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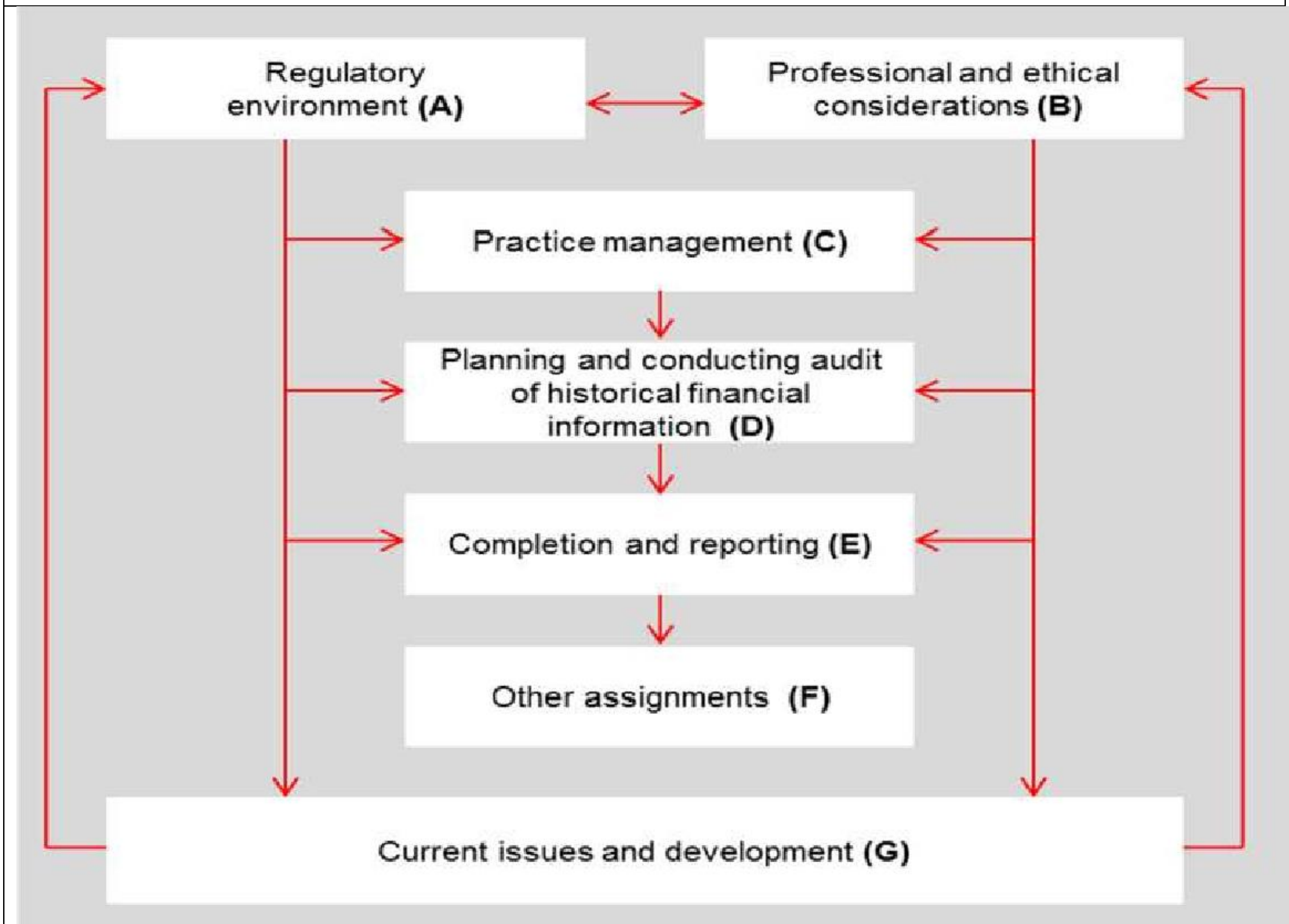
The syllabus



About Advanced Audit & Assurance

The Exam

- *100 marks*
- *3 hours, 15 minutes*
- *Two sections (A & B)*

Section A: *One Case Study-50 marks- Requirement from the entire syllabus.*

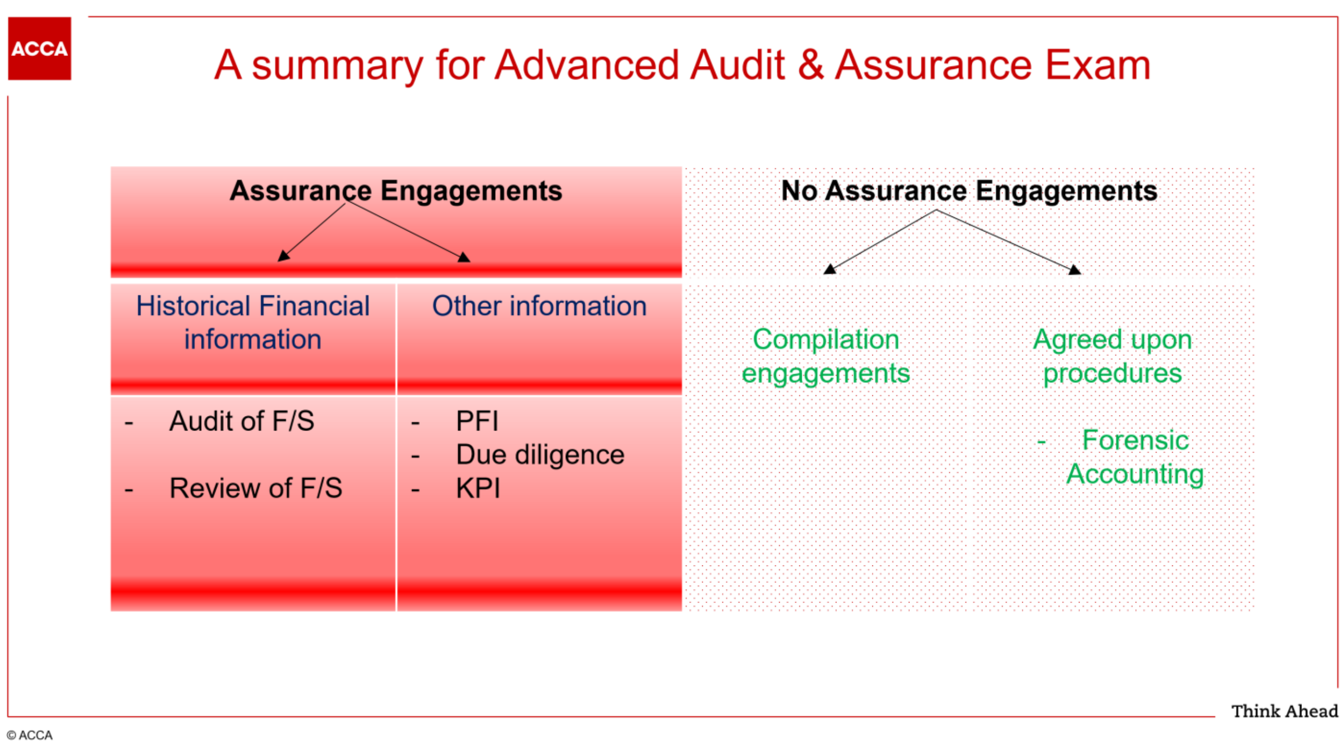
Detailed information will be given which likely to include:

- *extracts of financial information,*
- *strategic, operational and other relevant financial information for a client business,*
- *extracts from audit working papers*
- *results of analytical procedures.*

Includes 4 professional marks

Section B: 2 compulsory 25 mark questions-50 marks

- *One question from completion, review and reporting*
- *The other can be from any part of the syllabus*



Important terms- Previous knowledge

Terms you should be conceptually clear on!

Those charged with governance – The person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

Management – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role

Engagement partner – The partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who has the appropriate authority from a professional, legal or regulatory body.

Engagement quality control review – A process designed to provide an objective evaluation*, on or before* the date of the auditor's report, of the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report.

Engagement quality control reviewer – A partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, *none of whom is part of the engagement team*, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report.

Management's expert – An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements. The preparation of an entity's financial statements may require expertise in a field other than accounting or auditing, such as actuarial calculations, valuations etc. The entity may employ or engage experts in these fields to obtain the needed expertise to prepare the financial statements. Failure to do so when such expertise is necessary increases the risks of material misstatement.

Audit procedure: Analytical procedures: Analytical procedures consist of evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Audit procedure: Test of controls – An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level

Audit procedure: Substantive procedure – An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

(i) Tests of details (of classes of transactions, account balances, and disclosures); and

(ii) Substantive analytical procedures.

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Internal control – The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.

Deficiency in internal control – This exists when:

(i) 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

(ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

Test of controls- They are audit procedures performed to test the operating effectiveness of controls in preventing or detecting material misstatements in the financial statements. An auditor might use inspection of documents, observations of specific controls, re-performance of the control, test data or other audit procedures to gather evidence about controls. There are many other issues that auditors struggle with when understanding and testing internal controls in audits of all sizes, including:

• deciding whether to test the operating effectiveness of controls;

• determining what constitutes a deviation and the tolerable deviation rate, and then dealing with deviations;

• revising the control risk assessment, and the effect of a revision on other audit procedures; and

• balancing the results of controls testing with substantive procedures

Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Appropriateness (of audit evidence) – The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Sufficiency (of audit evidence) – The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

Sources of audit evidence

Inspection	Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. An example of inspection used as a test of controls is inspection of records for evidence of authorization.
Observation	Observation consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed
External confirmation	An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.
Inquiry	Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity.
Recalculation	Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically
Re-performance	Re-performance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.
Analytical procedures	Analytical procedures consist of evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Audit documentation – The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "work papers" are also sometimes used).Audit documentation may be recorded on paper or on electronic or other media. Examples of audit documentation include:

- Audit programs.
- Analyses.
- Issues memoranda.
- Summaries of significant matters.
- Letters of confirmation and representation.
- Checklists.
- Correspondence (including e-mail) concerning significant matters.

Misstatement – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Misstatements may result from:

(a) An inaccuracy in gathering or processing data from which the financial statements are prepared;

(b) An omission of an amount or disclosure, including inadequate or incomplete disclosures

(c) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts;

(d) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.;

(e) An inappropriate classification, aggregation or disaggregation, of information; and

(f) For financial statements prepared in accordance with a fair presentation framework, the omission of a disclosure necessary for the financial statements to achieve fair presentation beyond disclosures specifically required by the framework.

Misstatement of a qualitative disclosure

Each individual misstatement of a qualitative disclosure is considered. This is done to evaluate its effect on the relevant disclosure(s), as well as its overall effect on the financial statements as a whole. The determination of whether a misstatement(s) in a qualitative disclosure is material is a matter that involves the exercise of professional judgment.

Examples where such misstatements may be material include:

- Inaccurate or incomplete descriptions of information about the objectives, policies and processes for managing capital for entities with insurance and banking activities.

- The omission of information about the events or circumstances that have led to an impairment loss (e.g., a significant long-term decline in the demand for a metal or commodity) in an entity with mining operations.

- The incorrect description of an accounting policy relating to a significant item in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows.

- The inadequate description of the sensitivity of an exchange rate in an entity that undertakes international trading activities.

Professional judgment – The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

Professional skepticism – 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. Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the ISAs.

Reasonable assurance – In the context of an audit of financial statements, a high, but not absolute, level of assurance.

Assertions – Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

Assertions about *classes of transactions and events and related disclosures* **for the period under audit**

1. Occurrence – the transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.
2. 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.
3. Accuracy – amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
4. Cut–off – transactions and events have been recorded in the correct accounting period.
5. Classification – transactions and events have been recorded in the proper accounts.
6. 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* ***at the period end***

1. Existence – assets, liabilities and equity interests exist.
2. Rights and obligations – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity
3. 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.
4. 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 have been appropriately recorded and related disclosures have been appropriately measured and described.
5. Classification – assets, liabilities and equity interests have been recorded in the proper accounts.

6. Presentation – assets, liabilities and equity interests re 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

Business risk – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

Audit sampling (sampling) – The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

Sampling risk – The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Non-sampling risk – The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

Written representation – A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence.

The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements.

The written representations shall be in the form of a representation letter addressed to the auditor If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter.

If management does not provide one or more of the requested written representations, the auditor shall:

(a) Discuss the matter with management;

(b) Revaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

(c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report

Information obtained from outside of the ledger

Financial statements may contain information that is obtained from outside of the general and subsidiary ledgers. Examples of such information may include:

- Information obtained from lease agreements disclosed in the financial statements, such as renewal options or future lease payments.
- Information disclosed in the financial statements that is produced by an entity's risk management system (such as disclosures about credit risk, liquidity risk, and market risk)
- Fair value information produced by management's experts and disclosed in the financial statements.
- Information disclosed in the financial statements that has been obtained from models, or from other calculations used to develop estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, such as assumptions developed internally that may affect an asset's useful life
- Information disclosed in the financial statements about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.
- Information recognized or disclosed in the financial statements that has been obtained from an entity's tax returns and records
- Information disclosed in the financial statements that has been obtained from analyses prepared to support management's assessment of the entity's ability to continue as a going concern, such as disclosures, if any, related to events or conditions that have been identified that may cast significant doubt on the entity's ability to continue as a going concern.

Internal audit is defined as "An appraisal activity established within an entity as a service to the entity. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control".

Types of internal audit

There are numerous different types of audit that internal auditors can be involved in such as efficiency and effectiveness audits. For THE ADVANCED AUDIT & ASSURANCE EXAM the two most important are compliance and operational audits.

Compliance audits: Audit checks intended to determine whether the actions of employees are in accordance with company policy, laws and regulations.

Operational audits: Audits of the operational processes of the organization to check not only compliance with controls, but also the effectiveness of controls as part of the risk management process.

There are two broad categories of **Computer Aided Audit Techniques:**

1. Audit software; and
2. Test data.

Audit software

Audit software is used to interrogate a client's system. It can be either packaged, off-the-shelf software or it can be purpose written to work on a client's system. The main advantage of these programs is that they can be used to scrutinise large volumes of data, which it would be inefficient to do manually. The programs can then present the results so that they can be investigated further.

Specific procedures they can perform include:

- Extracting samples according to specified criteria, such as:
  - Random;
  - Over a certain amount;
  - Below a certain amount;
  - At certain dates.
- Calculating ratios and select indicators that fail to meet certain pre-defined criteria (i.e. benchmarking);
- Check arithmetical accuracy (for example additions);
- Preparing reports (budget vs actual);
- Stratification of data (such as invoices by customer or age);
- Produce letters to send out to customers and suppliers; and
- Tracing transactions through the computerised system.

These procedures can simplify the auditor's task by selecting samples for testing, identifying risk areas and by performing certain substantive procedures. The software does not, however, replace the need for the auditor's own procedures.

Test data

Test data involves the auditor submitting 'dummy' data into the client's system to ensure that the system correctly processes it and that it prevents or detects and corrects misstatements. The objective of this is to test the operation of application controls within the system.

To be successful test data should include both data with errors built into it and data without errors. Examples of errors include:

- codes that do not exist, e.g. customer, supplier and employee;
- transactions above pre-determined limits, e.g. salaries above contracted amounts, credit above limits agreed with customer;
- invoices with arithmetical errors; and
- submitting data with incorrect batch control totals.

Data maybe processed during a normal operational cycle ('live' test data) or during a special run at a point in time outside the normal operational cycle ('dead' test data). Both has their advantages and disadvantages:

- Live tests could interfere with the operation of the system or corrupt master files/standing data;

- Dead testing avoids this scenario but only gives assurance that the system works when not operating live. This may not be reflective of the strains the system is put under in normal conditions.

Other techniques

There are other forms of CAAT that are becoming increasingly common as computer technology develops, although the cost and sophistication involved currently limits their use to the larger accountancy firms with greater resources.

These include:

Integrated test facilities - this involves the creation of dummy ledgers and records to which test data can be sent. This enables more frequent and efficient test data procedures to be performed live and the information can simply be ignored by the client when printing out their internal records; and

Embedded audit software - this requires a purpose written audit program to be embedded into the client's accounting system. The program will be designed to perform certain tasks (similar to audit software) with the advantage that it can be turned on and off at the auditor's wish throughout the accounting year. This will allow the auditor to gather information on certain transactions (perhaps material ones) for later testing and will also identify peculiarities that require attention during the final audit.

Public oversight committee

Earlier, the accountancy profession was self-regulated. However, due to globalisation and the failure of big organisations such as Enron the effectiveness of self-regulation came into doubt and a need for external regulation emerged.

A public oversight committee is an **independent body created to oversee the governance and financial reporting of public organisations**. Its main role is:

- To protect the interests of investors and the public at large.
- To give investors and others confidence that an organisation's activities are not detrimental to the public interest.
- To ensure that the audit report is fair and independent, providing all the essential information.
- To ensure that registered public accounting firms maintain high professional standards so as to improve the quality of audit services offered.

Impact of corporate governance principles on audit

Corporate governance is the system by which organisations are directed and controlled. It encompasses the relationship between the board of directors, shareholders and other stakeholders, and the effects on corporate strategy and performance. Corporate governance is important because it looks at how these decision makers act, how they can or should be monitored, and how they can be held to account for their decisions and actions.

THE MAIN PRINCIPLES- TECHNICAL ARTICLE

LEADERSHIP: *Every company should be headed by an effective board which is collectively responsible for the long-term success of the company, and should lead and control the company's operations. There should be a clear division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Non-executive directors should constructively challenge and help develop proposals on strategy. The board should include a balance of executive and non-executive directors such that no individual or small group of individuals can dominate the board's decision taking.*

EFFECTIVENESS: *The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively. There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge. All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance.*

ACCOUNTABILITY: *The board should present a balanced and understandable assessment of the company's position and prospects. The board should maintain sound risk management and internal control systems. The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditor.*

REMUNERATION: *Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.*

RELATIONS WITH SHAREHOLDERS: *There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place. The board should use the Annual General Meeting to communicate with investors and to encourage their participation.*

EXTERNAL AUDITORS – GENERAL PRINCIPLES

The audit committee has specific responsibilities in respect of the external auditors, including recommending the appointment, reappointment and removal of the external auditor, approving fees paid for audit and non-audit services, and agreeing on the terms of engagement with the external auditor.

One of the key issues is that the audit committee should annually assess the independence, objectivity and effectiveness of the external audit process, considering of the ethical framework applicable in the jurisdiction in which the organisation is operating. The audit committee should report annually to the board on their assessment with a recommendation on whether to propose to the shareholders that the external auditor be reappointed. The audit committee section of the annual report should also discuss the annual assessment of the external audit process by the audit committee and also include information on the length of tenure of the current audit firm, when a tender was last conducted, and any contractual obligations that acted to restrict the audit committee's choice of external auditors.

In relation to potential threats to objectivity, the audit committee should seek reassurance that the auditors and their staff have no financial, business, employment or family and other personal relationship with the company which could adversely affect the auditor's independence and objectivity. The audit committee should seek from the audit firm, on an annual basis, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners and staff.

EXTERNAL AUDITORS – THE ANNUAL AUDIT CYCLE

The audit committee should be involved at all stages of the audit, to obtain comfort that a quality audit will be performed. The *Guidance on Audit Committee* specifically requires the following to take place:
At the start of each annual audit cycle, the audit committee should ensure that appropriate plans are in place for the audit. This includes consideration of planned levels of materiality, and the proposed resources to execute the plan, having regard also to the seniority, expertise and experience of the audit team. In practice this means that before any audit fieldwork takes place, the audit firm should meet with the audit committee to discuss the audit strategy and audit plan, demonstrating that auditing standards and quality control principles have been adhered to in their development.

The audit committee should review, with the external auditors, the findings of their work. In the course of its review, the audit committee should discuss with the external auditor major issues that arose during the course of the audit and have subsequently been resolved and those issues that have been left unresolved; review key accounting and audit judgements; and review levels of errors identified during the audit, obtaining explanations from management and, where necessary, the external auditors as to why certain errors might remain unadjusted. The audit committee should review and monitor management's responsiveness to the external auditor's findings and recommendations. Thus, all key audit findings should be shared with the audit committee and discussed with them as the audit progresses.

At the end of the annual audit cycle, the audit committee should assess the effectiveness of the audit process, by:

- reviewing whether the auditor has met the agreed audit plan and understand the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditors to address those risks
- considering the robustness and perceptiveness of the auditors in their handling of the key accounting and audit judgements identified and in responding to questions from the audit committee
- obtaining feedback about the conduct of the audit from key people involved, for example the finance director and the head of internal audit
- reviewing and monitoring the content of the external auditor's management letter (report to those charged with governance), in order to assess whether it is based on a good understanding of the company's business and establish whether recommendations have been acted upon and, if not, the reasons why they have not been acted upon, and
- reporting to the board on the effectiveness of the external audit process.

In summary, the audit committee carefully monitors the conduct of the audit, and plays an important part in ensuring the quality and rigour of the external audit of the financial statements.

EXTERNAL AUDITORS – PROVISION OF NON-AUDIT SERVICES

Specifically, the audit committee should develop and implement a policy on the engagement of the external auditor to supply non-audit services, taking into account the relevant ethical principles and requirements. The audit committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity. The audit committee should consider:

- whether the skills and experience of the audit firm make it the most suitable supplier of the non-audit service
- whether there are safeguards in place to eliminate or reduce to an acceptable level any threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditor
- the nature of the non-audit services
- the fees incurred, or to be incurred, for non-audit services both for individual services and in aggregate, relative to the audit fee, and
- the criteria which govern the compensation of the individuals performing the audit.

The audit committee should set and apply a formal policy specifying the types of non-audit service:

- for which the use of the external auditor is pre-approved (i.e. approval has been given in advance as a matter of policy, rather than the specific approval of an engagement being sought before it is contracted)
- from which specific approval from the audit committee is required before they are contracted, and
- from which the external auditor is excluded.

One of the non-audit services specifically referred to in the *Guidance on Audit Committees* is the provision of internal audit by the external auditor. If the external auditor is being considered to undertake aspects of the internal audit function, the audit committee should consider the effect this may have on the effectiveness of the company's overall arrangements for internal control and investor perceptions in this regard.

Audit Committee

The role and responsibilities of the audit committee should be in writing and set out in the terms of reference.

<table>
<tr>
<td>1. Financial reporting
The audit committee should monitor:
– The integrity of the financial statements of the company; and
– Any formal announcements relating to the company’s financial performance and review of significant financial reporting judgements contained in them.</td>
<td>2. Internal controls and risk management systems
The audit committee should review the company’s internal financial controls, internal control and risk management systems</td>
</tr>
<tr>
<td>3. Whistle blowing
The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters.</td>
<td>4. The internal audit process
The audit committee should monitor and review the effectiveness of the company’s internal audit function.</td>
</tr>
<tr>
<td colspan="2">5. Overseeing the external audit
The audit committee should make recommendations to the board in relation to the appointment, reappointment and removal of the external auditor and approval of the remuneration and terms of engagement of the external auditor.

The scope of the external audit should be reviewed by the audit committee with the auditor. The audit committee should review, with the external auditors, the findings of their work.

The audit committee should also review the audit representation letters before obtaining signatures of management and give particular consideration to matters where representation has been requested that relate to non-standard issues. Furthermore, the audit committee should review and monitor management’s responsiveness to the external auditor’s findings and recommendations.

The audit committee should review and monitor the external auditor’s independence and objectivity and the effectiveness of the audit process

The audit committee should develop and recommend to the board the company’s policy in relation to the provision of non-audit services by the auditor.</td>
</tr>
</table>

Laws and Regulations

ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements

An important part of an external audit is the consideration by the auditor as to whether the client has complied with laws and regulations.

Let's talk about THE ADVANCED AUDIT & ASSURANCE EXAM

The auditor needs to consider the requirements of ISA 250 , which states that while it is management's responsibility to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulation, the auditor does have some responsibility in relation to compliance with laws and regulations, especially where a non-compliance has an impact on the financial statements.

The auditor is required by ISA 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the*
Entity and its Environment to gain an understanding of the legal and regulatory framework in which the audited entity operates. This will help the auditor to identify non-compliance and to assess the implications of non-compliance.

ISA 250 requires that when a non-compliance is identified or suspected, the auditor shall obtain an understanding of the nature of the act and the circumstances in which it has occurred, and further information to evaluate the possible effect on the financial statements. Therefore procedures should be performed to obtain evidence about any suspected non-compliance.

ISA 250 requires suspected non-compliance to be discussed with management and where appropriate with those charged with governance.

The auditor needs to consider the potential implications for the financial statements. The non-compliance could lead to fines or penalties, which may need to be provided for in the financial statements.
Audit procedures should be performed to determine the amount, materiality and probability of payment of any such fine or penalty imposed.

In terms of reporting non-compliance to the relevant regulatory authorities, ISA 250 requires the auditor to determine whether they have a responsibility to report the identified or suspected non-compliance to parties outside the entity. In the event that management or those charged with governance fail to make the necessary disclosures to the regulatory authorities, the auditor should consider whether they should make the disclosure. This will depend on matters including whether there is a legal duty to disclose or whether it is considered to be in the public interest to do so.

An exam focussed overview

External auditor CANNOT prevent non- compliance
External auditor CANNOT detect ALL non-compliance
External Auditor needs to fully understand the legal and regulatory environment of the client

Laws and regulations which have a **direct effect on the F/s** (i.e. they determine reported amounts and disclosures like tax laws, pension laws, payroll) ↓	Laws and regulations which have an **indirect effect on the F/s** (-provisions under which organisations are allowed to conduct business .Non-compliance can result in fines, penalties etc which can have an impact on the F/S) Examples - relating to operational aspects (health and safety, equal opportunity, environmental laws) -Financial sector-highly regulated
External auditor has to : 1.**Gather sufficient appropriate evidence regarding compliance** 2.**Identify instances of non-compliance by**: - enquiry of management that complying -enquiry of legal advisor -inspection of minutes of meetings -inspection of correspondence with regulatory. licensing authorities -being alert when carrying out other audit procedures -get written representation that all suspected or identified non-compliance has been disclosed to the auditors and effects recorded in the F/S	

<u>**Procedures when non-compliance is suspected-**</u> ***these need to be tailored to the scenario given in the exam***

1. Obtain an understanding of the nature of the act and the circumstances in which it has occurred
2. Evaluate effect on F/S (financial consequences, double entries and disclosures)
3. Discuss with the management and ask them to provide sufficient information that the entity is complying
4. Perform audit procedures to determine the amount, materiality and probability of payment of any such fine or penalty imposed.
5. Determine whether they have a responsibility to report the identified or suspected non-compliance to parties outside the entity.

6. If sufficient appropriate evidence regarding compliance is not obtained:
   a) Consider effect on risk assessment that has been carried out
   b) Consider effect on evaluation of client's internal control system
   c) Re-consider the reliability of written representations obtained regarding laws and regulations (there may be further instances of non-compliance)
   d) Consider impact on audit opinion
   e) Get legal advice if needed

The auditing standard that is relevant to this article is ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, and the objectives of the auditor according to paragraph 10 in ISA 250 are:

- To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations that have a direct effect on the determination of material amounts and disclosures in the financial statements
- To perform specified audit procedures to help identify non-compliance with other laws and regulations that may have a material effect on the financial statements
- To respond appropriately to non-compliance or suspected non-compliance identified during the audit.

The standard defines an act of 'non-compliance' as follows:
'Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.'

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

(a) **The provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and pension laws and regulations**.	**(b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements**
The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements: (a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and (b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.	

During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. The auditor shall request management and, where appropriate, those charged with governance, to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor.	

Indications that non-compliance may have occurred:

- Investigations by government departments or payment of fines or penalties
- Payment for unspecified services or loans to consultants, related parties, employees or government employees
- Sales commission or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received
- Purchasing at prices significantly above or below market price
- Unusual payments in cash, purchases in the form of cashier's checks payable to bearer or transfers to numbered bank accounts
- Unusual transactions with companies registered in tax havens
- Payments for goods or services made other than to the country from which the goods or services originated
- Payments without proper exchange control documentation
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence
- Un-authorised transactions or improperly recorded transactions
- adverse media comment

Audit Procedures When Non-Compliance Is Identified or Suspected

If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall:

1. obtain an understanding of the nature of the act and the circumstances in which it has occurred
2. Obtain further information to evaluate the possible effect on the financial statements (potential financial consequences and/or disclosure requirements)
3. If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance.
4. If management or those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice.
5. If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

6. The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment, the internal control systems and the reliability of written representations, and take appropriate action

Reporting of Identified or Suspected Non-Compliance

The auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit.

If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board.

Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with ISA 705, express a qualified opinion or an adverse opinion on the financial statements

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with ISA 705.

Reporting Non-Compliance to Regulatory and Enforcement Authorities

If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

Recognise when withdrawal from an engagement is necessary.
If the entity does not take the remedial action that the auditor considers necessary in the circumstances, even when the non-compliance is not material to the financial statements, the auditor may decide to withdraw from the engagement. One of the reasons for such a decision by the auditor could be that the senior management is not considering the auditor's suggestions and therefore the auditor may have to reconsider the reliability of the management and the representation given by management. However, before reaching this conclusion, the auditor would ordinarily seek legal advice.

Money laundering

Let's talk THE ADVANCED AUDIT & ASSURANCE EXAM

Keep in mind the fact that questions in THE ADVANCED AUDIT & ASSURANCE EXAM will not always flag up that candidates need to consider laws and regulations; the challenging nature of THE ADVANCED AUDIT & ASSURANCE EXAM will mean that candidates will have to conclude for themselves that questions are testing a specific subject area of the syllabus

ACCA's Code of Ethics and Conduct defines 'money laundering' as:

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

Auditors need to be particularly careful where money laundering issues are concerned – especially for a business that is predominantly cash-based because the scope for money laundering in such businesses is wide. There are usually three stages in money laundering:

- *Placement* – which is the introduction or 'placement' of illegal funds into a financial system.
- *Layering* – which is where the money is passed through a large number of transactions. This is done so that it makes it difficult to trace the money to its original source.
- *Integration* – which is where the 'dirty' money becomes 'clean' as it passes back into a legitimate economy.

The steps can also be known by the terms, hide, move and invest.

Money laundering offences can include:

- Concealing criminal property
- Acquiring, using or possessing criminal property
- Becoming involved in arrangement which is known, or suspected, of facilitating the acquisition of criminal property.

There are many countries in which money laundering is a criminal offence and, where an accountant or an auditor discovers a situation which may give rise to money laundering, the accountant or auditor must report such suspicions to a 'money laundering reporting officer' (MLRO) whose responsibility it is to report such suspicions to an enforcement agency (in the UK, this enforcement agency is the National Crime Agency (NCA)).

It is an offence to fail to report suspicions of money laundering to NCA or the MLRO as soon as practicable, and it is also an offence if the MLRO fails to pass on a report to the NCA. Where the entity is actively involved in money laundering, the signs are likely to be similar to those where there is a risk of fraud, and can include:

- Complex corporate structure where complexity does not seem to be warranted
- Transactions not in the ordinary course of business
- Many large cash transactions when not expected
- Transactions where there is a lack of information or explanations, or where explanations are unsatisfactory, or
- Transactions with little commercial logic taking place in the normal course of business.

TIPPING OFF

The term 'tipping off' means that the MLRO discloses something that will prejudice an investigation. It is an offence to make the perpetrators of money laundering aware that the auditor has suspicions or knowledge regarding their money laundering activities or that these suspicions or knowledge have been reported. It is unnecessary for the auditor to gain all the facts, or to ascertain without a doubt, that an offence has occurred. The auditor only needs to satisfy themselves that their suspicions are reasonable, and obtain sufficient evidence to show the allegations are made in good faith.

Process of ML (explanation)

The basic money laundering process has three steps:

Placement: This is the introduction or placement of the illegal funds into the financial system. This is when cash obtained through criminal activity is first placed into the financial system. Business owners who have illegally obtained funds can use a cash-intensive business to mix legitimate cash receipts from business activity with the funds they wish to launder.

Examples include (amongst many possibilities):

– Making **lots of small cash deposits** in numerous **bank accounts**;
– Using a **cash-intensive business**, such as a betting shop or a used car dealership, to disguise 'dirty' money as legitimate revenue
– Purchasing a series of monetary instruments (cheques, currency exchange, money orders, etc.) that are then collected and deposited into accounts at another location.

Layering: layering involves moving the money through various financial transactions to change its form and make it difficult to locate the original source. Layering may involve:

– Several bank-to-bank transfers
– Wire transfers between different accounts in different names in different countries
– Making deposits and withdrawals so that the amount of money in the accounts varies continually
– Purchasing high value items such as diamonds to change the form of the money
– making numerous purchases and sales of investments;
– making fake sales between controlled companies (this can often be extremely subtle, eg through the use of invoices that do involve a transfer of goods, but which exaggerate the price).

Layering conceals the audit trail and provides inscrutability.

Integration: the illegitimate funds re-enter the legitimate economy in a legitimate form. At this stage, it becomes very difficult to catch a launderer if there is no documentation during the previous stages, therefore launderers can use the money without getting caught. The launderer might choose to invest the funds into real estate, luxury assets or business ventures.

Methods of ML

Structuring deposits/smurfing: In this case, large amounts of money are broken down into smaller amounts so that these appear less suspicious. These amounts are then deposited into one or more bank accounts. This may be done either by several people (also called 'smurfs') or by a single person over a long time period. This method is also known as smurfing.

Shell companies: These are bogus companies that exist solely for the purpose of money laundering. They accept illegal money as "consideration" for goods or services. However, in reality neither good nor services are provided.

Overseas banks: Money laundering can be done by sending money through various bank accounts in certain offshore locations / countries. These locations / countries allow anonymous banking for all purposes. Hong Kong, the Bahamas, Bahrain, the Cayman Islands, Singapore and Panama have been identified as the major offshore centres by the International Monetary Fund.

Alternative banking: Some countries have deep-rooted, unconventional banking systems that enable undocumented deposits, withdrawals and fund transfers to take place. Such banking systems operate outside the control of the government and transact without leaving a paper trail, making it difficult to unearth the transaction that took place.

