## 1.7 Procedures for the review of interim financial information

Procedures for the review of interim financial information (IFI) should include the following:

- The auditor should obtain an understanding of the entity and its environment, including its internal controls, in order to:
  - assess the risk of misstatement in the financial statements
  - select appropriate 'audit' procedures for the review.
- The auditor should make inquiries and perform analytical procedures sufficient to reach a conclusion for the review. This conclusion should be about whether anything has come to the auditor's attention to indicate that the IFI has not been prepared, in all material respects, in accordance with the applicable financial reporting framework. (As with ISRE 2400, the auditor's opinion is expressed in negative terms.)
- If any such matters come to the auditor's attention, the auditor should make additional inquiries or perform other procedures in order to obtain more information.
- The auditor should check that the IFI agrees or reconciles to the underlying accounting records.
- The auditor should discover whether management has:
  - taken subsequent events into account, and
  - made an assessment of the entity's ability to continue as a going concern.
- The auditor should evaluate any uncorrected misstatements in the IFI, both individually and in aggregate. (This is the same as for the annual audit.)
- The auditor should obtain written representations from management that:
  - they acknowledge their responsibility for internal controls

- the IFI has been prepared and presented in accordance with the applicable financial reporting framework
  - they believe the effect of any uncorrected misstatements are immaterial, both individually and in aggregate
  - there has been full disclosure of all significant facts, risk assessment, possible or actual non-compliance with laws and regulations, and subsequent events.
- The auditor should ensure that any other information issued with the IFI is materially consistent with the IFI.

### 1.8 Reporting on the review of interim financial information

The auditor should issue a written report on the review of the IFI. This report should consist of the following elements:

- Title: Review of the IFI
- Addressee.
- Identification of the IFI that has been reviewed. This should include the title of each of the financial statements in the set of financial statements subject to review, and the end-of-period date and the period covered by the IFI.
- A statement that management is responsible for preparing the IFI in accordance with the applicable financial reporting framework, and for its fair presentation.
- When the IFI consists of a complete set of general-purpose financial statements that should be prepared in accordance with a financial reporting framework, and the statements are **designed to achieve fair presentation**, the review report should include an auditor's conclusion. This conclusion should state whether anything has come to the auditor's attention that causes him to believe that the IFI does not **give a true and fair view** in accordance with the applicable financial reporting framework.
- A statement that the auditor is responsible for expressing a conclusion on the IFI, based on the review that the auditor has carried out.
- A statement that the review of the IFI was conducted in accordance with ISRE 2410, and a statement that this review consisted of making inquiries and applying analytical procedures and other review procedures.
- A statement that a review is substantially less in scope than an audit conducted in accordance with ISAs. Consequently the review does not enable the auditor to obtain assurance that he would become aware of all significant matters that might be identified in an audit. Accordingly, no audit opinion is expressed (and the auditor expresses a negative opinion rather than a positive opinion).
- Date of the report
- Location in the country or jurisdiction where the accountancy firm practises
- Signature of the auditor.

**Example:**



Shown below is an example of an unmodified report, based on ISRE 2410. The report relates to IFI comprising a complete set of general purpose financial statements prepared in accordance with IFRSs. (In other words, the report relates to a view of IFI that uses a financial reporting framework designed to achieve fair presentation). Note that ISRE 2410 has not yet been updated for the changes in terminology introduced by the revision of IAS 1 *Presentation of financial statements*.

**REPORT ON REVIEW OF INTERIM FINANCIAL INFORMATION**

(Appropriate addressee)

**Introduction**

We have reviewed the accompanying balance sheet of ABC Entity as of March 31, 20XX and the related statements of income, changes in equity and cash flows for the three-month period then ended, and a summary of significant accounting policies and other explanatory notes. Management is responsible for the preparation and fair presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

**Scope of review**

We conducted our review in accordance with International Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity." A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit.

Accordingly, we do not express an audit opinion.

**Conclusion**

Based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information is not prepared, in all material respects, in accordance with [applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards].

AUDITOR

Date Address

A **qualified or adverse opinion** should be given where the auditor/accountant believes that the IFI has not been prepared in accordance with the applicable financial reporting framework.

If a **limitation on scope** is imposed, the auditor should:

- Communicate to the appropriate level of management, and to those charged with governance, the difficulty the auditor had in reaching an opinion, and
- Consider whether he can issue a report.

If there are uncertainties surrounding going concern, then the auditor should modify his report in a manner consistent with ISA 570 *Going concern*.

## 2 AGREED-UPON PROCEDURES

### Section overview

- The nature of agreed-upon procedures
- International Standard on Related Services (ISRS) 4400
- Reporting on the agreed-upon procedures

#### 2.1 The nature of agreed-upon procedures

In an agreed-upon procedures engagement, the client that engages also decides the procedures that the accountant will follow.

**This is very different from an audit engagement, where the auditor decides the procedures to be followed in order to reach an audit opinion.**

- The accountant provides a **report on factual findings** from the procedures performed. **No assurance is provided.**
- It is left to the user to assess the procedures and findings and to draw their own conclusions.

The report issued at the end of an agreed-upon procedure should be made available only to those who have agreed the procedures with the auditor/accountant. This is because other people who are unaware of the agreed-upon procedures may misinterpret the meaning of the report.

#### 2.2 International Standard on Related Services (ISRS) 4400

The conduct of agreed-upon procedures is regulated by ISRS 4400 Engagements to perform agreed-upon procedures regarding financial information.

Key points in ISRS 4400 are as follows:

- The terms of engagement for agreed-upon procedures should be set out in an **engagement letter**. The engagement letter should include:
  - the nature and purpose of the engagement, including a specific clarification that it is not an audit and it is not a review
  - the procedures to be carried out by the accountant, and the information to which the accountant is required to apply these agreed-upon procedures
  - the form of the report to be issued at the end of the engagement, and agreed limitations on the distribution of the report.
- The processes undertaken by the accountant to perform agreed-upon procedures may be similar to those involved in an audit:
  - planning and documentation will be required
  - evidence must be collected
  - conclusions must be reached
  - a report must be prepared.

However, since there is **no assurance** attached to the assignment, it is likely that the volume of work undertaken by the accountant will be **significantly less than for an audit** of similar financial information.

### 2.3 Reporting on the agreed-upon procedures

The report of factual findings should contain:

- Title;
- Addressee (ordinarily the client who engaged the auditor to perform the agreed-upon procedures);
- Identification of specific financial or non-financial information to which the agreed-upon procedures have been applied;
- A statement that the procedures performed were those agreed upon with the recipient;
- A statement that the engagement was performed in accordance with the International Standard on Related Services applicable to agreed-upon procedures engagements, or with relevant national standards or practices;
- When relevant a statement that the auditor is not independent of the entity;
- Identification of the purpose for which the agreed-upon procedures were performed;
- A listing of the specific procedures performed;
- A description of the auditor's factual findings including sufficient details of errors and exceptions found;
- Statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed;
- A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported;
- A statement that the report is restricted to those parties that have agreed to the procedures to be performed;
- A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial



### **Example: Report at the end of an engagement with agreed-upon procedures**

An example of an appropriate report in connection with accounts payable is set out below.

**To: The Board of Directors, C B R Manufacturing Company**

#### **REPORT OF FACTUAL FINDINGS**

We have performed the procedures agreed with you and enumerated below with respect to the accounts payable of C B R Manufacturing Company as at (date), set forth in the accompanying schedules (not shown in this example). Our engagement was undertaken in accordance with the International Standard on Related Services (or refer to relevant national standards or practices) applicable to agreed-upon procedures engagements. The procedures were performed solely to assist you in evaluating the validity of the accounts payable and are summarized as follows.

*[Insert a list of agreed upon procedures]*

We report our findings below:

*[Insert findings resulting from each of the procedures, with details of exceptions' as relevant]*

Because the above procedures do not constitute either an audit or a review made in accordance with International Standards on Auditing or International Standards on Review Engagements (or relevant national standards or practices), we do not express any assurance on the accounts payable as of (date).

If we had performed additional procedures or had we performed an audit or review of the financial statements in accordance with International Standards on Auditing or International Standards on Review Engagements (or relevant national standards or practices), other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report and for your information and is not to be used for any other purpose or to be distributed to any other parties. This report relates only to the accounts and items specified above and does not extend to any financial statements of ABC Company, taken as a whole.

AUDITOR

Date

Address

### 3 COMPIILATION ENGAGEMENTS

#### Section overview

- Nature of a compilation engagement
- International Standard on Related Services (ISRS) 4410
- Reporting

#### 3.1 Nature of a compilation engagement

In a compilation engagement, the accountant is engaged **to prepare** financial statements or other information, and not to audit or review the financial statements or other information that has been prepared by someone else. They will therefore use accounting expertise rather than auditing expertise.

An example is the preparation of financial statements for a sole trader or a club or association.

- The accountancy firm is engaged for its accounting expertise, not its auditing expertise.
- No assurance is provided by the accountant who carries out the work.
- The work normally involves the collection and summarising of information.
- A 'compilation report' may be issued at the end of the assignment, but some compilation assignments (such as doing a tax calculation for the client) do not require a report.

#### 3.2 International Standard on Related Services (ISRS) 4410

ISRS 4410 (*revised*) *Compilation Engagements* regulates the conduct of compilation engagements. The standard was revised in March 2012 following growth in demand from SMEs for services other than audit. Demand has been particularly strong in jurisdictions where audit exemptions have either been introduced or extended.

No assurance is given by the accountant about the information that has been compiled. However the client gains some assurance from the requirement that the accountant for a compilation assignment must comply with professional codes of conduct. The accountant is therefore obliged to exercise due care and technical competence in carrying out the work.

The key points of ISRS 4410 are as follows:

- An **engagement letter** is required, confirming:
  - that the work to be carried out is not an audit and is not a view
  - that the engagement cannot be relied upon to disclose error, fraud or other irregularities
  - the information on which the assignment will be based (for example, its accuracy and completeness) is the responsibility of the client's management
  - the intended use and distribution of the information that will be provided at the end of the engagement.
  - the applicable financial reporting framework

- the objective and scope of the engagement
  - responsibilities of the practitioner, including the requirement to comply with relevant ethical requirements
  - the expected form and content of the practitioner's report
- Planning and documentation will be required for the engagement.
- The accountant needs to have adequate knowledge of the client's business and its operations. This knowledge must also cover the accounting system, accounting records and applicable financial reporting framework
- If the accountant becomes aware that the information provided is unsatisfactory (incomplete, inaccurate or otherwise unsatisfactory), he should ask management to correct or improve the information. If management refuses to do this, the accountant should withdraw from the engagement, and inform the entity accordingly.
- The practitioner must obtain an acknowledgement from management or those charged with governance that they take responsibility for the final version of the information

### 3.3 Reporting

ISRS 4410 (*revised*) *Compilation Engagements* requires that the report on a compilation engagement must be in writing and contain the following:

- Title
- Addressee
- A statement that the practitioner has compiled the financial information based on information provided by management
- A description of the responsibilities of management, or those charged with governance in relation to the compilation engagement
- Identification of the applicable financial reporting framework
- Identification of the financial information, including the title of each element of the financial information (if it comprises more than one element) and the date of the financial information
- A description of the practitioner's responsibilities in compiling the financial information, including that the engagement was performed in accordance with ISRS 4410 (*revised*) and that the practitioner has complied with relevant ethical requirements
- A description of what a compilation engagement entails.
- Explanation that as the compilation engagement is not an assurance engagement, the practitioner is not required to verify the accuracy or completeness of the information provided by management for the compilation
- Explanation that the practitioner does not express an audit opinion or a review conclusion on whether the financial information is prepared in accordance with the applicable financial reporting framework.
- If the financial information is prepared using a special purpose framework an explanatory paragraph that describes the purpose of the financial information and the intended users and draws the readers' attention to the fact that the information may not be suitable for other purposes.

- Date of the report
- Practitioner's address
- Practitioner's signature.

**Example: Compilation report**

An example of a compilation report is set out below.

**PRACTITIONER'S COMPILATION REPORT**

[To Management of ABC Company]

We have compiled the accompanying financial statements of ABC Company based on information you have provided. These financial statements comprise the statement of financial position of ABC Company as at December 31, 20X4, the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

We performed this compilation engagement in accordance with International Standard on Related Services 4410 (Revised), Compilation Engagements.

We have applied our expertise in accounting and financial reporting to assist you in the preparation and presentation of these financial statements in accordance with International Financial Reporting Standards for Small- and Medium-sized Entities (IFRS for SMEs). We have complied with relevant ethical requirements, including principles of integrity, objectivity, professional competence and due care.

These financial statements and the accuracy and completeness of the information used to compile them are your responsibility.

Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information you provided to us to compile these financial statements. Accordingly, we do not express an audit opinion or a review conclusion on whether these financial statements are prepared in accordance with IFRS for SMEs.

[Practitioner's signature]

[Date of practitioner's report]

[Practitioner's address]

## 4 INVESTIGATIONS

### Section overview

- Circumstances
- Investigations and the IAASB
- Comparison of investigations and statutory audit
- Stages of an investigation

#### 4.1 Circumstances

There are various circumstances under which accountants are involved in investigations. Sometimes an accountant is requested to investigate a matter on behalf of another party, for example in a forensic investigation which you will learn more about in chapter 12. In other cases, it is the accountant themselves being investigated by others, such as ICAN or the police.

Examples of investigations are given in the following table.

Subject matter of investigation	Party performing investigation
A <b>public enquiry</b> into a matter of national interest: This type of investigation looks into why an event has occurred and what can be done to prevent it happening again, for example an accident at a factory or an outbreak of disease	Funded by government and run by an appointed independent chairperson, often a judge
A <b>failed audit</b> where an auditor's report has wrongly stated financial statements are true and fair or there are no issues with going concern. These type of investigations into an audit firm typically arise after the collapse of a company, for example BHS in the UK	<ul style="list-style-type: none"> <li>■ Independent regulator, e.g. Financial Reporting Council of Nigeria(FRCN)</li> <li>■ An audit firm's internal quality control department</li> <li>■ An audit firm may hire an external independent quality control reviewer</li> </ul>
Suspected breach of ethical code by an accountant	Professional bodies such as ICAN will investigate their members
Suspected money laundering	Police or specialist government agencies
Bankruptcy/insolvency investigation	<ul style="list-style-type: none"> <li>■ Official receiver</li> <li>■ Government agency, especially if financial misconduct is suspected</li> </ul>
Whether government has been spending public money effectively	Government auditors such as the National Audit Office in the UK
Value for money audit	Internal auditors (see chapter 13)

#### 4.2 Investigations and the IAASB

There is no official definition of investigation in the ISAs and those performing an investigation are not required to follow ISAs as with a statutory audit. The laws or rules that are followed when performing an investigation are very much

dependent on the type of investigation being performed and whose legal authority this falls under.

Nevertheless, the IAASB Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements refer to investigations in a few instances:

- Investigation of audit failure by a professional accountancy organisation or independent audit regulator
- Investigations by an audit firm with regards to:
  - Complaints or allegations of wrong doing
  - Deficiencies in the design or operation of the firm's quality control policies and procedures
  - An individual's non-compliance with the firm's policies and procedures
- Investigation of exceptions or inconsistencies during an audit
- Investigations by regulatory organisations and government departments that may result in the payment of fines and penalties
- Investigations by an appropriate authority into an actual or suspected illegal act

#### 4.3 Comparison of statutory audit and investigations

The following table compares statutory audit against investigations.

Factor	Statutory audit	Investigation
Duties and responsibilities	To express an opinion on the truth and fairness of the annual financial statements	Set by the appointing body. May be defined in statute in some circumstances.
Qualification to act	Set out by statute.	May or may not be defined in statute - depends on the nature of the investigation. Notwithstanding, the practitioner must be suitably qualified, competent and independent to act.
Mode of appointment (the appointing body)	The shareholders	No restriction. Examples could include: management, shareholders, internal audit, regulatory/legal authorities (e.g. tax authority, government, police, FRCN), creditors, receivers, professional bodies such as ICAN.
Duties set by	Statute	The appointing body.
Reporting line	The shareholders	The appointing body.

#### 4.4 Stages of an investigation

Any investigation will typically follow these three stages:

1. Acceptance
2. Investigation
3. Reporting

##### Acceptance

In deciding whether to accept an engagement to perform an investigation, the firm (or other party such as those detailed in section 4.1) will follow a similar process to accepting an audit or assurance engagement.

- Does the firm have the required competency and experience to perform the investigation?
- Are staff with the appropriate level of experience available to perform the investigation?
- Is there enough time available to perform the investigation and meet the required deadlines?
- Will the firm be breaching any ethical standards if the engagement is accepted?

##### Investigation

The investigative work itself will vary and is dependent on the subject matter of the investigation.

##### Reporting

The form and structure of an investigation report will always be specific to the circumstances. In some cases the report will follow a prescribed standard such as that given in ISRS 4400 for an agreed-upon procedures investigation (see section 2) or an assurance report (covered in the next chapter).

In other cases, the report will not follow a prescribed standard. These investigation reports will tend to consist of a number of core components.

- Addressee
- Caveat/limitation of liability of the investigator
- Respective responsibilities of the investigator and addressee
- Description of the work performed
- Conclusions

## 2 LIQUIDATION AND BANKRUPTCY

### Section overview

- The meaning of winding up, liquidation, dissolution and insolvency
- Bankruptcy, winding up, receivership and administration

#### 2.1 The meaning of winding up, liquidation, dissolution, insolvency

A company is a legal person, and it exists separately from its member shareholders. It also has a perpetual existence. Shareholders may sell or transfer their shares and cease to be members, and the company may get new shareholder members: although the members may change, the company remains the same.

The existence of a company can be brought to an end. This is achieved through a process of winding up and liquidation.

- Winding up** means that the affairs of a company are brought to an end.
- The company is put into **liquidation**, which means that its assets are 'realised' (usually, disposed of through sale) and the company's creditors are paid from the proceeds of the liquidation. Any money remaining after the creditors have been paid is distributed to the shareholders.
- Liquidation leads to the **dissolution** of the company, when its name is removed from the official register of companies, and the company ceases to exist.

When the winding up of a company begins, the company may be:

- solvent**, which means that it is able to pay its creditors in full out of the proceeds from the disposal of its assets
- insolvent**, which means that it is unable to pay its creditors in full.

#### Insolvency vs illiquidity

- 'Insolvent' refers to an overall position of net liabilities in the statement of financial position. 'Liquidity' generally refers to current assets and liabilities – 'today's cashflow'. Thus a company that is technically solvent may still have liquidity problems in the short-term if, for example, most of its assets are long-term compared to a greater proportion of liabilities being short-term.
- The procedures for winding up differ according to whether the company is solvent or insolvent.

#### Insolvency in context

Two of the primary drivers for a company becoming insolvent are:

- Overtrading** – when a company is unable to fund its current liabilities as a result of rapid growth
- General long-term **lack of profitability**

## 2.2 Bankruptcy, windingup, receivership and administration

Practical 'next steps' when a company faces liquidity problems and potential insolvency typically involve one of the following:

- Winding up (closing down) the company
- Trying to save the company e.g.
  - Appoint an insolvency practitioner to run the company and return it to profitability during a period known as 'administration'
  - Ask the auditors for help.

### Bankruptcy

Whilst insolvency refers to the overall position of net liabilities, bankruptcy is a legal declaration of a company's inability to pay-off debts. A formal declaration of bankruptcy often follows when a company becomes insolvent.

Bankruptcy is governed in Nigeria by the 'Bankruptcy & Insolvency Act (Repeal & Re-enactment) Bill, 2016'.

### Winding up

The winding up of a company may be either voluntary or compulsory, and may or may not involve the declaration of bankruptcy (depending on whether the company has become insolvent).

- In a voluntary winding up, the company is wound up without any intervention by the court.
- A compulsory winding up is made as a result of a court order, following a petition to the court that the company should be wound up.

When a company is wound up, a liquidator is appointed to liquidate the assets of the company, pay the creditors and distribute the surplus money (if there is any) to the shareholders.

### Receivership

Receivership is commonly associated with the winding up of a company, but a winding up is not necessary for a receiver to be appointed.

A receiver is a person appointed by a creditor or by the court on behalf of a creditor, to realise secured assets and use these to obtain payment of a secured debt.

A receiver is someone appointed when there is a fixed charge, to take control of a non-current (or fixed) asset (or several non-current assets) to which the charge applies. He is usually appointed under the terms of the debenture that created the charge, typically when the company is in default on the payment of interest or capital on the secured debt. The powers of the receiver are set out in the debenture.

The function of a receiver is to realise the charged asset and use the proceeds to pay the debt to the creditor who is the fixed charge holder. Any surplus should be paid to the company or its liquidator.

A receiver acts only in the interests of the creditor with the security. Once the creditor has been paid in full from the charged assets, a receiver will:

- allow the directors to resume full control of the company, or
- if the company is being wound up, hand over the company's affairs to the liquidator.

#### **Administration**

In some cases, however, a company might be in financial difficulties, but if it is given a 'reprieve' and time to sort out its difficulties, it might be able to recover and become a profitable company.

Many countries provide for an alternative process to winding up and liquidation when a company becomes insolvent. The purpose of the alternative process is to give the company an opportunity to 'trade its way out of its difficulties', so that it can eventually:

- pay its creditors in full, and
- continue in business.

In the UK, this alternative process is called **administration**. (In the US, an alternative process is available under Chapter 11 of the Bankruptcy Code, and the process is known as 'Chapter 11 bankruptcy'. You will often hear on the news about American companies seeking Chapter 11 protection.)

### 3 CHAPTER REVIEW

#### Chapter review

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

- Describe the objectives and conduct of review engagements in accordance with ISRE 2400 and 2410
- Describe the objectives and conduct of related services engagements in accordance with ISRS 4400 and 4410
- Discuss when an investigation is necessary, and the stages involved
- Explain the basic principles of company liquidation and bankruptcy

**Quick quiz question**

- 1 What is the level of assurance in a compilation?
  - A Absolute
  - B High
  - C Moderate
  - D None
  
- 2 What sort of assurance is provided in engagement to review historical financial statements?
  - A Positive assurance
  - B Limited assurance
  - C High level of assurance
  - D No assurance
  
- 3 Performing a tax calculation for a client is:
  - A an attestation engagement
  - B a review engagement
  - C a compilation engagement
  - D an agreed upon procedures engagement.
  
- 4 Which of the following statements is correct?
  - A When a company negotiates a 'friendly' takeover, it usually appoints a firm of accountants to carry out due diligence on the takeover target.
  - B In an attestation engagement, the accountant is required to report on the quality of work performed.
  - C In a review engagement, evidence is gathered mainly by means of computation and inspection.
  - D In an engagement to review financial statements, the amount of work required is the same as for an audit.
  
- 5 For companies required to produce interim financial statements (IFI) and have an annual statutory audit which of the following scenarios would be most likely to occur?
  - A one firm audits the IFI and a different firm audits the financial statements for the year as a whole.
  - B the same firm audits both the IFI and the financial statements for the year as a whole.
  - C one firm reviews the IFI and a different firm reviews the financial statements for the year as a whole.
  - D the same firm reviews the IFI and audits the financial statements for the year as a whole.

### Quick quiz answers

1 D

No assurance is provided in a compilation engagement. The accountant compiles the financial statements from the information provided to him, but he does not review or audit those statements.

2 B

In a review engagement the accountant carries out sufficient procedures to enable him to report in terms of limited assurance.

3 C

4 A

In an attestation engagement, the accountant is required to report that certain procedures have been performed, but not to report on its quality. In a review engagement, evidence is gathered mainly by means of enquiry and analytical procedures. In an engagement to review financial statements, the amount of work is less than for an audit because the required level of assurance is lower.

5 D

The IFI should be subject to a review, not an audit.

CHAPTER  
**12**

## **Assurance services**

### **Contents**

- 1 Introduction and available guidance
- 2 The objective and nature of assurance engagements
- 3 Main types of assurance engagement
- 4 Prospective financial information
- 5 Pro forma financial information included in a prospectus
- 6 Forensic auditing
- 7 Chapter review

## INTRODUCTION

### Competencies

#### Planning and undertaking audit work

**C4 (a)** Understanding special features of certain types of audit and investigation situations.

**C 4(a) i** Forensic investigation and reporting

- Describe the major applications of forensic auditing e.g. fraud, negligence, insurance claims and analyse the role of a forensic auditor as an expert witness.
- Distinguish among forensic accounting, forensic investigation and forensic audit.
- Identify the various government agencies associated with forensic auditing.
- Apply the fundamental ethical principles to forensic auditor's engagement.
- Describe the procedures to be adopted in forensic audit.
- Select investigative procedures and evaluate the evidence appropriate to determine the amount of loss in specific circumstances.

**C4 (e)** Discuss the duties and responsibilities of a reporting accountant in raising capital.

#### Drawing conclusions and reporting

**D2 (h)** Draft extracts of suitable audit, assurance and management reports based on a given scenario in accordance with Nigerian laws and international standards on auditing.

**D2 (j)** Evaluate and apply suitable judgments on when it may be appropriate to withhold an opinion, withdraw an opinion or take other such appropriate actions on an audit or assurance engagement.

### **Exam context**

This is the second of two chapters that looks specifically at non-audit services. In this chapter you will learn about assurance engagements performed in compliance with ISAEs 3000, 3400 and 3420. The chapter then closes with a section on forensic auditing.

At the end of this chapter, readers should be able to:

- Discuss the need for, objective and nature of assurance engagements
- Describe the steps involved in performing an assurance engagement in compliance with ISAE 3000
- Explain the steps involved in performing an examination of prospective financial information in compliance with ISAE 3400
- Explain the steps involved in performing an engagement to report on the compilation of proforma financial information included in a prospectus in compliance with ISAE 3420
- Describe what is involved in forensic auditing

## 1 INTRODUCTION AND AVAILABLE GUIDANCE

### Section overview

- The need for assurance services
- Available guidance on assurance engagements
- The International Framework for Assurance Engagements
- International Standard on Assurance Engagements (ISAE) 3000

#### 1.1 The need for assurance services

Traditionally, the 'assurance' role of the professional accountant has mainly been concerned with provision of audit services within a statutory framework – the audit of published annual financial statements. An audit provides a high level (but not absolute level) of assurance. The requirement for an audit of the annual financial statements therefore has the objective of adding 'assurance' (or 'credibility') to the financial statements under audit.

However, the management of companies and other organisations are required or expected to report to stakeholders on a wide range of information, both financial and non-financial, that is not subject to statutory audit. This might include such matters as:

- corporate governance issues, including risk assessment and internal control systems
- e-commerce and the operation of e-commerce activities
- systems reliability
- performance measurement (both financial and non-financial)
- value for money (VFM).

Although information about these matters may not be subject to a statutory audit, it is often considered important that the information should have credibility.

Credibility may be obtained from an assurance report provided by a professionally-qualified accountant.

This chapter deals with:

- the framework for the regulation of assurance reports
- the objectives and key features of an assurance engagement
- specific features of certain specific types of assurance engagement.

#### 1.2 Available guidance on assurance engagements

Guidance on the conduct of assurance engagements is provided by:

- the International Framework for Assurance Engagements, and
- International Standard on Assurance Engagements (ISAE) 3000

#### 1.3 The International Framework for Assurance Engagements

The International Framework for Assurance Engagements was revised in 2013 and describes the objectives and elements of an assurance engagement.

The Framework makes a distinction between:

- Attestation engagements
- Direct engagements

The Framework also makes a distinction between:

- assurance assignments that give a **reasonable level of assurance**, and
- assurance assignments that give a **limited level of assurance**.

In assurance engagements it is not possible to give an absolute level of assurance as a result of:

- the lack of precision often associated with the subject matter
- the nature of the evidence available
- the time scale involved.

#### **Reasonable level of assurance**

Where a reasonable level of assurance is given, the risk attached to the assignment is at a sufficiently low level to enable the practitioner to give **positive assurance**.

Reasonable assurance can only be given in the following circumstances:

- the subject matter of the assurance service engagement is the responsibility of another party, and
- the subject matter is identifiable and can be subjected to evidence-gathering techniques.

In other words, a reasonable level of assurance can be given only if the accountant is carrying out an assignment that looks at information that has not been prepared by the accountant (or relates to some other subject matter that is not the responsibility of the accountant). In addition, the accountant must be able to obtain sufficient evidence for giving a positive opinion.

#### **Limited level of assurance**

Where only a limited level of assurance is given:

- the risk is higher than that for an engagement where the accountant is able to give a reasonable assurance, but
- the risk is sufficiently low to allow for a 'negative' expression of the accountant's conclusions (a negative opinion, as in a review report).

#### **Non-assurance engagements**

In addition, the Framework distinguishes assurance and non-assurance engagements. Examples of a non-assurance engagement are:

- preparation of tax returns;
- management or tax consulting; and
- agreed-upon procedures or compilation engagements (which you learnt about in the previous chapter).

#### 1.4 International Standard on Assurance Engagements (ISAE) 3000

ISAE 3000 Assurance engagements other than audits and reviews of historical financial information sets out basic principles, key procedures and guidance for professional accountants (referred to as '**practitioners**') when carrying out relevant assurance engagements.

Key general points from ISAE 3000 are set out below.

- Ethical requirements.** The IESBA ethical code should be followed.
- Quality control.** Appropriate procedures for quality control of the accountant's work should be applied to each engagement.
- The engagement should be planned and performed with a degree of **professional scepticism**, recognising that the subject matter of the engagement may be materially misstated.
- Before completion of an assurance engagement, the client may ask for the nature of the engagement to be changed to a 'non-assurance' engagement, or for the level of assurance to be reduced. If this happens, the practitioner should consider whether the request is appropriate, and should not agree to the change unless there is a good reason.

## 2 THE OBJECTIVE AND NATURE OF ASSURANCE ENGAGEMENTS

### Section overview

- Objective of an assurance engagement
- The elements of an assurance relationship and an assurance engagement
- Suitable criteria for assessment
- Reporting on an assurance engagement

#### 2.1 Objective of an assurance engagement

The objective of an assurance engagement is:

*'...To obtain either reasonable assurance or limited assurance, as appropriate, about whether the subject matter information is free from material misstatement;*

*To express a conclusion regarding the outcome of the measurement or evaluation of the underlying subject matter through a written report that conveys either a reasonable assurance or a limited assurance conclusion and describes the basis for the conclusion; and*

*To communicate further as required by ISAE 3000 and any other relevant ISAEs.'*

(Note: the accountant who carries out an assurance engagement is called a 'practitioner'.)

#### 2.2 The elements of an assurance relationship and an assurance engagement

An assurance relationship is a three-party relationship between:

- the practitioner (the accountant)
- the party responsible for the subject matter of the engagement
- the intended user of the subject matter of the engagement.

There will be:

- a defined subject matter
- suitable criteria for assessment
- sufficient appropriate evidence
- at the end of the engagement, the accountant prepares a report containing a conclusion based on the evidence that has been gathered and evaluated

#### 2.3 Suitable criteria for assessment

Suitable criteria are the standards against which the subject matter of the assignment is assessed. This can be a difficult aspect of some assurance assignments.

- Establishing suitable criteria is relatively straightforward where regulations are involved (for example, the law or accounting standards).
- The process is more difficult in more subjective assurance engagements, in areas such as customer care or labour relations.

**Example:**

A firm of accountant stakes on an engagement to report on the standards of care provided by a state-owned hospital.

What criteria are used to measure the standards of patient care in the hospital?

Suitable criteria might include the mortality rates of patients treated in the hospital. (This might be expressed as the number of patients who die within a specified period of time after treatment.) However, mortality rates are also affected by factors such as the age of patients and the seriousness of their illnesses.

It is therefore not certain that mortality rates would be a suitable criterion for assessing the performance of the hospital.

## 2.4 Reporting on an assurance engagement

The report prepared by accountants at the end of an assurance engagement will include the following elements:

- A **title**, indicating that the report is an independent assurance report.
- An **addressee** (= the person or body to which the report is addressed).
- Identification of the **level** of assurance obtained.
- Subject matter of the report**, including any relevant information relating to the subject matter reviewed, such as the time period for which the information was gathered.
- Suitable criteria** that have been selected for assessment.
- Any inherent **limitations** in performing the work
- Where appropriate, a statement that the use of the report must be **restricted** to certain specified users, or that the use of the report should be restricted to a specific purpose for which it was prepared.
- A statement to identify the responsible party and the measurer and to describe their and the practitioner's responsibilities.
- A statement that the engagement was carried out in accordance with ISAEs, ISQC 1 and independence and ethical requirements.
- A summary of the work performed.
- The practitioner's **conclusion**.
- The **date, name and address** of the practitioner.

As with a statutory audit report, qualifications may be required in the conclusion provided by an assurance report, where the matter involved may be material. These possible qualifications are set out in the table below.