Contents of an anti- ML program

Appointment of Money Laundering Reporting Officer (MLRO)	The MLRO is a nominated officer who is responsible for receiving and evaluating reports of suspected money laundering from colleagues within the firm, and making a decision as to whether further enquiry is required and if necessary making reports to the appropriate external body. The MLRO should have an appropriate level of seniority and experience and would usually be a senior partner. *Main Responsibilities* – *Consider internal reports of money laundering* – *Decide if there are sufficient grounds for suspicion* – *Prepare external report for appropriate authority when needed* – *Advise the engagement team/individual on how to continue their work and interact with the client to balance professional responsibilities, risk to the business and legal responsibilities under the money laundering legislation (need to ensure tipping off doesn't take place)* – *Train the firm's employees in anti-ML and reporting suspicion procedures* – *Design and implement internal anti-ML systems and procedures in the firm* External Report Contents **1.** Full name of the reporting business **2.** Identification information on each subject (e.g. full name, date of birth, nationality, occupation) **3.** The role of each subject in the matter being reported (suspect, victim) **4.** Any bank account or transaction details (for identification/reference) **5.** Details of transactions or activities giving rise to suspicion or knowledge (including amounts, dates, currencies, sources) **6.** Information on the location of any laundered property **7.** Any other relevant information (for example persons associated with the suspect)

Customer Identification Procedures. (CDD/KYC)	This is often referred to as customer due diligence, or 'know your client' procedures. The point of these procedures is to ensure that the firm has verified the identity of clients (whether the client is an individual or an entity), and has obtained evidence of that identity. These procedures should be applied to new clients as well as existing ones. This involves an understanding of: – Who the client is and what they do (business/economic purpose) – Who owns the entity – Who controls the entity – Client's sources of funds As part of the risk-based approach, firms are expected to approach the CDD process with a view to identifying situations which by their nature can present a higher risk of ML . For example, a client which is a company which is owned by an offshore trust may be considered to offer higher risk than an individual client who is well known to you. Examples of 'high-risk' situations include: - where the new client has not been physically present for identification purposes - where the new client is a 'politically exposed person' (PEP) – a PEP is someone who is or has in the last year exercised a prominent public function in a foreign country or an international body, or a family member or known close associate of such a person. The purpose of making special provision for PEPs is, quite clearly, to recognise the possibility that persons holding political power may have or have had means of access to public funds, and means of transporting them, that other citizens will not have, and to ensure that accountants are doubly aware of the heightened risk that such persons may consequently present. Ongoing monitoring of the business relationship In keeping with the spirit of the 'Know your Client' concept, there is a need to monitor the transactions being carried out by and on behalf of the client throughout the business relationship – this is referred to as 'ongoing monitoring'. The aim behind this is to enable the accountant to remain aware of the scale and nature of the client's business affairs and to enable him to become aware of transactions which are so unusual, in size or nature, that they might give him cause to suspect ML. Methods of verification Individuals – Name, Date of Birth, Residential Address

	Corporate bodies – Full name, registered and trading addresses, date of incorporation, registration details, names/address/DOBs of directors and main shareholders, % shares held by each, annual accounts/annual return, details of trading or current operations, tax registration details etc. Trusts – Trust deed including name, date of establishment, names/address/DOBs of the settlors, trustees and main beneficiaries, deed of appointment, full details on the beneficial ownership, tax details or arrangements etc. Charities – Full name, date of establishment, charities registration number, key personnel, tax details
Enhanced record keeping.	Records must be kept of clients' identity, the firm's business relationship with them, and details of transactions with the client. All records should be kept for five years after the end of the business relationship or completion of the transactions. Internal and external reports made in connection to money laundering should also be securely kept for five years.
Communication and training.	All relevant employees should receive training so that they are aware of the main provisions of money laundering regulations, and so that they know how to recognise and deal with activities which may be money laundering. The training programme should be offered to all members of the firm with an involvement in audit engagements. Training should also be provided on the firm's internal policies and procedures with relation to money laundering. In particular all staff should be aware of appropriate lines of communication, and who they should report suspicions of money laundering activities to. Training should be considered for all staff, including support staff who do not carry out an advisory role.
Internal controls, risk assessment, management and monitoring.	The firm should establish systems and controls to effectively manage the risk that the firm is exposed to in terms of money laundering activities. This could include: – Client screening procedures to minimise the risk of taking on a new client with a high risk of money laundering activities – Systems and controls to ensure that training is taken/attended and understood by all relevant employees – Systems that allow periodic testing that the firms' policies and procedures comply with legislative and regulatory requirements.
Include responsibilities regarding ML in the engagement letter	

Code of Ethics for Professional Accountants

A professional accountant shall comply with the following fundamental principles:

(a) Integrity – to be straightforward and honest in all professional and business relationships.	A professional accountant shall not knowingly be associated with reports, returns, communications or other information where the professional accountant believes that the information: **(a)** Contains a materially false or misleading statement; **(b)** Contains statements or information furnished recklessly; or **(c)** Omits or obscures information required to be included where such omission or obscurity would be misleading.
(b) Objectivity – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments	A professional accountant may be exposed to situations that may impair objectivity. It is impracticable to define and prescribe all such situations. A professional accountant shall not perform a professional service if a circumstance or relationship biases or unduly influences the accountant's professional judgment with respect to that service.
(c) Professional Competence and Due Care – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.	The principle of professional competence and due care imposes the following obligations on all professional accountants: **(a)** To maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service; and **(b)** To act diligently in accordance with applicable technical and professional standards when providing professional services. Competent professional service requires the exercise of sound judgment in applying professional knowledge and skill in the performance of such service. Professional competence may be divided into two separate phases: **(a)** Attainment of professional competence; and **(b)** Maintenance of professional competence.
(d) Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty	The principle of confidentiality imposes an obligation on all professional accountants to refrain from: **(a)** Disclosing outside the firm or employing organization confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose; and **(b)** Using confidential information acquired as a result of professional and business relationships The following are circumstances where professional accountants are or may be required to disclose confidential information or when such disclosure may be appropriate: **(a)** Disclosure is permitted by law and is authorized by the client or the employer;

to disclose, nor use the information for the personal advantage of the professional accountant or third parties.	**(b)** Disclosure is required by law, for example: **(i)** Production of documents or other provision of evidence in the course of legal proceedings; or **(ii)** Disclosure to the appropriate public authorities of infringements of the law that come to light; and by law: **(i)** To comply with the quality review of a member body or professional body; **(ii)** To respond to an inquiry or investigation by a member body or regulatory body; **(iii)** To protect the professional interests of a professional accountant in legal proceedings; or **(iv)** To comply with technical standards and ethics requirements. In deciding whether to disclose confidential information, relevant factors to consider include: • 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 professional accountant. • Whether all the relevant information is known and substantiated, to the extent it is practicable; when the situation involves unsubstantiated facts, incomplete information or unsubstantiated conclusions, professional judgment shall be used in determining the type of disclosure to be made, if any. • The type of communication that is expected and to whom it is addressed. • Whether the parties to whom the communication is addressed are appropriate recipients.
(e) Professional Behavior – to comply with relevant laws and regulations and avoid any action that discredits the profession.	The principle of professional behavior imposes an obligation on all professional accountants to comply with relevant laws and regulations and avoid any action that the professional accountant knows or should know may discredit the profession. This includes actions that a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at that time, would be likely to conclude adversely affects the good reputation of the profession. In marketing and promoting themselves and their work, professional accountants shall not bring the profession into disrepute. Professional accountants shall be honest and truthful and not: **(a)** Make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; or **(b)** Make disparaging references or unsubstantiated comparisons to the work of others.

Threats

a) **Self-interest threat –** the threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behavior;
b) **Self-review threat –** the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made or service performed by the professional accountant, or by another individual within the professional accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of providing a current service;
c) **Advocacy threat –** the threat that a professional accountant will promote a client's or employer's position to the point that the professional accountant's objectivity is compromised;
d) **Familiarity threat -** the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work; and
e) **Intimidation threat –** the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant.

Conflicts of Interest

(Firm competes with client or firm has a joint venture with a competitor of a client or the firm has competitors as clients)

A professional accountant in public practice shall take reasonable steps to identify circumstances that could pose a conflict of interest. Such circumstances may create threats to compliance with the fundamental principles. For example, a threat to objectivity may be created when a professional accountant in public practice competes directly with a client or has a joint venture or similar arrangement with a major competitor of a client.

A threat to objectivity or confidentiality may also be created when a professional accountant in public practice performs services for clients whose interests are in conflict or the clients are in dispute with each other in relation to the matter or transaction in question.

Application of one of the following safeguards is generally necessary:
(a) Notifying the client of the firm's business interest or activities that may represent a conflict of interest and obtaining their consent to act in such circumstances; or
(b) Notifying all known relevant parties that the professional accountant in public practice is acting for two or more parties in respect of a matter where their respective interests are in conflict and obtaining their consent to so act; or
(c) Notifying the client that the professional accountant in public practice does not act exclusively for any one client in the provision of proposed services (for example, in a particular market sector or with respect to a specific service) and obtaining their consent to so act.

The professional accountant shall also determine whether to apply one or more of the following additional safeguards:
(a) The use of separate engagement teams;
(b) Procedures to prevent access to information (for example, strict physical separation of such teams, confidential and secure data filing);
(c) Clear guidelines for members of the engagement team on issues of security and confidentiality;
(d) The use of confidentiality agreements signed by employees and partners of the firm; and
(e) Regular review of the application of safeguards by a senior individual not involved with relevant client engagements.

Second Opinions

Situations where a professional accountant in public practice is asked to provide a second opinion on the application of accounting, auditing, reporting or other standards or principles to specific circumstances or transactions by or on behalf of a company or an entity that is not an existing client may create threats to compliance with the fundamental principles.

For example, there may be a threat to professional competence and due care in circumstances where the second opinion is not based on the same set of facts that were made available to the existing accountant or is based on inadequate evidence. The existence and significance of any threat will depend on the circumstances of the request and all the other available facts and assumptions relevant to the expression of a professional judgment.

When asked to provide such an opinion, a professional accountant in public practice shall evaluate the significance of any threats and apply safeguards when necessary to eliminate them or reduce them to an acceptable level.

Examples of such safeguards include seeking client permission to contact the existing accountant, describing the limitations surrounding any opinion in communications with the client and providing the existing accountant with a copy of the opinion.

If the company or entity seeking the opinion will not permit communication with the existing accountant, a professional accountant in public practice shall determine whether, taking all the circumstances into account, it is appropriate to provide the opinion sought.

Key threats and safeguards-summary

- The basic ethical standards at this level are the same as those examined previously in F8; what sets apart the level of the questions is your ability to apply those standards to more complex situations and show that you understand both threats and safeguards.

- Often the marks for this area will be spread over more than one question and may be combined with planning, professional issues or as a standalone!

Writing answers in the exam

Identify threats: Words from the case;

Principle or threat name;

Principle of threat explanation;

Comment on the significance of threat;

Safeguard.

Terms used in the code for the firm: *professional accountant in public practice*

QCR = Quality Control Review

Independence of mind: the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

Independence in appearance: the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firms, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

Public interest entities are:
(a) All listed entities; and
(b) Any entity:
(i) Defined by regulation or legislation as a public interest entity; or
(ii) For which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities. Such regulation may be circulated by any relevant regulator, including an audit regulator.

Actual or threatened litigation by client (self interest, intimidation: firm will be worried about bad publicity, loss of client, being proved negligent) When litigation takes place, or appears likely, between the firm or a member of the audit team and the audit client	- If the litigation involves a member of the audit team, removing that individual from the audit team; or Having a professional review the work performed. - If such safeguards do not reduce the threats to an acceptable level, the only appropriate action is to withdraw from, or decline, the audit engagement.
Gifts and hospitality (self interest, familiarity, intimidation)	- Not allowed unless trivial The existence and significance of any threat will depend on the nature, value, and intent of the offer. Where gifts or hospitality are offered that a reasonable and informed third party, weighing all the specific facts and circumstances, would consider trivial and inconsequential, a professional accountant in public practice may conclude that the offer is made in the normal course of business without the specific intent to influence decision making or to obtain information.

Compensation and evaluation: team member compensated for or evaluated on selling non-assurance services to an audit client (self interest)	- Partner not allowed - Other senior team member and compensation is material, remove - QCR A self-interest threat is created when a member of the audit team is evaluated on or compensated for selling non-assurance services to that audit client. The significance of the threat will depend on: • The proportion of the individual's compensation or performance evaluation that is based on the sale of such services; • The role of the individual on the audit team; and • Whether promotion decisions are influenced by the sale of such services. The significance of the threat shall be evaluated and, if the threat is not at an acceptable level, the firm shall either revise the compensation plan or evaluation process for that individual or apply safeguards to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include: • Removing such members from the audit team; or • Having a professional accountant review the work of the member of the audit team. A key audit partner shall not be evaluated on or compensated based on that partner's success in selling non-assurance services to the partner's audit client. This is not intended to prohibit normal profit-sharing arrangements between partners of a firm.
Fee dependence (self interest and intimidation)	**Public interest clients:** If gross recurring fee from one client greater than 15% of the firm's revenue for two consecutive years, - Tell client's TCWG - Independent QCR or external QCR before OR after issuing 2nd year's opinion **Other clients:** - Reducing the dependency on the client; - External quality control reviews; or - Consulting a third party, such as a professional regulatory body or a professional accountant, on key audit judgments. Audit Clients that are Public Interest Entities (explained)

	Where an audit client is a public interest entity and, for two consecutive years, the total fees from the client and its related entities represent more than 15% of the total fees received by the firm expressing the opinion on the financial statements of the client, the firm shall disclose to those charged with governance of the audit client the fact that the total of such fees represents more than 15% of the total fees received by the firm, and discuss which of the safeguards below it will apply to reduce the threat to an acceptable level, and apply the selected safeguard: • Prior to the issuance of the audit opinion on the second year's financial statements, a professional accountant, who is not a member of the firm expressing the opinion on the financial statements, performs an engagement quality control review of that engagement or a professional regulatory body performs a review of that engagement that is equivalent to an engagement quality control review ("a pre-issuance review"); or • After the audit opinion on the second year's financial statements has been issued, and before the issuance of the audit opinion on the third year's financial statements, a professional accountant, who is not a member of the firm expressing the opinion on the financial statements, or a professional regulatory body performs a review of the second year's audit that is equivalent to an engagement quality control review ("a post-issuance review"). When the total fees significantly exceed 15%, the firm shall determine whether the significance of the threat is such that a post-issuance review issuance review is required. In such circumstances a pre-issuance review shall be performed. Thereafter, when the fees continue to exceed 15% each year, the disclosure to and discussion with those charged with governance shall occur and one of the above safeguards shall be applied. If the fees significantly exceed 15%, the firm shall determine whether the significance of the threat is such that a post-issuance review would not reduce the threat to an acceptable level and, therefore, a pre-issuance review is required. In such circumstances a pre-issuance review shall be performed.
Referral fee or commission For example, where the professional accountant in public practice does not provide the specific service required, a fee may be received for referring a continuing client to another professional accountant in public practice or other expert. A professional accountant in public practice may receive a commission from a third party	Examples of safeguards include: • Disclosing to the client any arrangements to pay a referral fee to another professional accountant for the work referred; • Disclosing to the client any arrangements to receive a referral fee for referring the client to another professional accountant in public practice; or • Obtaining advance agreement from the client for commission arrangements in connection with the sale by a third party of goods or services to the client.

(for example, a software vendor) in connection with the sale of goods or services to a client. Accepting such a referral fee or commission creates a self-interest threat to objectivity and professional competence and due care. A professional accountant in public practice may also pay a referral fee to obtain a client, for example, where the client continues as a client of another professional accountant in public practice but requires specialist services not offered by the existing accountant. The payment of such a referral fee also creates a self-interest threat to objectivity and professional competence and due care.	
Overdue fee: Perceived as a loan to the client (self interest, intimidation)	- QCR - At least partial recovery or recovery plan before starting new work THE ADVANCED AUDIT & ASSURANCE EXAM: also means your firm's credit control procedures are weak! An additional professional accountant who did not take part in the audit engagement provide advice or review the work performed. The firm shall determine whether the overdue fees might be regarded as being equivalent to a loan to the client and whether, because of the significance of the overdue fees, it is appropriate for the firm to be reappointed or continue the audit engagement.
Contingent fee : Contingent fees are fees calculated on a predetermined basis relating to the outcome of a transaction or the result of the services performed by the firm. (self interest, advocacy)	- not permitted for audit - Contingent fees are widely used for certain types of non-assurance engagements. Examples of safeguards include: • An advance written agreement with the client as to the basis of remuneration; • Disclosure to intended users of the work performed by the professional accountant in public practice and the basis of remuneration; • Quality control policies and procedures; or • Review by an independent third party of the work performed by the professional accountant in public practice.
Serving as a Director or Officer of an Audit Client (self interest, self review)	- No allowed. - Particular reference made by the code to the role of the Company Secretary. If allowed under local laws or professional rules, the duties and activities shall be limited to those of a routine and administrative nature, such as preparing minutes and maintaining statutory returns.

Long Association of Senior Personnel (Including Partner Rotation) with an Audit Client Familiarity and self-interest	The significance of the threats will depend on factors such as: • How long the individual has been a member of the audit team; • The role of the individual on the audit team; • The structure of the firm; • The nature of the audit engagement; • Whether the client's management team has changed; and • Whether the nature or complexity of the client's accounting and reporting issues has changed. Examples of safeguards include: • Rotating the senior personnel off the audit team; • Having a professional accountant who was not a member of the audit team review the work of the senior personnel; or • Regular independent internal or external quality reviews of the engagement. *Audit Clients that are Public Interest Entities* In respect of an audit of a public interest entity, an individual shall not be a key audit partner for more than seven years. A key audit partner may remain on the audit team for up to one additional year in circumstances where, due to unforeseen events, a required rotation was not possible, as might be the case due to serious illness of the intended engagement partner After such time, the individual shall not be a member of the engagement team or be a key audit partner for the client for two years. When an audit client becomes a public interest entity, the length of time the individual has served the audit client as a key audit partner before the client becomes a public interest entity shall be taken into account in determining the timing of the rotation.
Recent Service with an Audit Client Self-interest, self-review or familiarity threats	If employed during the period for which the audit is being done-no safeguard possible. If, before the period covered by the audit report, existence and significance of any threats will depend on factors such as: The position the individual held with the client; The length of time since the individual left the client; and The role of the professional on the audit team. Safeguard: review of work done by him
Temporary Staff Assignments lending of staff by a firm to an audit client may create a self-review threat	Such assistance may be given, but only for a short period of time and the firm's personnel shall not be involved in: (a) Providing non-assurance services that would not be permitted under this section; or (b) Assuming management responsibilities.

	In all circumstances, the audit client shall be responsible for directing and supervising the activities of the loaned staff. Examples of such include: • Conducting an additional review of the work performed by the loaned staff; • Not giving the loaned staff audit responsibility for any function or activity that the staff performed during the temporary staff assignment; or - Not including the loaned staff as a member of the audit team.
Employment with an audit client: the director or a senior member of the audit client has been a member of the audit team or partner of the firm in the past (self-interest, familiarity, intimidation)	Ex-firm member now at the client and significant connection remains between the firm and the individual**- no safeguard acceptable** Otherwise: • Modifying the audit plan; • Assigning individuals to the audit team who have sufficient experience in relation to the individual who has joined the client; or • Having a professional accountant review the work of the former member of the audit team. For public interest entities, a 12 month gap is required. **Considering a job offer at the client** A self-interest threat is created when a member of the audit team participates in the audit engagement while knowing that the member of the audit team will, or may, join the client some time in the future. Firm policies and procedures shall require members of an audit team to notify the firm when entering employment negotiations with the client. On receiving such notification, the significance of the threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include: - Removing the individual from the audit team; or - A review of any significant judgments made by that individual while on the team.
Family and personal relationship (self interest, familiarity, intimidation)	The existence and significance of any threats will depend on a number of factors, including the individual's responsibilities on the audit team, the role of the family member or other individual within the client and the closeness of the relationship. If a director or an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion, - no safeguard acceptable

	Otherwise: Removing the individual from the audit team; or Structuring the responsibilities of the audit team so that the professional does not deal with matters that are within the responsibility of the immediate family member.
Business relationship (self interest, intimidation due to actual or perceived pressure about losing the audit assignment) - Commercial relationship - Common financial interest Examples: joint venture with the client or a controlling owner/ director, formal marketing of each other's product, combine the services of the firm with those being offered by client and market the package	Commercial relationship or common financial interest: • Having a financial interest in a joint venture with either the client or a controlling owner, director, officer or other individual who performs senior managerial activities for that client. • Arrangements to combine one or more services or products of the firm with one or more services or products of the client and to market the package with reference to both parties. • Distribution or marketing arrangements under which the firm distributes or markets the client's products or services, or the client distributes or markets the firm's products or services. If material, no safeguard acceptable. The purchase of goods and services from an audit client by the firm, or a member of the audit team, or a member of that individual's immediate family, does not generally create a threat to independence if the transaction is in the normal course of business and at arm's length. However, such transactions may be of such a nature or magnitude that they create a self interest threat. The significance of any threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include: • Eliminating or reducing the magnitude of the transaction; or • Removing the individual from the audit team.
Loans and Guarantees (team member, his immediate family, or firm) Self interest	If not under normal lending conditions, no safeguard acceptable If under normal lending conditions- review by network firm
Financial interest (self interest, intimidation) Holding a financial interest in an audit client may create a self-interest threat. The existence and significance of any threat created depends on: **(a)** The role of the person holding the financial interest, **(b)** Whether the financial interest is direct or indirect, and **(c)** The materiality of the financial interest.	Direct financial interest: has control over the investment vehicle: Team member or immediate family, other partners or immediate family have direct financial interest- no safeguard Close family of team member- review of work or removal from team: Team member and director of client have a financial interest in another company- review of work or removal from team If a firm or a partner or employee of the firm, or a member of that individual's immediate family, receives a direct financial interest or a material indirect financial interest in an audit client, for example, by way of an inheritance, gift or as a result of a merger and such interest would not be permitted to be held under this section, then:

	(a) If the interest is received by the firm, the financial interest shall be disposed of immediately, or a sufficient amount of an indirect financial interest shall be disposed of so that the remaining interest is no longer material; **(b)** If the interest is received by a member of the audit team, or a member of that individual's immediate family, the individual who received the financial interest shall immediately dispose of the financial interest, or dispose of a sufficient amount of an indirect financial interest so that the remaining interest is no longer material; or **(c)** If the interest is received by an individual who is not a member of the audit team, or by an immediate family member of the individual, the financial interest shall be disposed of as soon as possible, or a sufficient amount of an indirect financial interest shall be disposed of so that the remaining interest is no longer material. Pending the disposal of the financial interest, a determination shall be made as to whether any safeguards are necessary.
Custody of Client Assets (Custodial services: documents, assets kept for a fee) A professional accountant in public practice shall not assume custody of client monies or other assets unless permitted to do so by law and, if so, in compliance with any additional legal duties imposed on a professional accountant in public practice holding such assets. The holding of client assets creates threats to compliance with the fundamental principles; for example, there is a self-interest threat to professional behavior and may be a self-interest threat to objectivity arising from holding client assets.	A professional accountant in public practice entrusted with money (or other assets) belonging to others shall therefore: **(a)** Keep such assets separately from personal or firm assets; **(b)** Use such assets only for the purpose for which they are intended; **(c)** At all times be ready to account for those assets and any income, dividends, or gains generated, to any persons entitled to such accounting; and **(d)** Comply with all relevant laws and regulations relevant to the holding of and accounting for such assets. As part of client and engagement acceptance procedures for services that may involve the holding of client assets, a professional accountant in public practice shall make appropriate inquiries about the source of such assets and consider legal and regulatory obligations. For example, if the assets were derived from illegal activities, such as money laundering, a threat to compliance with the fundamental principles would be created. In such situations, the professional accountant may consider seeking legal advice. -

Provision of Non-assurance Services to an Audit Client

self-review, self-interest and advocacy threats.

Firms have traditionally provided to their audit clients a range of non-assurance services that are consistent with their skills and expertise.
Providing non-assurance services may, however, create threats to the independence of the firm or members of the audit team. The threats created are most often self-review, self-interest and advocacy threats.

New developments in business, the evolution of financial markets and changes in information technology make it impossible to draw up an all inclusive list of non-assurance services that might be provided to an audit client.

Before the firm accepts an engagement to provide a non-assurance service to an audit client, a determination shall be made as to whether providing such a service would create a threat to independence. In evaluating the significance of any threat created by a particular non-assurance service, consideration shall be given to any threat that the audit team has reason to believe is created by providing other related non-assurance services. If a threat is created that cannot be reduced to an acceptable level by the application of safeguards, the non-assurance service shall not be provided.

a) Management responsibility involve leading and directing an entity, including making significant decisions regarding the acquisition, deployment and control of human, financial, physical and intangible resources.	Okay If not related to decision making (eg routine and administrative like filing returns) Examples of activities that would generally be considered a management responsibility include: • Setting policies and strategic direction; • Directing and taking responsibility for the actions of the entity's employees; • Authorizing transactions; • Deciding which recommendations of the firm or other third parties to implement; • Taking responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; and • Taking responsibility for designing, implementing and maintaining internal control. Activities that are routine and administrative, or involve matters that are insignificant, generally are deemed not to be a management responsibility. For example, executing an insignificant transaction that has been authorized by management or monitoring the dates for filing statutory returns and advising an audit client of those dates is deemed not to be a management responsibility. Further, providing advice and recommendations to assist management in discharging its responsibilities is not assuming a management responsibility.

b) Prepare f/s	- public interest: not allowed - pvt: segregation of teams, QCR *Preparing Accounting Records and Financial Statements* Audit clients that are not public interest entities The firm may provide services related to the preparation of accounting records and financial statements to an audit client that is not a public interest entity where the services are of a routine or mechanical nature, so long as any self-review threat created is reduced to an acceptable level. Examples of such services include: • Providing payroll services based on client-originated data; • Recording transactions for which the client has determined or approved the appropriate account classification; • Posting transactions coded by the client to the general ledger; • Posting client-approved entries to the trial balance; and • Preparing financial statements based on information in the trial balance. Examples of safeguards include: • Arranging for such services to be performed by an individual who is not a member of the audit team; or • If such services are performed by a member of the audit team, using a partner or senior staff member with appropriate expertise who is not a member of the audit team to review the work performed Audit clients that are public interest entities Except in emergency situations, a firm shall not provide to an audit client that is a public interest entity accounting and bookkeeping services, including payroll services, or prepare financial statements on which the firm will express an opinion or financial information which forms the basis of the financial statements.
c) Valuation	Normally not allowed it material effect on F/s. Certain valuations do not involve a significant degree of subjectivity. This is likely the case where the underlying assumptions are either established by law or regulation, or are widely accepted and when the techniques and methodologies to be used are based on generally accepted standards or prescribed by law or regulation. In such circumstances, the results of a valuation performed by two or more parties are not likely to be materially different.

d) Internal audit	- Public interest: no for ICS over financial reporting - Pvt: segregation of teams, Board should acknowledge responsibility for establishing and monitoring ICS To avoid assuming a management responsibility, the firm shall only provide internal audit services to an audit client if it is satisfied that: **(a)** The client designates an appropriate and competent resource, preferably within senior management, to be responsible at all times for internal audit activities and to acknowledge responsibility for designing, implementing, and maintaining internal control; **(b)** The client's management or those charged with governance reviews, assesses and approves the scope, risk and frequency of the internal audit services; **(c)** The client's management evaluates the adequacy of the internal audit services and the findings resulting from their performance; **(d)** The client's management evaluates and determines which recommendations resulting from internal audit services to implement and manages the implementation process; and **(e)** The client's management reports to those charged with governance the significant findings and recommendations resulting from the internal audit services. Audit clients that are public interest entities In the case of an audit client that is a public interest entity, a firm shall not provide internal audit services that relate to: **(a)** A significant part of the internal controls over financial reporting; **(b)** Financial accounting systems that generate information that is, separately or in the aggregate, significant to the client's accounting records or financial statements on which the firm will express an opinion; or **(c)** Amounts or disclosures that are, separately or in the aggregate, material to the financial statements on which the firm will express an opinion.
e) IT systems	- Public interest: no if related to financial reporting - Pvt: segregation of teams, Board should acknowledge responsibility for establishing and monitoring ICS In the case of an audit client that is a public interest entity, a firm shall not provide services involving the design or implementation of IT systems that **(a)** Form a significant part of the internal control over financial reporting or **(b)** Generate information that is significant to the client's accounting records or financial statements on which the firm will express an opinion.

<table>
<tr><td></td><td>Otherwise:
(a) The client acknowledges its responsibility for establishing and monitoring a system of internal controls;

(b) The client assigns the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system to a competent employee, preferably within senior management;
(c) The client makes all management decisions with respect to the design and implementation process;
(d) The client evaluates the adequacy and results of the design and implementation of the system; and
(e) The client is responsible for operating the system (hardware or software) and for the data it uses or generates.</td></tr>
<tr><td>f) Recruiting services (self interest regarding the quality of shortlisted candidates, familiarity and intimidation as won't criticize the person firm has recommended)</td><td>- Public interest: not allowed for directors or senior positions related to f/s preparation
- Otherwise, final decision should be by the client and DO NOT negotiate on the client's behalf

The significance of any threat created shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. In all cases, the firm shall not assume management responsibilities, including acting as a negotiator on the client's behalf, and the hiring decision shall be left to the client.

The firm may generally provide such services as reviewing the professional qualifications of a number of applicants and providing advice on their suitability for the post. In addition, the firm may interview candidates and advise on a candidate's competence for financial accounting, administrative or control positions.

Audit clients that are public interest entities

A firm shall not provide the following recruiting services to an audit client that is a public interest entity with respect to a director or officer of the entity or senior management in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion:
• Searching for or seeking out candidates for such positions; and
• Undertaking reference checks of prospective candidates for such positions.</td></tr>
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<td>g) Corporate finance services

Providing corporate finance services such as:
• Assisting an audit client in developing corporate strategies; Identifying possible targets for the audit client to acquire;
• Advising on disposal transactions;
• Assisting finance raising transactions; and
• Providing structuring advice,</td>
<td>Not allowed to promote shares, deal in shares or underwrite shares

For other services like advice In raising finance, identifying possible targets for acquisition etc.:
- Using professionals who are not members of the audit team to provide the services; or
- Having a professional who was not involved in providing the corporate finance service advise the audit team on the service and review the accounting treatment and any financial statement treatment.</td>
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<tr>
<td>h) Taxation</td>
<td>Tax return preparation: okay if management takes responsibility for the return
Calculation for accounting entries: not allowed for public interest entities
Tax planning: okay if supported by tax authorities/ precedent
Tax disputes resolution: not recommended if raltes to a material areas and if the subject of dispute is a service given by the firm, otherwise, segregation of teams, external tax professional advice should be taken</td>
</tr>
<tr>
<td>i) Litigation Support Services</td>
<td>Litigation support services may include activities such as acting as an expert witness, calculating estimated damages or other amounts that might become receivable or payable as the result of litigation or other legal dispute, and assistance with document management and retrieval. These services may create a self-review or advocacy threat.
If significant, same safeguards as valuation services</td>
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<td></td>
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<tr>
<td colspan="2">Generic intimidation examples-
- Being asked to reduce extent of work to reduce fee
- Team members feels pressured to agree with client’s judgment as client has more expertise</td>
</tr>
<tr>
<td colspan="2">Advocacy examples
Legal services(eg expert witness), corporate finance work like negotiating with banks on client’s behalf, contingent fee</td>
</tr>
</table>

Technical article: Exam techniques

Ethical standards and their application form a major part of the Advanced Audit and Assurance syllabus and are examined regularly. Often the marks for this area will be spread over more than one question and may be combined with planning, professional issues or as a standalone.

The basic ethical standards at this level are the same as those examined previously in Audit and Assurance; what sets apart the level of the questions is your ability to apply those standards to more complex situations and show that you understand both threats and safeguards. This is an area of the exam where candidates can use good exam technique to increase the marks attained without having to rote learn much additional information above that learnt for previous exams.

This article will demonstrate how to maximise marks on these areas using good technique. It is, however, specific to the context of auditing and assurance and will therefore have a different focus and application to the way ethics is examined in other areas of the ACCA Qualification.

WHAT YOU NEED TO KNOW

The starting point for preparing for any exam is to know the underlying knowledge that is required for this part of the syllabus. At this level the content of the guidance is what you should focus on. Marks are not awarded for memorising or quoting standard numbers, it is the application of the content of those standards that is important. For the Advanced Audit and Assurance exam the following standards are examinable:

- ACCA's Code of Ethics and Conduct (2016)
- IESBA's Code of Ethics for Professional Accountants (Revised May 2015)
- IESBA–Changes to the Code Addressing Certain Non-Assurance Services Provisions for Audit and Assurance Clients Ethical Considerations Relating to Audit Fee Setting in the Context of Downward Fee Pressure (January 2016)

In addition, for the UK exam candidates will be examined on the Financial Reporting Council's Revised Ethical Standard 2016, for the IRL exam candidates will be tested on the IAASA's Ethical Standard for Auditors (Ireland) 2016, and SGP candidates should also refer to the ISCA Code of Professional Conduct and Ethics (Revised November 2015).

You will be familiar with ACCA's Code of Ethics from the Audit and Assurance exam. This mirrors the IESBA's Code of Ethics so you will be familiar with the five basic principles of Integrity, Objectivity, Professional Competence and Due Care, Confidentiality, and Professional Behaviour. You will also be familiar with the general areas of threat to the fundamental principles of Self Review, Self Interest, Advocacy, Familiarity, and Intimidation.

The situations you will be appraising at this level will usually involve an assessment of those same principles within scenarios given in the question. In addition, you may be expected to identify situations where the auditor is at risk of assuming a management responsibility with respect to providing additional services to audit clients or appreciate the differences between listed (or other public interest entities) and non-listed clients when it comes to applying these principles.

With regards to objectivity and independence, the general conceptual approach in the codes is as follows:

(a) Identify threats to independence
(b) Evaluate the significance of the threats identified, and
(c) Apply safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level.

When the professional accountant determines that appropriate safeguards are not available or cannot be applied to eliminate the threats or reduce them to an acceptable level, the professional accountant shall eliminate the circumstance or relationship creating the threats or decline or terminate the audit engagement.

HOW TO APPLY THE KNOWLEDGE

When addressing ethical situations in the exam, you will usually have to demonstrate these skills:

1. that you can identify an ethical threat
2. that you understand how it arises and the implication of the threat, and
3. that you can relate the guidance to the specific scenario to determine the safeguards or course of action required.

Each of these skills can be illustrated through the examples below (note that the answers provided here are focusing on the ethical issues arising and do not cover the professional or other issues you might also need to discuss arising from the scenarios). These answers are not fully comprehensive and give an example of the content which could be produced in an exam. There are further points in each case that could be developed and additional outcomes available within the ethical codes; however, they do represent a well-developed answer a candidate could use to attain the full marks available.

Example 1
The audit committee of, Mumbai Co, has asked the partner to consider whether it would be possible for the audit team to perform a review of the company's internal control system. A number of recent incidents have raised concerns amongst the management team that controls have deteriorated and that this has increased the risk of fraud, as well as inefficient commercial practices. The auditor's report for the audit of the financial statements of Mumbai Co for the year ended 31 March 2016 was signed a few weeks ago. Mumbai Co is a listed company.

Required:
Comment on the ethical issues raised and the actions your firm should take in response to the client's request.
(6 marks)

In this example, we are asked to provide an additional service to an audit client – a review of systems and controls. This is going to give rise to a self-review threat and may possibly lead to assuming a management responsibility. This identification is the first step to answering the question, but these points alone will not score credit in the exam until you have developed them. In order to do this you can use the steps described to build up marks as follows. The important phrases are in bold.

Demonstrating you understand the threats, how they arise and the implication

Providing a review of the company's system and controls gives rise to a self-review threat as these controls will then be **reviewed by the firm when determining our audit strategy.** The firm may be **reluctant to highlight errors** or adopt a substantive approach during the audit as this may highlight deficiencies in the firm's work on the additional service. *(1 mark)*

The **design of systems and controls is a management responsibility** so a review of such may give rise to a situation where the auditor is assuming a management responsibility by **taking on the role of management.** *(1 mark)*

Apply the guidance to the scenario – evaluate the significance and suggest safeguards

The code states that the threat to independence of undertaking management responsibilities for an audit client is so significant that there are **no safeguards**which could reduce the threat to an acceptable level. *(1 mark)*

However, this answer could score three marks, it is likely that more marks are available. From an exam technique point of view, you should be looking for additional points to make. At this stage, don't start speculating about relative fee size; try to focus on the information the examiner has given you. Here, the company is flagged as listed, so there must be further development available on this area. Think about how you've seen management responsibility issues overcome during your studies and past question practice. It is these points that you can use to attract further marks.

Management responsibility can be avoided if the **client takes responsibility** for monitoring the reports made and taking the decisions on recommendations.
(1 mark)

However, as this **client is listed, we are prohibited** from undertaking internal audit services which relate to a significant part of the controls over financial reporting. *(1 mark)*

Conclude

As such we must **decline** the additional work. *(1 mark)*

In other circumstances, the safeguard of using separate teams to overcome self-review threats or considering the competence of the firm to provide this service would attain credit; however, in this case, the client is listed so these points are irrelevant here.

Note that, in the exam, no marks are awarded for simply listing self-review or management responsibility as they will need to be described before marks are awarded. As such, ensure that you take the time to explain the threats rather than simply writing terms.

Example 2
Your firm's advisory department has been carrying out a due diligence assignment on a potential acquisition target of an audit client, Blue Co. The management team of Blue Co has also approached White & Co to ask whether representatives of the firm would be available to attend a meeting with the company's bankers, who they are hoping will finance the acquisition of Red Co, to support the management team in conveying the suitability of the acquisition of Red Co. For the meeting the bank requires the most up-to-date interim accounts of Red Co with the accompanying auditor's independent interim review report. Your firm is due to complete the interim review shortly and the management team of Red Co has requested that the interim review is completed quickly so that it does not hold up negotiations with the bank, stating that if it does, it may affect the outcome of the next audit tender, which is due to take place after the completion of this year's audit.

Required:
Comment on the ethical issues raised and recommend any actions your firm should take in response to the client's requests.

(8 marks)

In this example we have additional services and pressure relating to existing services to an audit client. The issues we face are advocacy, self-review, management responsibility and intimidation.

Demonstrating you understand the threats, how they arise and the implication

Attending a meeting with the bank would give rise to an advocacy threat as we would be perceived as **promoting the interests of our client and confirming the client's assertions** in negotiations. *(1 mark)*

In addition, this may give rise to **legal proximity** exposing the firm **to potential litigation.** *(1 mark)*

Attending the meeting may result in the firm being perceived to support the acquisition of Red Co. As these are **decisions which should be taken by management** we could be perceived as taking on a **management role**. *(1 mark)*

Self-review threats may also arise when we **later audit** the finance and acquisition in **the financial statements** of the group as we may be **reluctant to highlight errors** or are **less sceptical** about the values in the subsidiary as we have provided the due diligence work. *(1 mark)*

Further, an intimidation threat exists as the client **has threatened** that if the interim report is delayed it would affect the outcome of the tender for audit in the future **and there is a risk that quality is reduced in order to meet the client's demands.** *(1 mark)*

Apply the guidance to the scenario – evaluate the significance and suggest safeguards and conclude
Here, there are different directions that the answer could take – for example, discussing in depth the exact nature of the assignment and meeting attendance; however, it is possible to attract marks without such detail in your answer as follows:

Assuming a management responsibility can be avoided if the **directors confirm in writing** that they are **responsible** for any decision regarding the acquisition. *(1 mark)*

The firm should **decline to attend the meeting** with the bank. *(1 mark)*

The self-review threat can be reduced by having **an independent partner review** the audit work prior to signing the auditor's report. *(1 mark)*

The intimidation threat should **be reported to those charged with governance**. *(1 mark)*

Note that, in this instance, a separate team for the due diligence and audit assignments was not suggested as the scenario already told us that a different department had been carrying out the due diligence work.

The above two examples aim to cover a range of issues and illustrate how candidates can attract strong marks when answering ethics questions. As with most areas of the Advanced Audit and Assurance exam, it is the application of knowledge to a scenario rather than the knowledge itself that will attract marks. This means that when preparing for this exam, a good grasp of the knowledge underpinning the syllabus is important but practising questions and developing the skills of applying that knowledge is key to passing. ***Written by a member of the P7 examining team***

Fraud

An exam focused overview

Types of fraud

1. **Fraudulent financial reporting** (fake journal entries, manipulating estimates and judgments, omitting transactions and events or recording them in the incorrect period, omitting or misstating F/S disclosures, altering records and supporting documents etc.)

2. **Misappropriation of assets** (embezzling receipts, stealing physical assets or intellectual property, causing an entity to pay for goods/services not received, using an entity's assets for personal use)

Responsibilities

Management: Prevent and detect fraud through strong internal controls and a culture of honesty.

External Auditor:

1. NOT primary responsibility to detect fraud- needs to gain reasonable assurance that F/S are free from **material** fraud. The auditor might not be able to detect fraud (and error) because evidence is persuasive not conclusive, sophisticated accounting techniques may have been used to commit fraud, collusion may have occurred, sampling is used so immaterial fraud may not be detected etc)

2. Professional skepticism

3. Discussion among the engagement team (how and where F/S may be susceptible to fraud)

4. Risk assessment(auditor has to identify and assess risk of misstatement in F/S due to fraud)

5. Analytical procedures

6. Enquire of management: their assessment of risk related to fraud, their process of assessing risk, whether they have knowledge of actual or suspected fraud

7. Enquire of Internal auditor: their assessment of risk related to fraud, whether they have knowledge of actual or suspected fraud

8. Auditor has to design and implement appropriate responses to risky areas identified and when fraud is identified

9. When fraud is discovered, auditor has to extend testing into other areas and consider implications for the entire audit.

Fraud: ISA 240 (Redrafted) defines fraud as: *'An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.'*

Error: is an unintentional misstatement in financial statements, including the omission of an amount or a disclosure.

Irregularity: refers to **intentional misstatement** or omission of events, transactions or other significant information.
Irregularity includes:

- Financial reporting which renders the financial statements misleading
- Misappropriation of assets

Hence an irregularity amounts to fraud.

Misstatement is a difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.
Misstatements can arise from error or fraud.

Two types of intentional misstatements are relevant to the auditor – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

Fraudulent financial reporting

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as intentionally:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Omitting, obscuring or misstating disclosures required by the applicable financial reporting framework, or disclosures that are necessary to achieve fair presentation.
- Concealing facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity

Altering records and terms related to significant and unusual transactions

Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

Earnings Management

An example of fraud is management overriding controls and manipulating information i.e. **'earnings management'**.
Earnings management occurs when companies deliberately manipulate their revenues and/ or expenses in order to inflate (or deflate) figures relating to profits and earnings per share. In other words, it is when companies use 'creative accounting' to construct reported figures that show the position and performance that management want to show.
Earnings management does not always mean that the applicable financial reporting framework has not been followed. Earnings management is often described as 'bending the rules'. It may be that the manipulation of published figures is the result of selecting an accounting policy which is allowed under the financial reporting framework, but which does not reflect economic reality. For example, changing the estimated life of a non-current asset is allowed under financial reporting standards, but if it is done purely to manipulate the depreciation charge (and therefore earnings), then it becomes an example of earnings management.

Responsibilities of External Auditors and Management in Relation to the Detection of Fraud

Management/TCWG

ISA 240 makes it clear that the primary responsibility for the prevention and detection of fraud rests with both those charged with governance and management of an entity. By establishing a sound system of operational and financial controls, management should reduce opportunities for fraud to take place, and establish a culture which should persuade individuals not to commit fraud due to the likelihood of detection and punishment. In some jurisdictions, codes of corporate governance require specific actions to be taken in respect of internal controls by management.

External Auditor

The external auditor may provide recommendations and advice on the improvement of internal controls, but it is not their responsibility to put the recommendations into practice.

The auditor’s responsibility is to consider the risk of material misstatement in the financial statements due to fraud. This means that the auditor is more focused on fraud that impacts on the accounts than on operational fraud which may not cause a material misstatement.

A fraud with an immaterial impact may not be detected by audit procedures. Because the external auditor will use sampling techniques based on a level of materiality, not all balances and transactions will be subject to detailed testing, so small frauds are not likely to be detected. A similarity is that both management and the external auditor should assess the strength of controls in place within the entity, and in doing so, evaluate the likelihood of a fraud occurring. The auditor will perform this evaluation while planning the audit.

ISA 240

1. **Professional Skepticism:** the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further.

2. **Discussion among the Engagement Team:** Led by the engagement partner. Particular emphasis should be placed on how and where the entity’s financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.

3. **Risk Assessment Procedures and Related Activities** ***(****Obtain information for use in identifying the risks of material misstatement due to fraud.)*

The auditor shall make inquiries:

- Regarding management’s assessment of the risk that the financial statements may be materially misstated due to fraud
- Regarding management’s process for identifying and responding to the risks of fraud in the entity
- to determine whether they the management/TCWG have knowledge of any actual, suspected or alleged fraud affecting the entity

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

The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures that may indicate risks of material misstatement due to fraud.

The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present.

<u>Overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level</u>

In determining the overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor shall:

a) **Assign engagement responsibilities to personnel based on knowledge, skill and ability.** For example, assigning additional individuals with specialised skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement;

b) **Evaluate whether the selection and application of accounting policies by the entity may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings**. This is particularly applicable to those accounting policies which involve subjective measurements and complex transactions, and

c) **Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures**, such as performing audit procedures at different locations or at particular locations, unannounced**.**

<u>Communication of Fraud and Error</u>

To appropriate level of management: material misstatement leading to fraud

To those charged with governance: fraud involving management or when fraud is ignored by management

To regulators: when the duty of confidentiality is overridden by law

To shareholders: when misstatements leading to fraud affect the F/S

Auditor's Withdrawal from an Engagement

When fraud and errors are suspected or detected, the auditor may withdraw from the engagement under the following conditions:

1. Sometimes the auditor may come across situations which will not permit the auditor to continue performing the audit.

Examples of such situations are as follows

- The auditor has serious concerns about the integrity of the management or those charged with governance, like an arms manufacturer supplying arms to a terrorist organisation.
- The entity does not address fraud which is not material to the financial statements, but for which the auditor requires the management to take suitable action.

2. All entities have various complexities. Hence fraud **occurs under different situations in different entities.** Therefore there are no clear guidelines of the situations in which the auditor can withdraw from the engagement. However the auditor may decide to withdraw from the assignment when the auditor is worried about the implications of the involvement of those charged with governance or the effect on the auditor of continuing the association with the entity. For example, the auditor of the arms manufacturer may be worried about being associated with the client on account of the client's dealings.

3. The auditor will also need to consider the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities.

   If the auditor withdraws:
   - Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
   - Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

4. However, according to ISA 240, auditors of public sector entities often do not have the option of withdrawing from the engagement due to public interest considerations.

Professional Liability

An exam focused overview

Criminal liability for negligence: breach of trust (e.g. confidentiality), breach of contract (e.g. insufficient skills and care, late audit report), insider dealing, failure to report money laundering, destroying documents
Specific statutory liability: arising from tax legislation, insolvency legislation tc.
Civil liability

1. An act of default

2. By a member or his employee

3. Which must lead to financial loss

4. To the client
   Or
   A 3rd party (for example bank, prospective investor) to who duty of care is owed the 3rd party informed the auditor that they will use the auditor's report **or** there was proximity: i.e. the auditor should have foreseen that F/S will be relied upon by the 3rd party

External auditor's liability towards client	External auditor's liability towards a 3rd party
-contract	-no contract
-duty of care owed to client	-3rd party has to prove duty of care owed to them
-client has to prove breach of contract/breach of duty of care	-3rd party has to prove that there has been a breach of duty of care
-client has to prove financial loss	-3rd party has to prove financial loss

How can auditor restrict professional liability? LEARN
Client acceptance procedures; Performance and documentation of audit work; Quality control; External consultations; Issue disclaimer; Use engagement letter; Capping or setting a limit on amount of liability; Operate as an incorporation Choosing limited liability partnership; Obtaining professional indemnity insurance

Accountants who **do not discharge their services responsibly** face the following **legal liabilities**:

1. **Criminal liability for negligence**
2. **Specific statutory liability**
3. **Civil liability for negligence**

1. Criminal liability

<table>
<tr><td>Breach of trust: the auditor not maintaining the confidentiality of information or not using client information for the benefit of the client.</td><td>Right Accountants are the auditors of Dvyne Plc. Dvyne Plc has recently tendered for a catering contract with Cat Airlines. The partner of Right informed his brother-in-law (who was a caterer) about the value of the tender.
This is a criminal liability involving a breach of trust since:
– Confidentiality is not maintained i.e. information about the client was passed to the auditor’s brother-in-law
– Client information was not used for the benefit of the client i.e. it was used for the benefit of the auditor’s brother-in-law.</td></tr>
<tr><td>Breaches of contract: continuation of an audit engagement after the term of appointment is completed.</td><td>An auditor is required to exercise sufficient care and skill while executing his duties. The ACCA clarifies this under Fundamental Principles in the Rules of Professional Conduct.

A company enters into a contract with its auditors. Therefore, the appointment of an auditor by a company is governed by contract laws.</td></tr>
<tr><td colspan="2">Insider trading: the auditor makes use of unpublished price sensitive information to obtain personal benefit. Auditors generally avoid purchasing shares in the client company so that the probability of insider trading will not occur.</td></tr>
<tr><td colspan="2">Failure to report fraud or money laundering</td></tr>
<tr><td colspan="2">Willful false statement</td></tr>
<tr><td colspan="2">Destroying or damaging any document</td></tr>
</table>

2. Specific statutory liability

Liability arising from insolvency legislation	Rex is a professional accountant. On 25 April 20X8, he was appointed the liquidator of Minerex Plc, a mining company located in the UK. The tasks which were performed for the winding up of the company included selling off all free assets and obtaining as much dividend as possible. The priority chain was as follows: – secured claims – claims with first priority (tax claims and settlement with regulators) – claims with second priority (wage claims or settlement with employees) – claims without priority (unsecured payables) The list of secured claims included Jasmine Plc (whose director is a cousin of Rex) who is actually a supplier of the company. Lisa, an employee of the company, was aware of the matter and sued Rex for negligence in the administration of his duties in the capacity of liquidator.
Liability arising from statute such as tax legislation.	For example, when the auditor does not disclose creative accounting practices made by the client with the intention of paying lower taxes
Liability arising under regulatory legislation	e.g. non-compliance with stock exchange regulations, Sarbanes-Oxley Act provisions

Criminal offences, if proved, are punishable by payment of a penalty and / or imprisonment.

3. Civil liability

A professional accountant can face civil liabilities for negligence, when he conducts his duties negligently. The **liability of the auditor towards third parties is called a liability in tort**. The term liability in tort means a third party liability.

Liability for negligence

The ACCA Rulebook deals with liability on account of professional negligence.

The circumstances which can give rise to a liability are as follows:

- ***an act of default;-----by member / his or her employee / associate;-----which must lead to financial loss;***
- ***to client or third party to whom duty of care is owed.***

An act of default means either **an act** or **omission** which occurs **due to non-application of the professional care and skills** which are normally applied by accountants and auditors.	**Professional competence and due care** Accountants can be charged with non-application of professional care and skills if they: **Do not ensure that clients or employers** are **provided** with professional services based on the **latest developments in the profession**, both legislative and technical. **Do not apply the code of ethics which are laid down by the profession.** Do not **ensure that either they or their employees and professional associates are suitably trained and supervised** **Not carry out further audit procedures on occasions when auditors suspect that there are material misstatements in the financial statements.**
by member / his or her employee / associate	**Professional accountant** is **expected to take responsibility for his work**. In short, the work of the accountant, if performed by his employee or his associate, needs to be carried out under the supervision of the accountant. Therefore, even if the accountant takes the assistance of either his employees or his associates, the accountant cannot be absolved of his responsibility.
must lead to financial loss	Professional accountants can be charged with liabilities for negligence, **only if either their clients or third parties suffer from financial loss on account of acts of negligence by auditor**. The financial loss suffered by a client must be a direct financial loss, i.e. not an indirect or remote loss.
to client or third party to whom duty of care is owed	An act of **negligence arises when a duty of care exists**. For a duty of care to exist, the following factors need to be satisfied: **i.** **The accountant must be in a position to reasonably foresee that the statements** (or the work carried out by the accountant) **would be relied upon by the client or the third party**. **ii.** **The accountant is sometimes informed before carrying out the work** that a third party would rely on the statements (or work) carried out by the accountant. For example, an accountant who is asked to prepare a project report for the purpose of getting a bank loan will be in a position to know, in advance, that the project report will be used by the bank for the purpose of vetting the loan application. However, even **when the accountant is not explicitly informed** by the client that a third party would rely upon the results of his work, **the accountant is expected to understand the likely parties who would rely on his work.** **iii.** **There has to be a "relevant degree of proximity" between the parties.** **Proximity means closeness**. **It does not mean physical nearness but rather closeness in terms of relationship or because the parties are likely to rely on the work of the accountant.** Jay, the auditor of Sea Shells Resorts, certifies a report **solely** for Prego Hotels, which has requested and commissioned this report. In this case, Jay will only have a duty of care towards Prego Hotels since he has 'proximity' with them. However, if the auditor's report is used by other prospective investors who suffer economic losses, the prospective investors have no proximity with the auditors. Therefore the auditors do not have a duty of care.

Restricting Audit Liability

All audit firms want to avoid litigation, due to the bad publicity that is likely to follow, the financial consequences, and the potential collapse of the audit firm. There are several ways that an audit firm can reduce its exposure to claims.

Client acceptance procedures	Firms should carefully assess the risk associated with potential audit clients. Screening procedures should be used to identify matters that create potential exposure for the audit firm. For example, it would be unwise to take on a new client with significant going concern problems. The issue is that a client should only be accepted if the associated risk can be managed to an acceptably low level given the skills and resources of the audit firm.
Performance and documentation of audit work	Audit firms should ensure that professional standards are maintained, and that International Standards on Auditing. (ISAs) are adhered to. It is crucial that full documentation is maintained for all aspects of the audit, including planning, evaluation of evidence, and consideration of ethical issues. A claim of negligence is unlikely to be successful if the audit firm has documentary evidence that ISAs have been followed.
Quality control	Firms must ensure they have implemented firm-wide quality control procedures, as well as procedures applicable to the individual audit engagement. Quality control acts as an internal control for the audit firm, helping to ensure that ISAs and internal audit methods have been followed at all times.
External consultations	Firms should make use of external specialists when the need arises, for example obtaining legal advice where appropriate, to ensure that the auditor's actions are acceptable within the legal and regulatory framework
Issue disclaimer	In recent years it has become common in some jurisdictions for audit firms to include a disclaimer paragraph in the audit report. This is an attempt to restrict the duty of care of the audit firm to the shareholders of the company, thereby attempting to restrict legal liability to that class of shareholders. Disclaimers, however, may not always be effective. "This report has been marked 'CONFIDENTIAL'. It has been prepared solely for the members of Cosby Company in accordance with the Companies Act 2006. The audit report consists of those matters that are required to be undertaken for an audit and to be stated in an audit report and not for any other purpose. In the circumstances, with the full support of law, I am not held responsible for any other party other than the company and the company members for the audit report or for the audit opinion." The ACCA (according to ACCA Fact sheet 84) discourages the use of standard disclaimers. This is because standard disclaimers amount to reducing the value of the audit report. Furthermore, the disclaimer can be misused by auditors as a safeguard against an improper audit
Use engagement letter	The engagement letter should be used to clearly state the responsibilities of the auditor, and of management. As it forms a contract between the audit firm and the client, it should be updated on an annual basis, with care being taken to ensure the client is fully aware of any changes in the scope of the audit, or the reporting responsibilities of the audit firm.

Capping or setting a limit on amount of liability	The auditor's liability can be restricted by capping or setting a limit on the amount of liability which can be imposed on any specific party. This amount can be determined as a multiple of audit fees for a particular engagement, i.e. there will be a direct relationship between the audit fees and the amount of liability or the liability will be a proportion of the turnover of the company.
Operating as incorporation	In many jurisdictions, auditors are allowed to operate only as sole traders or partners i.e. firms have joint and several liabilities. This means that a partner can face liability on account of negligence by other partners of the firm as well as the directors of the client company. KPMG in the UK is an example of where auditors have chosen to become incorporated. This means that the **liability of the partners is restricted to the assets of the incorporation.** **Audit firms may form incorporations to address their liability problems. However, forming incorporation does not overcome the problems described above**. This is because: – it makes the audit company fully liable for the total amount of any judgment which exceeds the professional indemnity insurance – it makes the audit partners and the company liable for negligent acts by any partner of the company – it protects the private assets of the 'innocent' audit partners – partners who are 'guilty' of negligence owe joint and several responsibilities – the firm can be forced into liquidation – the firm would need to publish its financial statements and also be subjected to audit
Choosing limited liability partnership	Under an LLP, 'innocent' members are not personally liable for the acts of negligence by other members. Their liability is restricted to their share in the assets of the business. In short there is no difference between the liabilities of members of incorporation and an LLP. The only difference between the two entities is the taxation implications, i.e. incorporation has to pay taxes like any other 'company'. However an LLP does not pay tax. Only its members pay taxes for the income earned through the LLP. Ernst & Young in the UK is an example of an LLP.
Obtaining professional indemnity insurance	Accountants who do not discharge their services responsibly face several legal liabilities**.** **Accountant's face legal claims from clients and third parties due to negligent services provided to clients.** Many countries have instituted insurance policies which cover risks associated with professional negligence. These risks include liabilities against claims for professional negligence or loss through fraud. The ACCA has made it mandatory for all ACCA holders of practicing certificates to obtain a minimum level of insurance cover.

Quality Control

An exam focused overview

ISQC 1 (applicable for the FIRM)

- Provides guidance on the overall quality control systems that should be implemented by an audit firm.

Quality control on AN INDIVIDUAL AUDIT-ISA 220

- Specifies the quality control procedures that should be applied by the engagement team in individual audit assignments.

Elements of quality control

1	**Leadership responsibility for quality**	**Audit:** Engagement Partner **Firm:** A senior member (responsible for creating awareness about quality, implemented a quality oriented culture, ensuring policies are followed, establishing communication channels from Engagement Partner to team and vice versa)
2	**Ethical requirements**	Engagement Partner to ensure independence not compromised throughout the audit
3	**Acceptance/ continuance of client**	As before (CDD, ethics, conflict of interest, resources etc.)
4	**HR policies**	**Audit:** Engagement Partner should have skills, authority, time required for audit. He should also ensure the team has relevant skills **Firm:** Appropriate policies regarding staff recruitment, performance evaluation, skills, promotion.
5	**Engagement performance**	**a) Direction** - Set by Engagement Partner - Set in the planning meeting - Responsibilities assigned to team - Objective of work to be done communicated - Initial audit approach decided - Risks - Team told how to deal with problems as they arise
		b) Supervision Main responsibility: Engagement Partner Should be continuous: The audit supervisor should keep track of the progress of the audit engagement to ensure that the audit timetable is met and should ensure that the audit manager and partner are kept updated of progress - Ensure work according to planned approach (The competence and capabilities of individual members of the engagement team should be considered, including whether they have sufficient time to carry out their

		work, whether they understand their instructions and whether the work is being carried out in accordance with the planned approach to the audit.) - Ensure important matters told to seniors - Ensure audit approach modified if needed (based on any significant matters that may arise during the audit) - See if consultation is needed.
6		**c) Consultation** - From outside the team or outside the firm - On difficult/contentious matters
		d) Review Hierarchical review (consider whether work has been performed in accordance with professional standards and other regulatory requirements and if the work performed supports the conclusions reached and has been properly documented.) - On a timely basis throughout the audit - Ensure work according to all relevant standards (including quality standards) - Check if objective of work has been achieved - Ensure conclusions are supported by sufficient appropriate evidence - HAS to be done by the Engagement Partner(need not review all audit documentation, but only a 'quick look' at the working papers could indicate that areas of risk or critical judgement have not been reviewed in sufficient detail.)
		e) Engagement Quality Control Review (if needed) - Reviewer appointed by Engagement Partner - Reviewer will review significant judgments - Reviewer will evaluate conclusions reached in making the audit report - Reviewer will ensure consultations have been taken where needed
		f) Documentation - Maintain and retain all documentation (working papers) - Ensure confidentiality
6	**Monitoring**	-The firm should ensure quality control procedures are adequate and complied with. -The firm should retain evidence about the relevance, adequacy and effectiveness of quality control procedures and of the corrective actions taken.

The firm shall establish and maintain a system of quality control that includes policies and procedures that address each of the following elements:

(a) Leadership responsibilities for quality within the firm.

(b) Relevant ethical requirements.

(c) Acceptance and continuance of client relationships and specific engagements.

(d) Human resources.

(e) Engagement performance.

(f) Monitoring.

Documentation of the System of Quality Control: The firm shall establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control. These should be communicated to the firm's personnel.

Element	**ISQC 1 (applicable for the FIRM)** *Engagements* provides guidance on the overall quality control systems that should be implemented by an audit firm.	**Quality control on AN INDIVIDUAL AUDIT-ISA 220** Specifies the quality control procedures that should be applied by the engagement team in individual audit assignments.
Leadership Responsibilities for Quality within the Firm	The standard requires that the firm implements policies such that the **internal culture** of the firm is one where **quality** is considered **essential**. Such a culture must be inspired by the leaders of the firm, who must sell this culture in their actions and messages. The firm may appoint an individual or group of individuals to oversee quality in the firm. Such individuals must have: – Sufficient and appropriate experience – The ability to carry out the job – The necessary authority to carry out the job	The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.
Relevant Ethical Requirements	The firm shall establish policies and procedures designed to provide it with reasonable assurance that the firm: – Maintains independence where required by relevant ethical requirements. – Is notified of breaches of independence requirements, and	Throughout the audit engagement, the engagement partner shall remain alert, through observation and making enquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. The engagement partner shall: (a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate

	takes appropriate actions to resolve such situations.	circumstances and relationships that create threats to independence (b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement (c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is possible under applicable law and regulation.
Acceptance and Continuance of Client Relationships and Specific Engagements	Consider whether the firm: (a) Is competent to perform the engagement and has the capabilities, including time and resources, to do so; (b) Can comply with relevant ethical requirements; and (c) Has considered the integrity of the client, and does not have information that would lead it to conclude that the client lacks integrity.	There should be full documentation, and conclusion on, ethical and client acceptance issues in each audit assignment. The engagement partner should consider whether members of the audit team have complied with ethical requirements, for example, whether all members of the team are independent of the client. Additionally, the engagement partner should conclude whether all acceptance procedures have been followed, for example, that the audit firm has considered the integrity of the principal owners and key management of the client. Other procedures on client acceptance should include: – Obtaining professional clearance from previous auditors – Consideration of any conflict of interest – Money laundering (client identification) procedures.
Human Resources	The firm should have policies and procedures on ensuring excellence in its staff, so that there is 'reasonable assurance that it has sufficient personnel with the **capabilities**, **competence**, and **commitment to ethical principles .** These will cover the following issues: – Recruitment – Performance evaluation – Capabilities -Competence – Career development – Promotion – Compensation	Procedures should be followed to ensure that the engagement team collectively has the skills, competence and time to perform the audit engagement. The engagement partner should assess that the audit team, for example: – Has the appropriate level of technical knowledge – Has experience of audit engagements of a similar nature and complexity – Has the ability to apply professional judgement – Understands professional standards, and regulatory and legal requirements. **ISA 220 text:** Assignment of the engagement team

	– The estimation of personnel needs The firm is responsible for the on-going excellence of its staff, through continuing professional development, education, work experience and coaching by more experienced staff.	This responsibility is given to the audit engagement partner. The firm should have policies and procedures in place to ensure that: – Key members of client staff and those charged with governance are aware of the identity of the audit engagement partner – The engagement partner has appropriate capabilities, competence, authority and time to perform the role – The engagement partner is aware of his responsibilities as engagement partner The engagement partner should ensure that he assigns staff of sufficient capabilities, competence and time to individual assignments so that he will be able to issue an appropriate report
Engagement Performance	Firms often produce a **manual of standard engagement procedures** to give to all staff so that they know the standards they are working towards. These may be electronic. Ensuring good engagement performance involves a number of issues: – Direction – Supervision – Consultation – Review – Resolution of disputes	**Direction** The partner directs the audit. Procedures such as an engagement planning meeting should be undertaken to ensure that the team understands: – Their responsibilities – The objectives of the work they are to perform – The nature of the client's business – Risk related issues – How to deal with any problems that may arise; and – The detailed approach to the performance of the audit. The planning meeting should be led by the partner and should include all people involved with the audit. There should be a discussion of the key issues identified at the planning stage. **Supervision** Supervision should be continuous during the engagement. Any problems that arise during the audit should be rectified as soon as possible. Attention should be focused on ensuring that members of the audit team are carrying out their work in accordance with the planned approach to the engagement. Significant matters should be brought to the attention of senior members of the audit team. Documentation should be made of key decisions made during the audit engagement.

		Consultation Finally the engagement partner should arrange consultation on difficult or contentious matters. This is a procedure whereby the matter is discussed with a professional outside the engagement team, and sometimes outside the audit firm. Consultations must be documented to show: – The issue on which the consultation was sought; and – The results of the consultation. **Review** The review process is one of the key quality control procedures. All work performed must be reviewed by a more senior member of the audit team. Reviewers should consider for example whether: – Work has been performed in accordance with professional standards – The objectives of the procedures performed have been achieved – Work supports conclusions drawn and is appropriately documented. The review process itself must be evidenced. **Quality control review** The audit engagement partner is responsible for **appointing** a reviewer, if one is required. He is then responsible for discussing significant matters arising with the reviewer and for not issuing the audit report until the quality control review has been completed. A quality control review should include: • An evaluation of the **significant judgements** made by the engagement team • An evaluation of the **conclusions** reached in formulating the auditor's report A quality control review for a listed entity will include a review of: • Discussion of significant matters with the engagement partner • Review of financial statements and the proposed report • Review of selected audit documentation relating to significant audit judgements made by the audit team and the conclusions reached

<table>
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Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the auditor's report is appropriate
The engagement team's evaluation of the firm's independence towards the audit
Whether appropriate consultations have taken place on differences of opinion/contentious matters and the conclusions drawn
Whether the audit documentation selected for review reflects the work performed in relation to significant judgements/supports the conclusions reached
When ISA 701applies, the conclusions reached by the engagement team in formulating the auditor’s report include determining:

The key audit matters to be included in the auditor’s report;
The key audit matters that will not be communicated in the auditor’s report in accordance, if any; and
If applicable, depending on the facts and circumstances of the entity and the audit, that there are no key audit matters to communicate in the auditor’s report.

In addition, the review of the proposed auditor’s report includes consideration of the proposed wording to be included in the Key Audit Matters section.

Other matters relevant to evaluating significant judgements made by the audit team are likely to be:

The significant risks identified during the engagement and the responses to those risks (including
assessment and response to fraud)
Judgements made, particularly with respect to materiality and significant risks
Significance and disposition of corrected and uncorrected misstatements identified during the audit
Matters to be communicated with management/those charged with governance

</td></tr>
<tr><td>Monitoring</td><td>The standard states that firms must have policies in place to ensure that their quality control procedures are:
– Relevant
– Operating effectively</td><td>The audit engagement partner is required to consider the results of monitoring of the firms (or network's) quality control systems and consider whether they have any impact on the specific audit he is conducting.</td></tr>
</table>

	– **Adequate** – **Complied with** In other words, they must monitor their system of quality control. Monitoring activity should be reported on to the management of the firm on an annual basis. There are two types of monitoring activity, an ongoing evaluation of the system of quality control and period inspection of a selection of completed engagements. An ongoing evaluation might include such questions as, 'has it kept up to date with regulatory requirements?' A period inspection cycle would usually fall over a period such as three years, in which time, at least one engagement per engagement partner would be reviewed. The people monitoring the system are required to evaluate the effect of any **deficiencies** found. These deficiencies might be one-offs. Monitors will be more concerned with **systematic or repetitive deficiencies that require corrective action**. When evidence is gathered that an inappropriate report might have been issued, the audit firm may want to take legal advice. **Corrective action** – Remedial action with an individual – Communication of findings with the training department – Changes in the quality control policies and procedures – Disciplinary action, if necessary	

Eligibility of a person to perform an engagement review.

ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements* outlines how a firm decides on the eligibility of a person to perform an engagement review.

Firstly, the reviewer must have a high standard of technical knowledge, encompassing a thorough understanding of auditing and financial reporting standards, as well as any specific regulatory issues (such as stock exchange listing rules) which may be relevant to the client.

In addition, the reviewer should be an experienced auditor, preferably with specific practical experience of auditing companies operating in a similar industry or business sector as the client.

The reviewer should possess a level of authority within the firm. This will allow the reviewer to challenge the decisions made by other members of the firm, including senior managers and partners. It is important that the reviewer is not intimidated by the senior members of the audit team who could feel criticised by any negative comments that the reviewer may have on their work and decisions. ISQC 1 recommends that a reviewer of listed client's audits should normally be at partner level within the firm.

Finally, the reviewer must be independent of the audit team. This allows a totally objective review to take place. The engagement partner therefore should not be involved in deciding who should review the audit. Consultations between the engagement partner and the reviewer can take place during the audit, but care should be taken to preserve the reviewer's objectivity.

Obtaining and accepting professional appointments

Change in auditor- reasons

1. Audit fee: perceived to be too high, not value for money, not competitive
2.Size: Client's business expands beyond auditor's capacity, client falls below exemption limit
3.Personality: client falls out with auditor
4.Audit rotation: independence related reasons
5.Auditor does not seek re-election: disagreement with client, another client in competition, auditor has ethical reasosn

Advertising

Basic Guidelines

Advertising is allowed as long as the advertising does not go against any of the fundamental principles contained in ACCA's *Code of Ethics and Conducto*r IFAC's *Code of Ethics for Professional Accountants*.

1. Advertisements should be truthful and not make false claims. For example, it would be inappropriate to claim that a firm could promise to offer a cheaper audit service than the competitor firm. Equally, it would be inappropriate to make exaggerated claims regarding the experience or the qualifications possessed by the firm's partners and employees.

2. In addition, any advertisement should not make disparaging remarks about any other audit or accountancy firm, for example, it would be inappropriate to state that a firm offered a higher quality service than any other provider.

3. Any advertisements should also be in compliance with any local rules and regulations. For example, in some jurisdictions it is prohibited for professionals such as auditors to advertise on television, and most jurisdictions will have some kind of regulatory authority, such as the Advertising Standards Authority in the UK, which imposes rules on advertising to ensure it is not misleading and is in good taste.

Practice Descriptions

Members:

- can use ACCA or FCCA after their names
- not permitted to add Honours/ hons after ACCA or FCCA

A firm can describe itself as:

- "chartered certified accountants" if half or more partners are members of ACCA and they have at least 51% of voting rights
- "members of ACCA" if all the partners are members of ACCA
- "registered auditors" if it holds auditing certificate from ACCA

Firm names should not

- Hamper the reputation/dignity of accountancy profession
- Bring discredit to other accountants
- Be the same as existing firm's name
- Be misleading

<u>Use of the ACCA logo:</u> The ACCA logo, also known as the ACCA mark, **can be used on the letterheads, other professional stationery or on the website** of a firm which has at least one partner or director who is a member of the ACCA.

The logo should be exactly as recommended by the ACCA in respect to its colour, size and positioning. If the firm has a logo of its own, it should be distinguishable from the ACCA logo

<u>Tendering</u>

Auditors are often approached by **interested clients to submit quotations for fees** to conduct particular work. The process of calling for quotations and submitting quotes is known as tendering.

Tendering is a process through which an interested party (i.e. the client) tries **to obtain quotations for fees** from the provider of services (i.e. the auditor) for a particular kind of work to be done. It is customary to submit tenders in sealed envelopes. Such sealed offers, including firm / company information, a project outline, and a price quote are known as tenders or bids. When an invitation to submit a proposal or fee quote is received by the auditor, the auditor must decide whether it wants to undertake that work.

<u>Information to be considered for a proposal</u>

Before submitting the proposal or fee quote for an audit or other professional engagement, the bidder must be aware of certain facts regarding the prospective client in order to be able to draw up a proposal. Such information can be obtained through discussions with the client or may have been made available by the prospective client at the time it invited the bids.