Situation	Impact on the conclusion
Limitation on scope.	A qualified conclusion or disclaimer of opinion.
The assertion made by the responsible party is not fairly stated.	A qualified or adverse conclusion.
The subject matter has been materially misstated.	A qualified or adverse conclusion.

The criteria are unsuitable or the subject matter is not appropriate to an assurance engagement.

- A qualified or adverse conclusion, if users are likely to be misled.
- Otherwise, a qualified conclusion or disclaimer.

The **level of materiality** that is attached to the matters giving rise to the qualification in the report is important. This will determine whether the report should be qualified, or whether the accountant should give a disclaimer of opinion or an adverse opinion.

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### 3 MAIN TYPES OF ASSURANCE ENGAGEMENT

#### Section overview

- Engagements relating to risk assessment
- Engagements relating to performance measurement
- Engagements relating to value for money (VFM)
- Engagements relating to systems reliability
- Engagements relating to e-commerce matters
- Continuous auditing

Four types of assurance engagement that may be the subject of an examination question are engagements relating to:

- Risk assessments
- business performance measurement
- systems reliability, and
- e-commerce matters

#### 3.1 Engagements relating to risk assessment

The concept of business risk assessment was introduced earlier, in the context of auditors using business risk assessments as part of audit approach.

Obviously businesses have systems in place to identify and monitor business risks themselves. Management will distinguish between strategic, operating and information risks. They will analyse risks, considering potential impact on the business and probability of the risk occurring.

When risks have been identified and analysed in this way, management has to come up with strategies to manage risks. There are various strategies.

- If risks are low impact, low probability, then they may well be accepted.
- Higher impact risks must be dealt with, perhaps by taking out insurance against the eventuality (transferring the risk) or by putting in place internal controls to prevent the risk arising (managing the risk).
- If a risk is high impact, high probability it might have to be avoided, for instance, by not taking up the new business opportunity.
- The risks associated with e-commerce particularly are looked at below.

Increasingly large companies are focusing on enterprise-wide risk management, with an overall head of risk management, rather than dealing with it individually on a department by department basis, as has traditionally been the case.

#### Assurance on risk assessment

Monitoring risk assessment processes is often a task carried out by internal audit but which could equally be carried out by external parties (such as the audit firm) as an assurance engagement.

### 3.2 Engagements relating to performance measurement

#### The nature of performance measurement

All entities should have measurement systems for measuring and monitoring the performance of different aspects of the entity's operations and activities.

Performance measurement reports indicate to management whether the objectives of the entity are being achieved.

Performance is measured and compared with a 'benchmark', such as a target or budget, or by comparing actual results with results for the previous years, or results achieved by competitors. Examples of performance measurements include sales (and whether sales targets have been achieved), profit (and whether profit targets have been achieved), cost variances and other budget variances, product quality, customer satisfaction, employee efficiency, capacity utilisation, and so on.

There have been significant developments in performance reporting in recent years.

- Many entities publish some or all of their performance measures.
- A wide range of performance measures may be used, including performance relating to non-financial information (such as product quality or customer satisfaction) as well as financial measures. Non-financial measures might be particularly relevant for not-for-profit organisations.
- In some countries, the government sets performance targets for government departments and publicly-owned entities. (For example in the UK, the government publishes performance tables for schools and hospitals.)

#### Assurance engagements and performance

A client may ask a practitioner to provide assurance about the way in which performance measurements are calculated and presented. The practitioners will need to consider whether the performance measurement system operates as prescribed and intended.

To perform such an engagement, the practitioner will need to:

- understand the performance measurement system in use
- assess and evaluate it, and
- test the effectiveness of its operation.

### 3.3 Engagements relating to value for money (VFM)

'Value for money' means using resources in the best way in order to achieve intended objectives. There are three aspects to achieving value for money, often known as the '3 Es'.

- Economy.** This means spending money carefully, and not paying more than necessary for resources - materials, labour and other expenses.
- Efficiency.** Efficiency means using resources in such a way that they produce the greatest possible amount of 'output'. It means getting more from the use of available resources. For example, efficiency in the use of an employee means getting a high rate of output for every hour or day worked.

- Effectiveness.** Effectiveness means using resources in such a way as to achieve the desired objectives. Efficiency is of little value unless the output from the system is what the entity wishes to achieve.

Entities may use their own internal audit department to carry out value for money (VFM) audits.

Alternatively, an external firm of practitioners may be engaged to carry out a similar task.

#### Objective of a VFM engagement

The purpose of a VFM engagement is to investigate a particular aspect of an entity's operations, and reach a conclusion about whether the entity is obtaining value for money.

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

#### The practitioner's approach to a VFM engagement

The approach to performing a VFM engagement is summarised below.

- For the particular aspect of operations that is the subject of the investigation or 'audit', the practitioner should identify and **develop methods of measuring the 3Es** – measurements of economy, efficiency and effectiveness.
- It is often necessary to assess the 3Es by **making comparisons**. The practitioner should therefore establish an appropriate basis for making comparisons (such as economy, efficiency and achievements in previous periods, comparisons with other entities, comparisons with targets, and possibly comparisons with national averages).
- Having gathered and analysed measurements of the 3Es, the practitioner should reach a conclusion. Are the 3Es being achieved for the operations that have been the subject of the investigation?
- If appropriate, the practitioner should identify areas of weakness and make appropriate recommendations to the client about improvements that should be made.

#### 3.4 Engagements relating to systems reliability

Even if an entity is not specifically involved in e-commerce activities, it is likely that a large part of its internal information processing will be computer-based. Major systems failure would therefore make it difficult for many entities to operate effectively, especially if they use on-line systems (network systems) for their transaction processing.

Management and other stakeholders may therefore engage a practitioner to give assurance on the effective and secure operation of their computer systems.

The general approach that the accountant should take for these assurance engagements is similar to the approach to be taken for e-commerce activities which we shall look at below. However, the accountant's work will focus more on identifying, evaluating and testing controls **within** the company's information systems. (The web site aspects that are important for e-commerce engagements are less significant for engagements relating to systems reliability.)

- Computer-assisted audit techniques (CAATs) such as **audit software** and **test data** are likely to be used by the accountant to carry out the work. CAATs were described in an earlier chapter.

### 3.5 Engagements relating to e-commerce matters

Entities may use information technology to conduct business transactions, using:

- e-commerce**, or
- electronic data interchange (EDI)**. EDI is the process of transferring documents between the computer systems of different entities. An extension of EDI, known as **SET (secure electronic transmission)** is used to process money transfers electronically for credit cards and debit cards.

E-commerce is a general term that refers to trading electronically, at distances between the buyer and seller. Business transactions take place electronically, rather than face-to-face, or in a paper-based system. Rapid developments in information technology in recent years have led to substantial growth in the volume of e-commerce. Most e-commerce activity is carried out over the Internet, with customers buying goods or services through the web sites of sellers.

An important aspect of e-commerce is that users of an e-commerce system need to have trust in the **integrity** of the system. This means that a customer buying from a remote seller must be confident that the seller is 'genuine' and will deliver the goods that the buyer purchases. Similarly, the seller needs to be confident that the buyer has properly identified himself and can be trusted to pay.

Both the buyer and the seller need to be confident that the details of their transaction will not be 'intercepted' by a third party, because they want the details of the transaction to be kept confidential. For example the name and credit card number of the buyer has to be kept confidential, and there must be no risk of an unauthorised person intercepting and then making use of the buyer's credit card details.

#### Risk and risk management with e-commerce

Risks arise from the use of e-commerce systems, such as:

- a loss of transaction integrity
- increased security risks with 'remote' trading than with face-to-face trading or paper-based trading transactions
- the use of inappropriate accounting policies (for example, in respect of the capitalisation of website development costs)
- legal and regulatory risks: this is the risk, for example, that e-commerce activities may be breaking the law in some countries.

In addition, the internal controls for an e-commerce system may be efficient, but **there may not be an adequate audit trail** for checking transactions and confirming that the controls are efficient.

### **Management responsibility for e-commerce risks**

As in all risk situations, management should evaluate the risks to which the entity is exposed and take appropriate action to manage those risks. The general approach that should be taken is summarised below.

- Management should carry out risk assessment exercises on a regular basis.
- Management should create an appropriate control environment, including an information systems security policy.
- The entity should make appropriate use of an internal audit function, to obtain assurance that the e-commerce system is functioning properly.
- There should be adequate audit trails for e-commerce transactions.
- The entity should keep up-to-date back-up copies of data files.
- For some systems, it may be appropriate to use encryption for data: encryption involves the electronic conversion of data into a secure coded language for transmission, so that it will be incomprehensible to anyone who intercepts it in transmission.
- The system user should comply with generally-recognised standards and register with the **Web Trust** or a similar organisation.

Note: The **Web Trust** is an organisation established to provide confidence to customers using e-commerce. The Web Trust gives a seal of approval to web sites, and customers who use a web site that has the Trust's seal of approval can have confidence that their transactions are secure. Specially-licensed accountants grant the seal (which has to be renewed every three months), on behalf of the Trust. The accountants confirm that the controls operated by the site comply with the regulations of the Trust.

### **The e-commerce 'audit'**

A firm of accountants may be engaged by a client to provide assurance about the integrity of transactions on the client's web site, and that the client's e-commerce system is suitably protected from risk.

Performing an assurance engagement on electronic processing systems provides additional challenges for auditors. These include:

- the need for specialist knowledge about e-commerce systems
- problems that may arise when some aspects of the e-commerce system (such as the electronic payments system) are outsourced by the client to another entity
- the role of the client's internal auditors in monitoring the integrity of the e-commerce system
- the need for specialist controls (general and application controls) for the system
- possible problems of independence and conflicts of interest, if the audit firm was involved in designing or setting up the e-commerce system that is now subject to 'audit'.

The audit approach to an e-commerce system should include the following elements:

- First of all, the audit firm should decide whether the engagement should be accepted (as in any professional engagement).
- The firm should then plan the engagement: an important aspect of planning may be to make available audit staff with appropriate expertise in e-commerce systems.
- The firm should obtain a detailed knowledge of the client's business.
- It should consider liaison with the internal auditors of the client if there have been internal audit investigations into the client's e-commerce transactions or system.
- The firm should identify and evaluate the risks in the system.
- It should ascertain and evaluate the control environment and the specific internal controls that are in operation.
- It may also be appropriate to perform a going concern review, particularly in the case of entities that rely mainly on e-commerce activities for their income.

### 3.6 Continuous auditing

Continuous auditing is a process which allows auditors to give assurance on a subject matter concurrently or shortly after the occurrence of the event on which assurance is being given and therefore give assurance more frequently, by using automated procedures.

Continuous auditing requires using automated procedures which are embedded in a client's system, so they require technical skills as well as 'auditing' skills.

They will require strict controls and secure communications links to operate effectively.

## 4 PROSPECTIVE FINANCIAL INFORMATION

### Section overview

- The nature of prospective financial information (PFI)
- ISAE 3400: The examination of prospective financial information
- Reporting on PFI

#### 4.1 The nature of prospective financial information (PFI)

Traditionally, the role of the auditor has focused on providing assurance on 'historical' events, for example on financial statements relating to a period in the past.

When an auditor examines historical data, there is usually factual evidence to support the reported figures. This evidence will often come from events that have taken place since the financial statements were produced. For example, receivables may subsequently have been paid, inventories may subsequently have been sold, providing evidence that trade receivables were correctly valued in the statement of financial position, and that inventory was also correctly valued. This evidence is critical to the audit process.

As business and economic environments have changed, demand has grown for professional accountants to provide **assurance on information relating to the future**.

Such information is known as **prospective financial information (PFI)**.

PFI is widely used both within an entity (internally) and externally.

- **Internally**, forecasts and projections are widely used as a form of management information. Examples include forecasts and projections relating to:
  - revenue
  - capital expenditure
  - revenue expenditure
  - profits
  - cash flows
  - working capital
- **External** uses include:
  - profit forecasts, for providing to the stock market
  - forecasts of cash flows, to support an application for a loan from a bank
  - profit forecasts to support or defend take-over bids.

**The auditing profession has traditionally been cautious about expressing a firm opinion on financial information relating to a future period.**

However, when an audit firm undertakes this type of work, the work (on PFI) is closely regulated. For example, accountants are required to use very careful wording in their reports on PFI.

### Definitions

**Prospective financial information (PFI).** PFI is financial information based on assumptions:

- about events that may occur in the future, and
- possible actions by an entity.

**Forecast:** A forecast is PFI prepared on the basis of assumptions about:

- future events that management expect to take place, and
- the actions that management expect to take.

The assumptions that are used by management to prepare a forecast are called '**best estimate assumptions**'.

**Projection:** A projection is PFI prepared on the basis of:

- hypothetical assumptions** about future events and management actions that are not necessarily expected to take place, or
- a mix of best estimate and hypothetical assumptions.

A **forecast** is therefore a best estimate of what is expected to happen, and a **projection** is an estimate of what is likely to happen if certain conditions or events were to happen. Both are distinguished from a 'target', which is what management want to happen.

## 4.2 ISAE 3400: The examination of prospective financial information

ISAE 3400 The examination of prospective financial information is the main source of regulation in this area. It provides guidance on:

- the examination of PFI, and
- reporting on PFI

It focuses mainly on **numerical information** and numerical forecasts or predictions.

### Accepting a PFI assurance engagement

Many of the points relevant to deciding whether to accept any audit or assurance engagement will apply to accepting a PFI assurance engagement. Issues to consider will include, for example:

- the availability of resources and staff with the necessary expertise, and
- the timescale for the completion of the engagement
- agreeing a fee for the work with the client.

The accountant should also establish with the client the form that the assurance report should take. It is particularly important that the client should understand that in a review of forward-looking information, only negative assurance can be provided.

The client should also be informed that the audit firm will comply with the requirements of ISAE 3400 when reviewing the prospective financial information.

An **engagement letter** should be agreed and signed by both parties before the work is actually started.

### **Procedures in a PFI assurance engagement**

There are several specific points that might apply to PFI engagements:

- understanding the nature of the information to be examined
- establishing the intended use of the information (and the intended recipients of the final report)
- establishing whether the information will be for general distribution or limited distribution to a small number of users
- the nature of the assumptions that have been made by management (whether they are best estimate assumptions for a forecast, or hypothetical assumptions for the purpose of making a projection)
- the time period covered by this information.

When deciding the nature, timing and extent of the procedures required to complete a PFI assurance engagement, the auditor should consider the following issues:

- The likelihood of material misstatement in the forecast or projection.
- The knowledge that the auditor has obtained during any previous similar engagements.
- The competence of the client's management with regard to the preparation of PFI.
- The extent to which the PFI is affected by management's judgement (in other words, to what extent does the PFI depend on judgement about best estimates or hypotheses).
- The adequacy and reliability of the underlying data and assumptions that have been used as the basis for preparing the prospective financial information.

The general approach to the assurance work should be similar to the approach for audit work or other assurance work, but with some modifications to allow for the specific nature of the work.

### **Procedures will include the following:**

- Where the audit firm has no previous knowledge of the entity, it should obtain sufficient knowledge of the entity and its environment.
- If best estimate assumptions have been used in preparing the PFI (a forecast), the auditor should seek evidence to support these estimates.
- If hypothetical assumptions have been used (to prepare a projection), the auditor should assess whether they are realistic and sensible, and whether the full implications of the hypothetical assumptions have been properly reflected in the PFI.
- The auditor should assess whether the PFI contains all the relevant material items and that nothing of significance has been omitted.
- If part of the 'future period' in the forecast or projection has already passed, the auditor should review the actual results for that part of the period and compare actual results with the forecast or projection. The differences will help the auditor to assess the reliability of the forecast or accuracy of the projection.

- The auditor should also check the arithmetical accuracy and consistency of the projected financial information that has been prepared.
- The auditor should obtain representations from management on:
  - management's acceptance of responsibility for the information
  - the intended use of the information
  - the completeness of the assumptions that were made to prepare the PFI.

#### **Example: Profit forecast**

Procedures relating to a profit forecast that the entity will use in support of a bank loan application might be as follows:

- Understand the basis of the forecast (by asking the person who prepared it). Then test the calculation of the forecast according to its method (for example, if it has been extrapolated from previous results, re-perform the arithmetic of the extrapolation).
- Consider whether the assumptions in the forecast are consistent with each other (for example, will sales grow at that rate without additional marketing costs?)
- Consider whether the forecast is reasonable in the light of known facts such as:
  - Current economic circumstances
  - Past trading history
- Discuss the key variables and sensitivities with management. Often, key assumptions will be estimates of sales demand and sales price, and the gross profit ratio. The auditor should establish the basis on which these estimates have been made.
- Review internal consistency of forecast (for example, has the same interest rate been used throughout the forecast, has the same growth rate been applied to sales and purchases?)
- Compare assumptions and bases for forecasting with information used internally (for example, by the marketing department).
- Compare figures with other forecasts to ensure consistency (for example, depreciation should appear in both profit forecast and capital expenditure forecast)
- Compare figures with any available evidence – for example, costs may be compared to quotations for work to be done. Assess costs for reasonableness. For example if the profit forecast includes estimates of advertising and marketing costs, do these seem reasonable in comparison with the value of sales turnover and other operating costs?
- Consider whether all items of cost have been included. For example, if the profit forecast involves the launch of a new product, have all the initial running costs been included, such as initial marketing costs and set-up costs for operations.
- Consider whether the forecast of the amount of finance required allows for working capital.

- Check that the forecast of profit and cashflows includes the cost of borrowed finance.
- Check that forecasts of costs and revenues allow for estimated inflation.
- It would also be appropriate to carryout some sensitivity analysis of the forecasts of revenues, costs and profits, to establish the extent to which estimates in the forecast would need to differ before the forecast profit turns into a forecast of loss.

*Tutorial note:* If you are asked in your examination to list procedures in relation to a particular forecast, you should think what that forecast will contain and what it will not contain. For example, a cash flow forecast will not include amounts for depreciation.

#### 4.3 Reporting on PFI

A report from the audit/accountancy firm on PFI should contain the following elements:

- Title
- Addressee
- Identification of the PFI (for example by page references to pages in same document as the report, where the PFI can be found).
- A reference to the ISAE.
- A statement that management is responsible for the PFI, including the assumptions on which it is based.
- A reference to the purpose of the PFI and/or the restricted distribution of the report (and the PFI) to a limited number of users.
- A statement of negative assurance as to whether the assumptions that management have made provide a reasonable basis for the PFI.
- An opinion as to whether the PFI is properly prepared on the basis of these assumptions, and whether the PFI is presented in accordance with the relevant financial reporting framework.
- The report should also contain warnings (caveats) that the PFI is a forecast or projection, and the results indicated by the PFI might not be achieved.
- Date, address and signature of the accountant/auditor.



**Example: Unmodified report on a forecast**

The following is an example of an extract from an unmodified report on a forecast.

**REPORT ON A FINANCIAL FORECAST**

**To the Board of Directors of Entity AZ**

We have examined the forecast [Include name of the entity, the period covered by the forecast and provide suitable identification, such as by reference to page numbers or by identifying the individual statements] **in accordance with the International Standard on Assurance Engagement 3400.**

**Management is responsible for the forecast** including the assumptions set out in Note X on which it is based.

Based on our examination of the evidence supporting the assumptions, **nothing has come to our attention** which causes us to believe that these assumptions do not provide a reasonable basis for the forecast. Further, in our opinion **the forecast is properly prepared on the basis of the assumptions and is presented in accordance with** [indicate the relevant reporting framework].

**Actual results are likely to be different** from the forecast since anticipated events frequently do not occur as expected and the variation may be material

**PRACTITIONER**

**Address**

**Date**



### Example: unmodified report on a projection

#### REPORT ON A FINANCIAL PROJECTION

##### To the Board of Directors of Entity AZ

We have examined the projection [Include name of the entity, the period covered by the projection and provide suitable identification, such as by reference to page numbers or by identifying the individual statements] **in accordance with the International Standard on Assurance Engagements 3400.**

**Management is responsible for the projection** including the assumptions set out in Note X on which it is based.

This projection has been prepared for (**describe purpose**). As the entity is in a start-up phase the projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management's actions that are **not necessarily expected to occur**. Consequently, readers are **cautioned** that this projection may not be appropriate for purposes other than that described above.

Based on our examination of the evidence supporting the assumptions, **nothing has come to our attention** which causes us to believe that these assumptions do not provide a reasonable basis for the projection, assuming that (state or refer to the hypothetical assumptions). Further, in our opinion **the projection is properly prepared on the basis of the assumptions and is presented in accordance with** [Indicate the relevant financial reporting framework].

Even if the events anticipated under the hypothetical assumptions described above occur, **actual results are still likely to be different** from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

##### PRACTITIONER

Address

Date

The auditor may not be in a position to issue an unqualified report. In these circumstances, and after due consideration, the auditor may issue:

- a qualified report, or
- an adverse report, or
- he may decide to withdraw from the engagement.

## 5 PROFORM A FINANCIAL INFORMATION INCLUDED IN A PROSPECTUS

### Section overview

- Reporting on the compilation of pro forma financial information
- ISAE 3420 Assurance engagements to report on the compilation of pro forma financial information included in a prospectus
- Illustrative assurance report (ISAE 3420)
- Reporting accountants

#### 5.1 Reporting on the compilation of proforma financial information

Increasing globalisation of capital markets has made it important for the financial information used in capital market transactions to be understandable across borders and for assurance to be provided to enhance users' confidence in how such information is produced.

Given this trend the IAASB issued ISAE 3420 Assurance engagements to report on the compilation of pro forma financial information included in a prospectus in December 2011.

#### 5.2 ISAE 3420 Assurance engagements to report on the compilation of proforma financial information included in a prospectus

The nature of an ISAE 3420 engagement includes the following:

- The practitioner provides reasonable assurance on the responsible party's (i.e. the client's) compilation of pro forma financial information included in a prospectus.
- The practitioner has no responsibility to compile the pro forma financial information for the entity; such responsibility rests with the responsible party (the client).
- The objective of an ISAE 3420 engagement is to be able to assess whether the applicable criteria used by the responsible party in the compilation of the pro forma financial information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction, and to obtain sufficient appropriate evidence about whether:
  - The related pro forma adjustments give appropriate effect to those criteria; and
  - The resulting pro forma column reflects the proper application of those adjustments to the unadjusted financial information
- Applying ISAE 3420 also involves evaluating the overall presentation of the pro forma financial information.
- The engagement, however, does not involve the practitioner updating or reissuing any reports or opinions on any historical financial information used in compiling the pro forma financial information, or performing an audit or review of the financial information used in compiling the pro forma financial information.

### 5.3 Illustrative assurance report (ISAE 3420)

**INDEPENDENT PRACTITIONER'S ASSURANCE REPORT ON THE COMPIRATION  
OF PRO FORMA FINANCIAL INFORMATION INCLUDED IN A PROSPECTUS**  
[Appropriate Addressee(s)]

**Report on the Compilation of Pro Forma Financial Information Included in a  
Prospectus**

We have completed our assurance engagement to report on the compilation of pro forma financial information of ABC Company by [the responsible party]. The pro forma financial information consists of [the pro forma net asset statement as at [date]], [the pro forma income statement for the period ended [date]], [the pro forma cash flow statement for the period ended [date].] and related notes [as set out on pages xx–xx of the prospectus issued by the company]. The applicable criteria on the basis of which [the responsible party] has compiled the pro forma financial information are [specified in [Securities Regulation XX] and described in [Note X]]/[described in [Note X]].

The pro forma financial information has been compiled by [the responsible party] to illustrate the impact of the [event or transaction] [set out in Note X] on the [company's financial position as at specify date] [and] [the company's/s/its financial performance [and cash flows] for the period ended specify date] as if the [event or transaction] had taken place at [specify date] [and specify date respectively]. As part of this process, information about the company's [financial position], [financial performance] [and cash flows] has been extracted by [the responsible party] from the company's financial statements [for the period ended [date]], on which [[an audit]/[a review] report]/[no audit or review report] has been published.

**[The Responsible Party's] Responsibility for the Pro Forma Financial  
Information**

[The responsible party] is responsible for compiling the pro forma financial information on the basis of the [applicable criteria].

**Practitioner's Responsibilities**

Our responsibility is to express an opinion, as required by [Securities Regulation XX], about whether the pro forma financial information has been compiled, in all material respects, by [the responsible party] on the basis of the [applicable criteria].

We conducted our engagement in accordance with International Standard on Assurance Engagements (ISAE) 3420, Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus, issued by the International Auditing and Assurance Standards Board. This standard requires that the practitioner comply with ethical requirements and plan and perform procedures to obtain reasonable assurance about whether [the responsible party] has compiled, in all material respects, the pro forma financial information on the basis of the [applicable criteria].

For purposes of this engagement, we are not responsible for updating or reissuing any reports or opinions on any historical financial information used in compiling the pro forma financial information, nor have we, in the course of this engagement, performed an audit or review of the financial information used in compiling the pro forma financial information.

The purpose of pro forma financial information included in a prospectus is solely to illustrate the impact of a significant event or transaction on unadjusted financial information of the entity as if the event had occurred or the transaction had been

undertaken at an earlier date selected for purposes of the illustration. Accordingly, we do not provide any assurance that the actual outcome of the event or transaction at [specify date] would have been as presented.

A reasonable assurance engagement to report on whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria involves performing procedures to assess whether the applicable criteria used by [the responsible party] in the compilation of the pro forma financial information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction, and to obtain sufficient appropriate evidence about whether:

- The related pro forma adjustments give appropriate effect to those criteria; and
- The pro forma financial information reflects the proper application of those adjustments to the unadjusted financial information.

The procedures selected depend on the practitioner's judgment, having regard to the practitioner's understanding of the nature of the company, the event or transaction in respect of which the proforma financial information has been compiled, and other relevant engagement circumstances.

The engagement also involves evaluating the overall presentation of the pro forma financial information.

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

**Opinion**

In our opinion, [the pro forma financial information has been compiled, in all material respects, on the basis of the [applicable criteria]/[the pro forma financial information has been properly compiled on the basis stated].

**Report on Other Legal or Regulatory Requirements**

[Relevant law or regulation may require the practitioner to express an opinion on other matters. The form and content of this section of the practitioner's report will vary with the nature of such other reporting responsibilities.]

**PRACTITIONER**

**Date**

**Address**

#### 5.4 Reporting accountants

A company preparing for listing on the NSE (Nigerian Stock Exchange) or NASD (National Association of Securities Dealers) needs several advisers. Accountants providing assurance on pro forma financial information included in a prospectus are just one. Other advisers include but are not limited to:

- underwriters;
- stockbrokers;
- solicitors;
- issuing house;
- financial advisers; and
- reporting accountants.

The **reporting accountant** is different from the company's auditors but can be a team from the same firm. They are responsible for producing a number of reports for the company's nominated adviser to assist in preparation for a new listing.

Report	Description
Long form report	Detailed financial due diligence review including Items, such as: <ul style="list-style-type: none"><li>▪ Company history</li><li>▪ Nature of business</li><li>▪ Assessment of key employees</li><li>▪ Accounting systems and internal controls</li><li>▪ Analysis of last three year's financial statements and cashflows</li><li>▪ Key accounting policies</li><li>▪ Taxation issues</li><li>▪ Any legal issues e.g. ongoing litigation</li></ul>
Short form report	Focuses on the company's results for the past three years
Adequacy of Financial Reporting Systems Report	Comments on financial reporting systems and controls eg IT environment, accounting procedures, corporate governance structure
Working Capital Report	A review of the basis of the company's forecast working capital – including sensitivity analysis

## 6 FORENSIC AUDITING

### Section overview

- Forensic accounting, forensic investigations and forensic auditing
- The nature of forensic investigations and audits
- Application of ethical principles to forensic investigations
- Procedures in forensic investigations
- Reporting on forensic audits
- Government agencies associated with forensic auditing

#### 6.1 Forensic accounting, forensic investigations and forensic auditing

In general terms, 'forensic' means used in connection with courts of law. In accounting, the term 'forensic' therefore refers to the use of accounting information for legal purposes, in the resolution of legal disputes or in disputes that are resolved by a court of law. It may be used in both criminal cases (for example fraud cases) and civil cases.

##### Forensic accounting

Forensic accounting involves preparing financial information for use as evidence by a court of law. Examples include the provision of financial information relating to:

- loss of earnings
- settlement of a legal dispute involving the valuation of a business
- losses relating to an insurance claim
- a divorce settlement.

There are two aspects to forensic accounting:

- forensic investigations
- forensic audits.

##### Forensic investigations

A forensic investigation is a forensic audit carried out in response to a suspicion of wrong-doing, usually to prove or disprove certain assumptions, for example, 'X person is carrying out a fraud' or 'Y person was negligent in carrying out that piece of work'.

The objective of a forensic investigation is to obtain evidence that might be used in legal proceedings to resolve a dispute or prove innocence/guilt in a criminal case, such as providing evidence of money laundering.

Often forensic investigations are usually reactive, meaning that they seek to prove or disprove suspicions of wrongdoing and provide evidence for legal proceedings. However, investigations can also be proactive or preventative. Techniques of forensic auditing can be used to identify risks of wrongdoing and then steps can be taken to improve the situation.

### Forensic audit

Forensic audit is an element in forensic investigations. It refers to the methods and procedures used to obtain audit evidence in a forensic investigation. Forensic auditing may be defined as the process of:

- gathering, analysing and reporting on data, much of it financial in nature, in the pre-defined context of legal dispute or investigation into suspected irregularities; and
- in some cases, giving preventative advice in this area.

The terms 'forensic accounting', 'forensic investigations' and 'forensic audits' are closely connected, and an exam question may refer to any of these three terms.

## 6.2 The nature of forensic investigations and audits

Forensic investigations and audits are associated with situations where disputes arise or wrongdoing has occurred such that criminal or civil action is being taken in a court of law. The following general areas may give rise to forensic auditing:

- Fraud investigation
- Negligence investigation
- Insurance claims, and the assessment of losses.

In any of the above examples, a forensic accountant might be called on by the court to act in the capacity of expert witness, providing evidence to that court on the financial implications of a situation, or on whether there is evidence to substantiate claims of fraud or negligence.

#### Example: fraud investigation

In the case of a fraud investigation, a forensic accountant may be engaged to:

- Investigate whether fraud has actually occurred, and if so to obtain evidence to support that assertion in a court of law
- identify the individual or individuals who have committed the fraud, and obtain evidence that can be used in a court of law to link them to the fraud: this work will also involve obtaining evidence to show how the individual or individuals had an opportunity to commit the fraud
- estimate the financial loss that has occurred because of the fraud.

The forensic accountant is not a policeman and it is not his job to prosecute individuals for alleged fraud. However, he will be engaged by the criminal investigation authorities to obtain evidence that can be used to pursue a criminal prosecution (or to conclude that sufficient evidence cannot be obtained).

## 6.3 Application of ethical principles to forensic investigations

The ethical principles set out earlier apply to accountants carrying out forensic work as they do to accountants in every situation.

- Integrity:** In legal disputes and criminal investigations, individuals may be dishonest and tell lies. However the forensic accountant must act with integrity and honesty at all times.
- Objectivity:** The forensic accountant is paid by a client to carry out an investigation, and the client will presumably be hoping for a particular outcome to the investigation. For example, in a fraud investigation, the

criminal investigators who use a forensic accountant may be hoping for evidence of guilt. However the forensic accountant must remain independent (in spite of the advocacy threat) and should seek to obtain evidence to reach a fair opinion.

- ❑ **Professional competence and due care:** Forensic accounting is a specialised area of work, and individuals should be sufficiently competent to do the work.
- ❑ **Confidentiality:** The normal ethical rule is that accountants should maintain client confidentiality and should not disclose information without the client's consent. An exception is that the duty of confidentiality is overridden by the requirement to provide evidence when requested to a court of law. Legal requirements for disclosure override the rules of client confidentiality.
- ❑ **Professional behavior:** Forensic accountants often appear as witnesses in court, and in the public eye they should display professional behaviour and act in a way that is not detrimental to the image of the accounting profession.

There are some particular considerations that accountants will have to bear in mind when carrying out forensic work:

- ❑ to whom a duty of confidentiality is owed (particularly when acting as an expert witness in relation to both sides of a legal claim)
- ❑ duties to the court
- ❑ legal privilege in the context of money laundering.

This last area is a particularly important one for forensic accountants. Most accountancy work, for example, auditing or accounts preparation, gives rise to the duties to report suspicions of money laundering.

However, when an accountant is working in a legal capacity, it may be that information obtained during the course of that work is subject to legal privilege. If so the accountant would be wrong to make a report of suspicion of money laundering. Whether or not legal privilege applies in a particular situation is a complicated question, and the accountant should take legal advice on his position.

#### 6.4 Procedures in forensic investigations

The procedures that a forensic accountant will carry out will depend on the terms and the objectives of the engagement.

In many cases, procedures will be similar to auditing procedures and will depend on exactly what is being proved or disproved. In others, the accountant may be preparing financial information from a number of sources to substantiate a claim.

In the exam you may be asked to describe the procedures in a forensic investigation. In answering a question on this topic, it may be useful to think about the elements in a normal audit investigation:

- ❑ Establish the objectives of the investigation.
- ❑ Plan the investigation with a view to achieving the objectives. For example, in an investigation into suspected fraud, the auditor should plan how to establish whether fraud has occurred, how it could have happened and how long has it been going on – as well as who has committed the fraud and how much has been lost.

- The audit work should therefore be planned in a way that will provide sufficient appropriate evidence to achieve the objectives of the audit. The evidence should be strong enough to 'stand up' to scrutiny in court if required: in fraud cases, audit evidence should therefore try to establish a motive for the alleged fraudster, identify the opportunity that the fraudster had to commit the fraud and also any evidence of measures by the fraudster to conceal his crime.
- Note that audit evidence may be gathered in various ways – similar to the methods used in a normal audit. This includes interviewing individuals (including individuals suspected of fraud).
- The auditor should use the evidence obtained to reach an opinion. If the evidence is insufficient, he should try to obtain additional evidence.
- At the end of the investigation a report is prepared for the client.

**Examples:**

If an accountant is asked to give evidence of whether an audit file has been prepared negligently, he will review the file comparing the procedures carried out with the requirements of auditing standards.

If an accountant is asked to give evidence of whether inventory has been misappropriated, he may carry out analytical review (comparing margins year on year), he may carry out tests on cut – off and inventory counting to ensure that the figures are not misstated (giving the impression of a fraud), he may carry out tests of controls to establish whether they are capable of preventing frauds and whether they have been applied.

## 6.5 Reporting on forensic audits

Key issues in reporting will be:

- Whom the report is intended for and restriction of liability to other parties
- The type of assurance required (as for any assurance engagement, this will affect the level of evidence obtained)
- What purpose the report is required for, for example, to substantiate an insurance claim or to provide evidence to a court of law

## 6.6 Government agencies associated with forensic auditing

Part of the efforts of the Nigerian government to combat economic and financial crimes within the country is the establishment of some agencies that are meant to tackle these problems.

These agencies and their enabling Acts include:

Agency/enabling Act	Description
Economic and Financial Crimes Commission (EFCC) Act, 2004	Part of the duties of the EFCC is to carry out investigation of financial crimes, including advance fee fraud, money laundering, counterfeiting, illegal charges, transfers, future market fraud, fraudulent encashment of negotiable instruments, computer credit card fraud, contract crimes, etc.

Agency/enabling act	Description
Independent Corrupt Practices and Other Related Offences Commission (ICPC) Act, 2000	Duties of ICPC include receiving and investigating complaints from members of the public on allegations of corrupt practices and in appropriate cases, prosecute the offenders.
Money Laundering (Prohibition) Act, 2011 (as amended)	The purposes of the Money Laundering (prohibition) Act, 2011 (as amended) are the prohibition of: <ul style="list-style-type: none"> <li>▪ The conversion or transfer of resources or property derived directly from illegal and unlawful activity;</li> <li>▪ Making or accepting cash payments of sums exceeding the statutory provisions;</li> <li>▪ Collaboration in concealing or disguising the genuine nature, origin, movement or ownership of the resources, property or rights derived from the above-mentioned acts;</li> <li>▪ Retaining the proceeds of criminal activity; and</li> <li>▪ Conspiring to commit or the aiding and abetting of any offence under the Money Laundering Act.</li> </ul>
FIRS (Federal Inland Revenue Service)	Part of its duties include to adopt measures to identify, trace, freeze, confiscate or seize proceeds derived from tax fraud or evasion.
Bank and Other Financial Institutions Act (BOFIA), 1991 (as amended)	This Act grants to the CBN power to order a special examination or investigation of the books and affairs of any bank where it is in the public interest to do so.

## 7 CHAPTER REVIEW

### Chapter review

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

- Discuss the need for, objective and nature of assurance engagements
- Describe the steps involved in performing an assurance engagement in compliance with ISAE 3000
- Explain the steps involved in performing an examination of prospective financial information in compliance with ISAE 3400
- Explain the steps involved in performing an engagement to report on the compilation of proforma financial information included in a prospectus in compliance with ISAE 3420
- Describe what is involved in forensic auditing

**Quick quiz question**

- 1 How many parties are there to an assurance engagement?
  - A One
  - B Two
  - C Three
  - D Four
  
- 2 Which of the following is usually the most difficult aspect of an assurance engagement, in situations where there are no specific laws or regulations?
  - A Establishing suitable criteria
  - B Estimating the time needed to complete the work
  - C Recognising ethical requirements
  - D Preparing the assurance report
  
- 3 Which of the following statements is INCORRECT?
  - A A risk assessment engagement provides assurance on the adequacy of a client's risk management strategies.
  - B A performance measurement engagement provides assurance about the way in which performance measurements have been calculated and reported.
  - C A VFM engagement provides assurance about whether an operation is carried out in the best way to achieve its intended objectives.
  - D An engagement relating to systems reliability may require the assurance provider to report on security in an IT system.
  
- 4 Which of the following problems may affect the audit of an e-commerce system?
  - 1 The absence of any audit trail for e-commerce transactions
  - 2 Legal and regulatory risks for the client
  - 3 Risk to the integrity of the e-commerce transactions
  - A 1 and 2 only
  - B 1 and 3 only
  - C 2 and 3 only
  - D 1, 2 and 3

5 Which of the following is a type of assurance engagement?

- A Agreed-upon procedures
- B Compilation of a client's tax computation
- C Direct reporting engagement
- D Compilation of a client's financial statements

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### Quick quiz answers

1 C

The three parties are the accountant (e.g. auditor), the party responsible for the subject matter of the engagement (e.g. management of the client company) and the intended user of the subject matter of the engagement (e.g. shareholders of the client company).

2 A

Assurance cannot be provided without criteria for reaching an opinion. Deciding suitable criteria can be difficult unless there are laws or regulations against which a comparison can be made.

3 A

A risk assessment assurance engagement provides assurance about the risk assessment procedures in a client entity, not about risk management generally. A VFM engagement assesses the economy, efficiency and effectiveness of an operation, so that it achieves its intended objectives in the best way.

4 D

Risk to the integrity of transactions is a major risk. Political and legal risk may occur, for example the problem experienced by companies providing online poker facilities, which were illegal in the USA (and which prompted action by the US authorities). E-commerce systems should provide an audit trail; however the audit trail might be inadequate.

5 C

A review engagement offers limited assurance. Agreed-upon procedures and compilation engagements offer no assurance.

CHAPTER  
**13**

## **Internal audit and outsourcing**

### **Contents**

- 1 The nature and development of internal auditing
- 2 Types of internal audit
- 3 Outsourcing
- 4 Chapter review

## INTRODUCTION

### Competencies

#### Planning and undertaking work

**C1(I)** Reliance on internal audit, specialists and the work of other auditors.

### Exam context

This short chapter deals with two discrete topics – internal audit, and outsourcing.

You will learn about the type of work that an internal audit department typically performs and the reports they typically produce. The chapter also articulates the difference between internal and external audit.

This chapter also looks at outsourcing – what it is and how it works - as well as its advantages and disadvantages. You will see how a client's outsourced operations impact the audit and the subsequent audit approach that should be adopted in accordance with ISA 402.

At the end of this chapter, readers should be able to:

- Describe the function of internal audit and differentiate between internal and external audit;
- Explain the difference between financial, operational and compliance audits;
- Discuss which functions may be outsourced and the relative advantages and disadvantages of outsourcing; and
- Explain the audit considerations per ISA 402 relating to entities using service organisations and the nature of type 1 and type 2 reports as included in ISAE 3402.

## 1 THE NATURE AND DEVELOPMENT OF INTERNAL AUDITING

### Section overview

- Definition of internal audit
- Reasons for the development of internal auditing
- Typical functions of internal audit
- Comparison of external and internal audit

#### 1.1 Definition of internal audit

The role of the internal audit function has been defined as:

*'...an appraisal system established by management for the review of the accounting and internal control systems as a service to the entity.'*

There are several parts to this definition:

- Internal auditing is an appraisal system.
- It is established by management as a service to the entity.
- It involves the review of accounting systems.
- It also involves the review of internal control systems, which are systems for financial controls, operational controls and compliance controls.

Internal auditing is a separate and distinct branch of the accounting profession. The role of internal auditing has become more significant in larger entities and is now seen as an important management tool.

#### 1.2 Reasons for the development of internal auditing

The main reasons for the importance of the internal audit function are as follows:

- Internal audit helps management to monitor the controls within their entity. As entities increase in size and complexity, and become global in nature, the task of monitoring controls becomes more difficult. An internal audit function helps management to monitor these controls.
- Similarly, as markets become increasingly competitive, it is important that entities should be very competitive themselves. This means using resources efficiently and effectively. An internal audit function can be used to monitor the efficiency of operations.
- In many countries there is a large amount of statutory and accounting regulation, including corporate governance regulation. An internal audit function can be used by management to check on compliance with laws and regulations.
- Many entities use complex IT systems. Specialist internal auditors can help management to review the effectiveness of controls within IT systems (by means of IT audits).
- The increasing cost of the external auditor's services means that it may be cheaper to use internal auditors to perform audit tasks whenever possible. (The reliance of external auditors on work done by internal auditors is considered later. However, an internal audit department may be used for

work not related to the external audit that might otherwise be given to an external firm of accountants as non-audit work).

There is no legal requirement for an entity to establish an internal audit function. The fact that many organisations do so indicates that there are significant benefits to be gained.

For companies that operate over multiple sites, internal audit may be an essential tool for effective management. Senior management can use an internal audit department to carry out 'external' checks on its operational departments. Random visits or surprise visits by internal auditors may be used to confirm that all locations are applying internal controls properly, and are complying with relevant laws and regulations. The largest locations, or locations where there is a high risk of control failure, may be visited more frequently by the internal auditors.

### 1.3 Typical functions of internal audit

The scope and objectives of internal audit vary widely, and depend on:

- the size and structure of the entity, and
- the requirements of its management.

However, internal audit activities usually include one or more of the following:

- Monitoring of internal control.** Senior management need to reassure themselves that internal controls are functioning effectively. In a large organisation, they do not have the time to carry out this task personally, for example through observation. Monitoring controls, and making sure that the controls are working properly, needs attention on a continuous basis. An internal audit department is usually given the specific responsibility by management for reviewing controls, monitoring their operation and recommending improvements.
- Examination of financial and operating information.** An internal audit department might be given the responsibility for a detailed examination of financial and operating information, and in particular, its reliability and usefulness. Internal auditors may investigate how information is identified, measured, classified and reported, and recommend improvements where appropriate. The audit work may involve investigations into specific items of information, including the detailed testing of transactions, balances and procedures.
- Review of the economy, efficiency and effectiveness of operations,** including non-financial controls of an entity. Audits of economy, efficiency and effectiveness can be carried out on any aspect of operations and are usually called value for money (VFM) audits.
- Review of compliance.** Senior management may ask the internal auditors to check that operational departments are complying properly with certain laws, regulations and other external requirements, or with management policies and directives and other internal requirements. These investigations are often called 'compliance audits'.

Factors to consider in evaluating the internal audit function include:

- The quality of reports produced;
- The qualifications and experience of internal audit staff;
- Whether due professional care has been exercised;

- The degree of independence of the internal audit function;
- Resources available; and
- The scope of work performed.

#### 1.4 Comparison of external and internal audit

Internal and external auditors will often carry out their work using similar procedures. However, there are a number of fundamental differences between the two audit roles. These are summarised in the following table:

Factor	External audit	Internal audit
Duties and responsibilities	To express an opinion on the truth and fairness of the annual financial statements	To examine systems and controls and assess risks in order to make recommendations to management for improvement.
Qualification to act	Set out by statute.	No statutory requirements – management select a suitably competent person.
Mode of appointment	The shareholders	Management
Duties set by Reporting line	Statute The shareholders	Management Management

## 2 TYPES OF INTERNAL AUDIT

### Section overview

- Introduction
- Financial audits
- Operational audits
- Compliance audits

#### 2.1 Introduction

Internal auditors may be involved in 'financial' audits, focusing on the audit of items in the income statement/statement of comprehensive income and statement of financial position. When the internal auditors perform this type of work, they may duplicate work that the external auditors might otherwise be expected to do. The external auditors might therefore be able to rely on the work of the internal auditors in reaching their audit conclusion. This was considered in Chapter 8.

However, the internal audit function often has a much wider role than simply performing financial audits, and in many entities (particularly large entities) the internal auditors are involved in other aspects of auditing, such as:

- **energy audits:** these are checks on how the entity is making use of energy and whether its operations are energy-efficient;
- **social audits:** these are checks on the impact of the entity on the society in which it operates;
- **environmental audits:** these are checks on the effect the entity is having on its natural environment, and considers issues such as the use of sustainable materials, re-cycling, reducing pollution, and soon; and
- **human resource audits:** these are audits into the work force of an entity, to check whether the entity has adequate systems for the recruitment, training and development of employees to meet its current and future needs.

#### 2.2 Financial audits

Performing financial audits is the traditional role of the internal auditor. Internal auditors may be asked by management to review accounting records and other records to substantiate figures appearing in financial statements and management accounts.

This work overlaps with the work of the external auditor. Consequently, this aspect of internal audit work is now seen as a relatively minor part of the total work of an internal audit department.

However, it is important to remember that by performing financial audits, the internal auditor is able to look at the internal controls that are in place to minimise risks, to identify weaknesses and to recommend improvements in the internal control system.

### 2.3 Operational audits

Operational audits examine the entity's internal control procedures and whether or not the control systems that have been established by management are operating effectively. As a result of the audit, the internal audit department will make recommendations to management for improvements to the system or the way in which it is operated.

The **value for money** (or VFM) audit was described in an earlier chapter as an assurance service that might be performed for a client by an external accountancy firm. VFM audits may be carried out instead by the internal audit department.

Finding the best possible **combination** of the 3Es is seen as a strategy for maximising profit performance. It is not usually possible to achieve objectives (effectiveness) by using the cheapest resources (economy) in the most productive way possible (efficiency). Sometimes, greater efficiency can only be achieved by spending more, so a balance must be found between economy and efficiency. Sometimes, the benefits of greater effectiveness are not justified by the extra cost, so a balance must be found between economy and effectiveness.

One of the purposes of a VFM audit should be to check whether the most appropriate balance between economy, efficiency and effectiveness is being achieved.

### 2.4 Compliance audits

Entities are subject to a large number of laws and regulations, and they may be exposed to the risk of regulatory action by the authorities if they fail to comply with the regulations. The nature of important regulations varies from one industry to another. Controls over health and hygiene are important for the food manufacturing industry, for example. Controls over pollution are important for companies involved in oil and gas exploration. Controls over money laundering are important for financial services; and controls over safety are important for companies in the public transport industry.

Internal audit can be used by management as a tool to confirm that significant laws and regulations are being **complied with** by the company (or other reporting entity).

### 3 OUTSOURCING

#### Section overview

- Financial operations that might be outsourced
- Advantages and disadvantages of outsourcing
- Outsourcing the internal audit functions
- Outsourcing other finance or accounting functions
- ISA 402: Audit considerations relating to entities using service organisations
- ISAE 3402: Assurance reports on controls at a service organisation

#### 3.1 Financial operations that might be outsourced



##### Definition: Outsourcing

'Outsourcing' by a company means arranging for an external entity to perform a task that would otherwise be performed by the company's own staff. It usually refers to routine and repetitive procedures and operations.

Outsourcing of work to 'external suppliers' and service organisations is a common practice. Examples of work that may be outsourced include:

- Payroll operations
- Internal auditing
- financial and management accounting activities (for example data processing or pensions)
- IT services
- work relating to taxation compliance and tax consultancy
- due diligence procedures for acquisitions and mergers
- non-financial services, such as catering, cleaning, motor vehicle fleet management, and staff recruitment and selection.

Entire functions may be outsourced. For example, an entity may outsource all the financial accounting functions, from book-keeping through to the preparation of final financial statements.

Alternatively, only parts of functions may be outsourced, with the remainder of the function being retained 'in house'. For example, an entity may outsource its payroll function, but perform the rest of the accounting and finance function itself.

A problem for the auditors (internal and external) is that when work is outsourced, they need to satisfy themselves that the external agencies are performing their work properly. It may be necessary to check that the information provided by the external agency is correct (and not subject to misstatement) and that the internal controls applied by these external agencies are effective.

### 3.2 Advantages and disadvantages of outsourcing

#### Advantages

There are several reasons why entities outsource their operations.

- Cost savings. It may be cheaper to outsource work to an external service provider than to do the work in-house.
- The skills of the external agency or service provider. An external service provider may have skills and expertise for doing the work, that the entity itself does not have 'inhouse'.
- Access to the most up-to-date techniques and technology might not be readily available within the entity, but the external agency may have them.
- The management of the entity are able to focus their time and effort on 'core activities', and do not have to spend as much time monitoring the outsourced activities.

#### Disadvantages

There are also disadvantages with outsourcing.

- The management of the entity needs to make sure that the service provider understands the requirements of the entity in respect of the service that it is providing. If the work is not properly specified, the service provider may fail to do everything that the entity requires it to do.
- The entity relies on the service provider to do its work on time and have it ready at the time that the entity requires it. This is particularly important, for example, when payroll operations are outsourced.
- There may be problems with negotiating an appropriate fee for the work with the service provider.
- Management need to ensure that the service provider gives the organisation an appropriate level of priority and 'customer care'. This means that management must carry out regular reviews of the service level and service quality provided.

In general, the outsourcing arrangement needs to be effectively managed and controlled by the organisation.

### 3.3 Outsourcing the internal audit functions

Some entities outsource the work of the internal audit function. When this happens, the service provider is often the accountancy firm that provides the entity with its external audit services.

Several factors need to be considered when an entity outsources any of its internal audit functions.

- The accounting firm must have a greater level of independence than the entity's own internal audit staff. If the external audit firm is not properly independent from the executive management of the entity, it should not be given any internal audit work.
- The accounting firm may have access to more highly trained, specialist employees.
- The accounting firm will have greater numbers of employees available for any urgent internal audit assignments.

- Professional codes of conduct and standards of behaviour will regulate the accounting firm. This **might not** be the case with an in-house internal audit department.
- The accounting firm may be sued for breach of contract or for negligent work and should have professional indemnity insurance to meet claims for losses due to negligent work.

However, there are a number of disadvantages with outsourcing the internal audit function to the external accounting firm.

- Professional firms are not under the control of the entity in the same way as their 'in house' internal audit employees.
- Fees for internal audit work can be high.
- Professional firms may not have the same level of detailed knowledge of the entity and its operations that 'in house' internal auditors (working in the organisation on a daily basis) should have.
- There may be threats to the independence of the external audit where the firm acts as both internal auditors and external auditors.

### 3.4 Outsourcing other finance or accounting functions

A list of examples of other functions that could be outsourced was given at the start of this section. In the exam, you may be required to comment on the specific advantages and disadvantages of outsourcing any of these.

An important aspect of outsourcing accounting functions may be that the external supplier controls the accounting records from which figures for the financial statements are obtained. For example, if payroll work is outsourced, the data for employee costs and any liabilities for payroll (such as tax liabilities) may be held by the service provider, not by the audit client.

The audit client may hold none of this information. The auditor is engaged by the audit client and has no contractual relationship with the service organisation.

However, the auditor may need to obtain audit evidence from the service organisation. Clearly it is important that if the service organisation controls any accounting information for the audit client, the contractual arrangement between the audit client and the service organisation should include an obligation for the service organisation to provide the auditor with access to the information required.

Issues for the auditor to consider in this type of situation are as follows:

- Materiality:** The auditor should decide whether the outsourced operation is material in terms of the financial statements. If payroll work is outsourced, this is likely to be a material item and the auditor will have to consider how to obtain sufficient appropriate evidence about payroll costs.
- Accessibility to the records:** This point was considered earlier. It is important that access to the relevant records is available for the auditor, and the auditor should discuss with the service organisation the arrangements for obtaining the information required.
- Control risk:** The auditor will need to assess control risk in the outsourced operation. A systems audit will be possible only if the auditor is satisfied with the control system in the service organisation. Otherwise, substantive auditing procedures will be needed.

- Compliance:** Where the outsourced work is subject to regulatory requirements, the auditor will need to consider how to gather evidence about compliance with the regulations. An example is the need to check compliance with tax regulations for deductions from tax, in the case of outsourced payroll activities.
- Transfer of information.** It may also be necessary to check the procedures for the transfer of information between the service organisation and the audit client, to establish how information is transferred, how often it is transferred and whether the method of transfer is reliable.

If you are asked in an exam question to comment on outsourcing any function, remember to think specifically about the relevant function you are being asked about, and think through factors such as:

- the logistics/practical issues of the outsourced operation
- the confidentiality associated with the source information (for example, in respect of payroll, pension details are considered highly confidential by staff)
- the speed of technological advancement in the area
- the responsibility for the function: for example, directors will still be legally responsible to ensure that proper accounting records are kept, even if they outsource them.

### 3.5 ISA 402: Audit considerations relating to an entity using a service organisation

ISA 402 provides guidance to external auditors where clients outsource some of their operations to service organisations. The services provided by a service organisation are relevant to the audit when those services, and the controls over them, **are part of the entity's information system**. Such controls are most likely to relate to financial reporting, but other controls could also be relevant to the audit – such as controls over the safeguarding of assets.

When the client uses the services of a service organisation, the **objectives** of the auditor, per ISA 402, are:

- to obtain an understanding of the nature and significance of those services and their effect on his client's internal controls, sufficient to identify and assess the risks of material misstatement, and
- to design and perform audit procedures in response to the assessed risks.

#### Obtaining an understanding of the services provided

In obtaining an understanding of the services provided the auditor is applying ISA 315, which was discussed in a previous chapter. The auditor is **required** to:

- understand how his client uses the services provided, and
- evaluate the controls at his client which relate to the services provided.

For example, a client may have outsourced its payroll transactions, and have established controls over the submission and receipt of payroll information that would prevent or detect material misstatements. Testing these controls may enable the auditor to conclude that payroll is not materially misstated, regardless of the controls in place at the service organisation.

If the auditor is **unable to obtain a sufficient understanding from the client**, then he should use one or more of the following procedures:

- Obtain a Type 1 or Type 2 report (see below).
- Contact the service organisation, via the client, to obtain specific information.
- Visit the service organisation and perform appropriate procedures to give the necessary information.
- Use another auditor to perform such procedures.

#### Type 1 and Type 2 reports

A **Type 1 report** comprises:

- A **description** of the service organisation's system, control objectives and controls as at a specified date (prepared by the management of the service organisation), and
- A "**reasonable assurance**" report on the above description and the suitability of the controls to achieve the specified control objectives (prepared by an auditor instructed by the service organisation).

A **Type 2 report** is a more detailed report, covering not only the theoretical controls in place, but also whether, in practice, the **controls have achieved their objectives**. The description may now cover a specified period and may also report on the operating effectiveness of the controls over that period. The report will now also give:

- the "service auditor's" opinion on the operating effectiveness of the controls, and
- a description and the results of his tests of controls.

In response to the recent trend of an increase in the use of service organisations a new International Standard on Assurance Engagements (ISAE) 3402 *Assurance reports on controls at a service organisation* has been issued. This is effective for periods ending on or after June 15, 2011 – see below.

In common with earlier theory in this chapter, before relying on a Type 1 or Type 2 report the "user auditor" must be satisfied as to:

- the service auditor's professional competence and independence from the service organisation, and
- the standards under which the report was issued.

#### Responding to the assessed risks of material misstatement

In responding to the assessed risks, the auditor is applying ISA 330, which was discussed in a previous chapter. The auditor is **required** to:

- determine whether sufficient appropriate audit evidence is available from records held at the client, and, if not
- perform further audit procedures to obtain such evidence or use another auditor to perform those procedures at the service organisation on his behalf.

If the auditor wishes to perform **tests of controls**, he should use one or more of the following procedures:

- Obtain a Type 2 report.
- Perform appropriate tests of controls at the service organisation.
- Use another auditor to perform such procedures on his behalf.

#### Other requirements

The auditor should inquire of management as to whether the service organisation has reported any fraud, non-compliance or uncorrected misstatements to them.

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation, he should express a modified opinion in his audit report. (The different types of audit opinions are discussed in a later chapter.)

The auditor should **not refer in his report to the work of a service auditor** unless that is required by law or regulation. Even then, or if the auditor refers to the expert's work in his report because it is relevant to an understanding of a modified opinion, then he must make it clear that such a reference does not reduce his responsibility for that opinion in any way.

### 3.6 ISAE 3402: Assurance reports on controls at a service organisation

ISAE 3402 deals with assurance engagements undertaken by a professional accountant in public practice to provide a report for use by user entities (i.e. the audit client) and their auditors on the controls at a service organisation that provides a service to user entities that is likely to be relevant to user entities' internal control as it relates to financial reporting.

ISAE 3402 complements ISA 402 in that reports prepared in accordance with ISAE 3402 are capable of providing appropriate evidence under ISA 402.

ISAE 3402 states that the objectives of the service auditor are:

- To obtain reasonable assurance about whether, in all material respects, based on suitable criteria:
  - (i) The service organisation's description of its system fairly presents the system as designed and implemented throughout the specified period (or in the case of a type 1 report, as at a specified date);
  - (ii) The controls related to the control objectives stated in the service organisation's description of its system were suitably designed throughout the specified period (or in the case of a type 1 report, as at a specified date);
  - (iii) Where included in the scope of the engagement, the controls operated effectively to provide reasonable assurance that the control objectives stated in the service organisation's description of its system were achieved throughout the specified period.
- To report on the matters in (a) above in accordance with the service auditor's findings.

### **Illustrative opinion for a Type 1 report**

#### **Opinion**

*Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion are those described at page [aa]. In our opinion, in all material respects:*

- (a) *The description fairly presents the [the type or name of] system as designed and implemented as at [date]; and*
- (b) *The controls related to the control objectives stated in the description were suitably designed as at [date].*

### **Illustrative opinion for a Type 2 report**

#### **Opinion**

*Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion are those described at page [aa]. In our opinion, in all material respects:*

- (a) *The description fairly presents the [the type or name of] system as designed and implemented throughout the period from [date] to [date];*
- (b) *The controls related to the control objectives stated in the description were suitably designed throughout the period from [date] to [date]; and*
- (c) *The controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period from [date] to [date].*

#### **Description of Tests of Controls**

*The specific controls tested, and the nature, timing and results of those tests are listed on pages [yy–zz].*

## 4 CHAPTER REVIEW

### Chapter review

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

- Describe the function of internal audit and differentiate between internal and external audit
- Explain the difference between financial, operational and compliance audits
- Discuss which functions may be outsourced and the relative advantages and disadvantages of outsourcing
- Explain the audit considerations per ISA 402 relating to entities using service organisations and the nature of type 1 and type 2 reports as included in ISAE 3402

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### Quick quiz questions

- 1 Internal audit may be outsourced. Which one of the following does NOT represent an advantage of outsourcing compared with keeping the audit work in-house?
  - 1 Greater independence of the auditor
  - 2 Better knowledge
  - 3 Lower costs

A 1 and 2 only  
B 1 and 3 only  
C 2 and 3 only  
D 1, 2 and 3
- 2 Which of the following is NOT true about internal audit?
  - 1 Internal audit work may in some circumstances be performed by the external auditor
  - 2 The audit committee should review the work of internal audit
  - 3 The external auditor must use the work of internal audit

A 1 and 2 only  
B 1 and 3 only  
C 2 and 3 only  
D 1, 2 and 3
- 3 Which of the following criteria should the external auditor consider when performing a risk assessment of the internal audit function?
  - 1 Organisational status of internal audit within the entity
  - 2 Technical competence of internal audit
  - 3 Size of the internal audit department

A 1 and 2 only  
B 1 and 3 only  
C 2 and 3 only  
D 1, 2 and 3
- 4 The usual aim of a VFM audit is to:
  - A check whether more spending is necessary to improve economy, efficiency and effectiveness
  - B set realistic targets for economy, efficiency and effectiveness
  - C check whether a suitable balance exists between economy, efficiency and effectiveness
  - D check whether economy, efficiency and effectiveness are all being maximised.

- 5 Which of the following activities may be a function of the internal audit department?
- 1 Monitoring of internal control
  - 2 Review of compliance
  - 3 Preparation of month end accounts
- A 1 only
  - B 1 and 2 only
  - C 1 and 3 only
  - D 2 and 3 only

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### Quick quiz answers

1 C

Employees would be more likely to have an intimate knowledge of the particular business than bought-in external specialists.

2 C

The external auditor may use the work of internal audit, but there is no obligation. The audit committee should review the effectiveness of internal audit but will not review internal audit assignments in detail (since the committee's members lack the expertise or time to do this).

3 D

A risk assessment of internal audit is concerned with the risk that the internal auditors might not provide independent and reliable opinions on the subject matter of their audits. The organisational status of the head of internal audit may affect the independence of the department. Technical competence affects the quality of the work performed. The size of the department may also be relevant, because the department might not have enough staff to handle all the work that it is required to do.

4 C

It is rarely possible to maximise all three of the '3Es' – economy, efficiency and effectiveness, and a VFM audit is much more likely to consider whether a suitable balance between the three is being achieved. Economy means less spending (or 'better' spending); therefore checking whether more spending is needed to improve economy is a contradiction in terms.

5 B

Internal auditors carry out audits; they don't prepare sets of accounts

CHAPTER  
**14**

## **Reporting**

### **Contents**

- 1 The audit report and the meaning of 'a true and fair view'
- 2 The unmodified auditor's report: ISAs 700, 701 and 720
- 3 Audit reporting and the Companies and Allied Matters Act 2020
- 4 The modified auditor's report: ISAs 705 and 706
- 5 The Auditor's Responsibilities Relating to Other Information: ISA 720
- 6 The impact on the auditor's report of opening balances and comparatives: ISAs 510 and 710
- 7 The impact of going concern on the auditor's report: ISA 570
- 8 Communicating with those charged with governance: ISA 260
- 9 Communicating deficiencies in internal control: ISA 265
- 10 Specialised areas
- 11 Chapter review

## INTRODUCTION

### Competencies

#### Assessment of risks, internal controls, internal financial controls

- C2(a) Identify and assess reporting and compliance risks in the context of an assurance or audit engagement in the public or private sector based on a given business scenario.
- C2(b) Give an advice based on the assessment above.

#### Evaluation of accounting treatments

- C3(a) Evaluate and draw conclusions on the appropriateness of stated accounting treatments in the context of a given scenario for public or private sector based on national and international standards on auditing and international financial reporting standards (IFRS).

#### Drawing conclusions and reporting

- D2 (a) Discuss the concept of key audit matters (KAM) and justify the basis for reporting same.
- D2 (b) Explain the responsibilities of an auditor with respect to KAM.
- D2 (c) Explain the audit documentation requirements of ISA 701 with respect to KAM.
- D2 (d) Identify the additional national requirements beyond those of ISA 701 for entities that should be within the scope of ISA 701 per the requirements of the Financial Reporting Council of Nigeria.
- D2 (e) Appraise the form and contents of the audit report under ISA 700 (revised), given a specific situation.
- D2 (f) Explain the responsibilities of auditors in respect of other information in line with the requirements of ISA 710.
- D2 (g) Explain circumstances under which emphasis of matters or other matters paragraph may be appropriate to an audit report.
- D2 (h) Draft extracts of suitable audit, assurance and management reports based on a given scenario in accordance with Nigerian laws and international standards on auditing.
- D2 (i) Evaluate and apply suitable judgments on when it may be appropriate to refer to a specialist in giving an opinion or preparing a report.
- D2 (j) Evaluate and apply suitable judgments on when it may be appropriate to withhold an opinion, withdraw an opinion or take other such appropriate actions on an audit or assurance engagement.
- D2 (k) Identify and explain the issues that may be relevant and the nature of report that may be given relating to risk management, internal controls and governance.

### **Exam context**

This chapter is fundamental to students' advanced audit and assurance studies as it relates to the output for which a client pays a fee – i.e. the audit or assurance report.

Following a revision of the basic structure of an independent auditor's report as encountered in your earlier studies you will then learn about the various modifications that may be required in the auditor's report. You will encounter the various ISAs relevant to this final phase of the audit such as ISAs 510 and 710 on opening balances and prior year comparatives respectively and of course the early ISA 700-series specifically on auditor's reports.

You also need to be familiar with the nature and content of communication with the client and in particular with those charged with governance.

For completion the final section briefly addresses special purpose auditor's reports.