1. **What is the business of the prospective client? Is it a new business or an existing one?**

   The bidder must have information about the client's business, number of branches or subsidiaries, processes and products and internal control systems. This will help the bidder to evaluate the work involved and the expertise required. For example, if the client has undertaken an acquisition, expert knowledge on the accounting of acquisitions would be helpful.

   Similarly, knowledge of a client's business can help the bidder to decide whether or not it wants to take up the engagement, as there may be some issues which the bidder does not want to be involved with.

2. **What exactly does the prospective client expect the auditor to do? (statutory audit, taxation work etc)**
   The duties of the bidder must be clearly defined i.e. what the bidder is being hired for. Similarly, the timeline that the auditor is required to follow must be communicated. This will help the bidder to plan his work properly and also give an idea of the total time required to complete the assignment.

3. **What are the future plans of the prospective client?**
   Future plans refer to the business opportunities that the client plans to take up for **expansion or future growth**.

   This will help the bidder to assess his own **future prospects by working with the prospective client**. It can also help the bidder prepare for any future challenges that he might have to face while working for the client.

4. **Why does the prospective client intend to change the existing auditor?**
   If the client is seeking to change his existing auditor, the bidder may be interested to know the reason for this change.

<u>Matters to be included in tender document</u>

1. **Brief outline of firm:** This should include a short history of the firm, a description of its organisational structure, the different services offered by the firm (such as audit, tax, corporate finance, etc), and the locations in which the firm operates. The document should also state whether it is a member of any international audit firm network.

2. **Specialisms of the firm:** Describe the areas in which the firm has particular experience of relevance to the prospective client.

3. **Identification of the needs of the prospective client:** The tender document should outline the requirements of the client, for example that each subsidiary is required to have an individual audit on its financial statements, and that the consolidated financial statements also need to be audited.

4. **Outline of the proposed approach:** This is likely to be the most detailed part of the tender document. For example, in case of a tender for an audit, typically contained in this section would be a description of the audit methodology used by the firm, and an outline of the audit cycle including the key deliverables at each phase of work. For example:
   - How the firm would intend to gain business understanding at group and subsidiary level.
   - Methods used to assess risk and to plan the audits.
   - Procedures used to assess the control environment and accounting systems.

5. **Quality control:** The firm should emphasize the importance of quality control and therefore should explain the procedures that are used within the firm to monitor the quality of the services provided. This should include a description of firm-wide quality control policies, and the procedures applied to individual assignments. The firm may wish to clarify its adherence to International Standards on Quality Control.

6. **Communication with management:** The firm should outline the various reports and other communication that will be made to management.

7. **Outline the timeframe that would be used**

8. **Key staff and resources.**

9. **Fees:** The proposed fee for the audit of the group should be stated, and the calculation of the fee should be explained.

Accepting engagements

Let's talk about THE ADVANCED AUDIT & ASSURANCE EXAM

Factors to consider when accepting new client/client continuation

1. Resources (staff, time, competence of the firm including knowledge and experience of relevant industry, regulatory and reporting requirements, Scale of engagement-global?)
2. Commercial considerations (level of fee, profitability of the engagement etc)
3. Know Your Client/ Customer Due diligence
4. Risk (management integrity, money laundering, listed company, weak internal control etc)
   How to assess risk at this stage? Credit reference agencies, recently published F/S (solvency, adequacy of disclosures, appropriate accounting policies), contacts, newspapers, internet, company search(annual returns filed, SH details, PEP-politically exposed persons?)
5. Professional liability implication (e.g. audit required by lender)
6. Miscellaneous (complaints procedure, regulation by profession)
7. Independence, conflict of interest
8. Professional etiquette letter (clearance from outgoing auditor)
9. Pre- conditions of an audit

ISQC 1 sets out what a firm must consider and document in relation to accepting or continuing an engagement, which is the integrity of the client, whether the firm is competent to do the work and whether the firm meets the ethical requirements in relation to the work.

<table>
<tr><td>Ethical considerations</td><td>Procedures before accepting nomination
(a) Ensure that there are no ethical issues which are a barrier to accepting nomination (including any conflicts of interest)
(b) Ensure that the auditor is professionally qualified to act and that there are no legal or technical barriers
(c) Ensure that the existing resources are adequate in terms of staff, expertise and time
(d) Obtain references for the directors if they are not known personally to the audit firm
(e) Consult the previous auditors to ensure that there are not any reasons behind the vacancy which the new auditors ought to know. This is also a courtesy to the previous auditors

Competence of the firm
Do firm personnel have knowledge of relevant industries/subject matters?
Do firm personnel have experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively?
Does the firm have sufficient personnel with the necessary capabilities and competence?
Are experts available, if needed?
Are individuals meeting the criteria and eligibility requirements to perform the engagement quality control review available where applicable?
Is the firm able to complete the engagement within the reporting deadline</td></tr>
<tr><td>Work considerations</td><td>Setting fees
Once the total time and staff required for the assignment is ascertained, it should be easy for the auditor to determine the approximate fees that need to be charged. However, fees will not only be based on the time and staff required, but also on the following:
– Importance of the work to the client
– Urgency of the work
– Complexity (which relates to time)
– Need for travel (for e.g. to branch offices)</td></tr>
<tr><td>Legal considerations</td><td>a) Eligibility of an auditor
b) Restriction on the number of audits: In some jurisdictions (such as in India), there is a maximum limit to the number of audits that can be accepted by a member or audit partner.</td></tr>
<tr><td>Other considerations</td><td>a) What is the level at which fees are generally charged for the work concerned? For example, the fees that are charged by other auditors can be determined from the annual reports of public companies.
b) Would it be advantageous to the auditor to accept the assignment? For example, obtaining professional work from a particular client may enhance the auditor's image.
c) At what level of fees was the tender accepted last year?</td></tr>
</table>

Preconditions for an Audit

1. Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable

2. Obtain the agreement of management that it acknowledges and understands its responsibility:

(i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation

(ii) 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; and

(iii) To provide the auditor with:

a. Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
b. Additional information that the auditor may request from management for the purpose of the audit*******; and
c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence

*******Additional information: Additional information that the auditor may request from management for the purpose of the audit may include when applicable, matters related to other information in accordance with ISA 720 (Revised). When the auditor expects to obtain other information after the date of the auditor's report, the terms of the audit engagement may also acknowledge the auditor's responsibilities relating to such other information including, if applicable, the actions that may be appropriate or necessary if the auditor concludes that a material misstatement of the other information exists in other information obtained after the date of the auditor's report

Agreeing the terms of the engagement

Once the accountant agrees to work for a client, he must decide the terms of engagement in writing with the client. Such written communication is known as an ‘engagement letter’. ISA 210 Agreeing the Terms of Audit Engagements provides guidance on agreeing terms with a client and changes in the engagement terms. It assists the accountants in preparing audit engagement letters for accepting audit assignments, tax, accounting, or management advisory services.

Generally, an audit engagement letter includes the following matters:

1. **Objective of the audit:** e.g. statutory audit or internal audit

2. **Scope of the audit:** Elaboration of the scope of the audit, including reference to applicable legislation, regulations, ISAs, and ethical and other pronouncements of professional bodies to which the auditor adheres.

3. **Identification of the applicable financial reporting framework:** e.g. IFRS or US GAAP

4. **Time schedule:** estimated time required for completion of audit

5. The requirement for the auditor to communicate key audit matters in the auditor’s report in accordance with ISA 701

6. **Deliverables:** The form of any other communication of results of the audit engagement.e.g. letters, certificates or audit report.

7. The expectation that management will provide written representations

8. The basis on which fees are computed and any billing arrangements.

9. **Permission to communicate** with the previous accountant (by sending the etiquette letter)

10. **Access to all the records**, documentation and other information requested in connection with the audit, e.g. customs documents to verify whether the goods are being held by customs

11. **Management’s responsibility** for establishing and maintaining effective internal controls, e.g. maintenance of proper accounting records

12. The fact that because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.

13. Arrangements regarding the planning and performance of the audit, including the composition of the engagement team.

14. The expectation that management will provide access to all information of which management is aware that is relevant to the preparation of the financial statements, including an expectation that management will provide access to information relevant to disclosures.

15. The agreement of management to make available to the auditor draft financial statements including all information relevant to their preparation, whether obtained from within or outside of the general and subsidiary ledgers (including all information relevant to the preparation of disclosures), and the other information,3 if any, in time to allow the auditor to complete the audit in accordance with the proposed timetable.

16. The agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.

17. A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein.

Where the auditor is **replacing an existing auditor** while accepting a new client, he should **contact the existing auditor** and communicate his intentions for taking up the work of that client.

This must be done after taking **prior permission from the client**. Such communication usually takes place in the form of an etiquette letter or professional enquiry letter. If the client does not give permission to approach the outgoing auditor, the auditor should refuse the engagement.

An etiquette letter / professional enquiry letter enables the new auditor to communicate with the existing auditor and know if there are **any areas of concern** which he must consider before accepting the new engagement.

Many times, the apparent reason for a change of auditors may not fully reflect the facts and may indicate disagreements with the existing accountant that may influence the decision to accept the appointment.

Audit of the components in a group: If the client entity comprises various subsidiaries, divisions, units or branches, the auditor should consider sending separate engagement letters to each such subsidiary, division, unit or branch, if he is appointed as the auditor for the entire group. This is because the terms of the audit's legal requirements for appointment of auditors of different business units (i.e. subsidiaries, divisions etc.) may be different and may not apply to the group as a whole.

It also depends upon factors such as the extent of independence of the components in a group and the degree of ownership by the parent company.

Recurring audits: In recurring audits, the auditor should consider whether circumstances require the terms of the engagement to be revised and whether there is a need to remind the client of the existing terms of the engagement.

Acceptance of a change in engagement: An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

A request from the client for the auditor to change the engagement may come as a result of various reasons, these are as follows:

- A change in circumstances which affect the need for the service. E.g. a listed company may decide not to purchase a subsidiary so therefore may not require due diligence already agreed and therefore would want the auditors to discontinue the engagement.

- A misunderstanding in relation to the nature of an audit or a related service that was originally requested.
  E.g. if an auditor, who is appointed to audit the accounts of a client is held responsible by the management for not detecting a fraud in addition to performing the audit, then the management is said to have misunderstood the nature of a regular audit. If detection of fraud is the primary concern of the client, the client should hire the investigative assurance services of another auditor.

- A restriction on the scope of the engagement, whether imposed by the management or caused by circumstances. E.g. verification of physical records made difficult due to a factory closure during a workers' long term strike.
  The auditor should carefully consider the implications of a restriction on the scope of the engagement. For example, the auditor must evaluate the consequences of not being able to conduct the physical verification of records due to the strike on the audit opinion.

The Planning stage of audit

Planning Summary	**Audit strategy**: a) Understanding the business b) Risk assessment c) Materiality d) Scope, Timing, Direction **to ensure adequate resources are allocated to the audit.**	
	Audit Plan : detailed instruction on how to audit (audit programmes). This includes descriptions of risk assessment procedures and further planned audit procedures.	

Audit Strategy (approach/ initial client evaluation)

a) Understanding the client

- Industry, regulatory and other external factors(for example financial reporting framework, laws and regulations, stakeholders, economic conditions like volatility of exchange rates, competition, level of technology

- Nature of entity and accounting policies (legal structure, ownership and governance, main sources of finance)

- Objectives…strategies…related business risks!

- Measurement and review of Financial performance (measures important to the client, KPIs, budgets, targets)

- Internal control (gain an understanding about the design and implementation of internal controls)

This understanding is gained through Inquiry (from management, IA, TCWG, legal advisor). Observation, Inspection(interim F/S, policy manuals, brochures, minutes, business plans, website), Analytical Procedures

b) Risk Assessment

i)Assess risk (ISA 315)	**ii)Response (ISA 320)**	**III)Procedures**	**iv)Evaluate evidence**
This is done through understanding the client, Analytical procedures(evaluate plausible relationships between financial and non-financial data), Team discussions	- Professional skepticism - More skilled staff - Consultations - Unpredictable testing	-ICS -Substantive & Review	

Step 1
Business risk(problems faced by the management)

Step 2
Audit risk= Risk of material misstatement in F/S and Detection risk

Inherent risk and control risk sampling risk and non sampling risk

<u>Risk of material misstatement:</u> This is the risk that F/S could be misstated due to incomplete/incorrect recording of transactions/events/disclosures. This is affected by the volume of transactions, integrity of BOD, pressures on management, use of IT, use of accounting estimates, unusual transactions, items prone to theft etc)

If business risk is not addressed, risk of material misstatement increases!

c) **Materiality ISA 320** (affects how many items to test, what to test, sampling techniques, level of misstatement for modified opinion)
- By amount (P7: 5% of PBT, 2 % of TA)
- By nature (recurring errors, non-recurring items, items which affect statutory requirements, items which affect debt covenants, Bank, related party transactions etc.)
- By impact: used when evaluating misstatements towards the end of the audit
- Performance materiality (always less than the overall materiality level!)

Important: risk and materiality are inversely proportional!

d) Scope:
- locations/branches/offices,
- financial reporting framework,
- industry specific regulations,
- use/need of experts
- use of CAATS,
- reliance on Internal Auditors,
- use of service organisations by the client
- Group audit implications

Timings: deadlines/timing for
- reporting,
- Meetings with the management/ TCWG
- expected communication (management letter, auditor's report)
- team meetings
- review of audit team's work

Direction:

i) Systems audit
ii) Balance sheet approach
iii) Directional testing (test debits for overstatement and credits for understatement)
iv) Transaction cycle approach (audit trail verified for substantive testing)

<u>P7 Examples and writing technique- Business Risk</u>

<u>NO MARKS FOR COMMENTING ON MATERIALITY</u>

<u>Information from the case</u>

The Group offers a luxury product aimed at an exclusive market.

<u>Business Risk</u>

This in itself creates a business risk, as the Group's activities are not diversified, and any decline in demand will immediately impact on profitability and cash flows. The demand for luxury holidays will be sensitive to economic problems such as recession and travel to international destinations will be affected by events in the transportation industry

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<u>Information from the case</u>

It is questionable whether the Group has a sound policy on expansion, given the problems encountered with recent acquisitions which have involved expanding into locations with political instability and local regulations which seem incompatible with the Group's operations and strategic goals. The Group would appear to have invested $98 million, accounting for 28% of the Group's total assets, in these unsuitable locations, and it is doubtful whether an appropriate return on these investments will be possible.

<u>Business Risk</u>

There is a risk that further unsuitable investments will be made as a result of poor strategic decisions on where to locate new hotels. The Group appears to have a strategy of fairly rapid expansion, acquiring new sites and a hotel complex without properly investigating their appropriateness and fit with the Group's business model.

<u>Information from the case</u>

Medix Co appears to rely heavily on agents to secure sales to hospitals and clinics.

<u>Business Risks</u>

If the agents are unsuccessful, or decide to reduce the effort they put into promoting Medix Co's products in preference for products from an alternative supplier, then the company will face a substantial reduction in revenue and cash inflows.

A second risk associated with the use of agents is that there is a scope for fraud · the agents could deliberately overstate the value of sales in order to maximise the commission they receive. When this point is linked to the poor internal systems and controls as indicated by Mick Evans, it is likely that such frauds would not be detecte

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<u>P7 Examples and writing technique- RoMM</u>

Reminder: Audit Risk = RoMM and Detection Risk

1. Words from the case
2. Comment on materiality if possible (by amount or by nature)
3. Relevant accounting standard
4. The risk! For RoMM, the impact on the F/S HAS to be mentioned *(i.e an amount over or understated, for errors use misstatement, disclosure might be missing or inadequate, presentation incorrect)*

<u>Information from the case</u>

The 50% equity shareholding is likely to give rise to a joint venture under which control of WTC is shared between ZCG and Wolf Communications Co.

<u>Audit Risk</u>

IFRS 11 *Joint Arrangements requires that an investor which has joint control over a joint venture* should recognise its investment using the equity method of accounting.

Audit risk arises in that despite owning 50% of the equity shares of WTC, ZCG may not actually share control with Wolf Communications, for example, if Wolf Communications retains a right to veto decisions or if ZCG cannot appoint an equal number of board members in order to make joint decisions with board members appointed by Wolf Communications. If ZCG does not have joint control, then WTC should not be treated as a joint venture.

Information from the case
There is a deferred tax asset.
Audit Risk
According to IAS 12 *Income Taxes, a deferred tax asset is recognized* for an unused tax loss carry-forward or unused tax credit if, and only if, it is considered probable that there will be sufficient future taxable profit against which the loss or credit carry-forward can be utilised.
While it appears that some of the deferred tax asset has been utilised this year, there remains a risk that if it is no longer recoverable, then the amount would need to be written off.

Information from the case
A comparison of the statement of profit or loss for both years shows that the profit made on the disposal of shares in Calgary Co has been separately disclosed as part of profit in the year ending 31 July 2016.
Materiality: The profit recognised is material at 30.3% of profit before tax. Several errors seem to have been made in accounting for the disposal and in respect of its disclosure.
Audit Risk
It is not correct that this profit on disposal is recognised in the statement of profit or loss.
According to IFRS 10 *Consolidated Financial Statements, changes in a parent's ownership interest in a subsidiary which does not result in the* parent losing control of the subsidiary are treated as equity transactions. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent
This appears to have been incorrectly accounted for as there should not be a profit on disposal within the statement of profit or loss. Therefore profit before tax is overstated by $10 million.

Information from the case
Analytical procedures reveals that the Group's revenue has increased by 19%, but that operating expenses have disproportionately increased by 25.6%, resulting in the fall in operating margin from 12.1% in 2015 to 7.2% in 2016.
Audit Risk
This is a significant change, and while the higher costs incurred could be due to valid business reasons, the trend could indicate operating costs are overstated or sales are understated.
There is a risk that some of the costs involved in modernising the Group's warehousing facilities have been incorrectly treated as revenue expenditure when this should have been capitalized.

Commonly tested risk related requirement

Requirement examples:
- Evaluate the business risks faced by…
- Identify and explain the audit risks relevant to planning the audit…
- Evaluate the risk of material misstatement to be considered in planning the audit…
- Perform preliminary analytical procedures and evaluate the audit risks which should be considered…
- Recommend any **additional information** that should be requested/would be relevant…

When explaining questions in the P7 Exam

Business Risks: Think of what problems it can cause for the business (financial issues, compliance issues, operational issues)

Risk of material misstatement in the F/S: This of how it can impact areas in the statement of P/L, SOFP, Notes to the accounts (Disclosures)

Detection Risks: Think of how it could affect the auditor's work/ his ability to detect/find fraud/error

Analytical procedures at the planning stage: Advanced Audit & Assurance Exam

Ratios that HAVE to be calculated:

- Gross profit margin
- Operating profit margin
- Return on Capital Employed
- Current and quick ratios
- Inventory holding period
- Receivable collection period
- Trade payables payment period
- Gearing ratio
- Interest cover

Other than ratios…

- Compare with last year
- Calculate percentage increase/decrease
- Evaluate relationship: Tax and Profit before tax
- Evaluate relationship: changes in finance cost with changes in associated interest bearing elements
- Evaluate relationship: change in sales to change in cost of sales

Planning Activities: The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members

Overview of approach • *Perform **risk assessment** procedures (ISA 315)* • ***Assess** the risk of material misstatement (ISA 315)* • ***Respond** to assessed risk (ISA 330)* • *Perform **further** audit procedures (ISA 330)* • ***Evaluate** audit evidence obtained (ISA 330)*

Audit Strategy The overall audit strategy sets the scope, timing and direction of the audit The overall audit strategy should then lead to the development of the audit plan.	Scope	Scope involves determining the characteristics of the audit client, such as its locations, and the relevant financial reporting framework, as these factors will help to establish the scale of the assignment. • The financial reporting framework on which the financial information has been prepared • Industry-specific reporting requirements such as reports mandated by industry regulators. • Whether the entity has an internal audit function and if so, whether, in which areas and to what extent, the work of the function can be used for purposes of the audit. • The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them. • The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques. **For group audits**: • The expected audit coverage, including the number and locations of components to be included • The nature of the control relationships between a parent and its components that determine how the group is to be consolidated. • The extent to which components are audited by other auditors. • The reporting currency to be used, including any need for currency translation for the financial information audited. The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
	Timing	Timing refers to establishing deadlines for completion of work and key dates for expected communications.

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The entity’s timetable for reporting, such as at interim and final stages.
The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.
The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor’s report, management letters and communications to those charged with governance.
The expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.

For group audits:
Communication with auditors of components regarding the expected types and timing of reports to be issued and other communications in connection with the audit of components.
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<td>Direction

-Consider the factors that are significant in directing the engagement team’s efforts

-Consider the results of preliminary engagement activities

-Ascertain the nature, timing and extent of resources necessary to perform the engagement.
</td>
<td>Establishing the overall audit strategy also includes the consideration of preliminary materiality, and initial identification of high risk areas within the financial statements. All of these matters contribute to the assessment of the nature, timing and extent of resources necessary to perform the engagement.

Risk assessment and materiality are explained later in the revision notes.

It is important to carefully consider the selection of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement.
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<td>Audit Plan

- Details about who, what, where, when of the audit.

Who is going to carry out what procedures; Where are they going to do them; When are they going to do them; Why are they doing
</td>
<td colspan="2">The audit plan is more detailed than the audit strategy and includes a description of the risk assessment procedures, and the further planned audit procedures necessary at the assertion level for gathering evidence on the material transactions and balances in the financial statements. The general purpose of developing the audit plan is to design audit procedures which will reduce audit risk to an acceptably low level.

The difference between the audit strategy and the audit plan is therefore that the strategy is the initial planning to ensure there will be adequate resources allocated to the audit assignment in response to an initial evaluation of the entity’s characteristics, whereas the audit plan is a detailed programme of audit procedures.
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it- **what** risks are they trying to assess - Supervision and review of the audit plan is critical - The plan Must be documented - Plan must be flexible to deal with information discovered later	The strategy will therefore usually be developed before the plan; however, the two activities should be seen as inter-related, as changes in one may result in changes to the other. Both the strategy and the plan should be fully documented as this represents the record of proper planning of the audit assignment.

Risk assessment

The auditor needs to conduct procedures to :

a) Understand the entity

- **Industry, regulatory and other external factors:** *This means having an understanding of the industry in which the company operates, including the level of competition, the nature of the relationships with suppliers and customers, and the level of technology used in the industry. The industry may have specific laws and regulations which impact on the business. The auditor should also consider wider economic factors such as the level and volatility of interest rates and exchange rates and their potential impact on the client. The importance of these issues is their potential impact on the financial statements and on the planning of the audit. For example, if a client operates in a highly regulated industry, it may be worth considering the inclusion in the audit team of a person with specific experience or knowledge of those regulations. Regulations include the financial reporting framework, for example, whether the company uses local or international financial reporting standards.*
- **Nature of the entity and its accounting policies:** *This includes having an understanding of the legal structure of the company (and group where relevant), the ownership and governance structure, and the main sources of finance used by the company. Complex ownership structures with multiple subsidiaries and/or locations may increase the risk of material misstatement.Understanding the nature of the company also includes an understanding of the accounting policies selected and applied to the financial statements. The auditor must consider whether the accounting policies applied are consistent with the applicable financial reporting framework.*
- **Objectives and strategies and related business risks:** *The management of the company should define the objectives of the business, which are the overall plans for the company. Strategies are the operational approaches by which management intend to meet the defined objectives. For example, an objective could be to maximize market share, and the strategy to achieve this could be to launch a new brand or product every year. Business risks are factors which could stop the*

company achieving its stated objectives, for example, launching a product for which there is limited demand. Most business risks will eventually have financial consequences, and thus an effect on the financial statements. This is why auditors perform a business risk assessment as part of their planning procedures.

- **Measurement and review of the entity's financial performance:** *Here the auditor is looking to gain an understanding of the performance measures which management and others consider to be of importance. Performance measures can create pressure on management to take action to improve the financial statements through deliberate misstatement. For example, a bonus payable to the management based on revenue growth could create pressure for revenue to be overstated. Thus the auditor must gain an understanding of the company's financial and non-financial key performance indicators, targets, budgets and segmental information.*

b) Understand controls

- *The auditor must gain knowledge of internal control in order to consider how different aspects of internal control could impact on the audit. Internal control includes the control environment, the entity's risk assessment procedures, information systems, control activities, and the monitoring of controls. Put simply, the evaluation of the strength or weakness of internal control is a crucial consideration in the assessment of audit risk, and so will have a significant impact on the audit strategy. The design and implementation of controls should be considered as part of gaining an understanding. The auditor should also understand whether controls are manual or automated.*

How can all the above understanding be gained?

Procedures used to gain understanding

Inquiries of management and others within the company	A discussion with management is often the starting point in gaining understanding. A meeting is usually held with management to talk about all of the aspects of the company and its environment referred to in the first part of the briefing notes. However, inquiries can also be made of others, who may be able to provide a different perspective or provide specific insights into certain matters. For example, internal auditors would be able to comment specifically on internal controls.
Analytical procedures (Almost always financial info given in the THE ADVANCED AUDIT & ASSURANCE EXAM exam- you need to look at that to identify risk of material misstatement in the financial statements- do some calculations on the figures-**DO NOT ignore the numbers in the questions-** these are important	Auditors perform analytical procedures at the planning stage in order to identify unusual transactions or events, and to understand the main trends reflected in the financial statements for the year. This will enable the auditor, for example, to see if the company has experienced a growth or decline in revenue or profits in the year, which when reviewed in the context of industry or economic trends, may indicate a risk of material misstatement.

AND have easy marks. **Analytical procedures at planning stage are explained** later in these revision notes.	
Observation	Observation may help to support inquiries of management and others, and could involve, for example, physical observation of the internal control operations, and visits to premises such as factories, warehouses and head office.
Inspection ***Information Obtained in Prior Periods***	Inspection may support inquiries made of management and others. It could include, for example, an inspection of business plans, internal control manuals, reports made by management such as interim financial statements, the minutes of board meetings, and reviewing the company's website and brochures The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as: • Past misstatements and whether they were corrected on a timely basis. • The nature of the entity and its environment, and the entity's internal control (including deficiencies in internal control). • Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement. • Those particular types of transactions and other events or account balances (and related disclosures) where the auditor experienced difficulty in performing the necessary audit procedures, for example due to their complexity.

Dealing with Risk Questions in THE ADVANCED AUDIT & ASSURANCE EXAM

Business risk	**Risk of material misstatement in the F/S**	**Audit Risk** **AR= Risk of material misstatement in the F/S AND Detection Risk**
That can damage client's business (internal and external factors). Examples include: - Changes in legislations - Changes in technology - Changes in economy - Competition - Employees- loss of key staff - Systems or system changes (old may not work) - Cash flow - High gearing - Fraud **Writing your answer in the THE ADVANCED AUDIT & ASSURANCE EXAM Exam** In the exam, fully explain **WHY** they are a risk	Due to Error or fraud: 1. Misapplication of a standard leading Under/over statement of amounts - F/S Disclosures (Disclosures may have been omitted or Level of detail in the disclosure may be inadequate) **Writing your answer in the THE ADVANCED AUDIT & ASSURANCE EXAM Exam** 1.Discuss standard incorrectly applied 2.The risk that this incorrect application creates (under/over, non-Disclosure, inadequate disclosure)	In you answer, include risk of material misstatements in the F/S **AND** other factors that might increase detection risk Examples of factors which might increase detection risk: - Time pressure - Inexperienced audit team/incorrect task allocation to team members - New audit client - Newly listed/planning on getting listed soon - Intended sale of business - Pressure to meet targets

<u>Relationship between business risk and risk of material misstatement in the financial statements</u>

The business risk approach places the auditor 'in the shoes' of management, and therefore provides deeper insight into the operations of the business and generates extensive business understanding

The business risk model is not a replacement for the traditional audit risk model but rather a vehicle, or mechanism, for the identification of audit risk, recognising that most business risks will eventually have financial consequences and, therefore, an effect on the financial statements.

Business risk is defined in ISA 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment.* The definition states that business risk is a risk resulting from significant conditions, events, circumstances, actions or inactions which could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

Risk of material misstatement is defined in ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs* as the risk that the financial statements are materially misstated prior to audit.

Risk of material misstatement comprises inherent risk and control risk.

ISA 315 states that the auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

Business risks can be broken down into operational risk, financial risk and compliance risk.

1. ***Financial risk: risk arising from the financial activities or financial consequences of an operation***
2. ***Compliance risk: risk that arises from non-compliance with laws and regulations***
3. ***Operational risk: risk arising with regard to operations***

Each of these components can have a direct impact on the financial statements, and therefore understanding the components of business risk can help the auditor to identify risks of misstatement, and to design a response to that risk.

Some business risks impact the inherent risk component of risk of material misstatement. For example, the auditor may have identified that an audited entity has significant levels of debt with covenants attached. The business risk is that the covenants are breached and the debt recalled. An associated inherent risk at the financial statement level is that the financial statements could be manipulated to avoid breaching the debt covenant.

Other business risks impact on the control risk component of risk of material misstatement. For example, the auditor may have identified that an audited entity has a business risk due to having lost key members of personnel in the accounting department. This has a clear impact on control risk, as it means the accounting department is short of competent staff and errors are likely to go undetected and uncorrected.

Therefore the ISAs' approach to planning an audit is underpinned by the concept that it is essential for an auditor to understand the business risks of an audited entity in order to effectively identify and respond to risks of material misstatement.

Example

Esteem Club Plc is a hospitality service provider and runs a chain of clubs, one of which is situated in a small town near London. The club provides restaurant services, bar services, lodging and boarding facilities, a swimming pool and recreation facilities such as boating, billiards, tennis, cards room etc. It has recently obtained permission from the state **to sell alcohol in its club.**

The business risks and related financial statements risks of this can be:

Business risks	**Risk of material misstatement in the financial statements**
The permission to sell alcohol in the club may be misinterpreted as being applicable to all the facilities that the dub provides, whereas the company is actually allowed to sell alcohol only in the bar area. Hence, here there is a risk that the club will face severe penalties from the state since if it sells alcohol in areas that it is not permitted to sell in.	Breach of regulation may require paying a penalty. However, provision relating to breach of regulation may not be made. This means that the profit may be understated
In the restaurant, employees may misappropriate food items and indulge in fraud.	Fraud may remain undetected and therefore loss arising from such fraud may remain undisclosed in the financial statements

Materiality

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

Performance materiality means:

– The amounts set by the auditor at less than materiality for the financial statements as a whole
– To reduce the probability that the aggregate of uncorrected/undetected misstatements exceeds materiality for the financial statements as a whole

Performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

An item might be material due to its:

- ***Nature:*** *eg transactions related to directors, such as remuneration or contracts with the company*
- ***Value:*** *eg land with a value which comprised three-quarters of the asset value of the company*
- ***Impact:*** *eg a proposed journal which is not material in itself could convert a profit into a loss*

In order to calculate a level of planning materiality, auditors will often take a range of values and use an average/weighted average.

- ***Profit before tax:*** *5%*
- ***Gross profit:*** *1/2 – 1%*
- ***Revenue:*** *1/2 – 1%*
- ***Total assets:*** *1 – 2%*
- ***Net assets:*** *2 – 5%*
- ***Profit after tax:*** *5 – 10%*

When assessing materiality in exam questions calculate the relevant matter as a percentage of the relevant indicator and assess whether it falls within these ranges.

Analytical procedures and risk assessment

According to ISA 520 *Analytical Procedures*, analytical procedures are the evaluation of financial information through analysis of plausible relationships between both financial and non-financial data. Analytical procedures can involve comparisons of financial data including trend analysis and the calculation and comparison of ratios. Analytical procedures include comparisons of the Group's financial information with, for example:

o Comparable information for prior periods;

o Anticipated results of the Group, such as budgets or forecasts;

o Expectations of the auditor; or

o Comparable information from competitors.

Analytical procedures performed at the planning stage help the auditor to identify and respond appropriately to risk, and to assist the auditor in obtaining an understanding of the client

ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* requires the auditor to perform analytical procedures as part of risk assessment procedures at the planning stage of the audit to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

An example of how analytical procedures assist the auditor is that performing analytical procedures may alert the auditor to a transaction or event of which they were previously unaware, therefore prompting the auditor to investigate the matter, obtain understanding of the matter and plan appropriate audit procedures to obtain sufficient appropriate audit evidence. Therefore analytical procedures are an essential part of developing the audit strategy and audit plan.

Analytical procedures may also help the auditor to identify the existence of unusual transactions or events, such as significant one-off events. Unusual amounts, ratios, and trends might also indicate matters which indicate risk. Unusual or unexpected relationships which are identified by these procedures may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

Without performing analytical procedures, the auditor would be unable to identify risks of material misstatement and respond accordingly. This would increase detection risk, making it more likely that an inappropriate audit opinion could be issued.

Preliminary analytical review- Ratios normally used by the THE ADVANCED AUDIT & ASSURANCE EXAM examiner

Profitability

1. GP Margin = Gross profit/revenue x 100
2. Operating profit margin= operating profit/revenue x 100
3. Return on capital employed = Operating profit/capital employed x100

Liquidity

1. Current ratio = Current assets/current liabilities
2. Quick ratio = Current assets – inventory/current liabilities
3. Inventory holding period= Inventory/cost of sales x 365
4. Receivables collection period = Receivables/revenue x 365
5. Trade payables payment period = Trade payables/cost of sales x 365

Gearing

1. Gearing ratio =Long-term liabilities/equity
2. Interest cover = Operating profit/finance costs

Additional Considerations in Initial Audit Engagements

First audit? (New client with previous audit by another firm OR New client no audit before)

In an initial audit engagement there are several factors which should be considered in addition to the planning procedures which are carried out for every audit

1. Performing procedures regarding the acceptance of the client relationship and the specific audit engagement;

2. Communicating with the predecessor(outgoing) auditor (with client's permission)- ask for information and working papers from previous audit (accounting policies, risks assessed and how they were dealt with)

3. Review opening balances (Working papers from previous audit will help)-if no previous audit, more detailed testing will be needed. Particular care should be taken in planning the audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances, and procedures should be planned in accordance with ISA 510 *Initial Audit Engagements –Opening Balances*. For example, procedures should be performed to determine whether the opening balances reflect the application of appropriate accounting policies and determining whether the prior period's closing balances have been correctly brought forward into the current period.

4. Consider if previous audit report was modified- affecting this year? Risks identified change? Previous modifications of the opinion could be indicative of lack of trust in management

5. Consider Accounting policies- consistent?

6. Consider matters discussed with the management at the time of appointment. For example, there may have been discussion of significant accounting policies which may impact on the planned audit strategy.

7. Need to develop thorough business understanding. With an initial audit engagement it is particularly important to develop an understanding of the business, including the legal and regulatory framework applicable to the company. This understanding must be fully documented and will help the audit team to perform effective analytical review procedures and to develop an appropriate audit strategy. Obtaining knowledge of the business will also help to identify whether it will be necessary to plan for the use of auditors' experts.

8. There is risk of material misstatement in opening balances

9. Need to use experienced team to reduce detection risk

10. The firm may have quality control procedures in place for use in the case of initial engagements, for example, the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures. Compliance with any such procedures should be fully documented.

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

Tests of Controls

The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if:

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

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.

Overall responses to address the assessed risks of material misstatement at the financial statement level may include:

- Emphasizing to the engagement team the need to maintain professional scepticism.
- Assigning more experienced staff or those with special skills or using experts.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.

When the auditor has assessed the business and audit risks relating to the entity and decided on a materiality level, he must then decide on an approach for gathering audit evidence.

There are various approaches that could be adopted.

(a) Systems audits
(b) Balance sheet approach
(c) Directional testing
(d) Transaction cycle approach.