At the end of this chapter, readers should be able to:

- Audit opening balances and comparatives
- Explain the impact of going concern on the auditor's report as required by ISA 570
- Describe in detail the contents of an auditor's report
- Identify when the basic auditor's report should be modified, and if so, how
- Explain the auditors' duties with respect to other information in documents containing audited financial statements as per ISA 720
- Discuss which matters should be communicated with those charged with governance, and describe the communication process
- Briefly describe the form, content and use of specialised auditor's reports

## 1 THE AUDIT REPORT AND THE MEANING OF A 'TRUE AND FAIR VIEW'

### Section overview

- The auditor's report
- The meaning of a 'true and fair view'

#### 1.1 The auditor's report

The auditor's report on the financial statements is the only direct communication between the auditor and the owners of the company (to whom the auditor normally reports).

In the past, the auditor's report was criticised for being too brief to allow the general reader to understand the nature of an audit and the meaning of the auditor's report. This was seen to be a major cause of the 'expectation gap' – the problem that users of financial statements expect more from the audit than statutory and other regulations require.

#### The expectation gap

The term 'expectation gap' refers to the fact that the public perception of the role and responsibilities of the external auditor is different from his statutory role and responsibilities. The expectations of the public are often set at a level higher than that at which the external auditor actually operates.

Some examples of the misunderstandings inherent in the public's expectations are as follows:

The public believes that the audit opinion in the auditor's report amounts to a 'certificate' that the financial statements are correct and can be relied upon for all decision-making purposes, including decisions about takeovers.

The public also believes that the auditor has a duty to prevent and detect fraud and that this is a purpose of the audit.

The public assumes that in carrying out his audit work, the auditor tests 100% of the transactions undertaken during the accounting period.

One consequence of these misunderstandings has been an increasing tendency in some countries to undertake legal action against the auditors, sometimes on a 'frivolous' basis, in the belief that the auditor should have prevented misstatements in the financial statements or should have prevented fraud.

#### Responses to the expectation gap

Responses to the problem of the expectation gap have varied between countries. In some countries, corporate governance codes have been changed to strengthen the role and responsibilities of directors for sound internal control and accounting systems.

The auditor's report is addressed to the owners of the company, not to other users of the financial statements.

In the context of auditor liability, some countries such as the UK allow the auditor to include an additional paragraph in the auditor's report, after the opinion paragraph, disclaiming any liability that may arise from the use of the report by persons other than those to whom it is addressed. However, this currently is not the case in Nigeria.

The various auditor's report-related ISAs (700- series plus conforming amendments to other ISAs) were significantly revised in 2015. The objective was to make the auditor's report more informative and relevant by providing more useful information about the entity and the audit. The updates included the release of a new ISA – ISA 701 *Key audit matters in the independent auditor's report*.

### **Electronic reporting**

Many companies now publish their annual reports on their websites. This method of 'electronic reporting' has implications for the auditor. It is considered good practice for the auditor to check that the electronic form of the financial statements and auditor's report are identical to the paper copy.

#### **1.2 The meaning of a 'true and fair view'**

In most countries, auditors performing an audit in accordance with statutory requirements are required to produce a report that makes reference to whether the financial statements give 'a true and fair view'. In some countries, the auditor's report is required to give an opinion whether the financial statements 'present fairly, in all material respects'. The terms 'true and fair view' and 'fair presentation' have an equivalent meaning.

The meaning of the term 'a true and fair view' has not been rigorously defined, either by law or by the auditing profession. Many legal authorities and writers on auditing have developed their own definitions of the term. The main points to note are as follows:

Assessing whether financial information is true and fair is more an art than a science. The assessment relies heavily on the judgement of the auditor.

It is appropriate to think of 'true and fair' as a combined phrase. In practice,

- True can be interpreted as providing objective assurance that the information contained therein is factually without error; and
- Fair can be interpreted as providing objective assurance that the presentation and impression are not misleading

In summary, 'true and fair' will normally imply:

- compliance with any relevant legislation and accounting standards
- the use of accurate figures or best possible estimates
- meaningful presentation and disclosure of information
- the avoidance of bias, distortion, and manipulation of figures
- no concealment of material information.

## 2 THE UNMODIFIED AUDITOR'S REPORT: ISAs 700, 701 AND 720

### Section overview

- Definition of an unmodified auditor's report
- Reaching the audit opinion
- Basic elements of the auditor's report
- ISA 701 – Key audit matters
- Auditor's report prescribed by law or regulation
- Audits conducted in accordance with both ISAs and local auditing standards
- Unaudited supplementary information presented with the audited financial statements – ISA 720

#### 2.1 Definition of an unmodified auditor's report

An **unmodified auditor's report** is an auditor's report containing an audit opinion not modified in any way – either by changing the unmodified opinion (to a qualified opinion, an adverse opinion or a disclaimer of opinion) or by adding an extra paragraph such as an 'emphasis of matter' or 'other matters' paragraph after the opinion paragraph.

ISA 700 requires the auditor to give an unmodified opinion when he concludes that the financial statements have been prepared, in all material respects, **in accordance with the applicable financial reporting framework**.

If that framework is a "fair presentation framework" then the report will give an opinion stating whether or not the financial statements "give a true and fair view" or "present fairly" the position and results of the entity.

An unmodified opinion provides a high level of assurance that a professional, independent examination of the financial statements has not revealed any material misstatements in those financial statements.

#### 2.2 Reaching the audit opinion

In reaching his audit opinion, the auditor is **required** to evaluate whether:

- he has obtained sufficient appropriate audit evidence as to whether the financial statements are free from material misstatement.
- uncorrected misstatements are material, individually or in aggregate.
- the financial statements have been prepared in accordance with the requirements of the applicable financial reporting framework (which for a "fair presentation framework" will include evaluating whether the financial statements give a true and fair view) and in particular whether
  - the financial statements adequately describe the relevant financial reporting framework.
  - the financial statements adequately disclose the entity's significant accounting policies.
  - the significant accounting policies are appropriate and consistent with the relevant financial reporting framework.

- accounting estimates are reasonable
- the information in the financial statements is relevant, reliable, comparable and understandable
- the financial statements provide adequate disclosures
- the terminology used in the financial statements is appropriate.

### 2.3 Basic elements of the auditor's report

The basic elements of an unmodified auditor's report, as given in ISA 700, are as follows:

1. Title
2. Addressee
3. Auditor's opinion
4. Basis for opinion
5. Going concern - material uncertainty (if applicable)
6. Key audit matters (if applicable)
7. Other information (if applicable)
8. Responsibilities for the financial statements
9. Auditor's responsibilities for the audit of the financial statements
10. Other reporting responsibilities (if applicable)
11. Name of the engagement partner (if applicable)
12. Auditor's signature
13. Auditor's address.
14. Date of the auditor's report

These elements are designed to achieve the **objectives** of ISA 700, which are for the auditor to:

- form an opinion on the financial statements, based on the evaluation of the conclusions drawn from the audit evidence obtained; and
- express that opinion clearly through a written report that also describes the basis for that opinion.

#### Title

The auditor's report shall have a title that clearly indicates that it is the report of an **independent** auditor. This is to distinguish this type of auditor's report from other reports that might be issued by other auditors (who may not have to abide by the same ethical requirements and requirement for independence as the independent auditor - for example, internal auditors).

### Addressee

The report shall be appropriately addressed, as required by the circumstances of the engagement. The report is usually addressed to either:

- the shareholders of the entity whose financial statements are being audited, or
- the board of directors of the entity.

### Auditor's opinion

The first section of the auditor's report shall include the auditor's opinion and have the heading "**Opinion**". The opinion section shall:

- Identify the entity whose financial statements have been audited;
- State that the financial statements have been audited;
- Identify the title of each statement comprising the financial statements;
- Refer to the notes, including the summary of significant accounting policies; and
- Specify the date of, or period covered by, each financial statement comprising the financial statements.

When the financial statements have been prepared in accordance with a "**fair presentation**" framework an unmodified opinion shall be expressed when the auditor concludes that the financial statements **give a true and fair view** or are **presented fairly**, in all material respects, in accordance with the applicable financial reporting framework.

When the financial statements have been prepared in accordance with a "**compliance**" framework an unmodified opinion shall be expressed when the auditor concludes that the financial statements **have been prepared**, in all material respects, in accordance with the applicable financial reporting framework.

This can lead to a two-fold opinion. For example, in the UK, an opinion will be expressed on whether the financial statements:

- give a true and fair view (UK accounting standards) or present fairly (IFRSs), and
- have been properly prepared in accordance with the Companies Act 2006.

Where IFRSs are not used as the financial reporting framework, the reference to the financial reporting framework in the wording of the opinion shall identify the jurisdiction of the financial reporting framework.

In Nigeria the opinion will be expressed as a minimum on whether the financial statements:

- present fairly in all material respects, the financial position, financial performance and cashflows.
- have been properly prepared in accordance with the Financial Reporting Council of Nigeria Act No 6 2011 and the Companies and Allied Matters Act, 2020.

For some types of companies (e.g. Banks in Nigeria) there may be additional reporting requirements such as compliance with "Banks and Other Financial Institutions Act (BOFIA) of Nigeria", or reporting in compliance with IFRS for listed companies.

### Basis for opinion

The '**Basis for Opinion**' paragraph shall:

- State that the audit was conducted in accordance with International Standards on Auditing;
- Refer to the section of the auditor's report that describes the auditor's responsibilities under the ISAs;
- Include a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall identify the jurisdiction or origin of the relevant ethical requirements or refer to the International Ethics Standards Board for Accountants' '*Code of Ethics for Professional Accountants*'; and
- State whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

### Going concern – material uncertainty (if applicable)

If:

- the use of the going concern basis of accounting is **appropriate** but a material uncertainty exists; and
- the auditor considers that **adequate disclosure** about the material uncertainty has been made in the financial statements.
- ...then the auditor shall express an unmodified opinion and include an extra paragraph in the auditor's report entitled 'Material Uncertainty Related to Going Concern'.

This paragraph shall:

- draw attention to the note in the financial statements that describes the material uncertainty;
- state that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern; and
- state that the auditor's opinion is not modified in respect of the matter.

This paragraph was introduced by the 2015 revision to ISA 700. Prior to that, adequately disclosed material uncertainty of going concern would have been referenced in an emphasis of matter (EOM) paragraph. The new 'Material Uncertainty Related to Going Concern' paragraph replaces the former EOM approach.

### Key audit matters (if applicable)

For audits of:

- listed entities; and
- any other audits where the auditor is otherwise required by law or regulation, or decides voluntarily to communicate key audit matters,...
- ...the auditor shall communicate key audit matters in accordance with ISA 701 (see below).

#### **Other information (if applicable)**

Where the auditor has obtained (and/or additionally, in the case of listed entities, also expects to obtain subsequent) 'other information' (as defined by ISA 720 *The Auditor's Responsibilities Relating to Other Information*) as at the date of the auditor's report, the auditor shall include an '**Other Information**' paragraph.

#### **Responsibilities for the financial statements**

This section of the report shall describe the responsibilities of those responsible for the preparation and presentation of the financial statements. It shall include an explanation that management is responsible for:

- preparing the financial statements in accordance with the applicable financial reporting framework;
- such internal controls as are deemed necessary to enable the preparation of financial statements which are free from material misstatement; and
- assessing the entity's ability to continue as a going concern, whether the use of the going concern basis of accounting is appropriate and the adequacy of any related disclosures.

#### **Auditor's responsibilities for the audit of the financial statements**

This section of the report shall:

- State that the objectives of the auditor are to:
- Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
- Issue an auditor's report that includes the auditor's opinion.
- State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists;
- State that misstatements can arise from fraud or error;
- Describe materiality;
- State that the auditor exercises professional judgment and maintains professional scepticism throughout the audit;
- Describe the auditor's responsibilities in an audit. This description shall be located:
  - Within the body of the auditor's report;
  - Within an appendix to the auditor's report; or
  - By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority (where permitted by law, regulation or national auditing standards).

#### **Other reporting responsibilities (if applicable)**

In some countries, the auditor may have additional reporting responsibilities. For example, he may be required by local legislation to report certain matters if they come to his attention during the course of the audit, or he may be required to report on specific matters such as the adequacy of accounting records.

Such other reporting responsibilities shall be addressed in a separate section of the report, following the opinion paragraph, sub-titled "Report on Other Legal and Regulatory Requirements".

In Nigeria, auditors must report 'other reporting responsibilities' as detailed in the fifth schedule of the Companies and Allied Matters Act, 2020, namely:

- Whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purpose of their audit;
- Whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them; and
- Whether the company's balance sheet and profit and loss account dealt with by the report agree with the books of account and returns.

#### **Name of the engagement partner (if applicable)**

The auditor's report for listed companies shall state the name of the engagement partner unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat.

#### **Auditor's signature**

The report shall be signed:

- in the name of the audit firm, or
- in the personal name of the auditor, or
- both.

The report is usually signed in the name of the firm because the firm assumes responsibility for the audit. In some countries such as the UK, the report has to be signed by the 'senior statutory auditor' (the engagement partner) for and on behalf of the firm. In Nigeria the report must be signed by the engagement partner for and on behalf of the firm.

#### **Auditor's address**

The report shall give a specific location for the auditor. This will usually be the city where the office responsible for the audit is located.

#### **Date of the auditor's report**

The report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base his opinion on the financial statements.

This will not be earlier than the date on which the financial statements are signed or approved by the directors/management of the client company.

The date of the report informs the reader that the auditor has considered the effect on the financial statements (and on his auditor's report) of subsequent events which occurred after the reporting period and up to that date.



**Example:**

An example of an unmodified auditor's report is set out below.

**INDEPENDENT AUDITOR'S REPORT**

To the Shareholders of ABC Company (*or other appropriate addressee*)

**Opinion**

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at 31 December 20X6, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements give a true and fair view (or present fairly, in all material respects,) of the financial position of ABC Company as at 31 December 20X6, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

**Basis for Opinion**

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* (IESBA Code) together with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

**Key Audit Matters (*if applicable*)**

Key audit matters are those that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

*[Description of each key audit matter in accordance with ISA 701.]*

**Other information (*if applicable*)**

*[Reporting in accordance with the reporting requirements in ISA 720 (Revised).]*

**Responsibilities for the financial statements**

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs, and for such internal

control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting, unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

#### **Auditor's responsibilities for the audit of the financial statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

*[The subsequent explanations of the auditor's responsibilities listed below can either be presented here, in an appendix to the auditor's report, or (if allowed by law, regulation or national auditing standards) through reference to a website of an appropriate authority.]*

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsible to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

-Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to

continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

*[The following paragraph would be included where key audit matters have been presented.]*

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

#### **Other reporting responsibilities (if applicable)**

*[The form and content of this section would vary depending on the nature of the auditor's other reporting responsibilities – see section 3 below for additional statements required by CAMA 2020 for audits in Nigeria.]*

#### **(Name of the engagement partner) (if applicable)**

**(Auditor's signature)**

**(Auditor's address)**

**(Date of the auditor's report)**

#### **2.4 ISA 701 - Key audit matters**

ISA 701 Communicating Key Audit Matters in the Independent Auditor's Report is a new ISA introduced in 2015 as part of the IAASB's extensive revisions to ISAs

relating to audit reporting. The objective of the IAASB's revisions was to make the auditor's report more informative and useful for the intended users.

Key audit matters (KAMs) must be communicated:

- in the auditor's report of all listed companies; and
- when the auditor is required by law or regulation to communicate key audit matters in the auditor's report.

#### Determining key audit matters

KAMs are defined by ISA 701 as:

*"Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance."*

Note:

- KAMs are defined with reference to the auditor, NOT the user – i.e., the areas that required significant auditor attention in **performing the audit**.
- KAMs are a standard element of all unmodified auditor's reports for listed companies (and other entities where required to be presented by law or regulation). KAMs therefore DO NOT represent a modification to the auditor's report and must not be confused with modified audit opinion, emphasis of matter or other matters, all of which are determined with reference to the USER, not the auditor.
- ISA 701 explains that in determining KAMs, the auditor shall take into account:
  - Areas of higher assessed risk of material misstatement, or **significant risks**;
  - **Significant auditor judgements** relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty; and
  - The effect of **significant events or transactions** that occurred during the period.
- The auditor determines which of the above matters were **most significant** in the audit, and hence are the key audit matters.
- In June 2016, the IAASB issued a paper entitled "*Determining and communicating key audit matters (KAM)*". The paper conveys that:
  - KAMs are a subset of Matters that required significant auditor attention, which themselves are a subset of Matters communicated with those charged with governance.
- In certain limited circumstances, if there are no KAMs to communicate, the auditor's report includes a statement to that effect.

#### Communicating key audit matters

KAMs are described in a separate section in the auditor's report under the heading '**key audit matters**'. For each KAM the description must explain:

- Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter; and
- How the matter was addressed in the audit.

#### **Example**



The IAASB's '*Auditor Reporting Implementation Work Group*' issued a paper entitled '*Auditor Reporting -Illustrative Key Audit Matters*' which included the following:

#### **Key Audit Matters**

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

#### **Goodwill**

Under IFRSs, the Group is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the balance of XX as of December 31, 20X6 is material to the financial statements.

In addition, management's assessment process is complex and highly judgmental and is based on assumptions, specifically [describe certain assumptions], which are affected by expected future market or economic conditions, particularly those in [name of country or geographic area].

Our audit procedures included, among others, using a valuation expert to assist us in evaluating the assumptions and methodologies used by the Group, in particular those relating to the forecasted revenue growth and profit margins for [name of business line]. We also focused on the adequacy of the Group's disclosures about those assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill.

#### **Revenue recognition**

The amount of revenue and profit recognized in the year on the sale of [name of product] and aftermarket services is dependent on the appropriate assessment of whether or not each long-term aftermarket contract for services is linked to or separate from the contract for sale of [name of product]. As the commercial arrangements can be complex, significant judgment is applied in selecting the accounting basis in each case. In our view, revenue recognition is significant to our audit as the Group might inappropriately account for sales of [name of product] and long-term service agreements as a single arrangement for accounting purposes and this would usually lead to revenue and profit being recognized too early because the margin in the long-term service Agreement is usually higher than the margin in the [name of product]

sale agreement.

Our audit procedures to address the risk of material misstatement relating to revenue recognition, which was considered to be a significant risk, included:

- Testing of controls, assisted by our own IT specialists, including, among others, those over: input of individual advertising campaigns' terms and pricing; comparison of those terms and pricing data against the related overarching contracts with advertising agencies; and linkage to viewer data; and
- Detailed analysis of revenue and the timing of its recognition based on expectations derived from our industry knowledge and external market data, following up variances from our expectations.

#### **Interaction between KAMs, ISA 705 (revised) and ISA 570 (revised)**

Matters giving rise to a modified opinion in accordance with ISA 705 (revised), or a material uncertainty related to going concern in accordance with ISA 570 (revised), are by their nature key audit matters. However, in such circumstances, these matters shall not be described in the KAM section of the auditor's report.

- KAMs are not a substitute for expressing a modified opinion in accordance with ISA 705 (revised). Any matter that requires a modified opinion shall be explained in the 'basis for modification' paragraph rather than as a KAM.
- Where a material uncertainty related to going concern exists, the auditor shall insert a separate paragraph into the auditor's report entitled 'Material uncertainty in relation to going concern' and describe the material uncertainty therein. Once again there would be NO duplication of the matter in the KAM section.
- KAMs are NOT presented when the auditor disclaims an opinion.

#### **Interaction between KAMs and Emphasis of Matter**

The objective of an emphasis of matter paragraph is to draw attention to matters included (and adequately presented) in the financial statements and related disclosures, which, in the auditor's judgement, are fundamental to users' understanding of the financial statements (e.g., a subsequent event).

- ISA 706 (revised) has been revised to reflect the fact that matters needing highlighting as fundamental to the users' understanding may now be determined as KAMs. The auditor may wish to highlight or draw further attention to their relative importance by listing them as the first KAM, or by including additional information in the KAM description.
- An 'emphasis of matter' paragraph shall only be used to highlight matters that are NOT considered to be KAMs (and hence are not described/highlighted in the KAM section of the auditor's report).

#### **Interaction between KAMs and Other Matters**

'Other matters' as defined by ISA 706 (revised) relate to matters other than those presented or disclosed in the financial statements e.g., the fact that prior year financial statements were audited by a predecessor auditor. Given that KAMs are always drawn from matters relating to the presented and disclosed financial statements there shall be no overlap between 'other matters' and KAMs.

## 2.5 Auditor's report prescribed by law or regulation

If the auditor is required by law or regulation (e.g. a national auditing standard) to use a specific layout or wording of the auditor's report, rather than the wording in ISA 700, then the auditor's report may only refer to ISAs if it includes, as a minimum, the following elements:

- Title
- Addressee
- An opinion section containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used.
- An identification of the entity's financial statements that have been audited.
- A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall identify the jurisdiction of origin of the relevant ethical requirements or refer to the IESBA Code.
- Where applicable, a section addressing a material uncertainty of going concern (in compliance with ISA 570).
- Where applicable, a key audit matters section (in compliance with ISA701).
- Where applicable, a section addressing 'other information' (in compliance with ISA 720 (Revised)).
- A description of management's responsibility for the preparation of the financial statements and an identification of those responsible for the oversight of the financial reporting process.
- A reference to ISAs and the law or regulation, and a description of the auditor's responsibilities for an audit of the financial statements.
- For listed entities, the name of the engagement partner unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat.
- Auditor's signature.
- Auditor's address.
- Date of the auditor's report.

These headings correspond with those specified by ISA 700 (Revised) as headings to be included in an unmodified auditor's report.

## 2.6 Audits conducted in accordance with both ISAs and local auditing standards

An auditor may be required to conduct an audit in accordance with particular national auditing standards (e.g. in the past in Nigeria, with NSAs) but in doing so may have also complied with "pure" ISAs.

In this case the auditor's report may refer to ISAs in addition to the national auditing standards but only where:

- there is no conflict between the national auditing standards and ISAs which would have led the auditor to form a different opinion or not to include an emphasis of matter paragraph (see later) that would have been required by ISAs, and
- if the report follows the wording of national auditing standards, it includes, as a minimum, the elements as specified above.
- When the report refers to both national auditing standards and ISAs it shall clearly identify the jurisdiction of origin of the national standards.

Note that if there is conflict between the national auditing standards that an auditor is required to comply with, and ISAs, then the conflict must be resolved in favour of the national auditing standards.

## 2.7 Unaudited supplementary information presented with the audited financial statements – ISA720

The report and accounts issued by a company often contain supplementary information ('**Other Information**') that is not covered by the auditor's opinion. Examples might include a chairman's statement, employment report and business review.

The auditor should be satisfied that Other Information presented together with the audited financial statements is clearly differentiated from the audited financial statements.

The auditor's responsibilities in respect of Other Information are covered by ISA 720 and require the auditor to:

- Determine, through discussion with management, which document(s) comprises the annual report;
- Make appropriate arrangement with management to obtain in a timely manner (and if possible, prior to the date of the auditor's report), final version of the document(s) comprising the annual report; and
- read the '**Other Information**' (i.e. the unaudited part of the annual report) in order to identify material inconsistencies with the audited financial statements.

### Other Information - reporting

The auditor's report shall include a separate section with the heading "Other Information" (or other appropriate heading) when, at the date of the auditor's report...

- ...for the audit of listed companies, the auditor has obtained, or expects to obtain, 'other information'; or
- ...for the audit of non-listed companies, the auditor has obtained some or all of the other information.
- The 'Other Information' section shall include the following:
- a statement that management is responsible for the other information;

- an identification of:
- other information, if any, obtained by the auditor prior to the date of the auditor's report; and
- for listed entities, other information, if any, expected to be obtained after the date of the auditor's report';
- a statement that the auditor's opinion does not cover the other information and, accordingly, that the auditor does not express (or will not express) an audit opinion or any form of assurance conclusion thereon;
- a description of the auditor's responsibilities relating to reading, considering and reporting on other information as required by ISA 720; and
- when other information has been obtained prior to the date of the auditor's report, either:
  - a statement that the auditor has nothing to report; or
  - if the auditor has concluded that there is an uncorrected material misstatement of the other information, a statement that describes the uncorrected material misstatement of the other information.

### 3 AUDIT REPORTING AND THE COMPANIES AND ALLIED MATTERS ACT 2020

#### Section overview

- Reporting requirements of the Companies and Allied Matters Act 2020
- Report to the audit committee

#### 3.1 Reporting requirements of the Companies and Allied Matters Act 2020 (s404)

The auditors of a company shall make a report to its members on the accounts examined by them, and on every balance sheet and profit and loss account, and on all group financial statements, copies of which are to be laid before the company in a general meeting during the auditors' tenure of office.

The auditor's report shall state the matters set out in the Sixth Schedule as follows:



##### Fifth Schedule CAMA 2020 – Matters to be expressly stated in the auditor's report

1. Whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purpose of their audit.
2. Whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.
3. Whether the company's balance sheet and (unless it is framed as a consolidated profit and loss account) profit and loss account dealt with by the report agree with the books of account and returns.
4. Whether, in their opinion and to the best of their information and according to the explanations given them, the said statements give the information required by this Act in the manner so required and give a true and fairview:
  - (a) in the case of the balance sheet, of the state of the company's affairs as at the end of its year; and
  - (b) in the case of the profit and loss account, of the profit and loss for its year; or as the case may be, give a true and Fairview thereof subject to the non-disclosure of any matters (to be indicated in the report) which, by virtue of Part I of the Second Schedule of the Act, are not required to be disclosed.
5. In the case of a holding company submitting group financial statements whether, in their opinion, the group financial statements have been properly prepared in accordance with the provisions of this Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries and associates.

### **3.2 Report to the audit committee**

CAMA 2020 requires that, in addition to the report to the members, the auditor shall, in the case of a public company, also make a report to the audit committee. The form and nature of this report remains somewhat discretionary as CAMA 2004 does not prescribe the contents or scope of the required report. The form and content of the report should be agreed when agreeing the terms of the engagement and confirmed in the engagement letter.

It may be argued that formally satisfying the requirements of *ISA 260 Communication with Those Charged with Governance* and *ISA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* would satisfy the requirement of CAMA 2020 to report to the audit committee.

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## 4 THE MODIFIED AUDITOR'S REPORT: ISAS 705 AND 706

### Section overview

- The nature of a modified auditor's report
- Emphasis of matter paragraphs and other matter paragraphs: ISA 706
- Emphasis of matter paragraphs
- Other matter paragraphs
- The modified opinion: ISA 705
- Form and content of a modified opinion
- Examples of modified opinions
- Deciding to give a modified opinion
- Auditor's reports and the exam

#### 4.1 The nature of a modified auditor's report

Before issuing a modified report, the auditor shall discuss with management the reason for the modification. The reason shall be explained, and the auditor shall ask the client entity's management to amend the financial statements.

- If management make the necessary adjustments, the auditor will not need to issue a modified report.
- If management refuse to make the amendments, a modified report may be the only course of action available to the auditor.

An auditor's report is said to be **modified** where either:

- a matter arises which **does not affect the opinion** given by the auditor, but which gives rise to an '**emphasis of matter paragraph**' or an '**other matter paragraph**' in the auditor's report (covered by ISA 706)
- a matter arises which does affect the opinion issued on the financial statements. This will give rise to a **qualified opinion**, a **disclaimer of opinion** or an **adverse opinion** (covered by ISA 705).

A modified auditor's report can therefore either have an unmodified audit opinion or a modified audit opinion.

#### 4.2 Emphasis of matter paragraphs and other matter paragraphs: ISA 706

As discussed above, an auditor's report may include an 'emphasis of matter' paragraph and/or an 'other matter' paragraph. These types of paragraphs are the subject of ISA 706 *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report*.

The purpose of these paragraphs is to provide additional communication in the auditor's report when the auditor wishes to draw the attention of users to a particular matter in the financial statements. They do not modify the audit opinion.

- An **emphasis of matter paragraph** draws the attention of users to an item (or 'matter') that is **included** in the financial statements and which the auditor considers **fundamental** to an **understanding of the financial statements**.

- Note that if such a matter is considered a 'key audit matter' (per ISA 701) then it shall be addressed in the 'key audit matters' section of the auditor's report rather than in an 'emphasis of matter' paragraph.
- An other matter paragraph deals with a matter which is not included in the financial statements, but which is relevant to an understanding of the audit, the auditor's responsibilities or the auditor's report.

### 4.3 Emphasis of matter paragraphs

An 'emphasis of matter' paragraph is used to draw the reader's attention to a matter presented or disclosed in the financial statements **which is fundamental to an understanding of those financial statements**.

When an auditor's report contains an emphasis of matter paragraph, **the opinion is not modified**. It can therefore only be used where the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. (If the matter is materially misstated, a modified opinion is required.)

Although the opinion is not modified, there is an item in the financial statements, properly presented or disclosed, that the auditor wishes to bring to the attention of users because it is fundamental to an understanding of the financial statements.

When a key audit matters section is included in the auditor's report, the Emphasis of Matter paragraph is placed either directly before or directly after the key audit matters section (based on the auditor's judgment as to the relative significance of the information included in the emphasis of matter paragraph).

When no key audit matters are presented, the Emphasis of Matter paragraph appears immediately after the basis of opinion paragraph.

When the auditor includes an emphasis of matter paragraph in the auditor's report the auditor is **required** to:

- use the heading 'Emphasis of Matter' for the paragraph (or another appropriate heading)
- include a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements
- indicate that his opinion is not modified in respect of the matter being emphasised.

#### Circumstances in which an emphasis of matter paragraph may be necessary

ISA 706 (revised) gives the following examples of circumstances in which an emphasis of matter paragraph may be necessary:

- Where there is an uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- Where the entity has adopted a new IFRS early and that has had a pervasive effect on the financial statements.
- To draw attention to a major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.



#### Example: Emphasis of matter paragraph

The following illustrative wording is given in ISA 706.

##### Emphasis of matter

We draw attention to Note X to the financial statements which describe the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

#### ISAs requiring emphasis of matter paragraphs

A number of ISAs **require** the auditor to use an emphasis of matter paragraph in certain circumstances. For example:

- ISA 210 *Agreeing the terms of audit engagements* requires an emphasis of matter paragraph when the financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.
- ISA 560 *Subsequent events* requires an emphasis of matter paragraph to be used in two specific circumstances. These relate to the circumstances when a subsequent auditor's report is issued relating to subsequent events.

#### 4.4 Other matter paragraphs

An 'other matter' paragraph is used if the auditor considers it necessary to communicate a matter other than those included in the financial statements that, in his opinion, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

The positioning of the other matter paragraph in the auditor's report requires judgement. ISA 706 provides the following guidance:

- The illustrative auditor's report in the appendix to ISA 706 presents the 'other matter' paragraph immediately after the Key Audit Matters paragraph.
- When an other matter paragraph is included to draw users' attention to a matter relating to Other Reporting Responsibilities addressed in the auditor's report, the paragraph may be included in the Report on Other Legal and Regulatory Requirements section.
- When relevant to all the auditor's responsibilities or users' understanding of the auditor's report, the other matter paragraph may be included as a separate section following the Report on the Audit of the Financial Statements and the Report on Other Legal and Regulatory Requirements.

#### Circumstances in which an other matter paragraph may be necessary

ISA 706 gives the following examples of circumstances in which an 'other matter' paragraph may be necessary:

- Where the auditor is unable to resign from the engagement even though the possible effect of a limitation of scope imposed by management is pervasive (relevant to users' understanding of the audit). This should be rare in practice.

- Where local law or custom allows the auditor to elaborate on his responsibilities in his report (relevant to users' understanding of the auditor's responsibilities or auditor's report).
- Another example when an other matter paragraph might be used is when the prior year financial statements were audited by a previous auditor, or not audited, so this is the first-year audit for the current auditor.

#### **Example: Other matter paragraph**

The following example is given in the appendix to ISA 706.

##### **Other Matter**

The financial statements of ABC Company for the year ended December 31, 20X5, were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X6.

#### **ISAs requiring an 'other matter' paragraph**

A number of ISAs require an 'other matter' paragraph to be used, including:

- ISA 560 Subsequent events
- If management amends and re-issues the financial statements, the auditor shall include in the new or amended auditor's report an Emphasis of Matter paragraph or Other Matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.
- ISA 710 Comparative information – corresponding figures and comparative financial statements
- When prior period financial statements were not audited.
- When prior period financial statements were audited by a predecessor auditor.
- When the auditor's opinion on prior period financial statements differs from the auditor's previously expressed opinion on those prior period financial statements in the circumstance where the auditor reports on the prior period financial statements in connection with the current period's audit.

#### **4.5 The modified opinion: ISA 705**

##### **When the auditor must issue a modified opinion**

ISA 705 Modifications to the opinion in the independent auditor's report **requires** the auditor to **modify** his opinion in the auditor's report in two situations:

- Material misstatement.** This occurs when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are 'not free from material misstatement'. In other words, the auditor considers that there is a material misstatement in the financial statements.
- Limitation on scope.** This occurs when the auditor is unable to obtain sufficient appropriate evidence to conclude that the financial statements as a whole are free from material misstatement. In other words, the auditor has been unable to obtain sufficient appropriate audit evidence to reach an

opinion that the financial statements give a true and fair view; therefore the financial statements may contain a material misstatement.

ISA 705 lists three types of **modified opinions**:

- a **qualified** opinion
- an **adverse** opinion, and
- a **disclaimer** of opinion.

Each of these types of modifications is explained below.

#### Deciding the type of modified opinion required

The following table from ISA 705 provides a useful summary of when each type of modified opinion is **required** to be given in the auditor's report:

	Auditor's judgement about the pervasiveness of the effects (or possible effects) on the financial statements	
Nature of matter giving rise to the modification	Material but not pervasive	Material and pervasive
<b>Financial statements are materially misstated</b>	Qualified opinion	Adverse opinion
<b>Inability to obtain sufficient appropriate audit evidence (limitation on scope)</b>	Qualified opinion	Disclaimer of opinion

#### Qualified opinions

A qualified audit opinion shall be given when, in the opinion of the auditor, there is a material misstatement or a limitation on scope, and the effect on the financial statements is material but not pervasive.

Qualified audit opinions are sometimes called 'except for' opinions, because the auditor's report shall state that in the auditor's opinion the financial statements give a true and fair view **except for** the matter or matters described in the report.

#### The meaning of pervasive: disclaimer of opinion or adverse opinion

Generally, a matter will be **material but not pervasive** when the auditor encounters a material problem with one or more **specific items** in the financial statements (such as a problem with inventory or revenue), but the remaining items and the financial statements as a whole provide a true and fair view.

'**Pervasive**' effects on the financial statements are defined by ISA 705 as those that, in the auditor's judgement:

- are not confined to specific elements, accounts or items of the financial statements, or
- are confined to specific elements in the financial statements, but these represent (or could represent) a substantial proportion of the financial statements, or
- in relation to disclosures in the financial statements, are fundamental to users' understanding of those statements.

The difference between a 'material' and a 'pervasive' modification is a matter of judgement. There are no absolute cut-off points or dividing lines that separate one from the other.

### Limitations on scope

Limitations on scope occur when the auditor is unable to obtain sufficient appropriate audit evidence about something that is material. ISA 705 suggests that this may happen as a result of:

- circumstances beyond the control of the entity, such as when the entity's accounting records have been destroyed
- circumstances relating to the nature or timing of the auditor's work: an example is when the auditor is appointed too late to enable him to attend the physical inventory count
- limitations imposed by management. The management of the client entity may prevent the auditor from obtaining the audit evidence required, for example by:
  - preventing the auditor from observing the physical inventory count
  - preventing the auditor from asking for confirmation of specific account balances (for example, a receivables circularisation).

### Management imposed limitations on scope

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit which is likely to result in a qualified or disclaimer of opinion, the auditor is **required** to ask management to remove the limitation. If management refuse to do this, the auditor must:

- communicate the matter to those charged with governance
- consider whether it is possible to perform alternative audit procedures in order to obtain sufficient appropriate audit evidence.

If it is not possible to obtain audit evidence in another way and the matter is **material but not pervasive** the auditor must give a **qualified opinion**.

If it is not possible to obtain audit evidence in another way and the matter is **material and pervasive** the auditor must:

- resign** from the audit where practicable and not prohibited by law or regulation, or
- if not practicable or possible, issue a **disclaimer of opinion**.

## 4.6 Form and content of a modified opinion

### Opinion paragraph

The opinion paragraph at the start of the auditor's report must be headed '**Qualified opinion**', '**Adverse opinion**', or '**Disclaimer of opinion**', as appropriate.

Specific wording is prescribed for the different types of modified opinions which is best illustrated by the examples shown later.

### Basis for modified opinion paragraph

When a modified opinion is issued, ISA 705 **requires** the '**basis for opinion**' **paragraph** to be amended to '**Basis for qualified opinion**', '**Basis for adverse opinion**', or '**Basis for disclaimer of opinion**', as appropriate. Examples of these types of opinion are shown later.

This 'basis for opinion' paragraph must include the following:

- For a material misstatement relating to **specific amounts** – a description and quantification of the impact on the financial statements (or a statement that quantification is not possible).
- For a material misstatement relating to **narrative disclosures** – an explanation of how the disclosures are misstated.
- For a material misstatement relating to the **non-disclosure** of information that should have been disclosed – the nature of the omitted information and, unless prohibited by law or regulation, the omitted disclosures.
- If the modification results from **an inability to obtain sufficient appropriate audit evidence** – the reasons for the inability.

For qualified and adverse opinions, the basis for the qualified/adverse (as appropriate) opinion paragraph will also state:

- We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified/adverse (as appropriate) opinion.

#### 4.7 Examples of modified opinions

Illustrative examples of the different types of modified opinion are shown below. They are all taken from ISA 705. Where paragraphs in the examples are incomplete, the wording of the report commences or concludes in the same way as in the example of the unmodified report, shown in an earlier section of this chapter.

##### Example 1: Qualified opinion – limitation on scope

This is an example of a qualified opinion, arising from the auditor's inability to obtain sufficient appropriate audit evidence. The only paragraphs from the report that are shown here are those that are relevant to the modified opinion.

##### Qualified Opinion

[We have audited the financial statements of.....]

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements give a true and fair view....

##### Basis for Qualified Opinion

The Group's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at XXX on the statement of financial position at 31 December 20X6, and ABC's share of XYZ's net income of XXX is included in ABC's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ at 31 December 20X6 and ABC's share of XYZ's net income for the year because we were denied access to the financial information, management and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

[We conducted our audit in accordance with .....

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

**Key Audit Matters**

[Key audit matters are.....]

In addition to the matter described in the *Basis for Qualified Opinion* section we have determined the matters described below to be the key audit matters to be communicated in our report.

[Description of each key audit matter in accordance with ISA 701].

**Example 2: Qualified opinion – material misstatement**

This is an example of a qualified opinion, arising from a material misstatement of the financial statements:

**Qualified Opinion**

[We have audited the financial statements of.....]

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements give a true and fair view....

**Basis for Qualified Opinion**

The company's inventories are carried in the statement of financial position at XXX. Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from IFRSs. The company's records indicate that had management stated the inventories at the lower of cost and net realisable value, an amount of XXX would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by XXX, and income tax, net income and shareholders' equity would have been reduced by XXX, XXX and XXX,respectively.

[We conducted our audit in accordance with .....,]

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

**Key Audit Matters**

[Key audit matters are.....]

In addition to the matter described in the *Basis for Qualified Opinion* section we have determined the matters described below to be the key audit matters to be communicated in our report.

[Description of each key audit matter in accordance with ISA 701].

**Example 3: Disclaimer of opinion – limitation on scope**

This is an example of a disclaimer of opinion where the auditor has been unable to obtain sufficient appropriate audit evidence about **multiple elements** of the financial statements:

**Disclaimer of Opinion**

We were engaged to audit the financial statements of ABC Company (the Company) ....

We do not express an opinion on the accompanying consolidated financial statements of the Company. Because of the significance of the matter described in the Basis for *Disclaimer of Opinion* paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

**Basis for Disclaimer of Opinion**

We were not appointed as auditors of the company until after 31 December 20X6 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at 31 December 20X5 and 20X6 which are stated in the statement of financial position at XXX and XXX, respectively. In addition, the introduction of a new computerised accounts receivable system in September 20X6 resulted in numerous errors in accounts receivable. As of the date of our auditor's report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the statement of financial position at a total amount of XXX as at 31 December 20X6. As a result of these matters, we were unable to determine whether any adjustments might have been found to be necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the income statement, statement of changes in equity and statement of cashflows.

*[Key Audit Matters are not presented when the auditor disclaims an opinion.]*

*[Responsibilities of Management and Those Charged with Governance for the Financial Statements – no change from standard wording]*

**Auditor's Responsibilities for the Audit of the Financial Statements**

*[Our responsibility is to....]*

However, because of the matters described in the Basis for *Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

*[We are independent of....]*

#### **Example 4: Adverse opinion – material misstatements**

This is an example of an adverse opinion is of a group auditor's report.

##### **Adverse Opinion**

*[We have audited the financial statements of.....]*

In our opinion, because of the significance of the matter discussed in the *Basis for Adverse Opinion* paragraph, the accompanying consolidated financial statements do not give a true and fair view....

##### **Basis for Adverse Opinion**

As explained in Note X, the company has not consolidated the financial statements of subsidiary XYZ Company it acquired during 20X6 because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under IFRSs, the subsidiary should have been consolidated because it is controlled by the company. Had XYZ been consolidated, many elements in the accompanying financial statements would have been materially affected. The effects on the financial statements of the failure to consolidate have not been determined.

*[We conducted our audit in accordance with .....*

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

##### **Key Audit Matters**

Except for the matter described in the *Basis for Adverse Opinion* section, we have determined that there are no other key audit matters to communicate in our report.

#### **4.8 Deciding to give a modified opinion**

The auditor will give a modified opinion only if he is satisfied that:

- the reasons for giving a modified opinion are justified, and
- the management of the client entity are unable or unwilling to act to remove the necessity for a modified opinion.

For example, suppose that the management of a client entity decides that a material non-current asset should not be depreciated. The auditor should first of all satisfy himself that there is no acceptable reason for the management's view, and that the asset should be depreciated.

- The auditor should review the audit file and check for any information about this matter from previous audits.
- He should consider whether there might be an acceptable reason for a departure from the requirements of international financial reporting standards and GAAP, in order to give a true and fairview.
- If the auditor is still satisfied that management is incorrect in their opinion, he should meet with the management and:
- Discuss their reasons for not depreciating the asset
- Obtain a representation from them confirming that the asset will not be depreciated

- Decide whether the effect of this action by management on the financial statements is material or 'material and pervasive' and so what form of modified opinion is necessary.
- Warn management that the audit opinion will be modified unless management change their view.
- If management still refuse to change their view, issue a modified opinion, which will be either a qualified opinion or an adverse opinion.

#### 4.9 Auditor's reports and the exam

For the exam, you may be expected to study an auditor's report that contains errors and identify and explain what those errors are. Alternatively, you may be asked to discuss what audit opinion would be appropriate in a particular situation.

The key issues to consider are as follows.

- Do the financial statements give a true and fair view? (Remember, misstatements do not affect the true and fair view if they are immaterial.)
- If they do, the audit opinion will be unmodified.
- If the draft financial statements give a true and fair view, is there any item that justifies an 'emphasis of matter' paragraph? For example, material uncertainty on the outcome of litigation, or a material subsequent event.
- Is there a material uncertainty related to going concern? Has any uncertainty been adequately described? Would it be appropriate to add a '*Material Uncertainty Related To Going Concern*' section to the auditor's report?
- If the financial statements do not give a true and fair view, what is the item of contention? Is it something that involves a disagreement with management (a misstatement) or is there inadequate audit evidence (a limitation on scope)?
- Is the matter material but not pervasive? If so, a qualified audit opinion is appropriate ('except for...').
- If the matter is material and pervasive, either an adverse opinion or a disclaimer of opinion is appropriate. (These are rare in practice, but of course they could feature in an exam question!)

Here are some examples.

##### Example 1

You are the manager in charge of the audit of Colorosso, a limited liability company. Your auditor's report for the previous financial year to 31 December Year 7 was signed, without modification, in February Year 8.

The scope of the audit for the year to 31 December Year 8 has been limited. This is because the company's chief executive officer fled the country in April Year 8, taking the accounting records with him.

You have identified a valuable training opportunity for Robin, one of your audit team. As a training exercise, you have asked Robin to draft the extracts for the basis of opinion and opinion paragraphs that would not be standard wording in an unmodified auditor's report.'

Robin's draft extracts were produced as follows:

**'Basis of opinion (extract)**

However, the evidence available to us was limited because accounting records were missing at the beginning of the year and it was not possible to reconstruct them completely.

**Opinion (extract)**

Because of the possible effect of the limitations in the information available to us, we do not express an opinion on the financial statements.'

**Required**

- (a) Identify and comment on the principal matters relevant to forming an appropriate opinion on the financial statements of Colorosso for the year ended 31 December Year 8.
- (b) Discuss the suitability of Robin's draft extracts.

**Answer**

**Tutorial note**

To answer this requirement, you need to:

- Identify the principal matters relevant to forming an appropriate opinion
- comment on these matters
- identify whether Robin's report indicates that Robin has identified and considered these matters
- reach a conclusion about whether Robin's report is suitable. This may involve setting out what would have been suitable if Robin's report is not suitable.

**Matters relevant to forming an opinion**

The following matters are relevant to forming an appropriate opinion.

- (1) The accounting records for the opening three or four months of the year are missing.
- (2) The accounting records are missing because the former CEO absconded with them. There must be some reason why he took the accounting records: fraud is a possible reason.
- (3) The audit opinion for the previous financial year was unmodified. This would imply that the opening balances for the current year and comparative figures for the previous year are correct. However, this might not be the case.
- (4) If there is a possibility of fraud, this would raise doubts about the correctness of the auditor's report for the previous year. There may have been fraud last year that was undetected fraud. And this might have caused material misstatement to that auditor's report.
- (5) There is an inability to obtain sufficient appropriate audit evidence (limitation on scope) for the year to 31 December Year 8.

Comments on these matters	
Matter listed above	Comment
(1)	<p>This constitutes a limitation on the scope of the audit (item 5 above). The auditors will not be able to obtain sufficient appropriate audit evidence about the relevant period. Therefore, the audit opinion will be modified.</p> <p>The modification should (a) give details of what records are missing and why, or (b) cross-refer to where this information is given in the financial statements.</p> <p>The extent of the modification will depend on which records are missing and where the auditors' scope is limited. It is likely that the information with regard to the income statement/statement of comprehensive income is limited, but possibly not the statement of financial position. A modification might be limited to a qualification ('except for') over the statement of comprehensive income for the first few months of the year.</p>
(2)	However, there is an indication in the manner in which the CEO has taken the accounting records that there may have been a fraud. It is therefore probable that the auditors will have to modify the opinion even if they are able to reconstruct the financial records as it will not be possible to gain sufficient appropriate evidence about the possible fraud.
(3) and (4)	The previous auditor's report cannot be withdrawn but the auditors are not precluded from modifying their opinion for the current year on the basis of the comparative figures for the previous year. It is probable that any fraud in progress at the start of this financial year could have affected the previous financial year, unknown to the auditors at the time.
<b>Conclusion about Robin's draft</b>	
<p>Robin is correct to modify the opinion on the grounds of limitation of scope. However, the draft should:</p> <ul style="list-style-type: none"> <li><input type="checkbox"/> refer to the exact nature of the problem/possible fraud</li> <li><input type="checkbox"/> take account of a possible modification in relation to the comparative figures for the previous financial year</li> <li><input type="checkbox"/> take account of the fact that the problem may be limited to the statement of comprehensive income.</li> </ul>	



### Example 2

A client company has recently prepared draft financial statements for the year to 31 December Year 2. During the year, the company closed a factory that made a loss-making product which contributed 14% to total sales revenue in the previous year and 10% in the current year.

The closure is permanent. It is mentioned in the directors' report and in the annual business review, but not in the financial statements themselves.

#### Required

What should be the auditor's view of this situation?



### Answer

The factory appears to have been a separate component of the company's business, making a separate product that contributed materially to total sales income.

The closure represents a discontinued operation, and failure to disclose the details is a failure to comply with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. It is also in breach of the requirements of IAS 7 *Statements of Cash Flow* and IFRS 8 *Operating Segments* which also require disclosures relating to discontinued operations.

The matter is material but is not pervasive. If management do not amend the financial statements to provide the required disclosures, a qualified audit opinion (for a misstatement) would be appropriate.



### Example 3

A client company has prepared draft financial statements for the year to 31 December Year 3. In February Year 4 a legal claim was made against the company, claiming substantial damages. The company's lawyers have advised that the claim has less than 50% chance of success. If it did succeed, the company would have sufficient cash resources to meet the claim in full.

The matter is disclosed in the draft financial statements in a note, as a material contingent liability.

#### Required

Should the audit opinion be unmodified, and if so, should the report contain a 'Material Uncertainty Related to Going Concern' paragraph?



**Answer**

The claim was made after the end of the reporting period and is a non-adjusting event. The probability that the claim will be successful is less than 50% (on the assumption that the lawyers have given a reasonable opinion).

It is therefore appropriate to disclose the item as a contingent liability (in this case, a material non-adjusting event after the reporting period). The auditor should therefore give an unmodified opinion.

A 'Material Uncertainty Related to Going Concern' paragraph is normally only used when the matter involves material uncertainty that is adequately disclosed. 'Material uncertainty' usually exists only when there is some concern about the going concern status of the entity or about a matter that could have a major impact on the financial statements. In this case, we are told that the company has sufficient cash resources to meet the legal claim in full, in the event that it is successful.

It therefore appears that material uncertainty does not exist, and a 'Material Uncertainty Related to Going Concern' paragraph would be inappropriate.

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## 5 THE AUDITOR'S RESPONSIBILITIES RELATING TO OTHER INFORMATION: ISA 720

### Section overview

- The nature of 'other information'
- ISA 720: The auditor's responsibilities relating to other information

#### 5.1 The nature of 'other information'

The published annual reports of major companies contain a significant amount of information that is not required by statute or by accounting standards.

The annual financial report is often used partly as a 'public relations' document, communicating a wide range of information from the company to shareholders and others, possibly in a report from the chairman or the chief executive officer.

If you have not done so already, you should read the published report and accounts of several public companies that have adopted international accounting standards and look at the information that they include. Published reports and accounts are normally available from the company's web site (often in the 'investor relations' section).

In doing this, you should note the following:

- the scope and contents of the report (in particular, what 'non-financial' information is published)
- the comments and reports on corporate governance matters.

It would also be helpful, for your auditing studies, to look at:

- the form and content of the auditor's report.
- the accounting policies applied.
- any accounting or auditing problems that may be evident from the financial statements.

#### 5.2 ISA720: The auditor's responsibilities relating to other information

One of the main benefits of the audit process is that audited information possesses a higher degree of credibility (and reliability) than equivalent information that has not been audited.

There is a possibility that the credibility of audited information may suffer if:

- information that has not been audited is published together with audited information (often in the same printed document); and
- the 'un-audited' information contains errors or is inconsistent with the audited information.

The auditor's report makes it clear what information has been subject to audit. However, there is a high risk of misunderstanding and a possibility that users of the financial statements will not make the distinction between audited information and other information.

For this reason, ISA 720 requires that auditors shall read this 'other' information and in doing so shall:

- consider whether there is a material inconsistency between the other information and the financial statements; and
- consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit

If the auditor identifies that a **material inconsistency** appears to exist (or becomes aware that the other information appears to be materially misstated), the auditor shall discuss the matter with management and, if necessary, perform other procedures to conclude whether:

- A material misstatement of the other information exists;
- A material misstatement of the financial statements exists; or
- The auditor's understanding of the entity and its environment needs to be updated.

#### Auditor's response

If a **material misstatement of the other information exists**, the auditors shall ask management to correct this and then check the correction has been made. If management refuse to make the correction, the auditors need to communicate with those charged with governance to make the correction.

If a **material misstatement of the financial statements exists** or the **auditor's understanding of the entity and its environment needs to be updated**, the auditor shall respond appropriately in accordance with the other ISAs as follows.

ISA	Response
ISA315	Revise the risk assessment
ISA450	Evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements
ISA560	Responsibilities relating to subsequent events

#### Reporting

- The auditor's report shall include a separate section with a heading "Other Information" (or other appropriate heading) when, at the date of the auditor's report:
  - For the audit of a listed entity, the auditor has obtained, or expects to obtain, the other information; or
  - For an audit of a non-listed entity, the auditor has obtained some or all of the other information.



### Example 1: Other information

The following illustrative wording is given in ISA 720 for a situation where no material inconsistency has been identified.

#### Other Information

Management is responsible for the other information. The other information comprises the [information included in the X report, but does not include the financial statements and our auditor's report thereon.]

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.



### Example 2: Other information

The following illustrative wording is given in ISA 720 for a situation where a material misstatement of the other information has been identified. Note the audit opinion is not modified by this matter.

#### Other Information

Management is responsible for the other information. The other information comprises the [information included in the X report, but does not include the financial statements and our auditor's report thereon.]

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. As described below, we have concluded that such a material misstatement of the other information exists.

[Description of material misstatement of the other information]

## 6 THE IMPACT ON THE AUDITOR'S REPORT OF OPENING BALANCES AND COMPARATIVES: ISAS 510 AND 710

### Section overview

- ISA 510: Initial audit engagements – opening balances
- ISA 710: Comparative information – corresponding figures and comparative financial statements

The audit work needed on opening balances and comparatives (ISAs 510 and 710) was described in an earlier chapter. The auditor must consider the possible impact of this work on the auditor's report.

#### 6.1 ISA 510: Initial audit engagements – opening balances

The auditor's report is **required** by ISA 510 to be **modified** where the auditor:

- is unable to obtain sufficient appropriate audit evidence on the opening balances (qualified ("except for") or a disclaimer of opinion)
  - concludes that there is a misstatement in the opening balances that materially affects the current period's financial statements and the misstatement is not properly accounted for/disclosed (qualified ("except for") or adverse opinion)
  - concludes that accounting policies have not been consistently applied (or a change of accounting policy has not been properly accounted for/disclosed) (qualified ("except for") or adverse opinion)
- or where
- the prior period's auditor's report was modified, and the matter is still relevant and material to the current period's financial statements (modify as appropriate).

#### 6.2 ISA 710: Comparative information – corresponding figures and comparative financial statements

Financial statements include audited figures for the current financial year (just ended) and for the previous financial year, which are presented as comparative information.

The audit opinion shall not refer to the corresponding figures, unless the following circumstances apply:

Circumstance	ISA 710 requirement
The auditor gave a qualified opinion for the previous financial period and the problem remains unresolved.	Modify this year's auditor's report.
The auditor finds a material misstatement in the prior period financial statements, on which an unmodified opinion was previously given, and the corresponding figures have not been appropriately restated.	Give a qualified or adverse opinion on the current period financial statements, in respect of the corresponding figures included.

Circumstance	ISA 710 requirement
The prior period financial statements were audited by another auditor	Use an "other matter" paragraph to explain this fact and the type of opinion given.
The prior period financial statements were not audited.	Use an "other matter" paragraph to state this fact. (However, the auditor remains responsible, per ISA 510, for obtaining sufficient appropriate evidence on opening balances.)

#### Other matter paragraph

If the prior period's financial statements 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 will include an 'Other matter' section in the auditor's report stating:

- The financial statements of the prior period were audited by the predecessor or auditor;
- The type of opinion expressed and, if modified, the reasons why; and
- The date of that report.

If the prior period's financial statements were unaudited, the auditor must include an 'Other matter' section in the auditor's report stating that the prior period's financial statements were unaudited. However, the auditor still needs to perform appropriate audit procedures on the opening balances in accordance with ISA 510.

## 7 THE IMPACT OF GOING CONCERN ON THE AUDITOR'S REPORT: ISA 570

### Section overview

- Introduction
- Where the use of the going concern assumption is appropriate but a material uncertainty exists
- Management's attitude to disclosure of material uncertainty
- Where the use of the going concern assumption is inappropriate

#### 7.1 Introduction

If indications are found which suggest that the going concern basis might not be appropriate for preparing the financial statements, the auditor is **required** by ISA 570 to consider the implications for his auditor's report.

The form of the report will depend on the auditor's judgement. There are two possible views he could take:

- the use of the going concern assumption is appropriate but a material uncertainty exists, or
- the use of the going concern assumption is inappropriate.

If management is unwilling to make or extend a going concern assessment (see previous chapter on ISA 570) the auditor is also **required** to consider the implications of this for his auditor's report.

#### 7.2 Where the use of the going concern assumption is appropriate but a material uncertainty exists

Where the auditor considers that the going concern assumption is **appropriate, but a material uncertainty exists**, he must consider whether the financial statements:

- adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with those events or conditions, and
- disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

If there is **adequate disclosure**, then the auditor shall express an unmodified opinion. However, he would add a separate section to the auditor's report immediately after the 'Basis for Opinion' paragraph entitled **Material Uncertainty Relating to Going Concern**. The separate section would:

- highlight the uncertainty;
- draw attention to the relevant note in the financial statements ;and
- state that the audit opinion is not modified in respect of this matter.
- A minor amendment would be made in the introductory paragraph of the *Key Audit Matters* section (if relevant) making reference to the *Material Uncertainty Relating to Going Concern* paragraph.



### Example 1: Material Uncertainty Related to Going Concern

#### Material Uncertainty Related to Going Concern

We draw attention to Note X to the financial statements which indicates that the company incurred a net loss of ZZZ during the year ended 31 December 20X6 and, as of that date, the company's current liabilities exceeded its total assets by YYY. As stated in Note X, these events or conditions, along with other matters as set forth in Note X, indicate that a material uncertainty exists that may cast significant doubt on the company's ability to continue as a going concern.

Our opinion is not modified in respect of this matter.

#### Key Audit Matters (if relevant)

*[Key audit matters are those matters that....]*

In addition to the matter described in the Material Uncertainty Related to Going Concern section, we have determined the matters described below to be the key audit matters to be communicated in our report.

*[Description of each key audit matter in accordance with ISA 701.]*

If there is not adequate disclosure of the uncertainty then the auditor shall express a qualified or adverse opinion. In this instance the auditor would not include the separate 'Material Uncertainty Related to Going Concern' section because the material uncertainty would be fully explained in the 'Basis for Qualified (Adverse) Opinion' section.

### 7.3 Management's attitude to disclosure of material uncertainty

The management of a client company will probably be reluctant to include a disclosure about material uncertainty in relation to the going concern assumption. There are several reasons for this.

- Admitting that there is material uncertainty about whether the company can continue as a going concern for the next 12 months can be seen as a sign of management failure. Management will probably be reluctant to admit their responsibility for failure to the company's shareholders.
- A statement that there is material uncertainty about the ability of the company to continue in business will make the situation even worse for the company. Banks will be reluctant to lend more money and may withdraw existing lending facilities. Suppliers may be reluctant to supply more goods without a credit guarantee (which the company would have to buy from an insurance company). Customers may stop buying the company's products due to concern that the company will not be in existence to provide after-sales service.
- Employees will become more concerned for job security, and many might look for jobs with other employers. Staff turnover would therefore increase.

It is also possible that management do not accept that there is material uncertainty about the ability of the company to continue in business. There could

therefore be genuine disagreement between management and the auditor on this issue.

As indicated above, if management refuse to provide suitable disclosure the audit opinion shall be modified.

#### 7.4 Where the use of the going concern assumption is inappropriate

Where the financial statements have been prepared on the going concern basis, but the auditor considers the going concern assumption is **inappropriate**, the auditor shall express an **adverse** opinion.

The auditor may give an unmodified opinion if the financial statements have been prepared on an alternative acceptable basis (for example, a break-up basis) and there is adequate disclosure of this basis. An emphasis of matter paragraph may be required in the auditor's report to highlight the alternative acceptable basis.

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## 8 COMMUNICATING WITH THOSE CHARGED WITH GOVERNANCE: ISA 260

### Section overview

- Introduction
- Matters to be communicated
- The communication process
- Actions when an auditor's report is to be modified

#### 8.1 Introduction

In most countries, the auditor communicates to the shareholders, as owners of the company, by means of his auditor's report. ISA 260 *Communication with those charged with governance* requires in addition that the external auditor shall communicate formally to those charged with governance to provide useful feedback about the audit.

In the case of a company those charged with governance are the board of directors or the audit committee (which is a sub-committee of the board of directors). In your exam it will usually mean the directors of the company.

The auditor's **objectives** in respect of ISA 260 are to:

- communicate his responsibilities and give an overview of the planned scope and timing of the audit
- obtain information relevant to the audit
- provide timely observations arising from the audit which are significant to management's responsibility to oversee the financial reporting process
- promote effective communication between the auditor and those charged with governance.

As a result of the communication, the auditor shall be satisfied that there is sufficient documentation of all the significant matters in the audit and that these have been brought to the attention of the individuals in the client entity who are accountable to its owners.

#### 8.2 Matters to be communicated

The auditor is required by ISA 260 to communicate the following matters:

- His responsibilities** in relation to the audit, including notification that:
  - he is responsible for forming and giving an opinion on the financial statements prepared by management, and
  - the audit does not relieve management or those charged with governance of their responsibilities.
- An overview of the **planned scope and timing** of the audit.

- Any significant findings from the audit. These are often called the **management letter points** and are usually communicated along with any deficiencies in internal control as required by ISA 265 (see below). They include:
  - the auditor's views on the entity's accounting policies, estimates and financial statement disclosures
  - any significant difficulties encountered during the audit
  - any significant matters arising from the audit already brought to the attention of management and written representations requested
  - any other matters arising from the audit that are significant to the oversight of the financial reporting process.
- For **listed entities** a statement (which must be made in writing):
  - that the audit team/firm have complied with relevant ethical requirements in respect of independence
  - of all matters relevant to independence (such as relationships and non-audit fees) and the safeguards applied.

\*This requirement does not apply if those charged with governance are involved in managing the entity as they will already be aware of these issues. The significant matters do not include material weaknesses in internal controls as such a report is a requirement of ISA 265, not ISA 260 (see next section).

### 8.3 The communication process

The communication with those charged with governance may be provided **either in writing or orally**. It could take place as a discussion between the auditor and an appropriate level of management, perhaps with the audit committee in the case of a larger company.

However, where oral communication would not be adequate, ISA 260 requires that communication is in writing, in the form of a letter or report. If communication is oral then the matters communicated, to whom and when must be documented.

Communication must be made on a **timely basis**. The appropriate timing will vary depending on the matter to be communicated. Communication in respect of planning matters will be likely to be made early in the engagement. Any significant difficulties encountered during the audit shall be communicated as soon as practicable, especially if likely to lead to a modified opinion.

### 8.4 Actions when an auditor's report is to be modified

ISAs 705 and 706 require the auditor to communicate any planned modification to the auditor's report with those charged with governance. This is to ensure that those charged with governance understand that a modification is to be made and the reasons for it. Early communication also gives those charged with governance an opportunity to provide the auditor with further information and explanation prior to the issuance of the auditor's report.

Other actions to consider when an auditor's report is to be modified include:

- External consultation – e.g. with legal counsel
- Re-consider management's integrity and whether there is a need to revise the audit strategy and plan (particularly relevant if the modification is due to a management-imposed limitation of scope).
- Withdrawal from the engagement if the matter is sufficiently serious (and if withdrawal allowed by law). In such a case it is always advisable to seek legal advice.

Note that ISA 210 requires an auditor to decline an engagement if there has been a limitation on scope prior to commencement of the audit which is expected to result in a disclaimer of opinion (unless required to undertake the engagement by law).

## 9 COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL: ISA 265

### Section overview

- Introduction and requirements of ISA 265
- The management letter

#### 9.1 Introduction and requirements of ISA 265

ISA 315, covered largely in an earlier chapter, requires the auditor to **communicate material weaknesses in internal control identified during the audit to management**. This requirement is embodied in ISA 265 *Communicating deficiencies in internal control to those charged with governance and management*.

A **deficiency** is defined by ISA 265 as where:

- a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis, or
- a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

A **significant deficiency in internal control** is one which merits the attention of those charged with governance.

ISA 265 **requires** the auditor to:

- Communicate significant deficiencies identified during the audit to those charged with governance in writing on a timely basis.
- Communicate any other deficiencies to an appropriate level of management

The communication of significant deficiencies must be **in writing** and is **required** to cover:

- A description of the deficiencies and an explanation of their potential effects.
- Sufficient information to allow those charged with governance and management to understand the context of the communication, including an explanation that:
  - the purpose of the audit was to express an opinion on the financial statements
  - whilst the audit did include consideration of internal controls in order to design appropriate audit procedures, this was not done for the purpose of expressing an opinion on the effectiveness of internal control, and
  - the matters being reported are limited to those deficiencies identified during the audit and considered of sufficient importance to be reported.

The above should make it clear that the report covers only those weaknesses that have been discovered as a result of the audit work that has been undertaken. It is a by-product of a statutory audit and is not the result of a full review of systems and controls. As a consequence, other weaknesses may exist that are not mentioned in the report.

The auditor will also usually state that such communication has been provided for the purposes of those charged with governance, and that it may not be suitable for other purposes.

## 9.2 The management letter

Although it is now a requirement of both ISA 315 and ISA 265, the **management letter** or **letter of weakness** has long been seen as an extra service provided to the client by the external auditor. If management address the points in the letter, the controls in place will be improved. This may enable future audits to focus on the more efficient systems-based approach. This in turn may reduce the cost of the audit to the client.

The report is prepared and sent after the results of the tests of control are known – usually after the **interim audit**.

The report may later be updated after the **final audit**, if further weaknesses have been found, or if weaknesses that were reported previously have not yet been dealt with.