Systems audit	These focus on the strength, or otherwise, of the internal control systems. The idea is to perform extensive tests of controls and reduce the level of substantive testing. During planning, the audit firm will ascertain record and evaluate the internal controls. If they judge control risk to be low, the controls will be tested to confirm this. **Tests of controls** will test that controls are properly designed, exist and have operated throughout the period. Deviations will be recorded and investigated regardless of the amount involved. If results are unsatisfactory then the initial assessment of control risk is not supported. The audit strategy will then need to be modified.
Balance sheet Approach	This is also known as the substantive approach. This strategy would usually be adopted when control risk is high, and controls cannot be relied upon. Ultimately the auditor's report contains an opinion on the figures in the financial statements. Therefore, all audits will involve some substantive testing of these balances. Substantive testing involves collecting evidence on the assertions implied in the accounts regarding balances.
Directional testing	This is based on the principles of double entry bookkeeping. If a trial balance is in balance, there must be a debit entry for every credit entry. If a debit entry has been overstated there should be a corresponding credit entry which is overstated, or another debit entry which is understated. Therefore, a test for overstatement of receivables will provide evidence concerning the overstatement of revenue. Directional testing also refers to checking the financial statements to the underlying records.

Transaction cycle approach	This approach is similar in some ways to the systems audit approach as it is based on the same transaction cycles. The difference here is that we are not focusing on controls testing but substantive procedures. Under this approach transactions that have occurred during the year and result in entries to the income statement are tested. In practical terms a sample of transactions relating to say, sales would be selected and substantiated to supporting documentation (order, invoice and dispatch note) to ensure the transactions are correctly and completely recorded in the financial statements.

Technical article: Exam technique

Risk is examined in several ways within the Advanced Audit and Assurance syllabus and understanding the difference between these can be key to scoring good marks in the exam. Quite often, risk forms part of a planning question but it is also examined with respect to financial reporting issues elsewhere in the exam.

The key to attaining good marks for risk comes from understanding the types of risk you are looking for and explaining them in the correct context. As with many areas of the exam, good exam technique can be used to increase the marks attained without having to rote learn much additional information. It is application and understanding that is important at the Professional level.

This article will demonstrate how to maximise marks on these areas using effective exam technique. It is, however, specific to the context of auditing and assurance and will therefore have a different focus and application to the way risks are examined in other areas of the ACCA Qualification.

WHAT YOU NEED TO KNOW

The three main types of risk you might be asked to evaluate in the exam are business risk, risk of material misstatement and audit risk. These are defined as follows:

Business risk
A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies (ISA 315)
Risk of material misstatement (RoMM)
'The risk that a material misstatement exists in figures or disclosures within the financial statements prior to audit' (IAASB – glossary of terms)
Audit risk
'The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of material misstatement and detection risk' (IAASB – glossary of terms)
How they interact
You should know from your study of Audit and Assurance that the audit risk model is comprised of:
Audit risk = RoMM x detection risk

For a risk of misstatement to occur there must be an inherent risk of an item being misstated and a risk that the client's controls did not identify and correct this misstatement. When you are asked to evaluate RoMM in an exam, the examiner is looking for those inherent and control risks and, in many cases, these arise from underlying business risks.

For something to be an audit risk, there must be either a RoMM or a detection risk, the risk that the auditor's procedures do not identify a material misstatement in the financial statements.

HOW TO APPLY THE KNOWLEDGE

Knowing these definitions will help you to remember which type of risk is which or to categorise risks into these sub types but it is not something you will be awarded direct credit for in an Advanced Audit and Assurance exam.

Remember that you are often being asked to prepare an answer for the attention of the audit engagement partner, who will certainly not need these terms explained. Therefore, these definitions are so that you know what type of risk you are looking for in a question but the marks will be awarded for your evaluation of these risks.

Let's consider an example of information that may be provided in the exam and how your answer would differ for each of the risk types you might be asked to evaluate. The following is an extract from the published September/December 2015 sample questions:

> Dali Co was established 20 years ago and has become known as a leading supplier of machinery used in the quarrying industry, with its customers operating quarries which extract stone used mainly for construction.
>
> The machines and equipment made by Dali Co are mostly made to order in the company's three manufacturing sites. Customers approach Dali Co to design and develop a machine or piece of equipment specific to their needs. Where management considers that the design work will be significant, the customer is required to pay a 30% payment in advance, which is used to fund the design work. The remaining 70% is paid on delivery of the machine to the customer. Typically, a machine takes three months to build, and a smaller piece of equipment takes on average six weeks. The design and manufacture of bespoke machinery involving payments in advance has increased during the year. Dali Co also manufactures a range of generic products which are offered for sale to all customers, including drills, conveyors and crushing equipment.

Business risk
For the purpose of the exam, these risks can usually be thought of in terms of conditions that may prevent a business from meeting its objectives and might include risks to achieving future profits or cashflows or to business survival. This is a simplified explanation, but will help you describe the implications of most risks you come across in the exam. There will be some risks whose explanation is more involved and you can find examples of these in past exams.
In general, you are looking for risks in the information that the examiner has presented to you within the scenario. You will be asked to evaluate **those** risks. At this level you **will not** be credited for defining business risk, nor will you receive credit for describing what a client could do to mitigate those business risks.
As set out in the ISAs, the focus of business risk evaluation as part of the audit process is identifying matters that could impact on audit planning, in particular matters that could give risk to risks of material misstatement or audit risks.

The focus in the Advanced Audit and Assurance exam is therefore quite different from other strategic level exams where you might be expected to consider risks from a business perspective and to describe methods the business may use to manage those risks. If you stray into risk mitigation from a business perspective rather than an auditor's perspective you are wasting valuable time on making points that cannot score marks.

As such, you need to consider how to frame the information which is provided as a business risk. As a general rule, marks for business risks will be awarded along the following lines:

- For identifying only without meaningful explanation, ½ mark
- For a briefly explained business risk, 1 mark will be awarded, and
- Full marks will only be awarded where a well explained business risk is presented.

Marks will not be awarded for points that are purely speculative – ie not based on specific information provided in the question scenario – nor will marks be awarded for business risks that do not impact on the audit.

Let's now apply that logic to the example provided above:

Identification only – worth ½ mark

The company manufactures bespoke machines for clients which may take six months to complete.

In an exam, an answer that merely repeats facts from the question is unlikely to attain many marks – in a business risk question it can score ½ mark for identification only as the implications for the company have not been considered.

Identified and briefly explained – worth 1 mark

The company manufactures bespoke machines for clients which may take six months to complete. During this time the company has funds tied up in work in progress.

This point cannot score full marks as there is no development of why this is a risk; how does it impact on the business or the audit?

Identified and well explained – worth full marks

The company manufactures bespoke machines for clients which may take six months to complete. During this time the company has funds tied up in work in progress, which could give rise to cashflow problems, especially as the 30% deposit may not cover all the upfront costs. This service has increased in the year putting further strains on cash flow.

It is also possible that a risk can have other implications or alternative descriptions that are valid and, if the answer was developed in one of these directions, that would still attract credit. For example, the following would also be an appropriate way to fully explain the same risk:

Identified and well explained – worth full marks

The company manufactures bespoke machines for clients which may take six months to complete. There is a risk that the customer cancels the order after the company has spent significant funds on the design and manufacture of the machine. This will have put strain on the company cash flow and it is unlikely that the machine can be sold to a different customer for the same price due to its bespoke nature. This may mean that the company makes a loss on the sale of the inventory or cannot sell it at all.

In an exam such as this, it's reasonable to assume that the examiner has given you each piece of information for a reason. It is likely to be relevant to one of the requirements and the examiner will often flag if there are areas which you should not consider. A good technique is to try and identify risks in each paragraph – there could be more than one but there is unlikely to be a section of text that does not flag something relevant for at least one requirement.

Another thing to watch for is describing risks that are speculative or insignificant in the context of the scenario you are given. There will be sufficient risk areas described in the scenario to score maximum credit if they are well described. If you find yourself hypothesising about potential issues that may affect the client, but you don't have enough information to know if it's a risk or not, then you are likely to be making irrelevant or marginal points. While it is true that valid risks – beyond those on the marking guide – can attract credit, it is much easier and less risky to use those that are flagged by the examiner.

Risks of Material Misstatement (RoMM)

RoMM often follow from business risks and are the impact that those risks might have on the financial statements. It can be good practice during preparation for the exam to try and think of how a business risk might affect the financial statements every time you are analysing them. You are looking to convert that business risk into an impact on the calculation or disclosure of items within the financial statements.

When describing RoMMs, an effective approach is to use the following steps to construct your answer

1. Calculate and conclude on the materiality of the issue where sufficient information is available – a mark will be given for a correct and relevant calculation of materiality with an appropriate conclusion – this will only be awarded once per issue and materiality marks may be capped in an exam question.
2. Briefly describe the relevant financial reporting requirement – note that no credit is awarded for the accounting standard names or numbers, only the accounting treatment.
3. Relate the risk in the scenario to the accounting treatment.
4. Illustrate the impact of the risk on the financial statements

In general, there will be credit available for each of these processes and you should recall this approach every time you tackle a question requirement on evaluating RoMM.

Let's consider the business risk we looked at above. The issue of bespoke machinery with an upfront payment can affect the financial statements in terms of revenue recognition, when dealing with the upfront payments, and inventory valuation. For the purposes of the exam, these two accounting issues are likely to be assessed as two separate RoMMs.

Applying this to the scenario we have above, the following illustrates a possible answer that could be written under exam conditions and would score full marks for each of the addressed risks.

<u>Revenue recognition</u>

The company receives a 30% deposit for the design of bespoke machinery.

Revenue should be recognised over time or at a point in time **when control is passed**. Such points will be **determined by the contractual terms**. Payments received in advance of control passing should be **recognised as deferred income**.

There is a risk that **revenue might be recognised early** when payment is received **rather than being deferred.**

This would result in an **overstatement of revenue** and an **understatement of liabilities** for deferred revenue**.**

<u>Inventory valuation</u>

The company manufactures machines over a period of up to three months. This gives rise to work in progress.

Work in progress is valued at the **lower of cost and NRV** where cost includes **all the costs of purchase and conversion** including overheads of getting the item to its present location and condition.

There is a risk that an order for bespoke machinery is **cancelled** and the inventory **NRV falls below** the net **costs** incurred.

This would result in an **overstatement of inventory** (or assets) in the statement of financial position and an understatement of cost of sales, therefore **an overstatement of profit**.

Note that we did not have sufficient information to calculate materiality in these examples.

Audit risks

Where you are asked to evaluate audit risks in an exam, much of your answer would be the same as for a requirement asking for risks of material misstatements as these form the major part of audit risk. The difference here is that detection risk is now also relevant. Examples of detection risk could include a recent appointment as the auditor, inexperience in a client's new market or time pressure for the audit.

If the information provided in the example we have been using included the following information:

You are the audit manager of Dali Co, a new audit client of your firm. The partner has asked you to plan the audit for 31 December 2015 and has provided you with the following information after a discussion with the client.

Then, in addition to the RoMMs we have discussed, there would be an additional audit risk.

We are newly appointed auditors of the client and, as such, do not have the same level of understanding of the client's business and controls as we would for an existing client. As such, we may fail to recognise certain RoMMs or may apply inappropriate procedures due to this lack of understanding

In addition, we have not audited the opening balances, so there is a risk that the opening balances may be incorrect or inappropriate accounting policies have been used.

There are two common errors candidates make in the exam around the issue of a new client. First, some candidates consider that a new auditor is a business risk or gives rise to a RoMM. This is incorrect. The underlying business is the same regardless and it is only detection risk that alters.

The second is to assume that a new manager on an assignment is the same as having a new client. The audit partner and the knowledge of the client within the firm is unaltered, so the discussion of a new manager to the audit resulting in a significant audit risk does not attract credit.

It is also important to note that, from an exam point of view, none of these examples require a definition to be given of risk types nor do they require any explanation of theories as part of the answer – if the examiner asks you to evaluate risks, then presenting your answer using the approach of a subheading for each risk and answers like those shown in the examples above is sufficient.

CONCLUSION: This article has focused on planning type questions where there is a specific requirement to describe one or more of business risk, RoMM and audit risk, and has laid out an effective approach for how you can tackle these questions to maximise your marks.

Note that RoMM is also relevant for matters and evidence questions where the structure of the answer in those questions may be broader but the basic thought process is similar. This will be addressed further in a separate article on accounting issues for Advanced Audit and Assurance.

Written by a member of the P7 examining team

Audit evidence and Audit Procedures

Let's talk THE ADVANCED AUDIT & ASSURANCE EXAM

"Matters to consider"

In the THE ADVANCED AUDIT & ASSURANCE EXAM Exam, the examiner will often ask for 'matters to consider' for a certain scenario. This requirement is then combined with either audit evidence or audit procedures.

The following approach needs to be used for 'matters to consider'

Think about the facts given in the case	What has happened in the scenario- should be reflected in the F/S on which you will provide an opinion.
What matters should we consider as an external auditor. Think of various aspects- dig deep into the scenario.	1. Is this material?-in relation to assets and/or profits- **Remember.** even if it isn't material in isolation, can be when aggregated with other misstatements towards the end of the audit 2. What are the risks to the F/S because of the facts given in the case? 3. What do the standards require?-use IFRS knowledge 4. Have the standards been complied with?

Audit Procedures

When a question asks for audit procedures, remember that there are some useful checklists:

- ❖ What documents would be available.
- ❖ Any 3rd Parties who can provide written confirmations.
- ❖ Would a written management representation help?
- ❖ What post year-end events may have occurred, that would help assess the year-end accounting treatment.
- ❖ Could this have happened in previous years – if so compare.

Another way to think of the above issues is by using the AEIOU mnemonic
(Analytical procedures, Enquiry and confirmation, Inspection, Observation and Recalculation)

Audit Work On: Inventory, Work in progress & Standard costing systems

Inventory

Audit evidence

According to **ISA 501, Audit Evidence – Additional Considerations for Specific Items,** when inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its **existence** and **condition** by **attending** physical inventory counting, unless this is impracticable.

When attendance is impracticable, the auditor has to consider whether **alternative procedures** provide sufficient and appropriate audit evidence of the existence and condition of inventory.

ISA 501 requires the auditor to **review the instructions issued by the management** for physical verification, focussing particularly on the following:

a) **Control activities:** count and recount procedures and control over used and unused stationery that is used to record inventory during the inventory count. The instructions should be simple and clear. They should lay down the responsibilities of different persons and state which location will be covered by which persons.

They should also specify the procedure to be followed and the identification marks to be made.

The intention should be to count each item and count it only once.

b) **Accurate identification** of slow moving / damaged items, inventory owned by third party, for example, goods received on consignment, stage of completion of WIP.

c) **Arrangements regarding the movement of inventory:** dispatch and receipt of inventory before and after cut-off date, movement of inventory between areas during the process of counting.

d) Subsequent arrangements to check the accounting of movements mentioned above.

Work in Progress-The valuation of work in progress is likely to be complex

Audit procedures in respect of the valuation of work in progress

- Obtain a schedule of items included in work in progress at the year end, cast it and agree the total to the general ledger and draft financial statements.
- Agree a sample of items from the schedule to the inventory count records.
- For a sample of jobs included on the schedule:
  - Agree costs to supporting documentation such as supplier's invoice and payroll records;
  - For any overheads absorbed into the work in progress valuation, review the basis of the absorption and assess its reasonableness;
  - Confirm that net realisable value is greater than cost

Standard costing systems

IAS 2, Inventories permits valuation of inventories based on standard costing when prices fluctuate.

Therefore, while auditing standard costing systems, the auditor needs to **ensure that standard costing is a valid basis** for valuing inventory and that the **standard cost has been reasonably calculated**.

Audit procedures

a) **Review the purchase invoices and price index** and enquire with management, to establish whether or not the prices have fluctuated. The source documents should also be reviewed in order to verify the standard cost calculations.

b) **Discuss with management, whether or not standard costing is a valid costing system** to use for the company's inventory.

c) Consider if the inventory is still comparable with the previous year's inventory due to a change in accounting policies, with appropriate disclosures of changes in accounting policies.

d) **Check the reasonableness and accuracy** of the standard cost calculation sheet by:

- Tracing the costs relating to purchases with the purchase invoices, wages with the wage sheets and personnel records and overheads with the expense invoices
- Verifying the invoices mentioned above and checking whether the calculations are reasonable
- Casting the calculation sheet
- Verifying the standard cost calculations, including arithmetical calculations with the account totals in the income statement.

Standard cost can also be verified by using analytical procedures such as comparison with the total related expense in the income statement. For example the proportion of total overhead expenses (in the income statement) to the total production during the year, would be the standard overhead cost

Factors to consider before accepting standard costs as an appropriate basis for the estimation of cost:

How often are the standard costs updated? --Do significant price variances arise? --Have the standard costs been acceptable in the past?--What controls are there over the amendment of standard cost data?

Audit work on: Statements of cash flows

Statements of cash flows are accounted for under the provisions of IAS 7 *Statement of cash flows*. The statement of cash flows is essentially a reconciliation exercise between items in the operating profit and the statement of financial position (cash).

As such, the statement of cash flows is often audited **by the auditor reproducing it from the audited figures in the other financial statements**. This can be done quickly and easily in the modern era by use of computer programmes.

However, if the auditor wished to audit it another way, he could check and recalculate each reconciliation with the financial statements. This would involve checking each line of the statement by working through the client's workings and agreeing items to the accounting records and backing documentation (for example, tax paid to the bank statements) and the other financial statements.

Why is the statement of cash flows relevant to the auditors?

Report on the statement of cash flows

The statement of cash flows is specified in the audit report, as a statement the auditors are reporting on.

Financial reports are obliged to include a statement of cash flows under IAS 7 in order to show a true and fair view. The auditors must therefore assess the truth and fairness of the statement of cash flows as required by IAS 7.

Analytical review

The information in the statement of cash flows will be used by the auditors as part of their analytical review of the accounts, for example, by adding further information on liquidity. This will be particularly helpful when comparing the statement to previous periods.

Going concern

The statement of cash flows may indicate going concern problems due to liquidity failings, overtrading and over gearing. However, the statement is an historical document, prepared well after the year-end, and is therefore unlikely to be the first indicator of such difficulties.

Audit evidence

The auditors will obtain very little direct audit evidence from the statement of cash flows. It has been prepared by the company (not the auditors or an independent third party) from records which are under scrutiny by the auditors in any case. Thus the auditors will already have most of this information, although in a different format.
However, the statement of cash flows should provide additional evidence for figures in the accounts, for example, the purchase or sale of tangible non-current assets. Consistency of evidence will be important and complementary evidence is always welcome.

The statements of cash flows can be audited in two ways:

a) By reconciling each item with the financial statements. This includes:

- Tracing the items to the source documents (e.g. tracing the loan document and bank statement to the entry on the SOCF relating to repayment of loans).
- Recalculating each reconciliation e.g. recalculating the interest paid on loans with the loan document).
- Agreeing the prior year items in the SOCF (of the current period) with the corresponding amounts in then audited SOCF of the earlier period.
- Agreeing schedules of cash receipts (prepared based on the analysis of cash book receipts) to the receivables ledger control account.
- Agreeing schedules of cash payments to suppliers and employees (prepared based on the analysis of cash book payments) to the payables ledger and payroll control accounts (respectively).
- Analytical procedures such as various liquidity ratios and gearing ratios, comparison of trade receivable (and payable) days (i.e. average credit periods given to customers and received from suppliers) with prior years, are performed on the current period and also on the previous period. This will enable assessment of the ratios with reference to previous years as well as with the industry.

b) By drawing up a statement of cash flow from the audited financial statements. The use of computers has made this task very quick and easy.

Audit work: Changes in accounting policy

According to IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, due to its materiality, the error must be adjusted for retrospectively by amending comparatives and restating retained earnings at the beginning of the earliest period presented.

The effect of a change in accounting estimates should be accounted for prospectively, and included in profit or loss from the date of the change in estimate. In other words, it is only current and future periods which are affected by the change in estimate.

In addition, IAS 8 requires a note to the financial statements to disclose the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods.

The effect of a change in accounting policy is treated as a retrospective adjustment to the opening balance of each affected component of equity as if the accounting policy had always applied.

IAS 8 *Accounting policies, changes in accounting estimates and errors* states that changes in accounting policies are rare, and only allowed if required by statute or if the change results in more reliable and relevant information.

Take care not to confuse a change in **accounting policy** with a **change in accounting estimate**. A change in policy is rare and per IAS 8 should be accounted for retrospectively, but a change in estimate (such as the method for calculating depreciation) is accounted for going forward (prospectively).

An example of a change in **accounting estimate** is a change to an entity's **depreciation policy**. In this case, the entity's accounting *policy* is *to depreciate non-current assets*, and the 'depreciation policy'(which would include eg reducing balance or straight line depreciation, estimates of useful lives, etc) is merely the policy chosen by management in order to estimate how much depreciation should be charged.

Changes in accounting policy will be rare and should be made only if :

(a) The change is required by an IFRS; or

(b) The change will result in a **more appropriate presentation** of events or transactions in the financial statements of the entity, providing more reliable and relevant information.

The standard highlights two types of event which do not constitute changes in accounting policy.

(a) Adopting an accounting policy for a **new type of transaction** or event not dealt with previously by the entity.
(b) Adopting a **new accounting policy** for a transaction or event which has not occurred in the past or which was not material.

Audit work: Taxation

IAS 12 Income Taxes requires deferred tax to be recognised in respect of taxable temporary differences which arise between the carrying amount and tax base of assets and liabilities, including the differences which arise on the revaluation of non-current assets, regardless of whether the assets are likely to be disposed of in the foreseeable future. There is no profit impact, however, as the deferred tax would be recognised in equity.

IAS 12 states that a deferred tax asset can only be recognised where the recoverability of the asset can be demonstrated.

Unutilised tax losses can be carried forward for offset against future taxable profits, so the client must demonstrate, using budgets and forecasts, that future tax profits will be available for the losses to be fully utilised

Examiner feedback: Students should remember there will be 3 types of adjustments (current tax , under/over provision tax provision from previous year, deferred tax)

1. Verify that current tax expenses are properly calculated.
2. **Review the provision** to make sure that it is in accordance with IAS 12.
3. Check the accounting for and disclosures related to current tax expenses, asset, and liability.
4. Carry out a numerical reconciliation between tax expense and accounting profit multiplied by the applicable tax rate.
5. Check the arithmetical accuracy **of the deferred tax calculations**. This would include checking the opening balances of the deferred tax account against the previous year's financial statements.
6. Obtain schedule of temporary differences : agree to tax computation and accounting records. **Match** the figures used to calculate the temporary differences to those on the financial statements. For example, trace the schedule of carrying amount (i.e. cost or revalued amounts net of accumulated depreciation) of non-current assets to the general account balances and agree these to tax computations and the asset register.
7. Ensure the rate applied is in accordance with IAS 12 (substantially enacted)
8. Enquire with management and verify that the tax computations include all differences which need to be adjusted. Obtain a written representation..
9. Ensure that all **necessary disclosures** have been made- Disclosure: items on which deferred tax has been calculated, the change in liability (reconciliation of opening and closing balance) and major components of income tax expense.
10. If a tax software is used, perform TOCs.
11. **Review** any correspondence with the tax authorities.

Principal audit procedures – recoverability of deferred tax asset

- Obtain a copy of current tax computation and deferred tax calculations and agree figures to any relevant tax correspondence and/or underlying accounting records.
- Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- Obtain forecasts of profitability and agree that there is sufficient forecast taxable profit available for the losses to be offset against. Evaluate the assumptions used in the forecast against business understanding.
- Assess the time period it will take to generate sufficient profits to utilise the tax losses. If it is going to take a number of years to generate such profits, it may be that the recognition of the asset should be restricted.
- Using tax correspondence, verify that there is no restriction on the ability of the client to carry the losses forward and to use the losses against future taxable profits.

Audit work: Segmental Reporting

IFRS 8 *Operating Segments* requires listed companies to disclose in a note to the financial statements the performance of the company disaggregated over its operating or geographical segments, as the information is viewed by management.

a) The identification of the operating segments and the amounts related to prior period that are included in segment information must agree with the segment information included in the financial statements of the earlier year.

b) The totals of the segment information disclosure must be cast.

c) The turnover and operating profit totals must be agreed with the amounts shown on the face of the income statement.

d) The segment results (i.e. segment revenue less segment expense) must be agreed with the internal MIS reports of the entity.

e) The appropriateness of the geographic segments identified for the primary reporting format must be confirmed. For this:

- The auditor must review the MIS information of the entity to ascertain whether it indicates that the **chief operating decision maker (like the board)** of the entity reviews the performance of the operating segments and also takes decisions relating to allocation of resources based on this information. The auditor will confirm that operating results include segment information.
- The entity must have a system of recording segment information in its accounting systems e.g. cost centre wise information. This will provide assurance that discrete financial information relating to operating segments is available.
- The numerical thresholds must be recalculated.
- The auditor would also discuss the basis of allocation with the entity. Furthermore on a sample basis the information must be verified with source data such as segment revenue with invoices.
- The auditor would also look at segments which were slightly too small and double check to see if they need to be included.

f) Revenue expenses that arise at the enterprise level on behalf of segments (e.g. head office costs) which are not directly attributable to a segment need to be allocated between the different segments on a reasonable basis. However, the IFRS has not explained how this is to be done. Furthermore the basis for allocation which is chosen can have a material effect on the segment result. Therefore the auditor needs to review the basis on which such expenses are attributed to segments and confirm that it is reasonable (i.e. whether it is in agreement with prior year basis).

The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by: *(a) Obtaining an understanding of the methods used by management in determining segment information* *(b) Performing analytical procedures or other audit procedures appropriate in the circumstances.* **Depending on the circumstances**, example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include: • Sales, transfers and charges between segments, and elimination of inter-segment amounts. • Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales. • The allocation of assets and costs among segments. • • Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.	**IFRS 8 *Operating segments*** An **operating segment** is a component of an entity: 1. That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity); Whose operating results are reviewed regularly by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and 2. For which discrete financial information is available. IFRS 8 requires an entity to report financial and descriptive information about its reportable segments. **Reportable segments** are operating segments or aggregations of operating segments that meet specified criteria: 1. Its reported revenue, from both external customers and intersegment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments; or 2. The absolute measure of its reported profit or loss is 10% or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not report a loss and (ii) the combined reported loss of all operating segments that reported a loss; or 3. Its assets are 10% or more of the combined assets of all operating segments. If the total external revenue reported by operating segments constitutes less than 75% of the entity's revenue, additional operating segments must be identified as reportable segments (even if they do not meet the quantitative thresholds set out above) until at least 75%of the entity's revenue is included in reportable segments.

Audit work: Property, Plant & Equipment

The key risk in relation to initial recognition is of costs being incorrectly recognised as assets, when they should in fact have been expensed to the income statement.

Non-current assets will be carried at cost or valuation (if an item has been revalued).

For assets that are measured at cost, the auditor would have to verify the cost from the asset's purchase invoice.

Valuation may be straightforward to audit – **it can be verified to the valuation certificate**.
Assets revalued by a value: The auditor would need the certificate from the valuer as proof to verify the value of the asset. However before accepting the work of an expert, the auditor must evaluate the experts' work (independence, objectivity, scope of work, assumptions used) and confirm the reasonableness of the valuation. Additionally, the auditor would have to check that the valued amount does not deviate too far from its fair value.

The carrying value of non-current assets is therefore depreciated cost, or depreciated valuation.

Once a company has revalued assets, it is required to continue revaluing them regularly so that the valuation is not materially different from the fair value at period end. The auditors should therefore check that valuation is comparable to market value. They would do this by comparing the existing valuation to current market values (for example, in an estate agent's window).

Assets are depreciated, so their carrying value will not be original cost or valuation.

Depreciation can be verified by re performing the depreciation calculations.

Often a '**proof-in-total**' check will be sufficient, where auditors calculate the relevant depreciation percentage on the whole class of assets to see if it is comparable to the depreciation charged for that class of assets in the year.

The depreciation rate is determined by reference to the useful life of the asset. This is determined by management based on expectations of how long the asset is expected to be in use in the business. The auditors will audit this by scrutinising those expectations and verifying them where possible – for example, to the minutes of the meeting where management decided to buy the asset, to capital replacement budgets, to past practice in the business.

Risks where revaluation has taken place:

IAS 16 Property, Plant and Equipment requires all assets in the same class to be revalued.

There is also a risk that depreciation has not been recalculated on the new, higher value of the properties, leading to overstatement of non-current assets and understatement of operating expenses.

IAS 16 also requires a significant level of disclosure in relation to a policy of revaluation, so there is a risk that the necessary disclosures are incomplete

Assets purchased during the year should be correctly classified under their own account headings. In the case of additions and disposals to the assets made during the year the auditor should inspect ledger accounts to ensure that the additions and disposals are not recorded as purchases and sales revenue.

Appropriate Cut off: This means that transactions and events have been recorded in the correct accounting period. In this case, when auditing non-current assets, the auditor has to ensure that all additions and disposals to the non-current assets account that have occurred during the year are recorded and that no transactions occurring in prior years have been recorded in the current year's accounts

Rights and obligations: This means that the entity has the right to use and dispose of the asset. Any liability arising from the asset has to be paid by the entity. Only when the rights of ownership are in the hands of the entity can it record the asset in its accounts. For property purchased during the year, the auditor would have to look at any legal documentation that would indicate ownership of the asset e.g. title deed documents.

Existence: By existence, it means that the non-current asset does really exist at the end of the reporting period. The auditor would have to visit the site of the assets and physically verify that the asset exists as at the end of the reporting period. If the auditor is not able to physically verify the assets the auditor can make a surprise physical check of significant assets. Furthermore the auditor will confirm whether physical verification of non-current assets was carried out by the entity. Existence will ensure that the items exist, but will not confirm the valuation. Hence valuation methods need to be used to confirm the valuation e.g. looking at the purchase invoices and confirming the original cost and then estimating depreciation based on past experience with the entity etc.

Audit work: Property, Plant & Equipment

Fair Value: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date

Fair value accounting is increasingly important and affects the audit of valuation for both assets and liabilities. In May 2011 the IASB issued IFRS 13 *Fair value measurement,* as a result of a joint project with the US FASB. Examples of accounting treatments where fair values are relevant include financial instruments, employee benefits and share-based payments.
IFRS 13 uses a 'fair value hierarchy', which categorises inputs into three levels:

- Level 1 inputs: quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date
- Level 2 inputs: inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly
- Level 3 inputs: unobservable inputs for the asset or liability

Exam focus point
Fair value is a very topical area at the moment, and is therefore likely to be tested, eg as part of a requirement to discuss the difficulties involved in auditing fair value estimates.

For auditors, the determination of fair value will generally be more difficult than determining historical cost. It will be more difficult to establish whether fair value is reasonable for complex assets and liabilities than for more straightforward assets or liabilities which have a market and therefore a market value. For example, for an apartment held as an investment property, a fair value might be relatively easy to estimate, as there may be a large and active market for similar properties that can be used as a guide to the value of the property in question. If, on the other hand, an entity has a large pension scheme, for which the fair value of the assets depends on actuarial assumptions about the future, then the fair value will be extremely difficult to measure, and the auditor will have to be very careful about the assumptions made in arriving at a valuation.

Generally speaking, balances held at fair value carry the following risks.

Component of audit risk	Risk
Inherent risk	**Estimates** are **inherently imprecise,** and involve judgements, eg about market conditions, timing of cash flows, or the intentions of the entity.
	Estimation **models are often complex,** eg discounted cash flows, or actuarial calculations. There is a risk of the model being misapplied.
	Assumptions often have to be made when estimating fair values, eg discount factors.
	However, obtaining a fair value for some assets will be **straight forward,** eg assets that are regularly traded on a stock exchange.

Control risk	Fair value assessment is likely to take place once a year, **outside of normal internal control systems.** Therefore it may not be monitored as stringently as more routine transactions and balances. Alternatively, management may take extra care over a fair value assessment because it is a material amount, in which case control risk is low.
Detection risk	The auditor minimises **detection risk** through understanding the entity and its environment at the planning stage, determining whether and where fair values are present, and what the level of risk associated with them is.

Risk procedures: fair value

The auditor is required to assess the entity's process for determining accounting estimates including fair value measurements and disclosures and the related control activities and to assess the arising risks of material misstatement.

Management's processes for determining fair values will vary considerably from organisation to organisation. Some companies will habitually value items at historical cost where possible, and may have very poor processes for determining fair value if required. Others may have complex systems for determining fair value if they have a large number of assets and liabilities which they account for at fair value, particularly where a high degree of estimation is involved in determining the fair value.

Once the auditors have assessed the risks associated with determining fair value, they should determine further procedures to address those risks.

Audit procedures: fair value

Audit procedures will depend heavily on the complexity of the fair value measurement. Where the fair value equates to market value, the auditor should be able to verify this with reference to the market, for example, published price quotations for marketable securities, or by using the work of an expert, for example, an estate agent in the case of land and buildings.

However, in some cases, there may be a great deal of estimation and management assumption related to a fair value. Where this is the case, the auditor needs to consider matters such as the intent and ability of management to carry out certain actions stated in the assumptions. This includes:

- Considering management's past history of carrying out its stated intentions with respect to assets or liabilities
- Reviewing written plans and other documentation, including, where applicable, budgets, minutes etc
- Considering management's stated reasons for choosing a particular course of action
- Considering management's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its contractual commitments

The auditor should consider the following when considering fair value measurements:

- The length of time any assumptions cover (the longer, the more subjective the value is)
- The number of assumptions made in relation to the item
- The degree of subjectivity in the process
- The degree of uncertainty associated with the outcome of events
- Any lack of objective data
- The timings of any valuations used
- The reliability of third party evidence

The impact of subsequent events on the fair value measurement

Where a fair value measurement is based on assumptions reflecting management's intent and ability to carry out certain actions, then the auditor should obtain **written representations from management** that these assumptions are reasonable and achievable.

Fair values – acquisition of new subsidiaries

When a parent company acquires a new subsidiary, it will pay the fair value of the acquired company as a whole. This is because the previous owners tend to be unwilling to sell their company for less than its fair value. In order to bring in a fair estimate of the initial value of goodwill, IFRS 3, *Business Combinations* requires that the individual net assets of the acquired company be valued at their fair value at the date of the acquisition. Often, the acquirer will have investigated their assessment of value of material assets, liabilities and contingent liabilities of the target company as part of a pre-acquisition due diligence investigation. In these circumstances, the values ascribed to individual assets and liabilities in this due diligence will be an appropriate value to use for the initial recognition of each asset and liability. This means that fair value often becomes fair value through the eyes of the acquirer. This is not always the most appropriate valuation basis, however, since the value given by the acquirer may include some degree of the acquirer's intentions. For example, it is common for a new acquirer to plan to restructure an acquired business shortly after the acquisition. This might include an intention to pay off any litigation in progress at the date of acquisition in order to fee management time for integration of the subsidiary into its new group. This could result in incorrect recognition of provisions that are higher than the true value of the obligation.