In line with ISA 265's requirement to give a description of the deficiencies and an explanation of their potential effects, the report will usually identify the following information for each weakness reported:

- Deficiency:** The nature of the weakness in the present system, in terms of both design and operation. (In other words, is there a control weakness 'on paper'? If there is no control weakness 'on paper', are the controls applied effectively in practice?)
- The implication** of this weakness in controls.
- Recommendations** for improvement.

The auditor shall ask management to provide a response and action plan for each weakness identified in the report. He shall also mention that the contents of the report will be followed up in future audits.

## 10 SPECIALISED AREAS

### Section overview

- ISA 800 Special considerations - Audits of financial statements prepared in accordance with special purpose frameworks
- ISA 805, Special Considerations - Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
- ISA 810, Engagements to Report on Summary Financial Statements

#### 10.1 ISA 800 Special considerations - Audits of financial statements prepared in accordance with special purpose frameworks

ISA 800 deals with special considerations **in the application of ISAs** to an audit of financial statements prepared in accordance with a special purpose framework.

Although such special considerations cover:

- acceptance of the engagement
- planning and performance of the engagement, and
- forming an opinion and reporting on the engagement

the bulk of the ISA is concerned with reporting. An auditor's report on such financial statements will add credibility to those financial statements.

##### Considerations when accepting the engagement

The auditor is **required** to determine the acceptability of the financial reporting framework applied by obtaining an understanding of:

- the purpose for which the financial statements have been prepared
- the intended users of those financial statements
- the steps taken by management to determine that the framework is acceptable in the circumstances.

The special purpose framework could be a fair presentation framework or a compliance framework, as discussed under ISA 700 above.

##### Considerations when planning and performing the audit

ISA 200 requires the auditor to comply with all ISAs relevant to the audit. ISA 800 **requires** the auditor to determine whether any special consideration is needed.

ISA 315 requires the auditor to obtain an understanding of the entity's selection and application of accounting policies. If the special purpose financial statements have been prepared **in accordance with the provisions of a contract**, then ISA 800 **requires** him to obtain an understanding of any significant interpretation of the contract that management has made in the preparation of those financial statements.

### Forming an opinion and reporting considerations

When forming an opinion and reporting on special purpose financial statements the auditor is **required to follow ISA 700 and other relevant reporting ISAs**. The table below shows how the requirements of ISA 700 (and ISA 706) are applied by ISA 800.

ISA 700/706 requirements	How applied by ISA 800
The auditor must evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework (ISA 700).	For financial statements prepared in accordance with the provisions of a contract the auditor must evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.
Provisions covering the form and content of auditor's reports (ISA 700)	The report must also describe the purpose for which the financial statements are prepared and, if necessary, the intended user (or refer to a note which gives that information). If management has a choice of financial reporting frameworks in this instance, the section on management's responsibilities must refer to its responsibility for making an acceptable choice.
Use of an emphasis of matter paragraph (ISA 706)	The report must include an emphasis of matter paragraph alerting users to the fact that the financial statements have been prepared in accordance with a special purpose framework and that, as a result, they might not be suitable for another purpose.

#### Example: Auditor's report on special purpose financial statements

Extracts of an auditor's report on a complete set of financial statements prepared in accordance with the financial reporting provisions established by a regulator (in this example a fair presentation framework) are set out below.

##### INDEPENDENT AUDITOR'S REPORT

(Appropriate addressee)

##### Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31st, 20X4, and the statement of comprehensive income, statement of changes in equity, and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements give a true and fair view (or present fairly, in all material respects,) of the financial

position of the Company as at December 31st, 20X4, and (of) its financial performance and its cash flows for the year then ended in accordance with the financial reporting provisions of Section Y of Regulation Z

**Emphasis of Matter - Basis of Accounting**

We draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the Company to meet the requirements of Regulator DEF. As a result, the financial statements may not be suitable for another purpose. Our opinion is not modified in respect of this matter.

**Other matter**

The Company has prepared a separate set of financial statements for the year ended December 31st, 20X4 in accordance with International Financial Reporting Standards on which we issued a separate auditor's report to the shareholders of the Company dated March 31st, 20X5.

**Management's responsibility for the financial statements**

Management is responsible for the preparation and fair presentation of the financial statements in accordance with the financial reporting provisions of Section Y of Regulation Z, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

**10.2 ISA 805 Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement**

**ISA 805**

The International Standards on Auditing (ISAs) in the 100–700 series apply to an audit of financial statements and are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

ISA 805 deals with special considerations in the application of those ISAs to an audit of a single financial statement or of a specific element, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, ISA 800 also applies to the audit.

ISA 200 requires the auditor to comply with all ISAs relevant to the audit. ISA 805 **requires** the auditor of single financial statements and specific elements, accounts or items of a financial statement to apply ISA 200 irrespective of whether they are engaged as the auditor of the entity's complete set of financial statements.

ISA 210 continues to apply and requires the auditor to consider whether application of the chosen financial reporting framework will result in a presentation that provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement, or element.

### Forming an opinion and reporting considerations

When forming an opinion and reporting on a single financial statement or a specific element, the auditor is still **required to follow ISA 700 and other relevant reporting ISAs, adapted as necessary in the circumstances of the engagement.**

Note that if the auditor of the single financial statement or specific element is also engaged to report on the full set of financial statements, they must provide separate reports for the two engagements.

The auditor shall not express an unmodified opinion on an element if that element constitutes a major portion of the entity's complete set of financial statements and their opinion on the complete set of financial statements as a whole is adverse or they have disclaimed an opinion.

#### Example

Extracts from an auditor's report on a single financial statement prepared in accordance with a fair presentation framework (non-listed entity).

#### INDEPENDENT AUDITOR'S REPORT

(Appropriate addressee)

#### Opinion

We have audited the balance sheet of ABC Company (the Company) as at December 31, 20X4 and notes to the financial statement, including a summary of significant accounting policies (together "the financial statement").

In our opinion, the accompanying financial statement presents fairly, in all material respects, the financial position of the Company as at December 31, 20X4 in accordance with those requirements of the Financial Reporting Framework in Jurisdiction X relevant to preparing such a financial statement.

#### Responsibilities of management and those charged with governance for the financial statement

Management is responsible for the preparation and fair presentation of the financial statement in accordance with those requirements of the Financial Reporting Framework in Jurisdiction X relevant to preparing such a financial statement, and for such internal control as management determines is necessary to enable the preparation of a financial statement that is free from material misstatement, whether due to fraud or error.

### 10.3 ISA 810 Engagements to Report on Summary Financial Statements

Many local jurisdictions allow entities to provide certain users, perhaps employees, with financial statements in a summarised form. These summarised statements present the aspects of the entity's financial performance and financial position which are considered to be the main parts that are useful and necessary for the majority of users.

The entity may ask its auditors to issue a report on these summary statements to add credibility to the information contained in the document. ISA 810

*Engagements to report on summary financial statements* provides guidance on this area.

The **objectives** of the auditor, per ISA 810 are to:

- determine whether it is appropriate to accept the engagement to report on summary financial statements (SFS)
- and, if engaged to:
  - form an opinion on the SFS based on evidence obtained, and
  - express that opinion clearly in a written report that also describes the basis for that opinion.

#### Requirements of ISA 810

The auditor shall not report on the SFS **unless he has already issued an opinion on the full financial statements** from which the SFS are derived.

Before accepting an engagement to report on SFS the auditor shall:

- decide whether the criteria applied by management in the preparation of the SFS are acceptable
- obtain management's agreement that it is responsible for:
  - preparing the SFS in accordance with the above criteria
  - making the "full" (i.e. audited) financial statements available to the users of the SFS
  - including the auditor's report on the SFS in any document which contains the SFS.

The "applied criteria" may be established by law or regulation.

The auditor shall perform the following **procedures** as a basis for his opinion on the SFS:

- Evaluate whether the SFS adequately disclose:
  - their summarised nature and identify the full financial statements
  - the criteria applied in the preparation of the SFS.
- When the SFS are not accompanied by the full financial statements, consider whether the SFS describe clearly where the full financial statements are available or the law or regulation which states that they need not be.
- Compare the SFS to the full financial statements to ensure they agree with or can be derived from the latter.

- Evaluate whether:
- the SFS have been prepared in accordance with the applied criteria
  - the SFS contain sufficient information so as not to be misleading
  - the full financial statements are readily available (unless not required to be).

Where the auditor is able to give an **unmodified opinion** on the SFS one of the following phrases shall be used:

- "The accompanying SFS are consistent, in all material respects, with the audited financial statements, in accordance with [applied criteria]", or
- "The accompanying SFS are a fair summary of the audited financial statements, in accordance with [applied criteria]."

The term 'true and fair' (or its equivalent) is not used in the report, because the SFS will not contain all the information required by a recognised financial reporting framework.

### Reporting

The auditor's report on the SFS shall include the following elements:

- Title
- Addressee
- Identification of the SFS on which the auditor is reporting
- Identification of the audited financial statements
- An opinion.
- A statement indicating that the SFS do not contain all the disclosures required by the financial reporting framework applied in the preparation of the audited financial statements and auditor's report and that reading the SFS is no substitute for reading the full financial statements or auditor's report.
- A statement that neither set of financial statements reflects the effect of events that occurred after the date of the auditor's report on the full financial statements (if the report on the SFS is dated later than the auditor's report on the full financial statements – note that it cannot be dated earlier).
- A reference to the auditor's report on the audited financial statements, its date and the type of opinion given in that report (e.g. unmodified)
- A description of management's responsibility for the SFS (the preparation of the SFS in accordance with the applied criteria).
- A statement that the auditor is responsible for expressing an opinion on the SFS based on the procedures required by this ISA.
- Auditor's signature.
- Auditor's address.
- Date of the report.

Note that the auditor might have issued a **qualified opinion on the full financial statements** or used an **emphasis of matter or other matter paragraph** but may nevertheless be satisfied that the SFS are properly derived from those full financial statements. In this situation, the auditor's report shall also describe:

- the basis for the opinion
- any effect of the opinion on the SFS.

If the opinion was an **adverse or disclaimer of opinion** the auditor's report on the SFS shall state that it is **inappropriate to express an opinion on the SFS**.



#### Example

Extracts of a report on SFS is set out below. This example is based on circumstances where an unmodified opinion was expressed on the audited financial statements and the auditor's report on the SFS is dated later than the "full" auditor's report

#### REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS

(Appropriate addressee)

##### Opinion

The summary financial statements, which comprise the summary statement of financial position as at December 31 20X3, the summary statement of comprehensive income, summary statement of changes in equity and summary statement of cash flows for the year then ended, and related notes, are derived from the audited financial statements of ABC Company for the year ended December 31 20X3.

In our opinion, the accompanying summary financial statements are consistent, in all material respects, with the audited financial statements in accordance with [describe established criteria].

##### Summary financial statements

The summary financial statements do not contain all the disclosures required by [describe financial reporting framework applied in the preparation of the audited financial statements]. Reading the summary financial statements and the auditor's report thereon, therefore, is not a substitute for reading the audited financial statements and the auditor's report theron. The summary financial statements and the audited financial statements do not reflect the effects of events that occurred subsequent to the date of our report on the audited financial statements.

##### Management's responsibility for the summary financial statements

Management is responsible for the preparation of the summary financial statements in accordance with [describe established criteria].

##### Auditor's responsibility

Our responsibility is to express an opinion on whether the summary financial statements are consistent, in all material respects, with (or are a fair summary of) the audited financial statements based on our procedures, which were conducted in accordance with International Standard on Auditing (ISA) 810 (Revised) *Engagements to report on summary financial statements*.

[Auditor's signature]

[Auditor's address]

[Date]

## 11 CHAPTER REVIEW

### Chapter review

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

- Audit opening balances and comparatives
- Explain the impact of going concern on the auditor's report as required by ISA 570
- Describe in detail the contents of an auditor's report
- Identify when the basic auditor's report should be modified, and if so, how
- Explain the auditors' duties with respect to other information in documents containing audited financial statements as per ISA 720
- Discuss which matters should be communicated with those charged with governance, and describe the communication process
- Briefly describe the form, content and use of specialised auditor's reports

### Quick quiz questions

- 1 On checking the other information that an audit client intends to publish with the financial statements and auditor's report, the auditor discovers some material inconsistencies in the other information. He asks the client's management to correct the other information, but they refuse.

Which of the following measures may the auditor now take?

- 1 Include a statement that there is an uncorrected material misstatement in the other information paragraph in the auditor's report
  - 2 Ask those charged with governance to correct the other information
  - 3 Withhold the issue of the auditor's report
  - 4 If allowed by law, withdraw from the audit
- A 1, 2 and 3 only  
B 1, 2 and 4 only  
C 1, 3 and 4 only  
D 2, 3 and 4 only
- 2 Which of the following will NOT be provided in an auditor's report?  
A 'Except for' opinion due to material limitation in scope  
B Unqualified opinion  
C Adverse opinion due to pervasive limitation in scope  
D 'Except for' opinion due to material disagreement
- 3 Which part of the auditor's report should include a statement that the auditor's report has been carried out in accordance with ISAs?  
A auditor's responsibilities for the audit of the financial statements  
B key audit matters  
C auditor's opinion  
D responsibility of management for the financial statements
- 4 Which of the following affect the audit opinion?  
1 material limitation on scope  
2 material disagreement  
3 emphasis of matter  
A 1 and 2 only  
B 1 only  
C 2 only  
D 1, 2 and 3.

- 5 When the auditor disagrees with a specific item in the financial statements, but considers that the financial statements as a whole give a true and fair view even though the matter is material, the auditor's report should:

A give a disclaimer of opinion  
B give an 'except for' opinion  
C state a disagreement  
D include an 'emphasis of matter' paragraph.

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**Quick quiz answers**

1 C

There is no reason to qualify the auditor's report if the auditor considers the financial statements to give a true and fair view. However, it is a matter of concern that the audit client will issue other information with the financial statements and auditor's report, which contain significant inconsistencies or misstatements of fact. (Users of the financial statements may assume incorrectly that the other information has been audited.)

2 C

A pervasive limitation in scope should lead to a disclaimer of opinion.

3 A

4 A

An emphasis of matter paragraph does not affect the audit opinion.

5 B

When there is material limitation on scope or a material disagreement, the auditor's report should give an 'except for...' opinion.

## **Current issues**

### **Contents**

- 1 Ethical issues
- 2 The accountancy and auditing profession
- 3 Transnational audits
- 4 Small companies
- 5 The impact of social and environmental matters on the statutory audit
- 6 Social and environmental reports and audits
- 7 Developments in emerging technologies
- 8 Companies and Allied Matters Act 2020
- 9 Chapter review

## INTRODUCTION

### Competencies

#### Laws, regulations and ethical issues

- A6** Evaluate and communicate the differences between various jurisdictions and how they deal with audit issues including national and international approaches such as the US Sarbanes-Oxley and related requirements for audit.

#### Planning and undertaking audit work

- C1 (m)** Describe the appropriate procedures for assurance engagements in respect of corporate social responsibility and sustainability reports.
- C5 (a)** Explain the impact of IT in an auditing environment.

### Exam context

As students progress into more senior positions within their firms it becomes even more important for them to keep abreast of current affairs in the audit and assurance industry.

This chapter summarises a number of key current affairs. There is also a section that deals with social and environmental audit and assurance, another growing market for practitioners.

At the end of this chapter, readers should be able to:

- Discuss current affairs impacting the audit and assurance industry
- Describe the demand for social and environmental reporting
- Summarise what is involved in a social and environmental audit
- Briefly explain developments in emerging technologies
- Explain the current issues and the Exposure Drafts in circulation
- Explain emerging technologies relevant to the auditing profession

## 1 ETHICAL ISSUES

### Section overview

- Introduction
- Regulation of auditing: an ethical framework or a rule book?
- Auditor independence
- The provision of non-audit services to audit clients
- Auditor rotation

#### 1.1 Introduction

Students need to be aware of current issues in auditing. These issues include ethical issues and the problem of auditing and exemption from audit of small companies.

Students should monitor the professional press for further developments over the course of their studies.

#### 1.2 Regulation of auditing: an ethical framework or a rule book?

There are generally recognised to be two methods of regulating the behaviour of individuals:

- a **rulebook approach**: this sets out the rules about what must and what must not be done - 'you must not do that'
- a **framework approach**: this sets out principles that should govern behaviour, with reasoned arguments to support the principles - 'you should understand why it is not acceptable to do that'.

Both approaches may be enforced by sanctions against individuals who do not comply.

There are a number of **advantages** of adopting a framework approach as opposed to a rulebook approach for regulating the behaviour of accountants and auditors.

- It is impossible to develop rules that will deal with all situations.
- In a rules-based system, the rules may be interpreted too narrowly. If so, the rules cease to be of practical value, because they cannot be applied with confidence in practice (unless there is a very detailed set of rules).
- An ethical framework is therefore more flexible. It sets out general principles and requires accountants to apply the general principles to the circumstances of each case that arises.
- It may also be argued that accountants are professionals with an ethical code of conduct: consequently, they do not need to have their behaviour regulated by detailed and strict rules and regulations.

#### 1.3 Auditor independence

It is well established that independence is fundamental to the credibility of the audit process. Much of the current thinking on independence has been developed by the Securities and Exchange Commission (SEC) in the USA. The work of the SEC has followed on from the corporate scandals in the US in 2001

and 2002, such as Enron and WorldCom. Similar proposals have been put forward in the UK and in other countries.

In the case of Enron, false accounting and fraud led to the company filing for bankruptcy in 2001. At that time, Enron was an energy company based in Houston, USA and had over 20,000 employees. Arthur Andersen, Enron's auditors, provided Enron with numerous consultancy services in addition to audit and were accused of not wanting to raise issues in the audit for fear of losing this lucrative consulting work. The audit firm was later found to have shredded documentation relating to the Enron audit. This all caused enormous damage to Arthur Andersen's reputation, many audit clients left and the firm eventually broke up with the loss of 85,000 jobs worldwide.

A massive fraud discovered at another US company WorldCom in 2002 also resulted in bankruptcy and the loss of thousands of jobs.

Both these scandals left the US government in need of a response in order to restore investor's trust in the markets and the audit process. That response came about in January 2003 when the SEC adopted rules to implement the **Sarbanes-Oxley Act 2002** on corporate governance. The rules aim to strengthen auditor independence and require additional disclosures to investors about the services provided to corporations by an independent accountant.

The SEC approved the following measures:

- The rules relating to non-audit services were revised, in cases where the independence of the firm would be impaired if it provided the non-audit services to the audit client.
- Rules for the rotation of audit partners. Certain partners on the audit engagement team should be 'rotated' (= changed) after no more than five or seven consecutive years, depending on the partner's involvement in the audit. However, some small accounting firms may be exempt from this requirement.
- Establish rules that an accounting firm would not be considered to be independent if certain members of management of the clients had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of the audit.
- A firm should not be considered to be independent from an audit client if any audit partner involved in the audit has obtained payment (for the firm) for services relating to engagements with the client for services other than audit, review and attestation services.
- The auditors should be required to report certain matters to the client's audit committee, including reports on any 'critical' accounting policies that are being used by the client.
- The audit committee of the client should be required to approve in advance all audit and non-audit services provided to the client by the auditor.
- There should be disclosure to shareholders of information about audit and non-audit services provided to the client by the auditor, and the fees for those services.

#### 1.4 The provision of non-audit services to audit clients

##### Non-audit services that might impair the firm's independence

The **Sarbanes-Oxley Act** (mentioned above) lists nine non-audit services that are considered to impair the firm's independence if they are provided to an audit client by the firm. These are set out below.

**(1) Book-keeping or other services related to the accounting records or financial statements of the audit client**

The rules prohibit an accountant from auditing the book-keeping work performed by his or her accounting firm on behalf of a client.

**(2) Financial information systems design and implementation**

The rules prohibit a firm from providing any service related to the information systems of the audit client, unless it is reasonable to conclude that the results of these services will not be audited.

These rules do not prevent a firm from working on the hardware or software systems of an audit client, if these are unrelated to the client's financial statements or accounting records and provided that the provision of these services by the firm is approved in advance by the audit committee.

**(3) Appraisal or valuation services, fairness opinions, or contribution-in-kind reports**

All these activities are essentially services involving a report from an accountancy firm on the valuation used in a transaction.

The rules prohibit an accounting firm from providing such services, unless the results of these services will not be audited as part of the audit of the financial statements.

**(4) Actuarial services**

The rules prohibit an accounting firm from providing any actuarial advisory service to an audit client that involves a decision about amounts to be recorded in the financial statements (and related accounts) of the audit client.

Such a service may apply, for example, to the valuation of pension funds (which is connected to the valuation of pension fund liabilities).

An accounting firm may, however, assist a client in understanding the methods, models, assumptions and inputs used in computing an amount.

**(5) Internal audit outsourcing services**

The rules prohibit the accounting firm from providing any internal audit service that has been outsourced by the audit client, where the internal audit work relates to the audit client's internal accounting controls, financial systems or financial statements.

This means that internal audit work relating to operational controls and compliance (operational audits, VFM audits and compliance audits) by the accounting firm are permissible.

**(6) Management functions or human resources**

The rules prohibit an accounting firm from:

- acting (even in a temporary capacity) as a director, officer or employee of an audit client, or
- performing any decision-making, supervisory, or ongoing monitoring function for the audit client.
- The independence of an accounting firm will also be impaired if the firm aids the audit client in connection with any senior level management appointment. An accountant's independence is impaired with respect to an audit client when the accountant:

- seeks out prospective candidates for managerial, executive or director positions within the client company, or
- acts as negotiator, on the audit client's behalf, with any person who has applied for a senior management position, or
- undertakes reference checks of prospective candidates for a senior management position.
- Under this rule, an accountant's independence will also be impaired when the accountant:
- engages in psychological testing or other formal testing or evaluation programmes, or
- recommends or advises the audit client to hire a specific candidate for a specific job.

**(7) Broker or dealer, investment adviser, or investment banking services**

Acting as a broker-dealer, promoter or underwriter on behalf of an audit client will make the accountant an advocate for the audit client and will impair his independence.

**(8) Legal services**

An accounting firm is prohibited from providing to an audit client any service that could be provided only by someone qualified to practise law in the jurisdiction in which the service is provided.

**(9) Expert services unrelated to the audit**

The rules prohibit an accounting firm from providing expert opinions to an audit client, for the purpose of advocating that audit client's interests in litigation or in any regulatory or administrative proceeding or investigation.

**Advantages and disadvantages of the auditor providing non-audit services**

**Advantages**

The accounting firm is in an excellent position to provide its client with non-audit services. This is because:

- it already has an extensive knowledge of its client, the client's business and its systems, and
- it should therefore be able to provide the additional non-audit services to the client at a lower cost than other accountancy firms, and with less disruption to the client.

Non-audit work also makes accounting firms more attractive in the recruitment market, because a wider range of work experience can be offered to trainees.

**Disadvantages**

However, there are some obvious disadvantages to providing non-audit services.

- The accounting firm may be seen by the world at large to lack independence from the client, because of the large fees it receives for audit and non-audit work. (This was a criticism levelled at the Houston office of accounting firm Andersens, following the collapse of Enron.)
- Accountants from the accounting firm may find themselves in a position where they are making management decisions. (If so, their independence is impaired.)

### 1.5 Auditor rotation

The need for auditor rotation has been a topic of discussion, following various major corporate failures in recent years. There has been a general perception that in many cases of corporate collapse, the accounting firm was 'too close' to the audit client and had failed to detect the warning signs of collapse for the client to take appropriate preventative measures.

It has therefore been suggested that there should be a regular change in the individuals who perform the audit of a client company. This should prevent the auditor from becoming too familiar with the client and key members of the client's staff as a result of developing a long and 'comfortable' relationship.

There are two different suggestions about how auditor rotation should be achieved.

- Audit partner rotation.** The accounting firm may remain as auditors of the same client company for an unlimited number of years (or until the company decides to change its auditors). However, the 'lead' engagement partner and other key members of the audit team should be 'rotated' regularly.
- Audit firm rotation.** Alternatively, the accounting firm itself should remain as auditor of a client company for no longer than a specified maximum number of years, say five years or seven years. Note that in many countries (including Nigeria) this would require legislative amendment as the law frequently provides that auditor's appointment is for one year, renewable indefinitely.

Audit partner rotation has been adopted in most countries. However, audit partner rotation is not visible to the world at large. In contrast, accounting firm rotation would provide a public demonstration of auditor independence.

#### Arguments in favour of accounting firm rotation

There are several arguments in favour of the rotation of firms providing independent audit including:

- In a long-term audit relationship, the auditors may become too close to management of the client company. This may weaken their professional scepticism and independence. They may be more likely to compromise when disagreements with management occur, in order to preserve the relationship – and the audit, and their fees.
- Even if rotation would not protect the independence of the accounting firm, it improves the public **perception** of independence, and so may increase confidence in the quality of external audits.

#### Arguments against accounting firm rotation

However, there are also a number of arguments against the rotation of firms providing independent audit including:

- There may be negative effects on audit quality and effectiveness in the first years following a change. This is because the new auditors may take several years to familiarise themselves with their new client and its procedures. There is some evidence to suggest that there may be a higher instance of audit failures in the first years following a change of auditors. If this evidence is valid, the connection between company failures and a change of auditors might reflect an inability of the newly-appointed auditor to identify problems in the client company.

- There are also substantial costs from changing auditors regularly, as the auditor attempts to familiarise himself with the new client. More management time is also needed to assist the new auditor to learn about the client company, its operations and its systems.
- There is no evidence that compulsory audit firm rotation has a positive impact on auditor independence and audit quality.
- The market for auditing listed companies is dominated by the 'Big Four' accountancy firms. If this domination of the audit market continues (which is probable), it may be difficult to change auditors easily. The other large firms may not have available resources to take on the audit or may not be 'independent' because of other non-audit services that they already provide.

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## 2 THE ACCOUNTANCY AND AUDITING PROFESSION

### Section overview

- The current structure of the auditing profession
- Incorporation and the problem of auditors' liability

#### 2.1 The current structure of the auditing profession

Because of increasing globalisation of companies, the auditing profession now has three tiers:

- the 'Big Four' international firms (Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers (PwC))
- the second tier – smaller firms but still with numerous offices and international resources
- the small firms.

The 'Big Four' came about from mergers and take-overs within the profession. They have the resources, expertise and geographical coverage to be able to audit the largest global entities. However, this level of amalgamation has left little choice for the largest clients and little competition for those large accounting firms.

#### 2.2 Incorporation and the problem of auditors' liability

In most countries, accountancy and auditing practices were originally established as sole practitioners or (where permitted by local law) partnerships.

With these business structures (sole practitioner and partnership) the owner or owners have unlimited liability for the liabilities of the practice. This would include liabilities arising from legal claims against the firm for negligent audit work. The owners' personal assets as well as business assets are at risk if the firm itself cannot pay claims against it.

This principle of unlimited liability was intended to promote public confidence in the auditing profession and to encourage auditors to carry out their work with due care.

However, problems began to emerge as businesses grew and the size of claims against auditors increased.

One response to this was the introduction of requirements for practising accountants to carry **professional indemnity insurance**, so that liabilities arising from legal claims against a practitioner or partners can be met through an insurance policy. However the premiums for professional indemnity insurance began to rise as the size of claims increased. This has imposed an increasing financial burden on accountancy firms, particularly on smaller firms.

A more recent development for giving financial protection to accountants has been a movement towards removing '**unlimited liability**' **status of auditors**. A number of approaches are available to achieve this. They include the following:

- accountancy practices may be permitted by law to trade as limited liability companies

- accountancy practices may be permitted by law to trade as limited liability partnerships (this is permitted, for example, under UK and Nigerian law)
- statute law may place a maximum limit on the size of legal claims against the auditor
- the auditor may be able to agree with the audit client a maximum limit on legal claims (by the client company), as a formal term in the written contract under which the audit is performed.

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### 3 TRANSNATIONAL AUDITS

#### Section overview

- Definition
- Transnational Audit Committee

##### 3.1 Definition

A transnational audit is an audit of financial statements which are or may be relied upon outside the audited entity's home jurisdiction for the purposes of significant lending, investment or regulatory decisions; this will include audits of all financial statements of companies with listed equities or debt and other public interest companies which attract particular public attention due to their size, products or services provided.

IFAC's Transnational Audit Committee (TAC) gives the following illustrations of transnational audits:

**Example 1:** US Company raising debt finance in Canada.

This will qualify as a transnational audit as it is reasonable to assume that providers of debt finance in Canada will use the financial statements of the company, prepared and audited by American standards, in making decisions.

**Example 2:** International charity taking donations through various national branches and making grants around the world.

This will qualify as a transnational audit as it is operating across national boundaries and is of public interest (being a charity). There is a reasonable expectation that the financial statements of this charity will be used by someone, perhaps donors, in countries other than the one it is domiciled in.

As companies subject to transnational auditing are generally listed, they will have a large amount of regulation in terms of listing requirements and corporate governance requirements which the auditors must be aware of.

Their listed status may also affect the standards by which their financial statements are prepared and audited, for example, if they are listed on a European stock market, the financial statements will have to be prepared according to international financial reporting standards and audited in accordance with international standards on auditing.

Such audits demonstrate the need for harmonised global standards in accounting and auditing.

##### 3.2 Transnational Audit Committee

The Transnational Audit Committee is a committee of IFAC. It represents and meets the needs of the Forum of Firms, which are firms that participate in transnational auditing.

Specific responsibilities of the TAC include:

- Identifying audit practice issues. When the issues suggest changes in auditing or assurance standards may be required, recommend to the appropriate IFAC standard setting boards that the issue be reviewed.

- Providing a forum to discuss 'best practices' in areas including quality control, auditing practices, independence, and training and development.
- Proposing members to the IFAC Regulatory Liaison Group and identifying qualified candidates to serve on IFAC standard setting boards.
- Acting as a formal conduit for interaction among transnational firms and international regulators and financial institutions with regard to audit quality, systems of quality control, and transparency of international networks.

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## 4 SMALL COMPANIES

### Section overview

- An audit is an audit
- Audit exemption for small companies
- The audit of smaller entities
- IAASB Alert: Applying ISAs proportionately with the size and complexity of an entity

#### 4.1 An audit is an audit

'An audit is an audit' is a phrase that may be used to argue that the essential features of all audits are the same, regardless of the nature or size of the entity under audit.

There is some truth in this view. For example, all audits are regulated by ISAs, and all audits result in an opinion from the auditor about whether the financial statements give a 'true and fair view'.

However, the **audit process** itself differs significantly between clients, depending on:

- the key characteristics of the client (such as the size of the client and its operations), and
- the audit strategy adopted for that client.

The entity's size is a key feature of an entity that has a significant impact on the audit approach. Smaller entities may require a very different audit approach from large entities.

#### 4.2 Audit exemption for small companies

Many countries do not require 'small' companies to undergo a statutory annual audit. However, the definition of 'small company' varies between countries. For example:

- in the UK legislation currently exempts from audit all companies with annual revenue not exceeding £6.5 million.
- in the US, only companies listed with the SEC are required to have an annual audit.

In Nigeria it is a requirement that all companies listed on the Nigeria Stock Exchange submit audited financial statements. Furthermore, section 401 of the Companies and Allied Matters Act 2020 states:

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

Small companies (as defined in section 394 of CAMA 2020) are exempted from statutory audit.

It is worth noting that small companies which are exempt from the statutory audit requirement may still choose voluntarily to have an audit of their financial statement in order to enjoy the benefits an independent audit may bring. Benefit

may include, for example, enhanced credibility when attempting to attract new capital.

#### 4.3 The audit of smaller entities

Standard audit practice requires the auditor to gain an understanding of the business and its environment in developing an audit strategy. Applying this principle to the audit of smaller entities will allow the auditor to focus attention on the main features of the client, which will affect the audit approach.

The key issue in deciding the audit approach is likely to be internal control, and the limited nature of the control system.

- Segregation of duties is likely to be weak, due to the restricted numbers of staff employed by smaller entities.
- Owners or senior management are likely to dominate all major aspects of the business activities. This is useful as a form of supervisory control, but the internal controls over management themselves are likely to be very weak and ineffective.
- In an expanding business, senior management may be closely involved in developing the business, leaving them with little time for supervisory controls or for implementing and monitoring other controls.
- Record-keeping and documentation of system and controls may be informal and inadequate. This further weakens the internal control system.

#### Audit approach to smaller entities

The table below summarises the main additional points for the auditor to consider when dealing with a smaller entity.

Area	Comment
<b>Acceptance of the audit appointment</b>	The auditor should be aware of the possible risks to independence, resulting from: <ul style="list-style-type: none"><li><input type="checkbox"/> close involvement with management</li><li><input type="checkbox"/> pressure by management to reduce the audit fee.</li></ul>
<b>Engagement letter</b>	This formalises the relationship between the auditor and the client. If necessary, it separates the accounts preparation function from the auditing function.
<b>Planning and recording</b>	This process will be similar to the audit engagement for larger entities but is likely to be simpler. The audit team may be very small so communication and co-ordination should be easier. A brief memorandum prepared at the completion of the previous audit, updated in the current period based on discussion with the owner-manager, may be sufficient as the documented audit strategy for the current audit.

Area	Comment
<b>Accounting systems</b>	The accounting systems may not be adequate for audit purposes, and the auditor may not be able to rely on the controls in place. As a result, control risk is likely to be high.
<b>Substantive procedures</b>	Substantive procedures are likely to form the basis of the audit work, if controls are weak. However, it is difficult to reach a conclusion on the <b>completeness</b> of accounting records, where the audit is based only on substantive procedures.
<b>Audit evidence</b>	High-quality evidence may be more difficult to find than in a larger entity.
<b>Materiality</b>	A smaller entity's profit before tax may be consistently negligible, as the bulk of any profit may be taken out by the owner-manager as remuneration. A benchmark such as profit before remuneration and tax might therefore be more relevant.
<b>Analytical procedures</b>	Smaller entities may not have interim or monthly financial statements which can be used for analytical review purposes. ISA 315 suggests that the auditor may be able to use an early draft of the entity's year-end financial statements.
<b>Management representations</b>	These are often more important in smaller entities than large entities. However, the auditor must look for evidence to <b>support</b> the management representations.
<b>Going concern</b>	A smaller entity may be more able to quickly respond to opportunities, but it may also be more vulnerable to a bank withdrawing support. The continued financial support of the owner-manager may be vital to the survival of the entity and the auditor will need to assess the risk of that support failing.
<b>Audit report</b>	There may be insufficient evidence as to the completeness and accuracy of the records, which may lead to a qualified audit opinion.
<b>Review of financial statements</b>	This is the same as for the audit of any other company, except that smaller entities may be exempt from certain reporting requirements (for example, from the application of certain requirements of International Financial Reporting Standards).

#### 4.4 IAASB Alert: Applying ISAs proportionately with the size and complexity of an entity

In August 2009 the IAASB issued a questions & answers (Q&A) publication to highlight how the design of the International Standards on Auditing (ISAs) issued by the IAASB under the Clarity Project enables them to be applied in a manner proportionate with the size and complexity of an entity.

Specifically, while ISAs apply to audits of entities of all sizes and complexities, the Q&A focuses on matters that are likely to be of particular relevance to their application in the context of an audit of a small- and medium-sized entity (SME).

The key points include:

- ❑ **The auditor's objectives are the same for audits of entities of different sizes and complexities.** This, however, does not mean that every audit will be planned and performed in exactly the same way. The ISAs recognize that the specific audit procedures to be undertaken to achieve the auditor's objectives and to comply with the requirements of the ISAs may vary considerably depending on whether the entity being audited is large or small and whether it is complex or relatively simple. The requirements of the ISAs, therefore, focus on matters that the auditor needs to address in an audit and do not ordinarily detail the specific procedures that the auditor should perform.
- ❑ Often, SMEs engage in relatively simple business transactions. This means that their audits under the ISAs will generally be relatively straightforward. The alert offers a number of illustrations:
  - the typically simpler structure and processes in an SME often mean that the auditor may obtain an understanding of the entity and its environment in accordance with ISA 315 quite readily and document this in a straightforward manner.
  - Similarly, internal control in the context of an SME may be simpler.
- ❑ The ISAs help guide the auditor in their application to an SME audit by:
  - Specifying alternative procedures regarding understanding the entity's risk assessment process when the entity has not established such a process
  - Specifying a choice of audit procedures based on the particular circumstances e.g., choice of responses to assessed risks for accounting estimates under ISA 540
  - They indicate if a requirement is conditional where those charged with governance and management are the same
  - Individual ISAs also include useful guidance that assists the auditor in understanding or applying specific requirements in the ISAs in the context of an SME audit
- ❑ **The auditor shall comply with all ISAs relevant to the audit.** However, for an SME audit several of the ISAs may not be relevant as the circumstances in which the ISA applies may not exist in the engagement. For example:
  - ISA 402 if the SME does not use a service organisation
  - ISA 510 if the SME audit is continuing and not an initial engagement
  - ISA 600 if the SME audit engagement is not a group audit
  - ISA 610 if the SME has no internal audit function
  - ISAs 800, 805 and 810 if the SME audit engagement is to report on general purpose financial statements
- ❑ Even if an ISA is relevant, not all of its requirements may be relevant. E.g.
  - Holding an engagement team discussion if it is only a one-person team

- Performing specified substantive and other follow-up procedures if the auditor has not identified previously unidentified or undisclosed related parties or significant related party transactions
- Audit documentation assists the auditor in an SME audit. E.g.
  - Assists in planning and performing the audit
  - Provides a record of matters of continuing relevance
  - Enhances the quality of the auditor's judgments

**The ISAs recognise it is unrealistic to expect every aspect of an audit to be documented.** E.g., documenting compliance with matters for which compliance is demonstrated by documents included within the audit file. E.g., An audit plan demonstrates the audit was planned.

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## 5 THE IMPACT OF SOCIAL AND ENVIRONMENTAL MATTERS ON THE STATUTORY AUDIT

### Section overview

- ISA 250: Consideration of laws and regulations in an audit of financial statements
- Other relevant ISAs
- Substantive procedures to detect a material misstatement due to environmental matters

#### 5.1 ISA250: Consideration of laws and regulations in an audit of financial statements

As discussed in a previous chapter, ISA 250 requires the auditor to obtain sufficient appropriate evidence in respect of non-compliance with laws and regulations which might be expected to have a direct effect on material amounts and disclosures in the financial statements. Non-compliance could be over a variety of social or environmental matters such as:

- health and safety legislation
- equal opportunities legislation, or
- anti-pollution legislation.

Social or environmental matters can have a direct impact on the statutory audit. This is because a breach of social or environmental legislation may have a material impact on the financial statements. For example, if an entity is in breach of social or environmental legislation (or other regulations):

- it may need to include a provision for fines or penalties in its financial statements
- it may need to disclose a contingent liability for a possible settlement in a court case, where the entity is facing a civil lawsuit for damages arising from a breach of environmental or social regulations
- it may be required by law to improve working conditions or rates of pay, which will affect labour costs
- it may be necessary to write down the value of certain assets due to impairment.

#### 5.2 Other relevant ISAs

There are some other ISAs that include a reference to social or environmental aspects of the external audit.

##### ISA 315: Identifying and assessing the risks of material misstatement through understanding the entity and its environment

The auditor should evaluate the environmental risks facing a client entity, and the controls that are in place to manage those risks. ISA 315 therefore requires the auditor to be aware of:

- relevant environment legislation
- the nature of the production processes used by the entity, and

- the general impact of the entity's activities on its physical environment.

Environmental risks will include:

- contingent liabilities arising from legal claims against the entity, as a result of environmental damage or a breach of environmental protection regulations
- provisions that may be required for restoration costs
- expenditure that may be required to modify or clean the production processes and re-design products, in order to meet environmental regulations.

#### **ISA 330: The auditor's responses to assessed risks**

ISA 330 requires the auditor to design audit procedures that take into consideration the environmental risk assessment. Designing suitable audit procedures to assess environmental risk will probably require a high level of professional judgement from the auditor. In particular, judgement may be required as to whether a liability exists, and if so, how it should be measured. As a result:

- the auditors may need to take advice from external experts, and
- written management representations should be obtained about the environmental risks.

#### **ISA 540: Audit of accounting estimates**

ISA 540 includes a requirement that the auditor should review the approach taken by management to making estimates that relate to environmental risks.

### **5.3 Substantive procedures to detect a material misstatement due to environmental matters**

The external auditors may design substantive tests for detecting a material misstatement in the financial statements due to environmental matters. The substantive tests may consist of the following checks:

- A review of documents such as:
  - minutes of meetings (board meetings, audit committee meetings, environmental committee meetings)
  - industry information
  - media comment
  - environmental reports and audits
  - internal audit reports
  - due diligence reports
  - reports from regulators
  - correspondence with environment agencies
  - correspondence with solicitors.
- The auditors may use an external expert to provide advice (in accordance with ISA 620).

- The auditors may use the work done by the internal audit department to investigate environmental risks and controls within the entity.
- The auditor may make some inquiries about the insurance cover obtained by the entity for its environmental risks.
- The auditors should obtain written representations from management that they have considered the effects of environmental matters on the financial statements, and that:
  - they are not aware of any material liabilities or contingencies arising from environmental matters, including those resulting from illegal or possibly illegal acts
  - they are not aware of environmental matters that may result in a material impairment of assets, or
  - if they are aware of such matters, they have disclosed all the relevant facts to the auditor.
- The auditor should ask about the policies and procedures of management for assessing the need to write-down the carrying amount of assets, in situations where any impairment of assets has occurred due to environmental matters. The auditor should also consider the adequacy of any write down of assets that the entity has made.
- The auditor should ask about the policies and procedures that are used by the entity to help identify liabilities, provisions or contingencies arising from environmental matters.
- The auditor should ask about events or conditions that may give rise to liabilities, provisions or contingencies arising from environmental matters. For example, the auditor should ask whether there have been:
  - violations of environmental laws and regulations
  - penalties arising from violations of environmental laws and regulations, or
  - claims and possible claims for environmental damage.
- If the entity has identified a need for site clean-up costs, restoration costs or penalties arising from non-compliance with environmental laws and regulations, the auditors should inquire about any related legal claims or possible legal claims.
- The auditor should ask whether there is any correspondence from regulatory authorities relating to environmental matters. When such correspondence exists, the auditor should consider whether the correspondence indicates the existence of a liability, provision or contingent liability.
- When property (land or buildings) has been abandoned, purchased, or closed during the period, the auditor should ask about regulatory requirements for cleaning up the site, or about the intentions of the entity with regard to clean-up, future removal of the building and site restoration at the end of the asset's life.
- The auditor should perform analytical procedures and consider, as far as practicable, the relationships between financial information and quantitative environmental information. For example, the auditor might analyse the entity's environmental records and establish whether there is a relationship between raw materials consumed and waste production/emissions.

- The auditor should review and test the process used by management to develop accounting estimates and disclosures relating to environmental matters. A review might consist of obtaining an estimate from an independent expert to corroborate the estimates of management. Alternatively, the auditor might be able to verify the estimates of management from subsequent events after the reporting period.
- For all liabilities, provisions, or contingencies related to environmental matters, the auditor should consider whether the assumptions underlying the estimates are appropriate, and whether the amount of the liability, provision or contingency is reasonable.
- The auditor should review the adequacy of the disclosures in the financial statements about the effects of environmental matters.

## 6 SOCIAL AND ENVIRONMENTAL REPORTS AND AUDITS

### Section overview

- The significance of social and environmental reporting
- Environmental reports
- Environmental audits
- Social reports and audits
- Audit evidence for social and environmental reports

#### 6.1 The significance of social and environmental reporting

Under pressure from public opinion, many entities are now aware of social and environmental issues, and the effect that the entity has on social and environmental matters in the countries where it operates. If it fails to recognise social and environmental problems and is not seen to be doing something about them, an entity's reputation may be at risk. Reputational risk can have consequences for customer demand for the entity's products. Many members of the public may refuse to buy goods from companies, or invest in the shares of companies, unless those companies have 'healthy' social and environmental policies.

The senior management of some major entities would argue that they show more concern for social and environmental matters than governments.

It has therefore become increasingly important for companies to demonstrate their social and environmental policies, by publishing social and environmental reports, or through their web sites, advertising and media reports.

In most countries including Nigeria, reporting on social and environmental issues is voluntary. However, the EU has recently issued an accounts modernisation directive, requiring quoted companies to publish a business review each year. This review should include information about a range of issues, including social and environmental matters.

#### Environmental policies

An entity's environmental policies might cover such matters as:

- Energy consumption
- pollution
- the use of natural resources and sustainability of the business
- use of re-cycled materials.

#### Social policies

Social policies might cover such areas as:

- employee rights (for example, rights to trade union membership)
- employee training and development
- human rights
- child labour in developing countries
- equal opportunities

- health and safety matters
- relationship with the local community
- supporting local, national and international good causes.

Many large companies now publish a social and environmental report, sometimes called a sustainability report. The aim of such reports is to demonstrate that the company has a strong social and environmental conscience and is actively engaged in improving social and environmental conditions.

Credibility can be added to these reports by an **independent verification statement** from a firm of accountants or similar firm of independent external experts.

## 6.2 Environmental reports

Many larger entities whose activities have an environmental impact now publish an annual environmental report or sustainability report. This may be published as part of the company's annual report. More often, it is published as a separate document.

The contents of environmental reports are not regulated, and although the external auditors may review the reports, they are not included within the scope of the statutory audit opinion. However, some entities engage external 'environmental experts' to review and report on their environmental reports.

An environmental report is seen as an important indicator of the commitment that the entity is giving to its impact on the physical environment and the future of the planet and its peoples.

An environmental report may cover such matters as:

- environmental performance targets and the extent to which they have been achieved (for example, in its 2005 sustainability report, Shell reported on whether it had met targets with respect to oil spills and greenhouse gas emissions)
- relevant environmental regulations imposed on the entity, and the extent to which they are complied with
- compliance with industry standards or other environmental standards
- the entity's policy on 'sustainable development'. Sustainability refers to the ability of the entity to meet the needs of the present generation of customers without adversely affecting future generations. For example, a supplier of timber may have a policy of re-forestation of large geographical areas, to replace timber that they cut down

## 6.3 Environmental audits

An environmental audit can be defined as:

*'...a management tool, comprising a systematic, objective assessment of how well an entity is performing with the aim of safeguarding the environment by enhancing management control of environmental practices including compliance with appropriate legislation and regulations.'*

An environmental audit may be performed by:

- the entity's external auditors, or
- the internal auditors, or
- external environmental experts.

Environmental audits are not subject to the same high level of regulation as financial audits. However, if an environmental audit is performed by professionally qualified accountants, it would be subject to the usual requirements of codes of professional practice for accountants.

Typically, an environmental audit involves an assessment of all impacts of the entity's activities on the environment, including:

- compliance with environmental regulations, for example on pollution of land, water and air
- waste disposal
- recycling policies
- sourcing of raw materials.

The accountant performing an environmental audit will determine the environmental policies that the organisation has in place and assess the entity's performance based on measurable performance criteria. For example, actual performance measures for pollution might be compared with pre-established targets.

#### 6.4 Social reports and audits

Many entities now publish a 'social report' or social information, often together with an environmental report. These reports may be subject to an audit or review process, by the entity's external auditors, internal auditors or external experts.

A social audit assesses whether a company has achieved its set social targets and objectives. For example a company with the objective of investing in its staff may set a target to provide all staff with a minimum number of hours training each year. A social audit will provide independent verification that the company has met this target. Since a social audit is voluntary the social audit report does not need to be published. However, companies may find it beneficial to publish the report to demonstrate their social responsibility and improve their corporate image.

An extract from the social report section of Shell's 2005 Sustainability Report gives some indication of the topics that these reports might cover.

##### Example:

##### Extracts from Shell's 2005 Sustainability Report

Living consistently by the Shell General Business Principles remains an important part of our culture. It requires concerted effort, particularly as the search for more oil and natural gas continues to take us to difficult locations and sensitive countries.

##### Human rights

We turn our commitment to human rights into action in many ways. One is by providing employees with a safe and healthy workplace, and access to unions, grievance procedures and staff councils. Another is avoiding the use of child

labour. A third is taking security measures that do not compromise the rights of the communities in which we operate.

We use independent Country Risk Assessments from a leading international human rights institute to help us understand human rights risks when we enter a new location.... Risk areas are highlighted, such as labour rights of migrant workers or behaviour of security forces. We then develop a set of actions to help us avoid violating rights in these risk areas.

#### **Contractors**

Contractors must manage HSE in line with our Health, Safety and Environment standard and are expected to follow our, or equivalent, business principles. In many countries, we work with contractors to help them understand and comply with these requirements. If they cannot, we are required to review the relationship.

In 2005, we cancelled 63 contracts because of such concerns.

#### **Our people**

We are committed to preventing incidents – such as spills, fires and accidents – that are a risk to people, the environment and our facilities. All Shell companies, contractors and joint ventures we control are obliged to operate in line with our Health, Safety and Environment (HSE) standard.

It requires them to take a systematic approach to managing their HSE risks. All our major facilities must be certified to the international ISO 14001 environmental standard. Sites must have emergency response plans and test them regularly, so that damage can be minimized in the event of an incident. We investigate serious incidents and near misses, so we can learn from them and help prevent similar incidents happening in the future.

#### **Labour rights and child labour**

We have made a specific commitment not to exploit children, through direct employment or indirectly through joint ventures, contractors or suppliers. By the end of 2005, Shell companies in nearly 90% of the countries where we operate had procedures to prevent the use of child labour.... Shell companies in nearly 70% of countries where we operate screened their contractors for child labour and nearly two-thirds screened their suppliers, up from less than a third five years ago.

#### **Shell in society: our contribution**

Our biggest contribution to society is through our products – the energy and petrochemicals that modern economies need. But our operations can also make a strong, positive contribution to development.

#### *Turning payments to governments into social benefits*

In 2005, we paid over \$19 billion in corporate taxes and \$2 billion in royalties. We collected more than \$72 billion in sales taxes and excise duties....

In energy-producing countries, oil and natural gas revenues can bring widespread benefits. Managed well, the money can fund services such as schools and hospitals and diversify the economy. Managed badly, it can stimulate corruption, breed conflict and hurt the country's competitiveness. We encourage and support host governments' efforts to use energy revenues wisely. We enforce our policy of zero tolerance of bribes and facilitation payments....

## 6.5 Audit evidence for social and environmental reports

In most countries there are currently only limited statutory requirements or no statutory requirements at all, about social and environmental reporting. For example in the European Union, quoted companies are required to include some information about social and environmental risks in their annual business review, but there are no rules about what these disclosures should contain.

Since companies decide what to include in their social and environmental report, the report may contain very few verifiable numbers and may consist largely of narrative ('words, not numbers').

However some companies have chosen to include quantified performance measurements in their social and environmental report. (Some companies publish 'sustainability reports'. These report figures for financial performance, social performance and environmental performance. Sustainability reports are sometimes referred to as 'triple bottom line reporting', because they present performance reports for each of these three areas.)

When social and environmental reports include quantified performance figures, performance is often reported by comparing actual performance against target for a number of different 'key performance indicators' or KPIs. The KPIs vary according to the nature of the company and its business.

To make these reports more convincing and believable to users, the figures may be audited to verify that they are reliable. In the exam you may be asked to:

- propose a number of different KPIs for a social and environmental report and
- provide suggestions about how an auditor might obtain evidence to verify the reliability of the performance measurements in the report for each KPI.

### Example: KPIs

The KPIs and sources of audit evidence in the table below are illustrative only. They provide an indication of the nature of performance measurements for social and environmental issues. The selection of KPIs is a matter of choice for the company itself, and the performance measurements used therefore, vary widely. (Remember that social issues include matters relating to employment and employees as well as matters relating to society as a whole and the 'corporate citizenship' of the company.)

Key performance indicator	Possible source of audit evidence
<b>Social indicators: employees</b>	
% of employees who are women, or from particular ethnic groups or in particular age groups (as evidence of non-discrimination)	Personnel file
Staff turnover ratio	Personnel files
Spending one employee training	Cash book or training account in the main ledger
Absentee levels	Payroll records, records of medical evidence of 'sick leave'
Injuries at work: number or expressed as a % of the workforce	Health and safety records

<b>Key performance indicator</b>	<b>Possible source of audit evidence</b>
<b>Social indicators: customers and general public</b>	
Customer satisfaction measurements: number of complaints as a % of sales orders	Records in sales administration
Spending on charitable causes, or investment in particular communities	Cash book or relevant expenditure account in the main ledger.
<b>Environmental indicators</b>	
Increase or reduction in consumption of natural resources (water) and energy	Invoices from utility companies
Pollution levels	Official regulatory measurements
% of waste re-cycled	Observation
Investment in environmentally-friendly materials (such as re-cycled paper)	Observation, purchase orders

## 7 DEVELOPMENTS IN EMERGING TECHNOLOGIES

### Section overview

- Introduction
- Cybersecurity
- Data analytics and big data
- The impact of emerging technologies on audit

#### 7.1 Introduction

Rapid developments in modern technology play a fundamental role in the operations of both practitioners and their clients. Organisations are increasingly falling into one of two categories:

- Established organisations who need to modernise their products and business models to embrace new technology; and
- New organisations whose business models and products are based on modern technology.

Irrespective of which category organisations fall into, technological development increasingly plays a significant role in the future prospects of all organisations. For example:

- Customers often use the internet to source products and information about possible suppliers. E.g., supermarkets, hardware stores and clothing shops offer online ordering and delivery. Online marketplaces such as Amazon, Alibaba and eBay are now commonplace.

Organisations must therefore offer online sales and marketing as a route to market – if they do not they will lose significant custom to competitors who do.

- Organisations integrate the internet into their actual products. E.g.
  - Traditional face-to-face training courses might be offered as online training products.
  - Face-to-face medical and legal advice could be offered by online artificial intelligence products.
  - Music CDs, books and videos are increasingly being replaced by online downloads.
  - At the forefront of technology, driverless cars are being heavily tested.
  - The use of drones in businesses such as parcel delivery, security and surveying is being researched.

Organisations must be aware of how their traditional products have been, or will be, impacted (and potentially replaced) by technology.

- Working models are changing. Manual operations continue to be semi- and fully- automated, for example the preparation of automated online tax returns and expense claims in businesses. Technology developments facilitate increasingly flexible working, such as staff working from home and the emergence of virtual companies and the 'gigconomy'.

The technological business risks for practitioners in the way they offer and deliver their professional services, and the nature of those services, as well as the business risks faced by clients that impact a practitioners' risk and going concern assessments, must be identified, assessed and managed effectively.

## 7.2 Cyber-security

Cyber-attacks on organisations such as distributed denial of service, ransomware and theft of confidential data, intellectual property and design secrets, have arguably become an inevitability rather than mere risk. Attacks are also becoming more sophisticated.

Organisations must embrace cyber-security as a key business risk and invest proportionately and robustly in assessing and responding to such risks. Not only can organisations suffer direct financial losses from cyber-attacks, but they can also suffer:

- Reputational damage;
- Operational disruption; and
- Fines and potential loss of licences due to breach of data security regulations.

The ultimate responsibility for cyber-security strategy sits within an organisation's leadership e.g., boards of directors, trustees and managing partners. It is up to the leadership as to how they discharge that responsibility, although they will typically involve resources such as an IT director, risk committee, internal audit and audit committee (where they exist).

One of the challenges facing organisations is the need to integrate IT and information risks with wider understanding and management of business risks. There is the real risk that boards (and their equivalent) fail to grasp the sheer scale and complexity of the challenge and subsequently leave their organisation vulnerable to devastating cyber-attacks.

Practitioners must consider cyber-security from two perspectives:

- Managing cyber-security within their firm. This includes establishing robust systems and operations that allow staff to work flexibly and remotely, often via the internet and the cloud, whilst safeguarding software, data and processes.
- Considering the cyber-security risks at a client. This might involve identifying, assessing and responding appropriately to the audit risks arising from cyber-security, including the potential impact on going concern.

The practitioner might also offer other assurance services relating to cyber-security and/or system design consultancy.

The practitioner must also consider cyber risk management along an organisation's supply chain given that security breaches have occurred because of vulnerabilities in suppliers.

## 7.3 Data analytics and big data

Data analytics (DA) describes the use of automated techniques to analyse a client's data. The key aim is to help the practitioner achieve a more efficient engagement and add value to their clients.

One of the key challenges facing the practitioner is how to access a client's dataset. The process would normally involve the use of the practitioner's IT experts to extract a copy of the client's data which the practitioner can then analyse and interrogate.

A further challenge is the evolution of 'big data' and how clients and practitioners draw value from it. 'Big data' describes large or complex data sets that traditional data processing application software is unable to deal with. Big data may take an unstructured or semi-structured form, for example rather than traditional records in a database it could include images and social media traffic.

There are no specific rules round when DA can or should be employed. In practice, DA is often used during the risk assessment phase of an assurance engagement to help identify and assess risks. DA may also be employed during risk response, for example in selecting a sample or recalculating an inventory or irrecoverable debt provision.

Examples of DA in practice might include:

- data visualisation - presenting data-sets with graphs, pies, clusters, visuals and dashboards to assist in analysing and understanding the data, e.g. trends by product or region;
- sampling, and in some cases, 100% testing to identify outliers, trends and anomalies;
- recalculating depreciation on PPE by item;
- assessing inventory ageing and the number of days' inventory held in stock;
- applying external FX rates to calculate the valuation of investments.

Some commentators describe DA as modern versions of CAATs in today's digital world. However, this perhaps underplays their relevance and potential in a rapidly technologically advancing world. Currently, DA tends to only be used by the largest audit firms (including all the Big 4) although techniques and capabilities will eventually start becoming more accessible to smaller firms.

Interestingly, the UK's audit regulator, the FRC, recently undertook a review of how DA impacts audits. Their conclusion was that whilst it is happening, there tends to be an over-emphasis of the importance and relevance of DA to audit (so far). That said, tenders for PIE audits now routinely require the bidder to articulate how they will employ DA in engagements.

#### 7.4 The impact of emerging technologies on audit

The fundamental principles of audit and assurance remain the same despite the evolution of new technologies. Subsequently, the IAASB has so far resisted any calls for wholesale changes to the ISAs.

The IAASB is, however, committed to keeping abreast of the impact of technological advancement on audit and assurance and will continue to routinely consider the need to amend the ISAs. The IAASB have set up a project team to this end.

Practitioners must, however, ensure they continue to understand technology applicable to their clients to enable them to identify and assess audit risk appropriately on an engagement.

As time passes, the tools and mechanics employed in performing an audit will continue to evolve as technology advances. For example, the 'bank letter'

procedure which might have taken an associate two weeks to complete as a manual process on a large complex group audit ten years ago might now only take one day to complete and be largely automated. A second example would be where the use of data analytics is used to apply an audit test on a 100% sample to identify all outliers and exceptions for further testing.

The expectation is that over time much of the routine work performed by audit juniors will be automated. This will free up junior staff to focus on more judgemental areas of the audit. However, this may lead to a skills gap associated with the fundamental basic audit techniques that have been automated.

The key impact of technology on audit firms may not be a change in audit principles and standards, but rather a change to the required skillset of the individual audit team members and a shift in the structure and balance of the team. An increase in the training and development of staff in computer technology and data analytic skills is likely both necessary and inevitable to ensure continued audit quality going forward.

ICAN 2022

## 8 COMPANIES AND ALLIED MATTERS ACT 2020

### Section overview

- Introduction
- Key changes relating to audit in the new CAMA

#### 8.1 Introduction

On 7 August 2020, the Nigerian President signed the Companies and Allied Matters bill into law. The new Companies and Allied Matters Act ("CAMA 2020") has replaced CAMA 1990.

The new provisions in CAMA aim to bring Nigeria in line with global standards of best practice and make it easier to carry out business. It is thought that these changes will increase Nigeria's ability to attract and retain foreign investors and benefit the economy.

#### 8.2 Key changes relating to audit in the new CAMA

##### Small business audit exemption

CAMA 2020 reduces certain compliance requirements for small companies (excluding insurance companies and banks). An audit exemption is proposed for companies that have not carried out any business since incorporation and small companies. A small company is defined as those that:

- have a turnover of less than ₦120 million in a financial year and a net asset is not more than ₦60 million;
- have no alien as a member;
- have none of its members to be government, government corporation or its agency; and
- the directors hold at least 51% of its equity share capital.

##### Audited accounts on websites

Public companies are required to keep a copy of their audited accounts displayed on their company website under CAMA 2020. This aims to ensure that investors have easy access to financial information.

##### Corporate responsibility for financial statements

Under CAMA 2020, the chief executive officer and chief financial officer of a company are required to certify the audited financial statements. This certification must state that:

- based on the officer's knowledge, the audited financial statements do not contain any untrue statement of material fact or omit to state a material fact, which would make the statements misleading, in the light of the circumstances under which such statement was made; and
- the audited financial statements and all other financial information included in the statements fairly present, in all material respects, the financial condition and results of operation of the company as of and for, the periods covered by the audited financial statement.

Failure to perform this obligation is an offence liable to a penalty if convicted.

### **Limited liability partnerships**

CAMA 2020 allows limited liability partnerships (LLPs) in Nigeria for the first time. This will allow partnerships the same legal protections as companies.

### **Improper influence on audit**

Under CAMA 2020, it shall be an offence for any officer, director or insider of a company to take any action to influence, coerce, manipulate or mislead any external auditor for the purposes of rendering the financial statements misleading. A person who commits such an offence is liable on conviction to a penalty as the Commission shall specify in its regulations.

ICAN 2021

## 9 CHAPTER REVIEW

### Section overview

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

- Discuss current affairs impacting the audit and assurance industry
- Describe the demand for social and environmental reporting
- Summarise what is involved in a social and environmental audit
- Briefly explain developments in emerging technologies
- Explain the current issues and the Exposure Drafts in circulation
- Explain emerging technologies relevant to the auditing profession

ICAN 2021

### Quick quiz questions

- 1 Which of the following is an argument AGAINST limited liability partnership (LLP) as a structure for an audit firm?
  - A Loss of joint and several liability
  - B Elements of choice as to whether to adopt LLP structure
  - C Loss of perceived integrity
  - D Loss of taxation advantages
- 2 Which one of the following statements is INCORRECT about the requirements of the Sarbanes-Oxley Act in the USA?
  - A The audit committee must approve all audit and non-audit services provided by the external auditors, although not necessarily in advance
  - B There must be full disclosure to shareholders of all fees for both audit and non-audit services provided by the auditors
  - C The auditors should report to the audit committee on any critical accounting policies that management are using to prepare the financial statements
  - D The audit firm cannot be considered independent if a senior accounting executive in the client company was a member of the audit team within the previous 12 months
- 3 Which one of the following is NOT an argument in favour of small company audits?
  - A An audit gives reassurance to user groups other than shareholders, such as trade suppliers
  - B An audit can help to identify potential for improvements in economy and efficiency
  - C Lending banks usually rely on an audit report for lending decisions
  - D An audit can help to impose internal control discipline on a small company
- 4 Which of the following is NOT true about environmental audits?
  - A They are mandatory for all quoted companies
  - B They are additional to the annual audit
  - C The objective is to contribute to safeguarding the environment
  - D The external auditor may perform an environmental audit
- 5 A sustainability report might report on three aspects of performance, sometimes referred to as the 'triple bottom line'. These aspects of performance are:
  - A corporate governance issues, social and environmental issues
  - B compliance issues, social and environmental issues
  - C financial, social and environmental issues
  - D corporate governance issues, environmental issues and financial issues

### Quick quiz answers

1 C

Some commentators argue that the traditional partnership structure encourages high standards of behaviour amongst partners, since they have unlimited liability if they are found guilty of acting dishonestly. An LLP might therefore reduce the perceived standards of integrity in the profession.

2 A

The provisions of the Sarbanes-Oxley Act include a requirement that the audit committee should approve in advance all audit and non-audit services provided by the external auditors.

3 C

Banks usually do not rely heavily on audited financial statements for lending decisions to small companies, although they might use audited statements if they are available.

4 A

Environmental audits are not mandatory in general, although in some countries many companies are required to include information about environmental risks in their annual business review.

5 C

The triple bottom line method of reporting is to report on financial, social and environmental performance (and targets). This is different from ESG reporting, which reports on environmental, social and governance issues.

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- 16.0 Purpose
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- 16.2 Impact of information technology on audit environment
- 16.3 Application of information technology to audit process
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- 16.9 Computer robotics in the audit process
- 16.10 The governing principles of the Nigerian Data Protection Regulation, 2019
- 16.11 National Information Technology Development Agency (NITDA) Act and Nigeria Data Protection Regulation (NDPR)
- 16.12 Chapter review

## **16.0 Purpose**

At the end of this chapter, readers should be able to:

- (a) Impact of information technology on audit environment;
- (b) Application of information technology to audit process;
- (c) Information technology tools applicable in assurance services;
- (d) Software solution for governance, risk and compliance (GRC) process;
- (e) Application of control evaluation frameworks in computerised business environment;
- (f) Risks inherent in e-business environment;
- (g) Application of digital forensics in fraud investigation;
- (h) Computer robotics in the audit process;
- (i) The governing principles of the Nigerian Data Protection Regulation, 2019; and
- (j) National Information Technology Development Agency (NITDA) Act and Nigeria Data Protection Regulation (NDPR).

### **16.1 Introduction**

No doubt, the revolution in the business environment occasioned by massive computerisation of business processes would obviously impact the process of providing audit and assurance services by practitioners. Organisations that migrated to advanced technologies such as cloud services, decentralised computer networks and mobile applications would mean that audit and assurance provisioning would seek for techniques and methodologies that are in tandem with the developments in today's technological driven business operations. In this sense, audit firms and practitioners would develop new audit techniques revolving around similar and enabling technologies necessary for providing quality assurance services.