Audit Work On: Employee Benefits

<table>
<tr>
<td>Scheme assets
(including
quoted and unquoted securities, debt instruments, properties)</td>
<td>– Obtain direct confirmations of scheme assets from the investment professional in charge of the plan assets.
– Obtain reconciliations from the company’s management of the valuation as at the scheme year end date with the entity’s reporting date.
– Consider requiring scheme auditors to perform procedures</td>
</tr>
<tr>
<td>Scheme liabilities</td>
<td>Work done by the actuary can be relied upon after evaluating his work in accordance with the provisions of ISA 620 Using the Work of an Auditor’s Expert. Auditors must assess whether it is appropriate to rely on the actuary's work
Specific matters would include
– The source data used
– The assumptions and methods used
– The results of actuaries' work in the light of auditors' knowledge of the business and results of other audit procedures

Actuarial source data is likely to include:
-Scheme member data (for example, classes of member and contribution details)
-Scheme asset information (for example, values and income and expenditure items)</td>
</tr>
<tr>
<td>Actuarial assumptions
(for example retirement ages, mortality rates, employee turnover/termination rate, changes in salary and benefits, funds’ assets performance)
Remember that it is unlikely that auditors will have the same level of expertise as the actuary!</td>
<td>– Discuss with the actuaries the basis used to calculate assumptions and review whether or not the assumptions appear to be reasonable based on their knowledge of the entity’s financial information.
– Compare the assumptions used in the current year with those used in the previous years, for consistency.
– Obtain written representations from the entity’s management regarding the appropriateness of the assumptions in relation to their knowledge of business.
– Auditors should determine whether the assumptions used by the entity are similar to the assumptions used by other entities in the industry.
– Evaluate the reasonableness of assumptions by using your knowledge of the business and results of other audit procedures</td>
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<tr>
<td colspan="2">– Recalculate actuarial gain/loss</td>
</tr>
<tr>
<td colspan="2">Ensure Accounting treatment in accordance with the provisions of IAS 19:
– The auditors should confirm that the accounting treatment of the various aspects of the plan is recorded in the financial statements in accordance with the provisions of IAS 19.
– Furthermore the auditor must trace some of the items recorded in the financial statements with the source documents. For example interest cost with the loan documents, bank statements; current service costs with payroll records, personnel records, etc.
– Defined benefit: be alert! Scheme valuation date may be different from the reporting date. In this case, a reconciliation will be requested from the directors.</td>
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Audit work: Government Grants

A government grant is recognised only when there is reasonable assurance that (a) the entity will comply with any conditions attached to the grant and (b) the grant will be received

Risks

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* requires that a grant is recognised as income over the period necessary to match the grant received with the related costs for which they are intended to compensate. This means that the amount received should not be recognised as income on receipt, but the income deferred and released to profit over the estimated useful life of the assets to which it relates.

The risk is that the grant has been recognised on an inappropriate basis leading to over or understated profit for the year.

The part of the grant not recognised in profit should be recognised in the statement of financial position.

IAS 20 allows classification as deferred income, or alternatively the amount can be netted against the assets to which the grant relates. There is therefore also a risk that the amount is recognised elsewhere in the statement of financial position, leading to incorrect presentation and disclosure.

If the terms of the grant have been breached, the grant or an element of it may need to be repaid. There is therefore a risk that if there is any breach, the associated provision for repayment is not recognised, understating liabilities.

Revenue Grant-A grant receivable as compensation for costs, either: Already incurred or For immediate financial support, with no future related costs.

Recognise as income in the period in which it is receivable.

It may be presented in one of two ways:

- Separately as 'other income'
- Deducted from the related expense.

Grants where related costs have already been incurred offer no difficulties to account for or to audit. To audit them, the auditor should:

- Obtain documentation relating to the grant and confirm that it should be classified as revenue
- The value may be agreed to the documentation (for example, a letter outlining the details of the grant, or a copy of an application form sent by the client)
- The receipt of the grant can be agreed to bank statements

A grant relating to assets may be presented in one of two ways:

- as deferred income, or
- by deducting the grant from the asset's carrying amount.

The grant is recognised as income over the period necessary to match it with the related costs, for which it is intended to compensate on a systematic basis and should not be credited directly to equity.

If a grant becomes repayable, it should be treated as a change in estimate.

Capital grants can be more difficult to audit

Audit procedures:

- Consider whether the basis of accounting is comparable to the previous year.
- Discuss the basis of accounting with the directors to ensure that the policy used is the best one
- Ensure that any changes in accounting policy are disclosed.

Under IAS 20, the grant should be presented on the statement of financial position either as deferred income, or by deducting the grant in arriving at the asset's carrying value.

<u>Audit procedures in respect of the recognition and measurement of the government grant</u>

- Obtain the documentation relating to the grant to confirm the amount, the date the cash was received, and the terms on which the grant was awarded.
- Review the documentation for any conditions attached to the grant
- Discuss with management the method of recognition of the amount received, in particular how much of the grant has been recognised in profit and the treatment of the amount deferred in the statement of financial position.
- Confirm that the grant criteria have been complied with (scenario specific information needs to be incorporated)
- Using the draft financial statements, confirm the accounting treatment outlined by discussion with management has been applied and recalculate the amounts recognised. {Recalculate 'release' to match with costs (revenue grant) or depreciation (capital grant)}
- Confirm the cash received to bank statement and cash book
- Review Disclosures for adequacy and completeness:

  Disclosure

  - **Accounting policy** note.
  - **Nature and extent** of government grants and other forms of assistance received.
  - **Unfulfilled conditions** and other contingencies attached to recognised government assistance.

Non-monetary grants, such as land or other resources, are usually accounted for at fair value.

<u>Audit work: Related parties</u>

Examples of related parties: subsidiaries, JV, shareholder with significant influence, directors, other senior management like CFO

Indicators: loans (with no interest, low interest, no specific repayment terms), non-monetary exchange of property, sale of real estate at a market value , loan from a stockholder to hide liquidity problems

Related party – A party that is either:

(i) A related party as defined in the applicable financial reporting framework; or

(iii) Where the applicable financial reporting framework establishes minimal or no related party requirements:
   a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
   b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
   c. Another entity that is under common control with the reporting entity through having:
      i. Common controlling ownership;
      ii. Owners who are close family members; or
      iii. Common key management.

ISA 550 *Related Parties* requires that the auditor evaluates whether identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

Why are related parties difficult to identify

Related parties and related party transactions can be difficult to identify.

1. Management may be unaware of the existence of all related party relationships and transactions, resulting in them not being revealed to the auditor on enquiry. Auditors of smaller companies can often find it difficult to identify related parties because management does not understand the disclosure requirements or the significance of the disclosures required.
2. It can also be difficult to decide if a related party relationship exists, as some of the definitions in IAS 24 *Related Party Disclosures* are subjective, also resulting in non-disclosure to the auditor of potential related parties and transactions.
3. Management of larger companies may have a better understanding of recording and disclosing related party transactions. However auditors of the larger companies have to deal with larger more complex transactions that can be more difficult to understand and follow.
4. There could also be a deliberate attempt by management to conceal related party relationships or transactions. Knowledge of related party relationships is largely confined to management, and in the absence of alternative procedures other than management enquiry, the auditor could not know of the existence of some related party relationships, especially the family members of key management personnel. ISA 550 *Related Parties* identifies that related party relationships may represent a greater opportunity for collusion, concealment or manipulation by management.

5. The accounting system may not be set up to identify related party transactions. For example, cash payments made to a related party may not be separately identified from payments to trade suppliers within the ledgers.
6. Finally, some related party transactions occur at minimal value, and sometimes at nil value. This makes the transaction almost impossible for the auditor to detect, other than relying on management to disclose the transaction on enquiry.

Procedures helpful in identifying related parties

- **Enquire of management** and the directors as to whether transactions have taken place with related parties that are required to be disclosed by the disclosure requirements that are applicable to the entity
- **Review prior year working papers** for names of known related parties
- **Review minutes** of meetings of shareholders and directors and other relevant statutory records such as the register of directors' interests
- **Review accounting records** for large or unusual transactions or balances, in particular transactions recognised at or near the end of the financial period
- **Review confirmations of loans receivable** and payable and confirmations from banks. Such a review may indicate the relationship, if any, of guarantors to the entity
- **Review investment transactions**, for example purchase or sale of an interest in a joint venture or other entity
- **Enquire** as to the **names** of all pension and other trusts established for the benefit of employees and the names of their management and trustees
- **Enquire** as to the **affiliation** of directors and officers with other entities
- **Review the register of interests in shares** to determine the names of principal shareholders
- **Enquire of other auditors** currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties
- **Review the entity's tax returns**, returns made under statute and other information supplied to regulatory agencies for evidence of the existence of related parties
- **Review invoices and correspondence** from lawyers for indications of the existence of related parties or related party transactions

Circumstances which indicate the existence of a related party

The following are the circumstances that indicate the existence of a related party.

1. **Economic substance of the transaction differs from form:** In situations where the substance and economic reality of a transaction is different from the legal form, the possibility of a related party exists and it becomes necessary to assess the transaction on its substance and economic reality.
2. **No logical business reason:** The auditor can identify the transaction where there is no logical business reason to effect the particular transaction.
3. **Not adhering to the set methods of processing transactions:** Transactions that are not processed in the routine manner may be on account of related party transactions.
4. **Terms of trade different from normal:** If the terms of trade are different and not according to routine business transactions, there can be a related party transaction.
5. **High volume with one customer / supplier:** An extraordinary high volume of sales or purchases with one customer or vendor is also a risky area as this can be construed as a related party transaction.

6. **Unrecorded transaction:** If there are any unrecorded transactions, the auditor can assess whether there is a genuine error or whether the mistake had been made on purpose.
7. **Transactions not having adequate evidence:** An auditor always asks for the audit evidence which is sufficient and reasonable to cover the risk. If any particular transaction is effected without adequate documentary evidence, there is a probability of the transaction being a related party transaction e.g. absence of documentary evidence to support an investment made in the shares of a company.
8. **Unusual transactions entered at the start and end of year**

Audit work

ISA 550 requires that where a significant related party transaction outside of the entity's normal course of business is identified, the auditor shall:

1. Inspect the underlying contracts or agreements, if any, and evaluate whether:
   a) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;
   b) The terms of the transactions are consistent with management's explanations; and
   c) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.
2. The auditor shall also obtain audit evidence that the transactions have been appropriately authorised and approved.
3. IAS 24 states that a related party transaction should be disclosed if it is material In relation to a material related party transaction, IAS 24 requires disclosure of the nature of the related party relationship along with information about the transaction itself, such as the amount of the transaction, any relevant terms and conditions, and any balances outstanding.
4. The auditor needs to get a written representation from management stating that management has disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware, and that management has appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of IAS 24.
5. ***Auditor shall inquire of management:***
   - The identity of related parties including changes from prior period
   - The nature of the relationships between the entity and its related parties
   - Whether any transactions occurred between the parties, and if so, what
   - What controls the entity has to identify, account for and disclose related party relationships and transactions
   - What controls the entity has to authorise and approve significant transactions and arrangements with related parties
   - What controls the entity has to authorise and approve significant transactions and arrangements outside the normal course of business
6. Perform procedures **specific to the transaction given in the question**

IAS 24

Related party: a person or entity that is either

(a) A person or a close member of that person's family is related to a reporting entity if that person:
- (i) has control or joint control over the reporting entity;
- (ii) has significant influence over the reporting entity; or
- (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

b) An entity is related to a reporting entity if any of the following conditions applies:
- (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).
- (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
- (iii) Both entities are joint ventures of the same third party.
- (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
- (v) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
- (vi) The entity is controlled or jointly controlled by a person identified in (a).

Related party transactions are a transfer of resources or obligations between related parties, regardless of whether a price is charged.

Audit work: Earnings per share

Audit issues

The size of the figure is unlikely to be material in itself, but it is a key investor figure. As it will be of **interest to all the investors** who read it, it is **material by its nature**.

When considering earnings per share, the auditor must consider **two issues**:
- Whether it has been disclosed on a comparable basis to the prior year, and whether any changes in accounting policy have been disclosed, and
- Whether it has been calculated correctly

A key audit risk is that the entity fails to meet IAS 33's disclosure requirements. These are:

(a) The amounts used as the **numerators** in calculating basic and diluted EPS, and a **reconciliation** of those amounts to the net profit or loss for the period

(b) The weighted average number of ordinary shares used as the **denominator** in calculating basic and diluted EPS, and a **reconciliation** of these denominators to each other.

IAS 33 requires EPS to be calculated based on the profit or loss for the year attributable to ordinary shareholders as presented in the statement of profit or loss, EPS based on an alternative profit figure is only allowed to be disclosed in the notes to the financial statements as an additional figure, and should not be disclosed on the face of the financial statements.

The denominator used in the EPS calculation should be based on the weighted average number of shares which were in issue during the financial year.

Audit procedures on earnings per share

- Review board minutes to confirm the authorisation of the issue of share capital, the number of shares and the price at which they were issued.
- Inspect any other supporting documentation for the share issue, such as a share issue prospectus or documentation submitted to the relevant regulatory body.
- Confirm that the share issue complies with the company's legal documentation (e.g. the memorandum and articles of association).
- Recalculate the weighted average number of shares for the year.
- Recalculate EPS using the profit as disclosed in the statement of profit or loss and the weighted average number of shares.
- Discuss with management the existence of any factors which may impact on the calculation and disclosure of a diluted EPS figure, for example, convertible bonds.
- Read the notes to the financial statements in respect of EPS to confirm that disclosure is complete and accurate and complies with IAS 33.

Audit work on: Impairment

When auditing an entity's non-current assets, the auditor would, use the same criteria as set out by the management in accordance with **IAS 36 Impairment of Assets**, check for indicators that may suggest a possibility for impairment on assets.

IAS 36 specifies the following indicators of possible impairment

External sources of information regarding possible impairment:

- Market value declines significantly;
- Negative changes in technology, markets, economy, or legal environment;
- Increases in market interest rates that are likely to affect the discount rate using to calculate value
- in use;
- Company stock price is below book value.

Internal sources of information regarding possible impairment:

- Obsolescence or physical damage;
- Significant changes with an adverse effect on use, eg asset will become idle, is part of a restructuring, or is held for disposal;
- Internal evidence shows worse economic performance of the asset than was expected..

The auditors will consider whether there are any **indicators of impairment** when carrying out risk assessment procedures. They will use the same impairment criteria laid out in IAS 36 as management do.

If there is an indication of impairment on an asset, the auditors should request the management for a copy of the impairment review. If the management has carried out an impairment review, that impairment review should be audited.

If the management has not conducted an impairment review, then the auditors should propose an impairment review and qualify their report depending on whether or not the management agrees to carry out the impairment review.

The matters to be audited would be:
Verify the Carrying Value (*the amount at which an asset is recognised in the balance sheet after deducting accumulated depreciation and accumulated impairment losses)*

Recoverable amount: this depends on the fair value, cost to sell and value in use.

Fair value and cost to sell: both are subject to estimations. Therefore they need to be reviewed carefully. The risk assessment procedures to assess the risks of material misstatement in relation to accounting estimates and fair values would have to be carried out. Additionally while reviewing cost to sell the items which can be included and excluded must be in accordance with the provisions of IAS 36.

Cost to sell should be checked for arithmetical accuracy. Furthermore, cost of delivery can be verified from the rates published by delivery companies. Cost to sell includes transaction taxes. These can be recalculated by applying the applicable tax rate to the fair value. Stamp duty can be recalculated based on the regulatory requirements.

Value in use
If the management has used the asset's value in use, the auditor must conduct the following audit procedures.
1. Physically inspect the asset; this provides evidence of existence and condition of asset as on the reporting date.
2. Obtain the document containing value in use (along with the working papers) from the entity.
3. Trace the projected cash flows in the workings with budgets and projections, to ensure that they are approved by the board and are reasonable (e.g. asset days available and average daily utilisation per asset).
4. Calculate/obtain from analysts the long term average growth rate for the products and ensure that the growth rates assumed in the calculation of value in use do not exceed it
5. Check the arithmetical accuracy of the document.
6. Cash flows need to be discounted to present values. Confirm that the present values used for discounting should be in accordance with the published market rates expected by the market.
7. Recalculate on a sample basis, the makeup of the cash flows included in the forecast..
8. Compare to previous calculations of value in use to ensure that all relevant costs of maintaining the asset have been included
9. Ensure that the cost/income from disposal of the asset at the end of its life has been included
10. Review calculation to ensure cash flows from financing activities and income tax have been excluded
11. Written representation: regarding expected future performance and that the management's assumptions are reasonable.

Ensure Disclosure requirements have been met.

- Impairment losses recognised in profit or loss , impairment losses reversed in profit or loss
- Impairment losses on revalued assets recognised in other comprehensive income , impairment losses on revalued assets reversed in other comprehensive income
- The valuation techniques used to measure fair value less costs of disposal and the key assumptions used in the measurement of fair value measurements
- Discount rate used for value in use

Audit procedures – impairment of goodwill

The auditor should perform the following procedures:

- The assumptions used in the impairment test should be confirmed as agreeing with the auditor's understanding of the business based on the current year's risk assessment procedures, e.g. assess the reasonableness of assumptions on cash flow projections.
- Confirm that the impairment review includes the goodwill relating to all business combinations.
- Consider the impact of the auditor's assessment of going concern on the impairment review, e.g. the impact on the assumption relating to growth rates which have been used as part of the impairment calculations.
- Obtain an understanding of the controls over the management's process of performing the impairment test including tests of the operating effectiveness of any controls in place, for example, over the review and approval of assumptions or inputs by appropriate levels of management and, where appropriate, those charged with governance.
- Confirm whether management has performed the impairment test or has used an expert.

- The methodology applied to the impairment review should be checked by the auditor, with inputs to calculations, e.g. discount rates, agreed to auditor-obtained information.
- Develop an independent estimate of the impairment loss and compare it to that prepared by management.
- Confirm that the impairment calculations exclude cash flows relating to tax and finance items.
- Perform sensitivity analysis to consider whether, and if so how, management has considered alternative assumptions and the impact of any alternative assumptions on the impairment calculations.
- Check the arithmetic accuracy of the calculations used in the impairment calculations

Audit work: provisions, contingent liabilities, contingent assets

According to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be recognised where there is a present obligation as a result of a past event, a probable outflow of economic benefit and a reliable estimate can be made.

Contingent Assets should not be recognised until such time as the inflow of economic benefits is virtually certain. If the inflow of benefits is probable rather than virtually certain, then the matter should only be disclosed in a note to the financial statements.

ISA 540 directs the auditor's work from a starting point of uncertainty rather than the materiality of the draft figure in the financial statements. The greater the estimation uncertainty, rather than the size of the draft figure, the greater the amount of evidence that the auditor will need to obtain.

- The schedule forming part of the financial statements relating to provisions and contingent assets and liabilities should be obtained from the client. The schedule must include opening balances, movements during the current period and the closing balances. The amounts relating to opening balances should be agreed with the previous period's financial statements.
- Considering the nature of the entity's business the auditor must consider whether appropriate provisions are made. For example the auditor of a mining company would verify whether provisions for site restoration are made on mines.

Obtain an understanding	When performing **risk assessment procedures**, the auditor shall obtain an understanding of the following: 1. The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures. 2. How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. 3. How management makes the accounting estimates, and an understanding of the data on which they are based, including: • The method, including where applicable the model, used in making the accounting estimate; • Relevant controls; • Whether management has used an expert; • The assumptions underlying the accounting estimates; • Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and • Whether and, if so, how management has assessed the effect of estimation uncertainty(The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.)
Review and test the process used by management to develop the estimate;	(a) Evaluation of the data and consideration of the assumptions on which the estimate is based (b) Testing of the calculations involved in the estimate (c) Comparison, where possible, of estimates made for prior periods with actual results of those periods (d) Consideration of management's approval process.

Use an independent estimate, either made or obtained by the auditor, for comparison with that prepared by management;	The auditor may make or obtain an independent estimate and compare it with the accounting estimate prepared by management. When using an independent estimate the auditor would ordinarily evaluate the data, consider the assumptions and perform audit procedures on the calculation procedures used in its development. It may also be appropriate to compare independent estimates made for prior periods with actual results of those periods.
Review subsequent events which provide audit evidence of the reasonableness of the estimate made.	Transactions and events which occur after period end, but prior to completion of the audit, may provide audit evidence regarding an accounting estimate made by management. The auditor's review of such transactions and events may reduce, or even remove, the need for the auditor to review and perform audit procedures on the process used to develop the accounting estimate or to use an independent estimate in assessing the reasonableness of the accounting estimate.
The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. Provisions: nature of obligation, timing of outflow, any uncertainty regarding amount or time, any assumptions about future events, numerical reconciliation of opening and closing balances	
The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias.	
The auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable	
Consider the need for 3rd party confirmation or inspection of client's correspondence with 3rd parties.	

Management Bias

"Management bias" according to ISA 540 *Auditing accounting estimates* is a lack of neutrality by management in the preparation of financial information. In theory, management should be unbiased or neutral when preparing financial information because the information itself needs to be unbiased so users can rely on it. However, management may find it difficult to take an objective view simply because they normally have an inherent interest in that information. For example, bonus payments may vary as a direct result of reported profit or share price change resulting from publication of financial information

THE ADVANCED AUDIT & ASSURANCE EXAM- extracted from past exams- examples given below.

Contingencies arising as a result of litigation. Litigation and legal claims against the entity may have a material effect on the financial statements. Due to this, the auditor should carry out appropriate audit procedures to identify litigation legal claims against the client. **Audit procedures** These procedures would include enquiring from management, reviewing board meetings and legal expense accounts, among other tasks.

If the audit procedures indicate the existence other material litigation or claims the auditor should seek direct confirmation (from the client's external legal counsel) on the litigation matter. This will enable the auditor to obtain sufficient appropriate evidence relating to:

- Identification of potentially material litigation
- Claims
- Management's estimates of the financial implications, including costs and whether they are reasonable.

This communication after the client's management provides the auditor with a letter requesting its legal counsel to directly communicate with its auditors.

If it is perceived that the external legal counsel would not respond to a general letter of enquiry, a letter of specific inquiry would have to be sent. This letter would include:

- A list of legal claims against the company,
- The management's assessment of the outcome (if available) of each of the identified litigation and claims and its estimate of the financial implications, including costs involved,
- A request to the lawyers to confirm or disaffirm the reasonableness of the management's assessment of the outcome of the claims brought up against the company. Furthermore a request for further information, if the list is considered by the entity's external legal counsels to be incomplete or incorrect.

Written representations from the management must include completeness of all the potential litigation and claims being disclosed to the auditors.

Refusal by the management to provide the auditor with permission to communicate with the legal counsel would result in a modified opinion in the audit report.

Decommissioning provision

According to IAS 16 *Property, Plant and Equipment*, the cost of an asset should include the estimated costs of dismantling and removing the asset (also known as decommissioning costs) if there is an obligation to incur the cost at the end of the life of the asset.

According to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should only be recognised if there is a present obligation as a result of a past event, giving rise to a probable outflow of economic benefit.

The measurement of the provision is inherently subjective and complex, as it involves estimations of the expected decommissioning cost, the estimated life of the power stations, and the application of an appropriate discount factor to calculate the present value of the expected costs. There is risk that inappropriate assumptions have been used in determining these estimates.

Important risky area: The auditor should consider whether it seems reasonable that in the scenario, the value of the provision is reducing over the period of time. It would normally be expected to see the value of the provision increase over time, as the provision is unwound each year to increase its present value. The fact that the provision has decreased in value could indicate that management has changed one or more of the assumptions used in the measurement of the provision (e.g. using a higher interest rate to calculate the present value of the provision), the reasons for which would need to be investigated.

It should be considered whether sufficient disclosure has been made in the notes to the financial statements. IAS 37 requires that the notes should contain narrative information including a brief description of the nature of the obligation and the expected timing of any outflows of economic benefits, and an indication of the uncertainties about the amount or timing of those outflows. In addition, the notes should disclose the major assumptions made concerning future events. The notes should also contain numerical disclosures, namely a reconciliation of the opening and closing provision, analysing the movement in the year.

Audit evidence
- A review of any agreement for confirmation that there is an obligation to decommission.
- A copy of management's calculations used to measure the provision, and confirmation that the calculation is based on assumptions in line with our understanding of the entity, and which are consistent with other audit evidence obtained (e.g. that the remaining life of the assets is 20 years, that the discount rate used to determine the present value of the provision is appropriate).
- A review of documentation used to support management's assumptions
- A discussion with management as to whether there has been, or ought to have been, a change from the prior year in the methods for making the estimates or assumptions used in the measurement of the provision.
- An assessment of the controls in place over the estimate of the provision (e.g. are there controls to ensure that the circumstances giving rise to the provision, and the assumptions used in calculations are periodically reviewed, and whether there is review and approval of the calculations).
- A written representation from management indicating that management consider that significant assumptions used in making the accounting estimate are reasonable.
- A review of the notes to the draft financial statements to confirm sufficiency of narrative and numerical disclosures

Restructuring provisions: A restructuring provision **shall include** only the direct expenditures arising from the restructuring.
Restructuring provisions were used by some companies to manipulate their results; therefore IAS 37 specifically lays down the accounting requirements in this area.
A **restructuring** is a programme that is planned and controlled by management, and materially changes either:
a) The scope of a business undertaken by an entity; or
b) The manner in which that business is conducted.

The following are examples of events that may fall under the definition of restructuring, as specified in the IAS:
a) Sale or termination of a line of business
b) The closure of business locations in a country or region or the relocation of business activities from one country or region to another
c) Changes in management structure, for example, eliminating a layer of management
d) Fundamental reorganizations that have a material effect on the nature and focus of the entity's operations

An entity is required to recognise the constructive obligations for restructuring if the following conditions are satisfied:
a) A formal plan exists
b) A valid expectation that it will carry out the restructuring exists

Onerous contracts
An **onerous contract** is a contract in which the **unavoidable costs of meeting the obligations** under the contract **exceed the economic benefit expected to be received** under the contract.

The liabilities derived from **onerous contracts have to be provided for** as onerous contracts **fulfill all the three conditions of the recognition criteria.**

Audit work: Intangible assets

IAS 38 *Intangible assets*

An **intangible asset** is an identifiable non-monetary asset without physical substance. It may be held for using in the production and supply of goods or services, or for rental to others, or for administrative purposes. The asset must be:

- Controlled by the entity as a result of events in the past, and
- Something from which the entity expects future economic benefits to flow.

Examples of items that might be considered as intangible assets include computer software, patents, copyrights, motion picture films, customer lists, franchises and fishing rights. An item should not be recognised as an intangible asset, however, unless it **fully meets the definition** in the standard.

Internally generated goodwill may **not** be recognised as an **asset**.

IAS 38 *Intangible Assets* states that an intangible asset with a finite useful life is amortised, and an intangible asset with an indefinite useful life is not.

An intangible asset with an indefinite useful life shall not be amortised BUT has to be tested for impairment annually, and whenever there is an indication that the intangible asset may be impaired

Audit work – development costs

Research costs must be expensed and strict criteria must be applied to development expenditure to determine whether it should be capitalised and recognised as an intangible asset.

For example, the ability of the development costs to generate economic benefit should be demonstrated, along with the existence of resources to complete the development.

When an intangible asset has a finite useful life, it should be amortised systematically over that life.

For a development asset, the amortisation should correspond with the pattern of economic benefits generated from the sale of associated goods. There is a risk that the amortisation period has not been appropriately assessed.

- Check project reports (from the management as well as experts) to ensure that the expenditure relating to the research and development project can be separately identified and feasible to be completed.
- Confirm that all the conditions relating to development cost are completed before the development expenses are capitalised. For this confirm:
  - The technical feasibility and viability by verifying reports from technical experts, results of test runs, etc.
  - The market research documents, budgets, forecasts to conclude whether the entity believes that a market for the internally developed asset exists.
  - That the various significant expenses are supported with valid invoices in order to confirm that expenditure that would be incurred from developing the asset and can be reliably measured.
  - View the budgeted revenues and costs and calculations for future cash flows to ensure that resources required to fulfil the budgets actually exist.
- Check the appropriateness of amortisation i.e. the asset should be amortised over its useful life. Therefore the auditor should verify the expert's report relating to useful life of the development costs.

- The auditor should also verify the accounting entries to confirm that the financial statements are correctly drawn up.
- Review adequacy and completeness of the Disclosure (useful life or amortisation rate, amortisation method, accumulated amortisation and impairment losses, basis for determining that an intangible has an indefinite life, intangible assets carried at revalued amounts , the amount of research and development expenditure recognised as an expense in the current period)
- Ensure **Initial measurement:** at cost. **Measurement subsequent to acquisition:** cost model and revaluation models allowed.

Audit work: Brands

The key accounting issue with regard to brands is whether the asset is **internally generated** or not.

Remember, IAS 38 forbids the capitalisation of internally generated brands.

If a brand has been purchased separately (that is, not as part of goodwill) then auditors should test the value of the brand according to the sales documentation.

Procedures on an acquired brand

- Review board minutes for evidence of discussion of the purchase of the acquired brand, and for its approval.
- Agree the cost to the company's cash book and bank statement.
- Obtain the purchase agreement and confirm the rights of client in respect of the brand.
- Discuss with management the estimated useful life of the brand and obtain an understanding of how the useful life has been determined.
- If the useful life is a period stipulated in the purchase document, confirm to the terms of the agreement.
- If the useful life is based on the life expectancy of the product, obtain an understanding of the basis for this, for example, by reviewing a cash flow forecast of sales of the product.
- Obtain any market research or customer satisfaction surveys to confirm the existence of a revenue stream.
- Consider whether there are any indicators of potential impairment at the yearend by obtaining pre year-end sales information and reviewing terms of contracts to supply the products to pharmacies.
- Recalculate the amortisation expense for the year and agree the charge to the financial statements, and confirm adequacy of disclosure in the notes to the financial statements.

Basic audit Work on Goodwill- to be discussed in detail later

1. **Verifying the amount of goodwill** calculated by matching the purchase consideration to the acquisition agreement.
2. Confirming that the fair value of the assets are acquired by conducting audit procedures, relating to fair values.
3. Recalculating the amount of goodwill and agreeing it with the amount recognised in the financial statements.
4. Ensuring that the goodwill calculation does not include **internally generated goodwill.**
5. Ensuring **that goodwill is not amortised as it** is not permitted by IFRS 3.
6. Reviewing the **calculations relating to impairment of goodwill** for accuracy and reasonableness.
7. Goodwill impairment test
8. If useful life is judged to be indefinite, ensure impairment review has been carried out

Audit work: Financial Instruments

When auditing financial instruments, the auditors will have to ensure that recognition and valuation is in accordance with IFRS 9 *Financial instruments*.

Financial assets

Initial recognition of a financial asset is at the fair value of the consideration. Subsequent to this initial recognition, IFRS 9 requires that **financial assets** are classified as measured at either:

- **Amortised cost, or**
- **Fair value**

The IFRS 9 classification is made on the basis of both:

(a) The **entity's business model** for managing the financial assets, and

(b) The **contractual cash flow** characteristics of the financial asset.

An application of these rules means that **equity investments may not be classified as measured at amortised cost** and must be measured at fair value. This is because contractual cash flows on specified dates are not a characteristic of equity instruments. In addition, **all derivatives are measured at fair value.**

A **debt instrument** may be classified as measured at either amortised cost or fair value **depending on whether it meets the criteria above.**

Financial liabilities

As with financial assets, a financial liability is initially measured at the fair value of the consideration received. Subsequent to this, IFRS 9 requires that financial assets are **classified as measured** at either:

(a) **Fair value through profit or loss**, or

(b) **Amortised cost** under the effective interest rate method

A financial liability is classified at **fair value through profit or loss if**:

(a) It is **held for trading**, or

(b) Upon initial recognition it is designated at fair value through **profit or loss.**

Derivatives are always measured at fair value through profit or loss.

IFRS 7 *Financial instruments: disclosure*

The principles in IFRS 7 complement the principles for recognising, measuring and presenting financial assets and financial liabilities in IAS 32 *Financial instruments: Presentation* IAS 39 *Financial instruments:*

Recognition and measurement, and IFRS 9 *Financial instruments*.

IFRS 7 requires entities to make extensive disclosures in relation to financial instruments, which we will recap briefly here. The standard requires qualitative and quantitative disclosures about exposure to risks arising from financial instruments and specifies minimum disclosures about credit risk, liquidity risk and market risk.

Two types of disclosure need to be made: about the **significance** of the financial instruments, and about the **nature and extent of risks arising** from the financial instruments.
IFRS 7 requires disclosures about the **significance** of financial instruments to be made in relation to the SOFP and the SOCI. For example, entities must disclose the carrying amounts included within each IAS 39/IFRS 9 category on the SOFP, and the reason for any reclassification between these categories. The SOCI must then disclose the net gain/loss that is attributable to each of these categories.

Regarding the **nature and extent of risks**, IFRS 7 requires disclosures in respect of credit risk, currency risk, interest rate risk, liquidity risk, loans payable, market risk, other price risks, and instruments that are past due.

Compound financial instruments: Convertible debt is a commonly-examined example here, where the debt and equity elements of the instrument need to be presented separately in the financial statements. Accounting in this area requires a level of **judgement**, which can be **risky** from an auditor's point of view. For example, judgement is required when calculating the present value of debt repayments (e.g. in selecting an appropriate discount rate).

Audit Risk
Classification: inaccurate classification of financial instruments can cause material misstatements in the financial statements as they will reflect incorrect gearing ratios and hence the risk profile of the entity.

Therefore the auditor will:
- Understand the classification by making enquiries with the management.
- Read the terms of contracts related to the financial instruments to determine the substance of the transaction.

<u>Challenging to audit because:</u>

Financial instruments, particularly complex ones, increase audit risk. Factors which increase audit risk include the following:
(a) Lack of management understanding of financial instruments and therefore inadequate management control.
(b) Inappropriate classification of financial instruments, particularly between debt and equity may lead to off-balance sheet financing. This will affect gearing and therefore the risk profile of the business. This is particularly an issue where hybrid or compound instruments have been issued with both debt and equity elements.
(c) The use of fair values involves the use of valuation techniques including market estimates. Judgements will need to be made to determine whether the valuation techniques and any estimates made are reasonable.
(d) Recognition of the costs associated with the instrument is not necessarily straightforward. For example, the discount on a discounted debenture should be treated as part of the overall cost of the instrument and recognised over the life of the debenture.

Audit procedures

Classification	Review the terms of the financial instrument and confirm that they have been classified in accordance with their substance. Enquire of management as to their intention ie to sell in the short term or hold to maturity. Corroborate any statements by a review of events after the reporting period, forecast and projections.
Existence	For listed shares the auditor can check the company exists by reviewing stock exchange listings. Unlisted companies can be verified by simple enquiries a the Companies Registry.
Valuation: initial fair value	Confirm that all financial assets and liabilities have been valued at fair value where this is required by IFRS 9. Agree fair value to transaction price (the cost of shares can be verified by checking the purchase documentation). Where part of the consideration has been given for something other than the financial instrument, assess valuation technique adopted, eg discounting of future cash flows.
Valuation: Subsequent Measurement	• Verify the subsequent classification of financial instruments by enquiry of management, as to the business model according to which the instruments are being held (ie whether they are being held for trading or to maturity). This information should be corroborated by a review of events after the reporting period and of forecasts and projections. • Confirm that all financial assets that are equity or are derivatives are held at fair value. • Check calculation of amortised cost complies with IFRS 9: • The initial amount recognised for the financial asset • Less any repayments of the principal sum • Plus any amortization – Confirm that the amount of amortisation has been calculated using the effective interest method. – Confirm that financial assets and liabilities at fair are remeasured to fair value at the end of the reporting period in accordance with IFRS 13. – Where there is an active market agree fair value to quoted market price (current bid price). – Where there is no active market assess the valuation technique adopted by management and any assumptions made.
Ownership	Ownership of shares in another company should be checked to the share certificate. The share certificate may be kept in a bank or at a brokers, in which case the auditor should confirm with these parties that the share certificate exists.
Presentation and disclosure	Check that disclosures comply with IFRS 7. This includes eg qualitative disclosures about exposure to risk and risk management, and quantitative disclosures of summary data about exposures.