Digital transformation inspired by technological advancement in the last two decades is disrupting nearly every industry, and auditing is no exception. The pace of technological change today is unparalleled and it has been demonstrated by many experts that most parts of accounting and auditing jobs are highly automatable.

### **16.2 Impact of information technology on audit environment**

The following are some of the new technologies that are likely to impact on audit and assurance services:

- i. Cloud-based accounting systems (cloud computing);
- ii. Big data analytics;
- iii. Artificial intelligence and robotics;
- iv. Blockchain technology; and
- v. Social media.

#### **(a) Cloud Computing Technology**

Some accounting software hosted in the cloud come along with an audit module used for auditing and verifying transactions. When an audit firm subscribes to a cloud-based audit solution, it is relieved of the need to invest in physical onsite servers and the costs associated with its maintenance and support.

Cloud-based audit software affords the auditor the opportunity to work remotely from practically any device with internet connection and serve their clients from any location

and at any time. It further helps audit firms to facilitate collaborations among themselves and clients.

**(b) Big data analytics technology**

Data has become the new cash as it is extremely crucial to make useful business financial decisions. Today, data is not just numbers and spreadsheets that accountants and auditors have been familiar with for years; it also includes unstructured data that can be analysed through automated solutions.

Data analytic software allows real-time monitoring of financial transactions and alerts the auditor on exceptions requiring further investigation. Data is the fuel that powers other technology trends that are transforming finance, accounting and auditing. In the financial realm, data produces valuable insights, drives results and creates better experience for clients. Since everything leaves a digital footprint, the unprecedented digitalisation of our world is creating opportunities to glean new insights from data that was not possible before.

These insights help tax administrators to improve internal operations and build revenue for the government. Through data analytics software, audit firms could offer more valuable advisory services to clients.

Some of the popular data analytic and audit tools available to auditors include:

- i. MS-excel application;
- ii. Active data software;
- iii. Audit command language (ACL) software;
- iv. Integrated data extraction and analysis (idea) audit software; and
- v. TeamMate audit software

**(c) Artificial intelligence and robotics**

Traditionally, audit firms put a lot of efforts to collate and analyse financial data in order to serve clients and taxpayers. Artificial intelligence (AI) and robotics makes it easier for audit firms to simplify and accelerate various data-related tasks. Robotic process automation (RPA) software have been demonstrated to be effective in handling routine and monotonous aspects of the auditor's job.

AI is capable of making auditors more productive as its algorithms allow machines to take over time-consuming, repetitive, and redundant tasks. Rather than just crunch numbers, auditors will be able to spend more time delivering actionable insight on historical financial data of the company. Machines can help reduce costs and errors by streamlining operations of the auditor.

For instance, the optical character recognition (OCR) technology enables practicing firms to automate and accelerate manual entries by converting textual data to digital files using scanners and mobile device cameras.

Apart from automating the repetitive and mundane tasks of auditors, AI would enable them focus on high value functions based on deeper insights on client's data.

**(d) Blockchain technology**

Blockchain technology became popular globally through the advancements in digital currency transactions, such as, Bitcoin. Many businesses now leverage on blockchain technology to record their financial and non-financial transactions in an open, secured and decentralised ledger.

Where the auditors are made part of the transaction flow and given access to the data chain, it makes it possible for them to see each transaction as they occur and be able to advise the client in real time.

Blockchain enables smart contracts, protecting and transferring ownership of assets, verifying people's identities, credentials, etc. Once blockchain is widely adopted, and challenges around industry regulation are overcome, it will benefit businesses by reducing costs, increasing traceability, and enhancing security.

There is an increasing fear that with blockchain, auditors may no longer be useful since the transactions are recorded in an open and distributed ledger where every party's consent is required for the recording to be complete.

**(e) Social Media technology**

Social media platforms are useful tools in the hands of auditors. Primarily, the social media platforms are used for disseminating information due to their wide reach and appeal to the younger generation. Beside information sharing, platforms, such as Facebook, Instagram, Twitter, LinkedIn, are useful for collaboration among practising firms and professional associations.

Many firms that render audit services have made themselves more visible and attractive to clients through the use of social media platforms.

With these digital technologies, it is estimated that some professions will disappear completely, some will develop more, and new branches of professions that were never known will emerge. As a result, it is inevitable that these systems will influence the auditing profession.

### **16.3 Application of information technology to audit process**

The following areas of audit and assurance likely to be affected by the emerging technologies, include:

- (a) Audit engagement planning** – Audit planning involves identifying the areas to be audited; audit team set up; assigning responsibilities to each audit staff; time allocation; establishing the materiality threshold; etc. There are many aspects of these activities that could be automated and made more efficient with the use of technology. Most available off-the-shelf audit software have capabilities and inbuilt tools to enhance audit planning activities.
- (b) Audit risk assessment** - Audit software and advanced data analytic solutions can be used to conduct audit risk assessment – both qualitative and quantitative risk assessment. For instance, in conducting quantitative risk assessment, all that is required is to upload the financial information of the client into the audit software and use existing functions to select and compute the relevant ratios, percentages and proportions for the auditor to interpret. In some cases, the results from the computations are given interpretation by the software and made available for the auditor to review and exercise human judgement.
- (c) Evaluation of internal controls** - After planning and risk assessment, the external auditor is expected to evaluate the operating effectiveness of internal controls which would most likely include computer controls. The only viable means to evaluate computer or IT controls is through the use of computer assisted audit tools (CAATs). Many audit software are built with the capacity to test IT controls to ascertain their level of adequacy and operating effectiveness.

- (d) **Audit substantive testing** - Substantive testing involves the use of analytical procedures and test of details to confirm the completeness, accuracy and validity of financial statements: amounts and disclosures. Ratios and trend analysis can easily be carried out by auditors using a software. Also automated audit solutions could be used to prepare and serve circularisation letters to obtain third party confirmations.
- (e) **Audit reporting** - Auditors normally use word processors and spreadsheets to compile their reports at the end of the exercise. However, modern audit software have embedded reporting modules that could be used by the auditor to put together relevant reports to users. With the help of the reporting modules of these applications, the auditor could convert aspects of his findings into diagrams and pictures which are easier to understand by the executives.

## 16.4 Information technology tools applicable in assurance services

### 16.4.1 Technology tools for the auditor

The following are some information technology tools auditors can deploy:

- (a) **Gantt chart software** - A Gantt chart is originally a project planning tool which is primarily a bar chart to provide a schedule of tasks involved in a project with timelines.

Auditors have found Gantt Chart useful in planning the audit engagement project. With this tool, auditors can view the start and end dates of an audit engagement in one simple chart, with clear list of audit activities. At a glance, the auditors can see:

- i. The start date of the audit engagement;
- ii. The audit activities;
- iii. The audit team members and tasks assigned to each of them;
- iv. The start and finish date of each audit activity;
- v. The link and relationship between audit activities;
- vi. Engagement dependencies;
- vii. The end date of the audit engagement; and
- viii. Identify the critical path to an engagement.

With a Gantt chart software, auditors can create work breakdown structure; assign activities to team members; track the progress of work and make necessary changes in real time. As the auditor inputs the audit activities, their start dates, end dates and their dependencies, the bars will be populated automatically. Please note that the vertical axis of a Gantt chart shows the activities that need to be completed, while the horizontal axis represents time.

- (b) **Risk analysis tool pack** - Managing risk is a necessity of life and should be taken seriously in all human endeavours with predetermined objective. Risk is evidently present in every audit engagement and ISA 315, as discussed in this Study Text, explains the concept of business and audit risk in detail. The risks (positive and negative) that auditors face in the course of their work must be anticipated, identified, evaluated, prioritised and addressed.

To enable auditors manage this process more efficiently and effectively, several automated tools have been developed and made available in the market. The assessment of a risk can either be done qualitatively or quantitatively. The tools which handle these, are called risk management tools.

Some of the popular risk management tools are:

- i. GRC Cloud Resolver;
- ii. SpiraPlan;

- iii. Enablon;
- iv. Checkit;
- v. Analytica;
- vi. Risk Management Studio; and
- vii. A1 Tracker.

It is important to note that most advanced audit software such as audit command language (ACL) and CaseWare IDEA are built with risk management capabilities. In other words, an auditor who purchases a topnotch audit software might not need any other independent risk management tool.

#### **General features and criteria for selecting a good risk assessment solution**

- Some of the features of these solutions include:
- i. Web-based application and good user interface (GUI);
  - ii. Scalability and ease of integration with other solutions;
  - iii. Risk dashboard (quick snapshot of risk issues in a single view);
  - iv. Inbuilt support for risk mitigation activities;
  - v. Risk audit trail (traceability);
  - vi. Support for electronic signatures;
  - vii. Support for generation of reports in MS Word; MS Excel; PDF; XML; HTML formats;
  - viii. Supports printing and emailing the risk reports to various stakeholders;
  - ix. Supports import and export functions;
  - x. Supports auto-alert system on risk related updates;
  - xi. Support for both qualitative and quantitative risk assessment; and
  - xii. Data entry supported by paper, browsers and mobile app.

Please note that the above points can serve as criteria for selecting a good risk analysis tool.

#### **16.5**

#### **Software solution for governance, risk and compliance (GRC) process**

Software solutions that started off as audit software have now been upgraded to become solutions for governance, risk and compliance (GRC).

GRC is more than a software platform or a set of tools, as it is effectively a broad framework that helps with decision-making, emergency preparedness, and collaboration across all segments of an organisation. Any organisation, regardless of industry or size, can benefit from a GRC strategy. It will help optimise performance, stay up-to-date with all compliance requirements, and be proactive in preventing and addressing all threats to your organisation.

Software help organisations manage all of the necessary documentation and processes for ensuring maximum productivity and disaster preparedness. Data privacy regulations like the Nigeria Data Protection Regulation (NDPR) and the Cybercrime Act 2015 can be difficult to navigate for most businesses, but GRC tools can simplify and streamline compliance with all of the requirements.

Some of the popular software solutions for GRC are:

- (a) SAP GRC;
- (b) Enablon GRC;
- (c) Riskonnect GRC;
- (d) RSA Archer GRC; and
- (e) LogicManager GRC.

Considerations in choosing a GRC platform include:

- i. Ease of use;
- ii. Supports mobile application on multiple devices;

- iii. Cloud-based solution;
- iv. Cost;
- v. Security;
- vi. 24/7 customer support; and
- vii. Scalability and ease of integration.

The best GRC tools have the following features to provide an all-in-one solution to businesses irrespective of the industry:

- Content management;
- Document management;
- Risk analytics;
- Risk and Control management;
- Workflow management;
- Audit management;
- Information security;
- Regulatory compliance management; and
- Dashboard and reporting.

## **16.6 Application of control evaluation frameworks in a computerised business environment**

Control objective for information and related technologies (COBIT) is an IT governance tool that has been of tremendous benefits to IT professionals and has contributed immensely to effective control of information systems. Linking information technology and control practices, COBIT, consolidates and harmonises standards from prominent global sources into a critical resource for management and auditors. COBIT, issued by ISACA and IT Governance Institute, represents an authoritative, up-to-date control framework, a set of generally accepted control objectives and a complementary product that enables the easy application of the Framework and Control Objectives, referred to as the Audit Guidelines.

COBIT applies to enterprise-wide information systems, including personal computers, mini-computers, main-frames and distributed processing environments. It is based on the philosophy that IT resources need to be managed by a set of naturally grouped processes in order to provide the pertinent and reliable information which an organisation needs to achieve its objectives.

### **16.6. 1 - The purpose of COBIT**

The purpose of COBIT is to provide management and business process owners with an information technology (IT) governance model that helps in understanding and managing the risks associated with IT. COBIT helps to bridge the gaps between business risks, control needs and technical issues. It is a control model to meet the needs of IT governance and ensure the integrity of information and information system.

COBIT is a framework for the governance and management of enterprise information and technology, aimed at the whole enterprise.

The COBIT framework makes a clear distinction between governance and management. These two disciplines involve different activities, require different approaches and serve different purposes.

(a) **Governance** ensures that:

- i. Stakeholder needs, conditions and options are evaluated to determine balanced, agreed-on enterprise objectives;
- ii. Direction is set through prioritisation and decision making; and
- iii. Performance and compliance are monitored against agreed-on direction and objectives.

In many enterprises, overall governance is the responsibility of the board of directors, under the leadership of the chairperson. Specific governance responsibilities may be delegated to management at an appropriate level, particularly in larger, complex enterprises.

- (b) **Management** plans, builds, runs and monitors activities, in alignment with the direction set by the governance body, to achieve the enterprise objectives.
- (c) **COBIT 2019** consists of four publications, namely:
  - i. Introduction and methodology;
  - ii. Governance & management objectives;
  - iii. Design guide; and
  - iv. Implementation guide.

#### 16.6.2 COBIT 2019 Principles (9 principles in all)

##### (a) **Introduction**

COBIT 2019 was developed based on two sets of principles:

- i. Principles that describe the core requirements of a **governance system** for enterprise information and technology; and
- ii. Principles for a **governance framework** that can be used to build a governance system for the enterprise

##### (b) **Principles for a governance system**

The six principles for a governance system include:

- i. Provide stakeholder value;
- ii. Holistic approach;
- iii. Dynamic governance system;
- iv. Governance distinct from management;
- v. Tailored to enterprise needs; and
- vi. End-to-end governance system.

#### 16.6.3 - Principles for a governance framework

The three principles for a governance framework are:

- (a) Based on conceptual model;
- (b) Open and flexible ; and
- (c) Aligned to major standards.

#### 16.6.4 Components of the governance system (7 components formerly known as 7 enablers)

To satisfy governance and management objectives, each enterprise needs to establish, tailor and sustain a governance system built from a number of components. These components have the following characteristics:

- (a) Components are factors that, individually and collectively, contribute to the good operations of the enterprise's governance system over IT;

- (b) Components interact with each other, resulting in a holistic governance system for IT; and
- (c) Components can be of different types. The most familiar are processes. However, components of a governance system also include organisational structures; policies and procedures; information items; culture and behaviour; skills and competencies; and services, infrastructure and applications.

The components are as follows:

- i. **Processes** describe an organised set of practices and activities to achieve certain objectives and produce a set of outputs that support achievement of overall IT-related goals;
- ii. **Organisational structures** are the key decision-making entities in an enterprise;
- iii. **Principles, policies and frameworks** translate desired behaviour into practical guidance for day-to-day management;
- iv. **Information** is pervasive throughout any organisation and includes all information produced and used by the enterprise. COBIT focuses on information required for the effective functioning of the governance system of the enterprise;
- v. **Culture, ethics and behaviour** of individuals and of the enterprise are often underestimated as factors in the success of governance and management activities;
- vi. **People, skills and competencies** are required for good decisions, execution of corrective action and successful completion of all activities; and
- vii. **Services, infrastructure and applications** include the infrastructure, technology and applications that provide the enterprise with the governance system for IT processing.

## 16.7 Risks inherent in e-business environment

The growth in electronic business and commerce has continued to increase exponentially across most sectors and it does not appear that this will slow down anytime soon. However, there are key risks associated with e-business that should be of interest to GRC professionals. They include:

- (a) Online security risks from hackers;
- (b) Website downtime risk;
- (c) Failure of service providers such as online payment providers;
- (d) Website traffic interruptions;
- (e) Credit card fraud;
- (f) Theft of Intellectual property; and
- (g) Warranty and return of goods policy failure.

To address some of the above risks, organisations involved in e-business should:

- i. Conduct periodic and regular IT awareness programmes;
- ii. Implement robust IT security policies including password protection policy;
- iii. Ensure all devices are protected with anti-malware solutions and firewalls;
- iv. Restrict customer data collection and storage to only those that are needed;
- v. Update all software regularly;
- vi. Ensure regular back up of critical data and applications; and
- vii. Take cyber insurance policy.

#### **16.8 Application of digital forensics in fraud investigation**

Digital forensics is the process of identification, extraction, preservation, examination and analysis of digital information which can be admissible in evidence in the court of law. It can be further defined as the science of finding admissible evidences from electronic media, such as computers, mobile phones, networks, servers, etc.

Digital forensics could be applied in many fields, but most of its global application is in the area of resolving suspected crimes, such as fraud investigation. Some of the cases where digital forensics could be applied include:

- (a) Fraud investigations;
- (b) Intellectual property theft;
- (c) Bankruptcy investigations;
- (d) Forgery;
- (e) Inappropriate use of corporate internet;
- (f) Industrial espionage; and
- (g) Contract disputes.

When fraud investigators apply digital forensic techniques, they are able to identify, collect, analyse and safeguard digital evidences residing in any electronic device used by the perpetrators of the fraud.

A digital forensic practitioner could be engaged or hired by a corporate entity or any of the law enforcement agencies. When performing digital forensic investigation, it is important for the corporate practitioner to follow the same procedures as the law enforcement officers, since his work might equally be used as evidence in the court of law, regardless of whether the case is of civil or criminal nature.

Digital forensic techniques enhance the auditor's capability in the following ways:

- (a) Digital forensics assist the auditor to identify, extract, analyse, and preserve computer evidences and related materials in order to present them as evidences in a court of law;
- (b) It helps to suggest the motive behind the crime and identity of those involved;
- (c) It helps the investigator to ensure that the digital evidences obtained at the crime scene are not corrupted;
- (d) Recovery of deleted files and deleted partitions from digital media;
- (e) Extraction of digital evidence and validate them;
- (f) It helps the auditor to identify the evidence quickly;
- (g) Facilitates the preparation of a computer forensic report which offers a complete report on the investigation process; and
- (h) To preserve the evidence by following the chain of custody.

Digital Forensics can support the objectives in a fraud investigation case:

- (a) To ascertain the actual time of the fraud;
- (b) To determine the exact amount lost;
- (c) To identify those involved in the fraud;
- (d) To determine the locations where the fraud was perpetrated;
- (e) To identify the control lapses that made the fraud possible; and
- (f) To obtain evidences acceptable in the court of law.

#### 16.8.1 Process of digital forensic

The process of digital forensic include:

- (a) **Planning of the work** - This is the first step in digital forensic and involves understanding:
  - i. The purpose of the investigation;
  - ii. Identification of the resources required; and
  - iii. What evidences are present, their locations and how they are stored (in what format).

The auditor could develop various theories and scenarios regarding the crime;

- (b) **Collection and preservation of evidences** - The forensic auditor collects the available information, isolates, secures and preserves them;
- (c) **Documentation and imaging** - At this stage, the auditor creates a record of all the available data. The crime scene needs to be properly documented with photographing, imaging, sketching and mapping techniques;
- (d) **Examination of documents** - The auditor is expected to evaluate and inspect each information in detail to reach an acceptable conclusion. This is likely to involve the use of some advanced tools for data extraction and analysis;
- (e) **Reporting** - The forensic auditor is expected to prepare and present a report in simple language. This report shall contain the procedures employed and conclusions reached; and
- (f) **Returning of evidence** - It is expected that the forensic auditor would return the information and devices used to their original location.

#### 16.8.2 - Examples of digital forensic procedures on allegation of payment to ghost workers include:

- (a) The auditor is to obtain the necessary approval from the chief executive officer of the company to commence the assignment;
- (b) Gain an understanding of and map the workflow for payroll transactions in the company;
- (c) Make arrangement to procure adequate storage space possibly in terabytes and create folders for every evidence type;
- (d) Obtain and scan all hardcopies of payroll information to PDF format;
- (e) Identify all the electronic devices used in processing payroll within the company;
- (f) Collect all electronic devices used and manually tag all evidence items with an assigned case number. Ensure all hard drives are connected to Write-blocker;
- (g) Using audit software, such as ACL, match the names on monthly payroll transaction files to the names on the master file (employee nominal roll);
- (h) Extract the event logs on each device and ascertain any unusual activities and investigate further;
- (i) Run keyword searches on the payroll data obtained. Keywords could include "delete"; "variance"; "no approval"; "difference"; "hired"; "sacked"; "leave"; etc; and

- (j) Obtain and review the email messages of Payroll staff; surveillance videos and CDs available.

#### **16.8.3 Advantages of digital forensics**

- (a) Digital forensics could be used to ensure the integrity of a computer system.
- (b) It guarantees speed and accuracy of information.
- (c) It could lead to reduction in global crime rate, especially in jurisdictions with advanced digital forensic techniques.
- (d) It produces the strongest evidences in the court, which can lead to the prosecution and conviction of the suspect.
- (e) It assists in capturing important information, if the computer systems or networks of an organization are compromised.
- (f) It efficiently tracks down cybercriminals through their digital footprints from anywhere in the world.
- (g) It could help to protect the organisation's money and valuable time.

#### **16.8.4 Disadvantages of digital forensics**

- (a) The tools used in conducting digital forensics are expensive.
- (b) The digital evidences presented in court of law could be easily thrown out if it appears to be tampered with.
- (c) Producing electronic records and storing them is costly.
- (d) Some judges and lawyers do not have a good understanding of computer systems.
- (e) If the tool used for digital forensic is not according to specified standards, then in the court of law, the evidence can be rejected.
- (f) The investigating officer might lack the needed technical knowledge which could affect the desired conclusion adversely.

#### **16.8.5 Challenges faced by auditors in using digital forensic technique**

The following are some of the challenges faced by auditors in using forensic technique:

- (a) Proliferation of various types and brands of personal computers and mobile phones;
- (b) Most modern devices have huge amount of storage capabilities as data could be stored in terabytes;
- (c) Wide availability of advanced hacking tools for deleting digital information;
- (d) Speed of technology innovations and changes; and
- (e) Lack of physical evidences that makes prosecution difficult, especially in some jurisdictions with old legal framework.

#### **16.9 Computer robotics in the audit process (such as robotic process automation and use of drones in delivering audit services)**

In the last three decades, auditors have seen a lot of improvements in their work, mainly through the use of spreadsheets, word processors, automated working papers and audit software. Despite these improvements, the audit process is made up of series of repetitive, manual and mundane tasks which are equally labour-intensive for auditors.

Some of these tasks which are equally prone to errors include:

- (a) Data preparation and entry;
- (b) Integration of data from multiple files;
- (c) Manual importation of audit-relevant data into spreadsheets or other software;
- (d) Copying, pasting and sorting data on spreadsheets;

- (e) Performing basic audit tests such as re-computations and analytical procedures; and
- (f) Inventory count.

Auditors are currently leveraging on mainly two newer technologies to assist them automate these tasks with a view to further enhancing the efficiency and effectiveness of audit practice. These two technologies are:

**(a) Robotic process automation (RPA)**

This is a software that is deployed at the user interface level to automate processes that are repetitive, structured and/or rule-based as well as those with machine-readable data. RPA can help auditors streamline evidence collection and achieve near end-to-end automation of audit process as it can be used to execute audit tests that have been pre-programmed in other applications such as spreadsheets.

Once RPA has been implemented to take over the various time-consuming audit tasks, the audit process is bound to become more efficient and the auditor would focus more on resolving complex accounting issues that require professional judgement.

Implementation of RPA solution should be carefully carried out by auditors and it is recommended for automation of audit activities to be done in phases. It is important to note that the activities identified as being automatable with RPA will need to be subdivided into discrete steps that can be translated into programmable functions (the data to be used must be standardised and in machine-readable format).

On the other side of the coin, robots are subjected to audit. Sometimes, auditors discover that a client to be audited had implemented the use of robots in one or more areas of their business.

The use of robots by audit clients brings the benefit of a reliable, standardised process flow as a basis for the audit. In addition, relevant data is made available in a reliable and consistent form. This enables the auditors to design an audit approach that focuses on the process and to put an even emphasis on detailed understanding and analysis of the financial situation, as well as to review in more detail the underlying management decisions.

The implementation of RPA by a client directly affects the auditor's approach and might lead to modifications in the nature, timing or the extent of the audit procedures to be performed.

**(b) Drone technology**

In audit, drones are deployed in the following areas:

- i. Inventory count; and
- ii. Identification of the physical conditions of assets (for possible impairments).

Drone technology provides the auditor with timely and more data which gives better insight into the physical quantity, locations and conditions of client's assets including inventories. It is a new and interesting way of collecting audit evidences that does not change the audit objectives.

In areas with high level of insecurity, it would be extremely difficult for the auditor to carry out physical verification of assets or inventory count exercises. Also, where there is a very big warehouse, drones may be deployed to carry out inventory count.

Drones provide the auditor with a faster, cheaper, safer and more accurate way of

collecting data on the physical conditions of clients' assets. The use of drones is likely to become more widespread in the future and every auditor would encounter it in one form or the other.

Another new invention is the use of Smart Glasses in audit as demonstrated recently by KPMG – one of the big four audit firms. Prior to the COVID 19 pandemic, KPMG had been exploring the use of smart glasses by auditors to enhance audit efficiency. This technology makes it possible for the auditor to monitor the client staff who count the inventory physically while wearing the smart glass.

Traditionally, inventory count requires an auditor to travel to a client's site, comb through their warehouses/stores, counting every item and thereafter travelling back. If the inventories consist of item that can expire, rot or become damaged, a subject matter expert may be brought in to confirm the quality and condition of the items. Sometimes, a partner in charge would be called in to make a decision on whether an item of inventory should be counted or not.

All these imply huge cost, time and man hours just for the purpose of confirming inventory quantity and quality. Smart glasses enable the wearer (inventory counting staff of the client) to count without the auditor being physically present but the auditor is able to see what the counter/wearer is seeing in real life clearly through internet connection and augmented reality technology.

## **16.10 The governing principles of the Nigerian Data Protection Regulation, 2019**

The National Information Technology Development Agency (NITDA) issued the Nigerian Data Protection Regulation in 2019, pursuant to its enabling power under the NITDA Act 2007. Without prejudice to other procedures in the regulation or any instrument for the time being in force, the regulation has the governing principles (Principle 2.1) of data processing to the effect that,

- (1). "Personal data shall be:
  - (a) Collected and processed in accordance with specific, legitimate and lawful purpose consented to by the Data Subject; provided that:
    - i. A further processing may be done only for archiving, scientific research, historical research or statistical purposes for public interest; and
    - ii. Any person or entity carrying out or purporting to carry out data processing under the provisions of this paragraph shall not transfer any Personal Data to any person;
  - (b) Adequate, accurate and without prejudice to the dignity of human person;
  - (c) Stored only for the period within which it is reasonably needed; and
  - (d) Secured against all foreseeable hazards and breaches such as theft, cyberattack, viral attack, dissemination, manipulations of any kind, damage by rain, fire or exposure to other natural elements;
- (2). Anyone who is entrusted with Personal Data of a data subject or who is in possession of the Personal Data of a Data Subject owes a duty of care to the said Data Subject; and
- (3). Anyone who is entrusted with Personal data of a Data Subject or who is in possession of the Personal Data of a Data Subject shall be accountable for his acts and omissions in respect of data processing, and in accordance with the principles contained in this Regulation."

### **16.10.1 Data privacy and security risk**

Hosting confidential data with cloud service providers involves the transfer of a

considerable amount of an organisation's control over data security to the provider. As a subscriber of cloud computing technology, make sure your vendor understands your organization's data privacy and security needs. Also, make sure your cloud provider is aware of particular data security and privacy rules and regulations that apply to your entity, such as the Nigeria Data Protection regulation (NDPR) / General Data Protection Regulation (GDPR), the Payment Card Industry Data Security Standard (PCI DSS), etc.

Data availability and business continuity risk. A major risk to business continuity in the cloud computing environment is loss of internet connectivity. You should ask your cloud provider what controls are in place to ensure internet connectivity. If a vulnerability is identified, you may have to terminate all access to the cloud provider until it is rectified. Finally, the seizure of a data-hosting server by law enforcement agencies may result in the interruption of unrelated services stored on the same machine.

Record retention requirements risk. If your business is subject to record retention requirements, make sure your cloud provider understands — and meets — them.

#### **16.11 National Information Technology Development Agency (NITDA) Act and Nigeria Data Protection Regulation (NDPR)**

##### **16.11.1 Introduction**

The introduction of the Nigerian Data Protection Regulation (NDPR) created awareness of data protection and privacy issues in Nigeria. It also provides the means of regulating the collection and processing of data. Previous regulations, unlike the NDPR, were ambiguous, inadequate, and ineffective in imposing sanctions and ensuring compliance in the event of a data breach. Thus, the introduction of the NDPR by the National Information Technology Development Agency (NITDA) initiated data protection in Nigeria.

The strict application of the provisions of the NDPR has led to the issuance of non-compliance notices to defaulting companies which included banks, telcos and some government parastatals. It is, therefore, essential for organisations involved in data collection and processing to comply effectively with NDPR.

##### **16.11.2 Benefits of compliance with NDPR**

Compliance with the provisions of NDPR confers the following benefits on organisations:

- (a) Improves the trust between businesses and their customers; and
- (b) Prevents the company from incurring expensive costs in forms of fines, litigation expenses, public embarrassment, and a bad reputation.

##### **16.11.3 Data protection framework**

The implementation framework stipulates the procedures to employ for a successful compliance. Below are components of the framework:

###### **a) Consent**

Data controllers and processors must first seek the consent of the data subject without undue influence, fraud, and coercion. Usually, consent is obtained through clear, unambiguous data privacy policies to which the data subject has consented.

###### **b) Data protection audit**

The NDPR mandates all organisations that process the personal data of more than 1000 data subjects in a period of 6 months and 2000 Data Subjects in a period of 12 months to submit a data protection audit report to NITDA not later than March 15, every year. This involves the organisation's audit of its data privacy and

protection practices. Audits are meant to show that the data controller or processor complies with the law. The audit should state the following:

- i. The data the organisation collects on its employees and members of the public;
- ii. The purpose for which such data is collected;
- iii. Notice given to individuals regarding the collection and use of their personal information;
- iv. The access given to individuals to review, amend, correct, supplement, or delete such data;
- v. Whether or not the consent of these individuals was obtained before collecting, using, transferring, or disclosing these data; and the methods employed to obtain consent;
- vi. The policies and practices of the organisation for the proper use and security of these data;
- vii. Organisation's policies and procedures for privacy and data protection; and
- viii. The policies and procedures of the organisation for assessing the impact of technologies on the stated privacy and security policies.

Data Controllers should also audit third party processor contracts which require the transfer of personal data to such third parties.

Arising from the above, it is obvious that compliance is not a one-off obligation but a continuing activity for data controllers and processors in Nigeria. Failure to file these returns to NITDA, is deemed a breach of the NDPR. A complete data protection audit results in the synchronisation of all the company's processes to align in a way that ensures that every data that comes through its system is treated without affecting data integrity and infringing on the privacy of the data owners.

The framework provides an audit template. To effectively comply with this provision, organisations may seek the help of a licensed data protection compliance officer (DPCO). It is important to note that every data audit report (DAR) must be accompanied by a verification statement by the DPCO.

#### c) Data protection compliance organisations (DPCOs)

In line with the draft framework, DPCOs are licensed professionals to provide auditing and compliance services for data controllers. Law firms, professional service consultancy firms, IT service providers, and audit firms may be licensed by NITDA, provided they have:

- i. Data protection certification or experience in data science;
- ii. Data protection and privacy;
- iii. Information privacy;
- iv. Information audit;
- v. Data management;
- vi. Information security;
- vii. Data protection legal services;
- viii. Information technology due diligence;
- ix. EU GDPR implementation and compliance;
- x. Cyber security/cyber security law;
- xi. Data analytics; and
- xii. Data governance.

#### 16.11.4 Services provided by DPCOs

Services provided by DPCOs include:

- (a) Data protection compliance audit;
- (b) Data protection and privacy training;
- (c) Advisory services;

- (d) Draft regulation contracts; and
- (e) Data protection impact assessment.

#### 16.11.5 Default and penalties

##### (a) Default

A data breach is an accidental or unlawful incident that exposes confidential or protected information or results in the loss or theft of customers' personal details. Non-compliance with the provisions of NDPR also constitutes a breach. In case of any breach, notify NITDA immediately.

##### (b) Penalties

According to the provisions of NDPR, where a data breach is reported and the data controller is found guilty, the company is liable to a:

- i. Payment of a fine of 1% of the annual gross revenue of the preceding year or payment of the sum of ₦2,000,000 (whichever is greater) where the data controller deals with less than 10,000 data subjects; and
- ii. Fine of 2% of the annual gross revenue of the preceding year or a payment of the sum of ₦10,000,000 (whichever is greater) where a data controller deals with more than 10,000 data subjects.

However, where the data controller, self-reports the breach, it is a major consideration in determining the amount of fine to be levied. Report must be made within 72 hours from time of knowledge of the breach.

#### 16.12 Chapter review

The chapter adequately covers the following topics:

- (a) Impact of information technology on audit environment
- (b) Application of information technology to audit process
- (c) Information technology tools applicable in assurance services
- (d) Software solution for governance, risk and compliance (GRC) process
- (e) Application of control evaluation frameworks in computerised business environment
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