Audit procedures on the portfolio of short-term investments

- Agree the fair value of the shares held as investments to stock market share price listings
- Confirm the original cost of the investment to cash book and bank statements.
- Review the notes to the financial statements to ensure that disclosure is sufficient to comply with the requirements of IFRS 9.
- Enquire with the treasury management function as to whether there have been any disposals of the original shares held and reinvestment of proceeds into the portfolio.
- Review board minutes to confirm the authorisation and approval of the amount invested.
- For any investments from which dividends have been received, confirm the number of shares held to supporting documentation such as dividend received certificates or vouchers.

Loan

Evidence

- Re-performance of management's calculation of the finance charge in relation to the loan,
- Agreement of the loan receipt and interest payment to bank statement and cash book.
- Review of board minutes for approval of the loan to be taken out.
- A copy of the loan agreement, reviewed to confirm terms including the maturity date, any premium to be paid on maturity and annual interest payments.
- A copy of the note to the financial statements which discusses the loan to ensure all requirements of IFRSs 7 and 13 have been met.

Extracted from past exam answers:

Commonly tested in THE ADVANCED AUDIT & ASSURANCE EXAM- Risks related to companies which have foreign exchange transactions:

"The company may have entered into hedging arrangements as a way to reduce exposure to foreign exchange fluctuations. There is a risk that hedging arrangements are not identified and accounted for as derivatives according to IFRS 9 *Financial Instruments* which could mean incomplete recognition of derivative financial assets or liabilities and associated gains or losses."

"This is a complex accounting issue, and there are numerous audit risks arising.
There is a risk that not all forward exchange contracts are identified, leading to incomplete recording of the balances involved. There is also a risk in determining the fair value of the derivative at the year end, as this can be judgemental and requires specialist knowledge. There is also a risk that hedge accounting rules have not been properly applied, or that inadequate disclosure of relevant risks is made in the notes to the financial statements."

"IFRS 9 requires that financial assets to be classified and then measured subsequent to initial recognition at either amortised cost or at fair value through profit or loss. Speculative investments in equity shares should be measured at fair value through profit or loss because the assets are not being held to collect contractual cash flows."

Audit work: Investment properties

A key factor to consider when auditing investment properties is whether one **exists** according to the **criteria** of IAS 40 *Investment property*.

Investment property is property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

- Use in the production or supply of goods or services or for administrative purposes, or
- Sale in the ordinary course of business

Recognition

Investment property should be recognised as an asset when it is probable that the future economic benefits that are associated with the property will flow to the entity, and the cost of the property can be reliably measured.

Procedures

Initial measurement: Investment property is initially measured at cost, including transaction costs.
Review breakup of cost and ensure Cost does not include start-up costs, abnormal waste, or initial operating losses incurred before the investment property achieves the planned level of occupancy.

Subsequent measurement :can choose between the fair value and the cost model. Ensure the accounting policy choice must be applied to all investment property.

Fair value model

– Investment properties are measured at fair value, which is the price that would be received to sell the investment property in an orderly transaction between market participants at the measurement date
– The auditor should be able to verify this by reference to a valuer's certificate as professional valuation is encouraged under the IAS.
– Gains or losses arising from changes in the fair value of investment property must be included in profit or loss for the period in which it arises

Cost model

– Investment property is measured in accordance with requirements set out for that model in IAS 16….cost less accumulated depreciation and less accumulated impairment losses

Carry out the normal property procedures	Existence, rights and obligation, valuation documents

Disclosure: The auditor should review the disclosures made in the financial statements in relation to investment properties to ensure that they have been made appropriately, in accordance with IAS 40.

– Whether the fair value or the cost model is used
– The methods and significant assumptions applied in determining the fair value of investment property
– The extent to which the fair value of investment property is based on a valuation by a qualified independent valuer; if there has been no such valuation, that fact must be disclosed

Audit Work On: Share-Based Payment

<table>
<tr><td>Ascertain the major terms of the plan from the contractual documentation</td><td>– Obtain the details of the share-based payment plan to ascertain the major terms of the plan including:
• The grant date and vesting date
• The number of executives and senior managers awarded options
• The number of share options awarded to each individual
• The required conditions attached to the options
• The fair value of the share options at the grant date.

– Scrutinise the conditions attached to the options to confirm any market conditions and non-market conditions according to IFRS 2.</td></tr>
<tr><td>Fair value of instruments</td><td>1. For equity-settled schemes check that fair value is estimated at grant date. The grant date fair value is recognised over the vesting period.
2. For cash-settled schemes check that the fair value is recalculated at the year end and at the date ofsettlement
3. Review the assumptions used, and inputs into the option pricing model used by management to estimate the fair value of the share options at the grant date.
4. Consider the appropriateness of the model used to generate a fair value for the share options.
5. Consider the use of an expert possessing specialist skills in share option pricing, such as a chartered financial analyst, to provide evidence as to the validity of the fair value of share options used in the calculations.
6. Consider whether assumptions used appear reasonable. For example, Obtain and review a forecast of staffing levels or employee turnover rates relevant to executives and senior managers over the vesting period and consider whether assumptions used appear reasonable.
7. Check the sensitivity of the calculations to a change in the assumptions used in the valuation.

Risks can be discussed relating to the use of option pricing models .In determining the expense to be recognised, client needs to use a valuation method for estimating the fair value of the share options at the grant date. Various models can be used, but all are based on inputs such as share price, exercise price, rate of return and estimated dividend yield. The risk is that inappropriate assumptions have been input to the valuation model, resulting in an unrealistic estimate of the fair value of share options at the grant date. Further, there is a risk that the wrong valuation model has been used.</td></tr>
<tr><td>Written representations</td><td>Obtain written representations from management confirming their view that:
– The assumptions used in measuring the expense are reasonable, and
– There are no share-based payment schemes in existence that have not been disclosed to the auditors.</td></tr>
</table>

Extracted from past exams

Equity-settled share-based payment plans are complicated to value and account for, and are inherently risky. IFRS 2 *Share-based Payment* requires that an expense should be recognised over the vesting period, calculated based on the fair value of the share options at the grant date. Market conditions are not relevant to determining whether an expense is recognised or the amount of it.

Market conditions should be taken into account when determining the fair value of the share options at the grant date and are not to be taken into account for the purpose of estimating the number of equity instruments that will vest. This means where the market condition has not been met, an expense should be recognised irrespective of whether that condition is satisfied, and an expense continues to be recognised over the remainder of the vesting period.

IFRS 2 also requires **extensive disclosures** including the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.

The share-based payment plan should also have a deferred tax consequence – a deferred tax asset arises due to the deductible temporary difference arising from the accounting treatment. There is a risk that assets are incomplete if this is not recognised in the statement of financial position.

Audit work: Assets Held For Sale and discontinued operations

Key points to remember for THE ADVANCED AUDIT & ASSURANCE EXAM

1. Assets can only be classified as held for sale if the conditions referred to in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* are met. The conditions include the following:
   a) Management is committed to a plan to sell the asset or disposal group;
   b) The asset must be available for immediate sale in its present location and condition
   c) An active programme to locate a buyer and complete the plan must have been initiated.
   d) The sale is highly probable, within 12 months of classification as held for sale
   e) The asset is being actively marketed for sale at a sales price reasonable in relation to its fair value;
   f) Actions required to complete the plan indicate that it is unlikely that the plan will be significantly changed or withdrawn.

2. *IFRS 5 requires that at classification as held for sale, assets are measured at the lower of carrying value and fair value less costs to sell.*

3. *The assets should not be depreciated after being classified as held for sale*

4. It is required by IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations* that the assets and liabilities of disposal groups should not be offset and must be presented separately within total assets and total liabilities

Audit work

1. Discuss with the management about the existence of assets held for sale.

2. Confirm that the assets meet the definition of assets held for sale:
   - ❖ Written representations from the management regarding its intention to sell
   - ❖ Discuss with management the availability of asset for sale
   - ❖ Written representation from management on the opinion that the assets will be sold
   - ❖ Assess management commitment, for example A copy of the board minutes at which the disposal was agreed by management.
   - ❖ Evaluate and assess practical steps being taken to sell the asset eg appropriate agents appointed
   - ❖ Determine when the sale is expected to take place by assessing progress to date
   - ❖ Determine and assess the basis on which the sale price has been set
   - ❖ Discuss with management any significant changes to the plans

3. Confirm that the asset has been valued as held for sale in accordance with IFRS 5 and assess how fair value has been determined. {Confirm assets measured at lower of: Carrying value and FV- costs to sell (any impairment loss to P & L)}
4. A copy of the client's depreciation calculations, to confirm that depreciation was not charged subsequent to the reclassification of the assets as held for sale.
5. Confirm separate disclosure in accordance with IFRS 5 {to include a description of the non-current assets classified as held for sale, a description of the facts and circumstances of the sale and its expected timing, and a quantification of the impairment loss and where in the statement of profit or loss and other comprehensive income it is recognised}

6. Subsequent events review, including a review of post year-end board minutes and a review of significant cash transactions, to confirm if any non-current assets are sold in the period after the year end.
7. Details of any impairment review conducted by management on the non-current assets
8. Ensure accurate presentation: must be presented separately on the face of the statement of financial position

Discontinued operations

To require separate classification in the statement of comprehensive income, discontinued operations must be:

- A component (i.e. separately identifiable)
- Which represents a separate major line of business/geographical area
- In part of a single co-ordinated plan to dispose of a separate major line of business/geographical area
- Or is a subsidiary acquired exclusively with a view to resale

Discontinued operations and operations held for sale must be disclosed separately in the statement of financial position *at the lower of their carrying value less costs to sell.*

An entity should **present and disclose information** that enables users of the financial statements to evaluate the financial effects of **discontinued operations** and disposals of non-current assets or disposal groups.

This allows users to distinguish between operations which will continue in the future and those which will not and makes it more possible to predict future results.

An entity should disclose a **single amount** in the statement of comprehensive income comprising the total of:

(a) The **post-tax profit or loss** of discontinued operations and
(b) The post-tax gain or loss recognised on the **measurement to fair value less costs to sell** or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

An entity should also disclose an **analysis** of this single amount into:

(a) The revenue, expenses and pre-tax profit or loss of discontinued operations
(b) The related income tax expense
(c) The gain or loss recognised on the measurement to fair value less costs to sell or on the disposal
(a) of the assets of the discontinued operation
(d) The related income tax expense

This may be presented either in the statement of comprehensive income or in the notes. If it is presented in the statement of comprehensive income it should be presented in a section identified as relating to discontinued operations, i.e. separately from continuing operations. This analysis is not required where the discontinued operation is a newly acquired subsidiary that has been classified as held for sale.

An entity should disclose the **net cash flows** attributable to the operating, investing and financing activities of discontinued operations. These disclosures may be presented either on the face of the statement of cash flows or in the notes.

Audit procedures

1. Discuss with the management the existence of discontinued operations.
2. Review minutes of meetings/make enquiries of management to ascertain management's intentions
3. Obtaining accounting records for component to ensure it is separately identifiable. Review company documentation (such as annual report) to ensure it is separately identifiable
4. The auditor must go through the entity's accounting records and other company documentation (e.g. MIS records, production records of the current year and previous year) to confirm that the discontinued operations represent a major line of the entity's business or is a subsidiary acquired with a view to resell). This will ensure that the assets meet the definition of discontinued operations.
5. Carry out the audit procedures to assess the reasonableness of the fair vales and cost to sell.
6. Compare the opening balance of the carrying value of the asset from the previous year's financial statements. Recalculate the depreciation for the current year (up to the date of classification as discontinued operations).
7. To audit whether the disclosures have been made correctly, the auditor should undertake the following procedures:
   a) Obtain a copy of the client's workings to disclose the discontinued operations.
   b) Review the workings to ensure that the figures are reasonable and agree to the financial statements.
   c) Trace a sample of items disclosed as discontinuing items to backing documentation (invoices) to ensure that they do relate to discontinued operations.

Remember, the results of discontinued operations should be presented separately in the statement of comprehensive income for *the entire period*, and not just the results since the operation became discontinued.
Comparative figures should also be re-stated

Audit work on: the effects of foreign exchange rates

Individual company

For an individual company conducting trade in foreign currencies, there are two separate accounting issues: conversion and translation.

Conversion is uncontroversial, and relates to an entity conducting transactions in a foreign currency, and which incurs exchange gains/losses in relation to these transactions.

According to IAS 21 *The Effects of Changes in Foreign Exchange Rates*, foreign currency transactions should be initially recognised having been translated using the spot rate, or an average rate may be used if exchange rates do not fluctuate significantly.

The rule is simple: the gain or loss on conversion is recognised directly in profit and loss in the period in which it occurs. The principal risk here is of the wrong exchange rate being used, resulting in misstatement of the gain/loss in the financial statements.

Translation is more complex. Translation is required at the end of an accounting period when a company still holds assets or liabilities in its statement of financial position which were obtained or incurred in a foreign currency. IAS 21 distinguishes between **monetary items** and **non-monetary items**. The basic rule is that monetary items (eg cash, receivables) should be retranslated using the rate rule at the end of each accounting period. Non-monetary items such as inventory are left at the amount recognised at the date of the transaction.

The risk is that the yearend retranslation does not take place, or that an inappropriate exchange rate is used for the retranslation

Audit procedures here would therefore include:

- Check that monetary items included in the statement of financial position at the year end are translated at the closing rate of exchange.
- Check that non-monetary items are translated at the historical rate of exchange.
- Check that items are included in the statement of comprehensive income at the historical rate of exchange.

Groups

It is also possible that a parent company may have overseas subsidiaries. It must translate the financial statements of those operations in to its own reporting currency before they can be consolidated in to group accounts. There are two methods of achieving this. The method used depends on whether the foreign operation has the same functional currency as the parent.

Same functional currency as the reporting entity

In this situation the foreign operation normally carries on its business as though it were an extension of the reporting entity's operations.

We can summarise the treatment as follows:

Income statement: Translate using actual rates. An average for a period may be used but not where there is a significant fluctuation and the average is therefore unreliable.

Non-monetary items: Translate using an historic rate at the date of purchase (or revaluation to fair value, or reduction to realisable/recoverable amount). This includes inventories and long-term assets (and their depreciation).

Monetary items: Translate at the closing rate

Exchange differences: Report as part of profit for the year

Different functional currency from the reporting entity
In this situation although the reporting entity may be able to exercise control, the foreign operation normally operates in a semi-autonomous way. It accumulates cash and other monetary items, generates income and incurs expenses, and may also arrange borrowings, all in its own local currency.

We can summarise the treatment as follows:

Assets and liabilities: Translate at the closing rate at the period end. (The balancing figure on the translated statement of financial position represents the reporting entity's net investment in the foreign operation.

Income statement: Translate items at the rate ruling at the date of the transaction (an average rate will usually be used for practical purposes)

Exchange differences: Taken to equity- *IAS 21 states that exchange gains and losses arising as a result of the restranslation of the subsidiary's balances are recognised in other comprehensive income. The risk is incorrect classification, for example, the gain or loss could be recognised incorrectly as part of profit for the year*

Audit Work On: Foreign Exchange Rates

- Discuss with management and verify the appropriateness of the functional currency used while recording transactions and preparing financial statements.
- Verify for the samples selected whether the transactions are recorded correctly using appropriate exchange rates.
- Discuss with management about foreign operations of the company and obtain a list of all branches, subsidiaries and associates situated in foreign countries along with their domestic currencies.
- Determine whether the hedging provisions are sufficient and appropriate for foreign exchange risks.
- Verify whether the account balances have been properly classified into monetary and non-monetary items.
- For a few transactions selected on a random basis, verify that the effect of the foreign exchange rate has been correctly taken in financial statements in accordance with IAS 21.
- Perform audit trail for a few transactions or carry out a walk through analysis to verify the efficiency of the accounting system from the inception to presentation of foreign exchange transactions

Audit work: Borrowing costs

According to IAS 23 *Borrowing Costs*, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset.

The borrowing costs should be capitalised only during the period of construction, with capitalisation ceasing when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete

Audit work

1. Review an original copy of the loan agreement, confirming the amount borrowed, the date of the cash receipt, the interest rate and whether the loan is secured on any assets.
2. Confirm: only directly attributable costs capitalized: *ask for the breakdown and review supporting documents*
3. Confirm: Capitalized only during construction- cease when suspended or completed; THEN depreciate.
4. Interest can be verified by performing analytical reviews as the relationship of various loans and the interest amounts is predictable.
5. Recalculate and agree the following figures to the draft financial statements.
   - The borrowing cost (Amount= borrowing cost less temp investment income OR if generally obtained loan, weighted average of borrowing costs applicable to borrowing outstanding)
   - Depreciation charge
   - Carrying value of the asset at the year end,
6. Agree figures in respect of interest payments made to statements from lender and/or bank statements
7. Ensure the adequacy and completeness of disclosures (Amount of **borrowing costs capitalized** during the period; **Capitalisation rate** used to determine borrowing costs eligible for capitalisation.)

IAS 23 *Borrowing costs*

- **Borrowing costs**. Interest and other costs incurred by an entity in connection with the borrowing of funds.
- *A **qualifying asset*** is an asset that takes a substantial period of time to get ready for its intended use or sale. That could be property, plant, and equipment and investment property during the construction period, intangible assets during the development period, or "made-to-order" inventories.

Accounting treatment

- Borrowing costs should be **capitalized** as part of the cost of the asset if they are directly attributable to acquisition/construction/production. Other borrowing costs must be expensed.
- **Borrowing costs eligible for capitalization** are those that would have been avoided otherwise. Use judgement where a range of debt instruments is held for general finance.
- **Amount of borrowing costs available for capitalization** is actual borrowing costs incurred less any investment income from temporary investment of those borrowings.
- For borrowings obtained generally, apply the **capitalisation rate** to the expenditure on the asset (weighted average borrowing costs). It must not exceed actual borrowing costs.
- **Capitalisation is suspended** if active development is interrupted for extended periods. (Temporary delays or technical/administrative work will not cause suspension.)
- **Capitalisation ceases** (normally) when physical construction of the asset is completed, capitalisation should cease when each stage or part is completed.
- Where the carrying amount of the asset falls below cost, it must be **written down/off**.

<u>**Audit work: Using the work of others**</u>

<u>**Using the work of an auditor's expert**</u>

Auditor's expert – An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is **used by the auditor to assist the auditor** in obtaining sufficient appropriate audit evidence.

Management's expert – An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is **used by the entity to assist the entity** in preparing the financial statements.

Reliance on an expert might be necessary in the following situations:

(a) Valuation of certain types of asset, e.g. land and buildings, precious stones
(b) Determination of quantities or physical condition of assets
(c) Actuarial valuations on pensions or insurance liabilities
(d) Measurement of work completed and to be completed on contracts in process
(e) Legal opinions re interpretations of agreements and regulations, or the outcome of litigation.

Contract with the auditor's expert

The following matters need to be agreed in writing:

- The nature, scope and objectives of that expert's work,
- The respective roles and responsibilities of the auditor and that expert,
- The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert,
- The need for the auditor's expert to observe confidentiality requirements.

Written instructions should have been provided by the auditor to the expert prior to them carrying out the work. The instructions should include matters such as the scope of the work, the applicable financial reporting framework and any specific matters to be addressed. As a first step, the auditor should consider if these instructions have been followed by the expert.

ISA 620 *Using the Work of an Auditor's Expert* contains requirements relating to **the objectivity** and **capabilities** of the auditor's expert, **the scope and objectives of their work**, and **assessing their work.**

1. **Objectivity: T**he auditor shall evaluate whether the auditor's expert has the necessary objectivity and that this should include inquiry regarding interests and relationships which may create a threat to the expert's objectivity. The audit firm will need to ensure that the expert has no connection to the client, for example, that they are not a related party of the company or any person in a position of influence over the financial statements. If the expert's objectivity is threatened, less reliance can be placed on their work.
2. **Competence:** ISA 620 also requires the competence of the expert to be considered; this should include considering the expert's membership of appropriate professional bodies. Any doubts over the competence of the expert will reduce the reliability of audit evidence obtained.

<table>
<tr><td colspan="2">3. Scope of work: ISA 620 requires the auditor to agree the scope of work with the expert. This may include agreement of the objectives of the work, how the expert’s work will be used by the auditor and the methodology and key assumptions to be used. In assessing the work performed by the expert, the auditor should confirm that the scope of the work is as agreed at the start of the engagement. If the expert has deviated from the agreed scope of work, it is likely to be less relevant and reliable.</td></tr>
<tr><td>4. Relevance of conclusions: ISA 620 states that the auditor shall evaluate the relevance and adequacy of the expert’s findings or conclusions. This will involve consideration of the source data which was used, the appropriateness of assumptions and the reasons for any changes in methodology or assumptions. The conclusion should be consistent with other relevant audit findings and with the auditor’s general understanding of the business. Any inconsistencies should be investigated as they may indicate evidence which is not reliable.</td><td>a) Review the auditor’s expert’s working papers and reports to ensure that:
– The work meets the objectives of the audit
– The evidence contained in the report is consistent with other evidence obtained by the auditor
– The work is based on the correct period and takes into account events after the reporting date where necessary.
b) Evaluate the appropriateness of models used by the expert
c) Compare the findings of the expert with results produced by management, eg compare the fair values determined by the expert with those determined by management.
d) Re-perform any calculations contained in the expert’s working papers, eg recalculate movements in fair value on the derivatives.
e) Evaluate the assumptions used by the expert, including:
– Whether the assumptions are consistent with the requirements of the relevant financial reporting framework
– If the assumptions are consistent with the auditor’s knowledge and understanding of the client’s operations and environment.
– Verify the origin of source data used in the expert’s work, eg agree figures used in calculations to the general ledger and documentation maintained by the client.</td></tr>
</table>

Relying on Internal Auditor’s work

Internal audit function – A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity’s governance, risk management and internal control processes.

Direct assistance – The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.
According to ISA 610 *Using the Work of Internal Auditors*, the external auditor may decide to use the work of the audit client’s internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor.

Note that in some jurisdictions the external auditor may be prohibited, or restricted to some extent, by law or regulation from using the work of the internal audit function.

The firm should consider whether it is prohibited by the law or regulations from relying on the work of internal audit department or using the internal auditors to provide direct assistance.

The firm must evaluate the internal audit department to determine whether its work is suitable by evaluating:

1. The extent to which the internal audit function's organisational status and relevant policies and procedures support the objectivity of the internal auditors.
2. The level of competence of the internal audit function.
3. Whether the internal audit function applies a systematic and disciplined approach, including quality control.

One of the key issues to be evaluated is objectivity – the internal audit department should be unbiased in their work and be able to report their findings without being subject to the influence of others. The internal audit department should report directly to the audit committee or to those charged with governance in order to maintain their independence.

The Factors that may affect the external auditor's determination include whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations. whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements and whether the internal auditors have adequate technical training and proficiency in auditing.

In order to determine whether the internal audit department works in a systematic and disciplined way, the firm should consider matters including the nature of documentation which is produced by the department and whether effective quality control procedures are in place such as direction, supervision and review of work carried out.

Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance

If the firm wants to use the internal audit function to provide direct assistance, then the firm should:

– obtain written agreement from an authorised representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and

– obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

If these confirmations cannot be obtained, then the internal auditors should not be used to provide direct assistance.

The external auditor shall not use internal auditors to provide direct assistance to perform procedures that:
(a) Involve making significant judgments in the audit;
(b) Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures orevaluating the audit evidence gathered is more than limited

The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement.

Relying on the work of service organisations

Outsourcing

Outsourcing is when certain functions within a business are contracted out to third parties known as service organisations.

In sourcing: In sourcing is when an organization decides to retain a centralised department for the key function, but brings experts in from an external market on a short-term basis to account for 'peak' and 'trough' periods.
It is a business decision that is often made to maintain control of certain critical production or competencies.
In sourcing is therefore a business practice in which work that would otherwise have been contracted out is performed in house.

Impact of outsourced functions on External Audit

Key terms

Service auditor – An auditor who, at the request of the service organization, provides an assurance report on the controls of a service organization.

Service organization – A third-party organization (or segment of a third-party organization) that provides services to user entities that are part of those entities' information systems relevant to financial reporting. User auditor – An auditor who audits and reports on the financial statements of a user entity. User entity – An entity that uses a service organization and whose financial statements are being audited.

Service organisations usually operate in one of two ways:

1. The service organisation fully maintains the outsourced function, dealing with all aspects of the function including establishing accounting records, maintaining those records and initiating transactions relevant to the function. Here the reporting entity may hold no internal records at all in relation to the function other than those provided from the service organisation.
2. The service organisation executes transactions only at the request of the entity, or acts as a custodian of assets. Here the reporting entity will maintain internal records relating to the outsourced function.

It is increasingly common for functions such as data processing, payroll, and internal audit to be outsourced. ISA 402 *Audit Considerations Relating to Entities Using Service Organisations* contains guidance for auditors on how outsourcing should be considered during the audit process.

The matters to be considered in planning the audit approach of the outsourced function are:

- Materiality of the outsourced area
- Accessibility: the auditors do not necessarily have the right of access to books and records held at the service organisation.

- Control risk: Extent of controls operated by service organisation; Extent of quality assurance within the service organisation (e.g. internal audit); Degree of monitoring by client (e.g. monthly review of records maintained by the service organisation)
- Experience of errors within the outsourced area since outsourcing commenced.
- Existence of independent records relating to the outsourced area (independent back up records maintained by the client)'
- Compliance with the relevant laws and regulations by the service organisation

Outsourcing does have an impact on audit planning. ISA 402 *Audit Considerations Relating to an Entity Using a Service Organisation* requires the auditor to obtain an understanding of how the audited entity (also known as the user entity) uses the services of a service organisation in the user entity's operations, including the following matters:

1. The nature of the services provided by the service organisation and the significance of those services to the audited entity, including the effect on internal control;
2. The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;
3. The degree of interaction between the activities of the service organisation and those of the audited entity;
4. The nature of the relationship between the audited entity and the service organisation, including the relevant contractual terms.

The reasons for the auditor being required to understand these matters is so that any risk of material misstatement created by the use of the service organisation can be identified and an appropriate response planned.

The auditor is also required under ISA 402 to evaluate the design and implementation of relevant controls at the audited entity which relate to the services provided by the service organisation, including those which are applied to the transactions processed by the service organisation. This is to obtain understanding of the control risk associated with the outsourced function, for example, whether the transactions and information provided by the service organisation is monitored and whether checks are performed prior to inclusion in the financial statements.

Information should be available from the audited entity to enable the understanding outlined above to be obtained, for example, through reports received from the service organisation, technical manuals and the contract between the audited entity and the service organisation.

The auditor may decide that further work is necessary in order to evaluate the risk of material misstatement associated with the outsourcing arrangement's impact on the financial statements. It is common for a report on the description and design of controls at a service organisation to be obtained.

A type 1 report focuses on the description and design of controls, whereas a type 2 report also covers the operating effectiveness of the controls. This type of report can provide some assurance over the controls which should have operated at the service organisation.

Alternatively, the auditor may decide to contact the service organisation to request specific information, to visit the service organisation and perform procedures, probably tests on controls, or to use another auditor to perform such procedures.

All of these methods of evaluating the service organisation's controls require permission from the client and can be time consuming to perform.

The purpose of obtaining the understanding above is to help the auditor to determine the level of competence of the service organisation, and whether it is independent of the audited entity. This will then impact on the risk of material misstatement assessed for the outsourced function.

Audit work: Other Information in documents containing Audited Financial Statements

Other information – Financial or non-financial information (other than financial statements and the auditor's report) included in an entity's annual report/Integrated report

Misstatement of the other information – A misstatement of the other information exists when the other information is incorrectly stated or otherwise misleading.

Obtaining the Other Information	The auditor shall: a) Determine, through discussion with management, which document(s) comprises the annual report, and the entity's planned manner and timing of the issuance of such document(s); b) Make appropriate arrangements with management to obtain in a timely manner and, if possible, prior to the date of the auditor's report, the final version of the document(s) comprising the annual report; and c) When some or all of the document(s) determined in (a) will not be available until after the date of the auditor's report, request management to provide a written representation that the final version of the document(s) will be provided to the auditor when available, and prior to its issuance by the entity, such that the auditor can complete the procedures required by this ISA.
Reading and Considering the Other Information	The auditor shall read the other information and, in doing so shall: (a) Consider whether there is a material inconsistency between the other information and the financial statements. (b) Consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit, in the context of audit evidence obtained and conclusions reached in the audit.

Responding When a Material Inconsistency Appears to Exist or Other Information Appears to Be Materially Misstated	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) A material misstatement of the other information exists; (b) A material misstatement of the financial statements exists; or (c) The auditor's understanding of the entity and its environment needs to be updated.
	If the auditor concludes that a material misstatement of the other information exists, the auditor shall request management to correct the other information. If management: (a) Agrees to make the correction, the auditor shall determine that the correction has been made; or (b) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance and request that the correction be made.

Reporting

The auditor's report shall include a separate section with a heading "Other Information" when, at the date of the auditor's report:

(a) For an audit of financial statements of a listed entity, the auditor has obtained, or expects to obtain, the other information; or

(b) For an audit of financial statements of an entity other than a listed entity, the auditor has obtained some or all of the other information.

When the auditor's report is required to include an Other Information section, this section shall include:

(a) A statement that management is responsible for the other information;

(b) An identification of:

- Other information, if any, obtained by the auditor prior to the date of the auditor's report; and
- For an audit of financial statements of a listed entity, other information, if any, expected to be obtained after the date of the auditor's report;

(c) 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;

(d) A description of the auditor's responsibilities relating to reading, considering and reporting on other information as required by this ISA; and

(e) When other information has been obtained prior to the date of the auditor's report, either:
(i) A statement that the auditor has nothing to report; or
(ii) 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.

Audit work: Opening balances in initial audit engagements

Initial audit engagement *– An engagement in which either:*
(i) The financial statements for the prior period were not audited; or
(ii) The financial statements for the prior period were audited by a predecessor auditor.

Opening balances *– Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.*

ISA 510 *Initial Audit Engagements – Opening Balances* requires certain audit procedures to be carried out in an initial engagement where the prior year financial statements were not audited.

1. It is required that the auditor shall read the most recent financial statements for information relevant to opening balances, including disclosures.	
2. Then the auditor shall obtain sufficient appropriate evidence about whether the opening balances contain misstatements that materially affect the current year's financial statements. – This evidence is obtained by firstly determining whether the prior period's closing balances have been correctly brought forward. – The auditor shall also determine whether the opening balances reflect the application of appropriate accounting policies.	
3. Depending on the nature of the opening balances, specific audit procedures are performed to gain specific evidence on those opening balances. Additional procedures would be required if it appears that the opening balances contain misstatements that could materially affect the current	The auditor needs to consider performing one or more of the following: – Where the prior year financial statements were audited, reviewing the predecessor auditor's working papers to obtain evidence regarding the opening balances; – Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances(***) ***For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures. For example, the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period. In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit

period's financial statements.	procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence: • Observing a current physical inventory count and reconciling it to the opening inventory quantities. • Performing audit procedures on the valuation of the opening inventory items. For non-current assets and liabilities, such as property, plant and equipment, investments and long-term debt, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.
4. Finally, the auditor shall obtain sufficient appropriate evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and that any changes in accounting policies have been accounted for and disclosed in accordance with IAS 8 *Accounting Policies, Changes in Accounting*	

When the financial statements include comparative financial information, the requirements and guidance in ISA 710 (comparative information) also apply.

If material misstatements found in opening balances

If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements.

The auditor shall communicate the misstatements with the appropriate level of management and those charged with governance.

Impact on audit report

- If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements.
- If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not appropriately accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion.
- If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements.

Audit work on: Corresponding figures and comparatives

Corresponding figures – Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures"). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

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

Audit procedures

The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified.

The auditor shall evaluate whether the comparative information agrees with the amounts and other disclosures presented in the prior period or, when appropriate, have been restated

The auditor shall evaluate whether the accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists.

If the prior period financial statements are amended, the auditor shall determine that the comparative information agrees with the amended financial statements.

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

Audit Reporting

Corresponding Figures

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

In the Basis for Modification paragraph in the auditor's report, the auditor shall either:
(a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
(b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

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

Prior Period Financial Statements Audited by a Predecessor Auditor

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

(b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and

(c) The date of that report.

Prior Period Financial Statements Not Audited

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

Comparative Financial Statements

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

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

Prior Period Financial Statements Audited by a Predecessor Auditor

If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:
(a) that the financial statements of the prior period were audited by a predecessor auditor;
(b) the type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
(c) the date of that report,

unless the predecessor auditor's report on the prior period's financial statements is reissued with the financial statements.

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

Prior Period Financial Statements Not Audited

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

Audit work on: Revenue from contracts with customers

Performance obligations satisfied at a point in time

- Substantive procedures: revenue recognized to relevant documents like work certificates, contracts etc
- Analytical procedures: Match with prior years and budgets, other related figures such as inventory and receivables, similar industry information
- Analytical procedures based on operational factors: for example, total rental income from a building predicted by considering the number of apartments, rental rates and vacancy rates etc.

Performance obligations satisfied over time

- Copy of revenue calculation: Recalculate assets/liabilities recognized
- Basis of revenue calculation: compare to last year
- Method of measuring progress for performance obligations: review to ensure reasonable and appropriate in line with IFRS 15
- Verify figures in calculation- for example, total contract price to original contract. Revenue can be compared with performance completed to date. Receivables can me matched to sales invoices. Performance completed to date matched with input methods such as certification of work completed, cost of work completed etc.

Audit work on: Lease

Classification and rights and obligations

- Copy of lease agreement: review to ensure lease terms has been determined correctly in line with IFRS 16

Valuation

- Client's workings of lease liability: Recalculate. Also recalculate interest and ensure implicit interest accounted for in accordance with IFRS 16.
- New assets matched to lease agreements
- Lease payments matched to bank statements

One of the trickiest parts of IFRS 16 is determining whether or not the contract is a lease at all. Leases may be found in many contracts that until recently were not treated as leases, so there is a risk regarding the **completeness** of leasing transactions – have any been missed out?
The definition of a lease refers to the '**right to control** the use' of an asset. Determining whether there is control involves judgment, which introduces an element of risk for the auditor. Likewise the assessment of **lease term** which requires judgment where there are options for either extension or termination.
IFRS 16 requires lease and non-lease components to be separated from one another. For example, a lease might be for just one part of a building, in which case it is necessary to allocate the consideration between the part that is leased and the part that is not leased. Again, this requires judgment and is therefore risky.

Many entities will not want to recognise assets and liabilities for lease transactions, so auditors need to be alert to the risk of distortion in relation to any of these areas of judgment.
The auditor needs to be alert to the possibility of **sale and leaseback** transactions. If there is a sale and leaseback, then you need to check that gains are treated in line with IFRS 16, along with any prepayments or additional financing.

Technical article: Exam techniques

In the Advanced Audit and Assurance exam you will be required to discuss accounting issues in many contexts. It could be that during planning you are asked identify areas of audit risk or risk of material misstatement arising from accounting issues. You may be expected to discuss accounting issues and their treatment in a completion question, where the appropriateness of a treatment is considered, or areas of risk exist. Accounting issues could arise in reporting questions where there may be an impact on the auditor's report and the type of opinion which will be given. This list is not exhaustive but illustrates how important it is to have a good understanding of the accounting and financial reporting issues covered in all of the financial reporting areas of the qualification. In addition you will be required to recommend audit procedures or explain the evidence you would expect to see in the audit file in order to conclude on the appropriateness of these treatments and amounts.

As such, bringing forward a sound knowledge of financial reporting is crucial when preparing for the Advanced Audit and Assurance exam. Some of those areas may be relatively straight forward, for example the valuation of inventory at the lower of cost and net realisable value while others can be more involved or complex such as financial instruments, revenue recognition or pensions.

The purpose of this article is to utilise past questions from the Advanced Audit and Assurance exam to illustrate how accounting issues could be examined and to recap the accounting treatment on some of the areas candidates typically find difficult in this exam.

EXAMPLE 1 – IMPAIRMENT

It is rare to see an Advanced Audit and Assurance exam which does not cover impairment and the requirements of IAS 36 *Impairment of Assets*. This is a crucial standard which you need to understand as impairment considerations apply to so many assets within a set of financial statements.
A summary of the key financial reporting principles from IAS 36 is provided below:

- An asset is impaired if its carrying amount is higher than recoverable amount.
- The recoverable amount of an asset is the higher of its value in use (the present value of future cash flows deriving from the asset – or group of assets) and its fair value less disposal costs (the price which would be received in an orderly transaction between market participants – eg what you could sell it for).
- Where an asset is impaired it should be written down to its recoverable amount and generally that loss would be taken to the statement of profit or loss for the year.
- An impairment review is required for assets where there is an indicator of impairment such as a change in technology, increase in interest rates or possible obsolescence.
- There is also a specific rule to perform annual impairment reviews on intangible assets with indefinite lives, intangible assets not yet available for use and purchased goodwill (remember that internally generated goodwill isn't recognised).
- Where an asset cannot be assessed for its recoverable amount individually it can be assessed as part of a cash generating unit. Where this is done the impairment is written off against the assets of the cash generating unit by allocating first against goodwill then against the other assets on a prorated basis but no asset should be reduced below the higher of its fair value less costs of disposal or value in use

IAS 36 paragraph 36.2 lists the assets which fall outside the scope of the standard including inventories, deferred tax assets, financial assets and non-current assets held for sale.

RECENT EXAMPLE – SAMPLE MARCH/JUNE 17, QUESTION 4

This is an example from a matters and evidence style question. These questions are typically set at the completion stage of an audit. Materiality, accounting treatment and risks are typical areas which would count as matters to be considered. In these questions the auditor's report implication is only relevant if you are asked specifically to consider this area.

You are the manager responsible for the audit of Osier Co, a jewellery manufacturer and retailer. The final audit for the year ended 31 March 2017 is nearing completion and you are reviewing the audit working papers. The draft financial statements recognise total assets of $1,919 million (2016 – $1,889 million), revenue of $1,052 million (2016 – $997 million) and profit before tax of $107 million (2016 – $110 million).

At the year end management performed an impairment review on its retail outlets, which are a cash generating unit for the purpose of conducting an impairment review. While internet sales grew rapidly during the year, sales from retail outlets declined, prompting the review. At 31 March 2017 the carrying amount of the assets directly attributable to the retail outlets totalled $137 million, this includes both tangible assets and goodwill. During the year management received a number of offers from parties interested in purchasing the retail outlets for an average of $125 million. They also estimated the disposal costs to be $1·5 million, based upon their experience of corporate acquisitions and disposals. Management estimated the value in use to be $128 million. This was based upon the historic cash flows attributable to retail outlets inflated at a general rate of 1% per annum. This, they argued, reflects the poor performance of the retail outlets. Consequently the retail outlets were impaired by $9 million to restate them to their estimated recoverable amount of $128 million. The impairment was allocated against the tangible assets of the outlets on a pro rata basis, based upon the original carrying amount of each asset in the unit. (7 marks)

In this question you can open with the materiality of the impairment. The impairment loss of $9m represents 0.47% of total assets and 8.41% of profit before tax and is material to the statement of profit or loss ***(1 mark for an appropriate calculation and conclusion).***

You should then state the underlying rule that an indicator of impairment triggers an impairment review and define impairment and recoverable amount. **(*1 mark*)**

Most of the credit will be available for determining and explaining the risks arising and applying the accounting treatment to the information you have available.

We're told that

- *Carrying value is $137m*
- *Net realisable value is $125m - £1.5m = $123.5m (you will generally receive ½ mark for calculating this figure)*
- *Value in use is estimated at $128m*
- *Recoverable amount is therefore $128m based on management's calculations*
- *Impairment write off was based on value in use and has been pro-rated against assets based on the original carrying value of the assets in each unit.*

As auditors we need to look for risks in the process and treatment. Based on the information you can conclude that the carrying value is relatively low risk – we audited last year's figures and it's not an inherently risky area in general so in the absence of other information to the contrary you need to focus on the more risky areas.

The net realisable value carries some risk – external offers though are a good source of evidence and while not set in stone there have been several parties interested so it's likely that the company would be able to sell the retail outlets for that price.

So what are the key risk areas and the matters which should be considered?

Risk 1 – Management has estimated the costs of sale. An estimation is inherently risky as it is not certain. It's also been estimated by management who could be biased.

Risk 2 – The value in use is the major source of risk. The calculation is complex and judgemental and so is inherently risky. It has been calculated by management who may be biased to keep the impairment loss as low as possible. The calculation was based on historic cash flows with 1% annual growth which appears unrealistic given that retail sales have fallen not grown at 1%.

If the forecast used is overly optimistic then the impairment write off is insufficient and therefore assets are overstated and profit is overstated (as expenses are understated).

Risk 3 – The treatment of the impairment write off may be incorrect as goodwill should be reduced before reducing the assets on a prorate basis and it should be ensured that no individual asset is reduced to below its own recoverable amount.

The matters part of this question as illustrated within the boxes above and answer points which focussed on these risk areas would attract maximum credit for that part of the question.

As this was a matters and evidence question remember that you also need to go on to explain evidence you would expect to find on the audit file. The requirement is for the evidence to be **explained** in these questions so listing sources of evidence is not sufficient. Your answer points must also explain what they are providing evidence of in order to attract high marks. If you write out evidence as a list of described procedures then this will be acceptable and well described, relevant procedures will generally receive a mark each.

EXAMPLE 2 – INTANGIBLES

Intangible assets are non-monetary assets without physical substance such as patents, trademarks, customer lists, quotas, brands, franchise agreements etc

A summary of the key financial reporting principles from IAS 38 *Intangible Assets* is provided below:

- Intangible assets must be
  - identifiable (capable of being separated and sold/transferred and arise from contractual or other legal rights)
  - controlled
  - provide future economic benefits

- In order to be recognised as an asset there must be a probable future economic benefit arising from the asset and the cost must be capable of reliable measurement. If this is not possible then expenditure on the asset must be recognised as an expense. This is why internally generated brands and customer lists are not allowed to be recognised but purchased ones can be (including those purchased as part of the acquisition of another company)

- Subsequent treatment of intangible assets will be either on a historical cost basis or under a fair value model if it is possible that fair value can be determined by reference to an active market (eg production quotas, taxi licences).

Exam focus

By definition brands are unique and therefore it would not be possible to compare to an active market hence the fair value model does not apply and they cannot be revalued upwards.

- Intangible assets will either have a finite life (a limited period of benefit to the company over which the asset will be amortised with the amortisation expense being charged to profit and loss) or an indefinite life (where no foreseeable limit to the period of economic benefits exist – hence no amortisation is charged)
- Where an asset is deemed to have an indefinite life it is not amortised but the useful life should be reviewed every reporting period to determine whether events continue to support an indefinite life and additionally, the asset should be assessed for impairment each reporting period.
- All intangible assets are subject to an impairment review where there is an indicator of impairment.

RECENT EXAMPLE – SAMPLE MARCH/JUNE, QUESTION 1

This is an extract from a planning question which asked candidates to evaluate risks of material misstatement arising from a scenario where the Group holds several purchased brand names for products.

Acquired brand names are held at cost and not amortised on the grounds that the assets have an indefinite life. Annual impairment reviews are conducted on all brand names. In December 2016, the Chico brand name was determined to be impaired by $30 million due to allegations made in the press and by customers that some ingredients used in the Chico perfume range can cause skin irritations and more serious health problems. The Chico products have been withdrawn from sale.

When answering a requirement to evaluate risks from a scenario relating to specific accounting issues you should start by calculating the materiality of the issue- in this question, total assets were $358 million and PBT $28million. The impairment of the Chico brand is 8.4% of total assets and more than 100% of PBT and is therefore material to both the statement of financial position and the profit and loss for the year.
(*1 mark for an appropriate calculation and conclusion).*

You should then state the underlying accounting rule (***1 mark*****).**

Acquired brand names should be capitalised and amortised over their useful life. Where this is indefinite, no amortisation is required, however an annual review of the appropriateness of the assumption of indefinite life should be performed and an annual impairment test is also required.

How this should be written up in a risk question has been illustrated in the second article in this series.
Here, the company has decided to hold brands at cost as they deem them to have an indefinite life – this is an acceptable treatment under IAS 38 however the important part of the standard which we need to consider is that this should only be done if there is no foreseeable limit to the periods of benefit. There's also a requirement that this assumption should be reviewed annually and additionally an impairment review performed. The scenario tells us that an impairment review has been performed but not that a review of the indefinite life has occurred hence there is a risk that this may not have been done

That decision to hold the brands with an indefinite life is a judgement call on behalf of management – judgements are subjective and therefore are a source of inherent risk. Quite often the justification for such a decision would be linked back to expenditure on the brand and marketing efforts along with market research. These costs cannot be capitalised but do provide evidence to support an indefinite life.

Similarly, impairment reviews for a brand would be looking at value in use based on the discounted value of future expected cash flows which is complex and judgemental.

In the exam you need to communicate these risk areas arising above- an example of a description for each that would be sufficient in an exam is shown below:

Risk 1 – Management's judgement that the brands have an indefinite life may be incorrect
Risk 2 – Management may not have reviewed the useful life of the brands in the reporting period to ensure that the assumption of indefinite life is still correct
Risk 3 – The impairment review may not be accurate as the assumptions used by management may not be appropriate as the calculation is complex and judgemental. (IAS 36)

The scenario goes on to describe the impairment of the Chico brand after allegations made about the products. The products have been withdrawn from sale. This brings in the impairment consideration in more detail. Here there has been a specific indicator of impairment for both the brand and inventory relating to Chico and therefore poses more risks.

Risk 4 – The impairment of the Chico Brand may not be sufficient (*we can't tell if it has been fully written down IAS 36)*
Risk 5 – The inventory relating to Chico products may need to be written off if its net realisable value is below cost (*IAS 2 Inventories)*
Risk 6 – Other brands and inventory may be affected by the negative publicity regarding Chico and may also need to be written down (IAS 36)

Exam focus

No credit is awarded for the name or number of auditing and financial reporting standards.

You should avoid describing audit approach or evidence/procedures unless you have been asked to do this in the requirement.

Written by a member of the P7 examining team

Group Audit

Let's talk THE ADVANCED AUDIT & ASSURANCE EXAM

The **group engagement team** shall determine the type of work to be performed on the financial information of components in response to assessed risks

The ISA distinguishes between **significant components** and **components that are not significant**

Components that are not significant: Group engagement team shall perform **analytical procedures** at **group level**

Significant components

- If a component is **financially significant**, perform a **full audit** based on the component materiality level
- If the component is otherwise significant due to its **nature or circumstances**, one of the following is required:
    - A full audit using component materiality
    - An audit of specified account balance related to identified significant risks
    - Specified audit procedures relating to identified significant risks

Key terms

a) Component –An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements. (subsidiaries, associates, joint ventures etc)

b) Component auditor – An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

c) Component management –Management responsible for the preparation of the financial information of a component.

d) Component materiality – The materiality for a component determined by the group engagement team.

e) Group –All the components whose financial information is included in the group financial statements. A group always has more than one component.

f) Group audit – The audit of group financial statements.

g) Group audit opinion – The audit opinion on the group financial statements.

h) Group engagement partner – The partner in the firm who is responsible for the group audit engagement and its performance, and for the auditor's report on the group financial statements that is issued on behalf of the firm.	The group engagement partner is responsible for the direction, supervision and performance of the group audit engagement and whether the auditor's report that is issued is appropriate. As a result, the auditor's report on the group financial statements shall not refer to a component auditor, unless required by law or regulation to include such reference.

i) Group engagement team – Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

j) Group financial statements – Financial statements that include the financial information of more than one component.

k) Group management – Management responsible for the preparation of the group financial statements.

l) Group-wide controls – Controls designed, implemented and maintained by group management over group financial reporting.

Group-wide controls may include a combination of the following:

• Regular meetings between group and component management to discuss business developments and to review performance.
• Monitoring of components' operations and their financial results, including regular reporting routines, which enables group management to monitor components' performance against budgets, and to take appropriate action.
• Group management's risk assessment process, that is, the process for identifying, analyzing and managing business risks, including the risk of fraud, that may result in material misstatement of the group financial statements.
• Monitoring, controlling, reconciling, and eliminating intra-group transactions and unrealized profits, and intra-group account balances at group level.
• A process for monitoring the timeliness and assessing the accuracy and completeness of financial information received from components.
• A central IT system controlled by the same general IT controls for all or part of the group.
• Control activities within an IT system that is common for all or some components.
• Monitoring of controls, including activities of the internal audit function and self-assessment programs.
• Consistent policies and procedures, including a group financial reporting procedures manual.
• Group-wide programs, such as codes of conduct and fraud prevention programs.

m) Significant component – A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.	As the individual financial significance of a component increases, the risks of material misstatement of the group financial statements ordinarily increase. The group engagement team may apply a percentage to a chosen benchmark as an aid to identify components that are of individual financial significance. Identifying a benchmark and determining a percentage to be applied to it involve the exercise of professional judgment. Depending on the nature and circumstances of the group, appropriate benchmarks might include group assets, liabilities, cash flows, profit or turnover. For example, the group engagement team may consider that components exceeding 15% of the chosen benchmark are significant components. A higher or lower percentage may, however, be deemed appropriate in the circumstances. The group engagement team may also identify a component as likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances (that is, risks that require special audit consideration. For example, a component could be responsible for foreign exchange trading and thus expose the group to a significant risk of material misstatement, even though the component is not otherwise of individual financial significance to the group.

If a component is financially significant to the group financial statements then the group engagement team or a component auditor will perform a full audit based on the component materiality level.

The group auditor should be involved in the assessment of risk in relation to significant components. If the component is otherwise significant due to its nature or circumstances, the group auditors will require one of the following:

- ✓ Full audit using component materiality
- ✓ An audit of specified account balances related to identified significant risks
- ✓ Specified audit procedures relating to identified significant risks

Components that are not 'significant components' will be subject to analytical procedures at a group level – a full audit is not required.

The diagram shows how the significance of the component affects the group engagement team's determination of the type of work to be performed on the financial information of the component.

Responsibility

The group engagement partner is responsible for the direction, supervision and performance of the group audit engagement in compliance with professional standards and applicable legal and regulatory requirements, and whether the auditor's report that is issued is appropriate in the circumstances. As a result, the auditor's report on the group financial statements shall not refer to a component auditor, unless required by law or regulation to include such reference.

The group engagement partner shall agree on the terms of the group audit engagement

The group engagement team shall establish an overall group audit strategy and shall develop a group audit plan which shall then be reviewed by the group engagement partner

Acceptance and Continuance

Determine whether sufficient appropriate audit evidence can reasonably be expected to be obtained in relation to the consolidation process and the financial information of the components on which to base the group audit opinion.	➦ obtain an understanding of the group, its components, and their environments that is sufficient to identify components that are likely to be significant components. ➦ Where component auditors will perform work on the financial information of such components, the group engagement partner shall evaluate whether the group engagement team will be able to be involved in the work of those component auditors to the extent necessary to obtain sufficient appropriate audit evidence.

Terms of Engagement

The group engagement partner shall agree on the terms of the group audit engagement in accordance with ISA 210.

Additional matters may be included in the terms of a group audit engagement, such as the fact that:

- The communication between the group engagement team and the component auditors should be unrestricted.
- Important communications between the component auditors, those charged with governance of the component, and component management, including communications on significant deficiencies in internal control, should be communicated as well to the group engagement team;
- Important communications between regulatory authorities and components related to financial reporting matters should be communicated to the group engagement team; and
- To the extent the group engagement team considers necessary, it should be permitted:
  - Access to component information, those charged with governance of components, component management, and the component auditors (including relevant audit documentation sought by the group engagement team); and
  - To perform work or request a component auditor to perform work on the financial information of the components.

Overall Audit Strategy and Audit Plan

The group engagement team shall establish an overall group audit strategy and shall develop a group audit plan in accordance with ISA 300.

The group engagement partner shall review the overall group audit strategy and group audit plan.

Understanding the Group, Its Components, and Their Environments

The auditor is required to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment.

The group engagement team shall:

Enhance its understanding of the group, its components, and their environments, including group-wide controls, obtained during the acceptance or continuance stage	(the industry, regulatory, and other external factors that affect the entity, including the applicable financial reporting framework; the nature of the entity; objectives and strategies and related business risks; and measurement and review of the entity's financial Performance)
Obtain an understanding of the consolidation process, including the instructions issued by group management to components	Group management ordinarily issues instructions to components. Such instructions specify the requirements for financial information of the components to be included in the group financial statements and often include financial reporting

	procedures manuals and a reporting package. A reporting package ordinarily consists of standard formats for providing financial information for incorporation in the group financial statements. Reporting packages generally do not, however, take the form of complete financial statements prepared and presented in accordance with the applicable financial reporting framework. The instructions ordinarily cover: - The accounting policies to be applied; - Statutory and other disclosure requirements applicable to the group financial statements, including: ○ The identification and reporting of segments; ○ Related party relationships and transactions; ○ Intra-group transactions and unrealized profits; ○ Intra-group account balances; and - A reporting timetable.
- obtain an understanding that is sufficient to assess the risks of material misstatement of the group financial statements, whether due to fraud or error.	Information used to identify the risks of material misstatement of the group financial statements due to fraud may include the following: • Group management's assessment of the risks that the group financial statements may be materially misstated as a result of fraud. • Group management's process for identifying and responding to the risks of fraud in the group, Whether there are particular components for which a risk of fraud is likely. The key members of the engagement team are required to discuss the susceptibility of an entity to material misstatement of the financial statements due to fraud or error, specifically emphasizing the risks due to fraud. In a group audit, these discussions may also include the component auditors.

Understanding the Component Auditor

If the group engagement team plans to request a component auditor to perform work on the financial information of a component, the group engagement team shall obtain an understanding of the following:

- Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, 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.

If a component auditor does not meet the independence requirements that are relevant to the group audit, or the group engagement team has serious concerns about the other matters ,the group engagement

Team shall obtain sufficient appropriate audit evidence relating to the financial information of the component without requesting that component auditor to perform work on the financial information of that component.

Materiality

The group engagement team shall determine the following:

(a) Materiality for the group financial statements as a whole when establishing the overall group audit strategy.	
(b) If, in the specific circumstances of the group, there are particular classes of transactions, account balances or disclosures in the group financial statements for which misstatements of lesser amounts than materiality for the group financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the group financial statements, the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.	
(c) Component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit.	Component materiality shall be lower than materiality for the group financial statements as a whole. Different component materiality may be established for different components. Component materiality is used by the component auditor to evaluate whether uncorrected detected misstatements are material, individually or in the aggregate.

Where component auditors will perform an audit for purposes of the group audit, the group engagement team shall evaluate the appropriateness of performance materiality determined at the component level.

Responding to Assessed Risks

The auditor is required to design and implement appropriate responses to address the assessed risks of material misstatement of the financial statements.

The group engagement team shall determine the type of work to be performed by the group engagement team, or the component auditors on its behalf, on the financial information of the components .

The group engagement team shall also determine the nature, timing and extent of its involvement in the work of the component auditors.

If the nature, timing and extent of the work to be performed on the consolidation process or the financial information of the components are based on an expectation that group-wide controls are operating effectively, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level, the group engagement teamshall test, or request a component auditor to test, the operating effectiveness of those controls.

Determining the Type of Work to Be Performed on the Financial Information of Components

Significant Components: For a component that is significant due to its individual financial significance to the group, the group engagement team, or a component auditor on its behalf, shall perform an audit of the financial information of the component using component materiality.

For a component that is significant because it is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances, the group engagement team, or a component auditor on its behalf, shall perform one or more of the following:

a) An audit of the financial information of the component using component materiality.

b) An audit of one or more account balances, classes of transactions or disclosures relating to the likely significant risks of material misstatement of the group financial statements.

c) Specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements.

Components that Are Not Significant Components

For components that are not significant components, the group engagement team shall perform analytical procedures at group level.

If the group engagement team does not consider that sufficient appropriate audit evidence on which to base the group audit opinion will be obtained from:

a) the work performed on the financial information of significant components;

b) the work performed on group-wide controls and the consolidation process; and

c) the analytical procedures performed at group level, the group engagement team shall select components that are not significant components and shall perform, or request a component auditor to perform

• An audit of the financial information of the component using component materiality.

• An audit of one or more account balances, classes of transactions or disclosures.

• A review of the financial information of the component using component materiality.

• Specified procedures.

The group engagement team shall vary the selection of components over a period of time.

Involvement in the Work Performed by Component Auditors

Significant Components—Risk Assessment

If a component auditor performs an audit of the financial information of a significant component, the group engagement team shall be involved in the component auditor's risk assessment to identify significant risks of material misstatement of the group financial statements.

It shall include:

a) Discussing with the component auditor or component management those of the component's business activities that are significant to the group;

b) Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error; and

c) Reviewing the component auditor's documentation of identified significant risks of material misstatement of the group financial statements. Such documentation may take the form of a memorandum that reflects the component auditor's conclusion with regard to the identified significant risks.

Identified Significant Risks of Material Misstatement of the Group Financial

Statements—Further Audit Procedures

If significant risks of material misstatement of the group financial statements have been identified in a component on which a component auditor performs the work, the group engagement teamshall evaluate the appropriateness of the further audit procedures to be performed to respond to the identified significant risks of material misstatement of the group financial statements. Based on its understanding of the component auditor, the group engagement team shall determine whether it is necessary to be involved in the further audit procedures.

Consolidation Process

The group engagement team obtains an understanding of group-wide controls and the consolidation process, including the instructions issued by group management to components.

The group engagement team, or component auditor at the request of the group engagement team, tests the operating effectiveness of group-wide controls .

The group engagement team shall design and perform further audit procedures on the consolidation process to respond to the assessed risks of material misstatement of the group financial statements arising from the consolidation process. This shall include evaluating whether all components have been included in the group financial statements.

The group engagement team shall evaluate the appropriateness, completeness and accuracy of consolidation adjustments and reclassifications, and shall evaluate whether any fraud risk factors or indicators of possible management bias exist.

If the financial information of a component has not been prepared in accordance with the same accounting policies applied to the group financial statements, the group engagement team shall evaluate whether the financial information of that component has been appropriately adjusted for purposes of preparing and presenting the group financial statements.

If the group financial statements include the financial statements of a component with a financial reporting period-end that differs from that of the group, the group engagement team shall evaluate whether appropriate adjustments have been made to those financial statements in accordance with the applicable financial reporting framework.

Subsequent Events

The group engagement team or the component auditors shall perform procedures designed to identify events at those components that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements, and that may require adjustment to or disclosure in the group financial statements.

The group engagement team shall request the component auditors to notify the group engagement team if they become aware of subsequent events that may require an adjustment to or disclosure in the group financial statements.

Communication with the Component Auditor

From group engagement team to component auditor

The group engagement team shall communicate its requirements to the component auditor on a timely basis. This communication shall set out the work to be performed, 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 shall also include the following:

- A request that the component auditor confirms that the component auditor will cooperate with the group engagement team.
- The ethical requirements that are relevant to the group audit and, in particular, the independence requirements.
- Component materiality (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.
- Identified significant risks of material misstatement of the group financial statements, due to fraud or error. The group engagement team shall request the component auditor to communicate on a timely basis any other identified significant risks of material misstatement of the group financial statements, due to fraud or error, in the component, and the component auditor's responses to such risks.
- A list of related parties prepared by group management. The group engagement team shall request the component auditor to communicate on a timely basis related parties not previously identified by group management or the group engagement team. The group engagement team shall determine whether to identify such additional related parties to other component auditors.

From component auditor to group engagement team

The group engagement team shall request the component auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit. Such communication shall 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 or regulations that could give rise 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;
- 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;
- The component auditor's overall findings, conclusions or opinion.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

Evaluating the Component Auditor's Communication and Adequacy of their Work

The group engagement team shall evaluate the component auditor's communication. The group engagement team shall:

- Discuss significant matters arising from that evaluation with the component auditor, component management or group management, as appropriate; and
- Determine whether it is necessary to review other relevant parts of the component auditor's audit documentation.

If the group engagement team concludes that the work of the component auditor is insufficient, the group engagement team shall determine what additional procedures are to be performed, and whether they are to be performed by the component auditor or by the group engagement team.

Sufficiency and Appropriateness of Audit Evidence

The group engagement team shall evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed on the consolidation process and the work performed by the group engagement team and the component auditors on the financial information of the components, on which to base the group audit opinion.

The group engagement partner shall evaluate the effect on the group audit opinion of any uncorrected misstatements (either identified by the group engagement team or communicated by component auditors) and any instances where there has been an inability to obtain sufficient appropriate audit evidence.

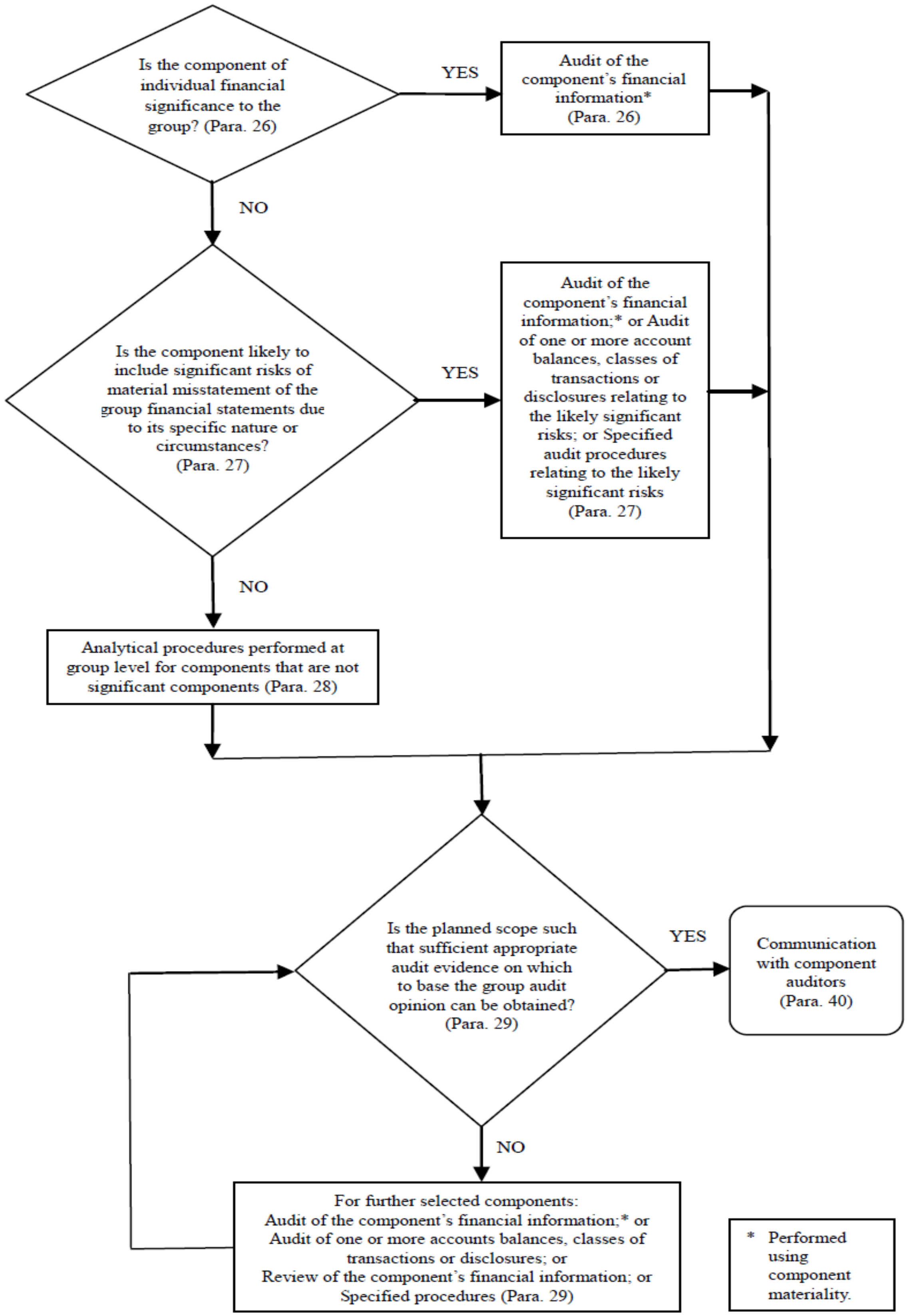
Communication with Group Management and Those Charged with Governance of the Group

Communication with Group Management

The group engagement team shall determine which identified deficiencies in internal control to communicate to those charged with governance and group management in accordance with ISA 265. In making this determination, the group engagement team shall consider:

- Deficiencies in group-wide internal control that the group engagement team has identified;
- Deficiencies in internal control that the group engagement team has identified in internal controls at components; and
- Deficiencies in internal control that component auditors have brought to the attention of the group engagement team.

If fraud has been identified by the group engagement team or brought to its attention by a component auditor or information indicates that a fraud may exist, the group engagement team shall communicate this on a timely basis to the appropriate level of group management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.


Is the component of individual financial significance to the group? (Para. 26)
YES
Audit of the component's financial information* (Para. 26)
NO
Is the component likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances? (Para. 27)
YES
Audit of the component's financial information;* or Audit of one or more account balances, classes of transactions or disclosures relating to the likely significant risks; or Specified audit procedures relating to the likely significant risks (Para. 27)
NO
Analytical procedures performed at group level for components that are not significant components (Para. 28)
Is the planned scope such that sufficient appropriate audit evidence on which to base the group audit opinion can be obtained? (Para. 29)
YES
Communication with component auditors (Para. 40)
NO
For further selected components: Audit of the component's financial information;* or Audit of one or more accounts balances, classes of transactions or disclosures; or Review of the component's financial information; or Specified procedures (Para. 29)
* Performed using component materiality.

Examples of Conditions or Events that May Indicate Risks of Material Misstatement of the Group Financial Statements

The examples provided cover a broad range of conditions or events; however, not all conditions or events are relevant to every group audit engagement and the list of examples is not necessarily complete.

- A complex group structure, especially where there are frequent acquisitions, disposals or reorganizations.
- Poor corporate governance structures, including decision-making processes, that are not transparent.
- Non-existent or ineffective group-wide controls, including inadequate group management information on monitoring of components' operations and their results.
- Components operating in foreign jurisdictions that may be exposed to factors such as unusual government intervention in areas such as trade and fiscal policy, and restrictions on currency and dividend movements; and fluctuations in exchange rates.
- Business activities of components that involve high risk, such as long-term contracts or trading in innovative or complex financial instruments.
- Uncertainties regarding which components' financial information require incorporation in the group financial statements in accordance with the applicable financial reporting framework, for example, whether any special-purpose entities or non-trading entities exist and require incorporation.
- Unusual related party relationships and transactions.
- Prior occurrences of intra-group account balances that did not balance or reconcile on consolidation.
- The existence of complex transactions that are accounted for in more than one component.
- Components' application of accounting policies that differ from those applied to the group financial statements.
- Components with different financial year-ends, which may be utilized to manipulate the timing of transactions.
- Prior occurrences of unauthorized or incomplete consolidation adjustments.
- Aggressive tax planning within the group, or large cash transactions with entities in tax havens.
- Frequent changes of auditors engaged to audit the financial statements of components.

Extracted from past exams
Overall risks

On consolidation, the intercompany receivables and payables balances should be eliminated, leaving only balances between the Group and external parties recognised at Group level.
If the intercompany transaction included a profit element, then the inventory needs to be reduced in value by an adjustment for unrealised profit.

There is a risk that intra-group sales, purchases, payables and receivables are not eliminated, leading to overstated revenue, cost of sales, payables and receivables in the Group financial statements.

There is also a risk that intercompany transactions are not identified in either/both companies' accounting systems.

intra-group transactions are by definition related party transactions according to IAS 24

Related Party Disclosures,
No disclosure of the transactions is required in the Group financial statements in respect of intra-group transactions because they are eliminated on consolidation. However, both the individual financial statements of the Group

company supplying the parent and the financial statements of the parent company must contain notes disclosing details of the intra-group transactions. There is a risk that this disclosure is not provided.
In addition, inventory may be supplied including a profit margin or mark up, in which case a provision for unrealised profit should be recognised in the Group financial statements. If this is not accounted for, Group inventory will be overstated, and operating profit will be overstated.

Other risks

Mid-year acquisition
Subsidiary was acquired part way through the accounting period. Its results should be consolidated into the group statement of comprehensive income from the date that control passed to the parent. The risk is that results have been consolidated from the wrong point in time.

The company's functional and presentational currency is local, and different to the rest of the group. Prior to consolidation, the financial statements must be retranslated, using the rules in IAS 21 *The Effects of Changes in Foreign Exchange Rates*. The assets and liabilities should be retranslated using the closing exchange rate, income and expenses at the average exchange rate, and exchange gains or losses on the retranslation should be recognised in group equity. This is a complex procedure, therefore inherently risky, and the determination of the average rate for the year can be subjective.

Adjustments necessary to bring in line with group accounting policies
Subsidiary does not use the same financial reporting framework as the rest of the group. The company's financial statements must be adjusted to align them with group accounting policies. This will require considerable expertise and the risk of errors is high.

Goodwill Risks

The various components of goodwill have specific risks attached. For the consideration, the contingent element of the consideration is inherently risky, as its measurement involves a judgement as to the probability of the amount being paid.

IFRS 3 (Revised) *Business Combinations* requires that contingent consideration is recognised at fair value at the time of the business combination, meaning that the probability of payment should be used in measuring the amount of consideration that is recognised at acquisition. This part of the consideration could therefore be overstated, if the assessment of probability of payment is incorrect.

Another risk is that the contingent consideration does not appear to have been discounted to present value as required by IFRS 3, again indicating that it is overstated.

The other component of the goodwill calculation is the value of identifiable assets acquired, which IFRS 3 requires to be measured at fair value at the date of acquisition. This again is inherently risky, as estimating fair value can involve uncertainty. Possibly the risk is reduced somewhat as the fair values have been determined by an external firm.

Goodwill should be tested for impairment annually according to IAS 36 *Impairment of Assets*, and a test should be performed in the year of acquisition, regardless of whether indicators of impairment exist. There is therefore a risk that goodwill may be overstated if management has not conducted an impairment test at the year end.

Risks of material misstatement arise because the various components of goodwill each have specific risks attached, for example:

– Not all assets and liabilities may have been identified, for example, contingent liabilities and contingent assets may be omitted
– Fair value is subjective and based on assumptions which may not be valid.
– There is also a risk that the cost of investment is not stated correctly, for example, that any contingent consideration has not been included in the calculation.

Subsequent measurement of goodwill

According to IFRS 3 *Business Combinations*, goodwill should be subject to an impairment review on an annual basis. The risk is that a review has not taken place, and so goodwill is overstated and Group operating expenses understated if impairment losses have not been recognised

Disclosure

Extensive disclosures are required by IFRS 3 to be included in the notes to the Group financial statements, for example, to include the acquisition date, reason for the acquisition and a description of the factors which make up the goodwill acquired. The risk is that disclosures are incomplete or not understandable

Goodwill Evidence

The goodwill should be recognised as an intangible asset and measured according to IAS 38 *Intangible Assets* and IFRS 3 *Business Combinations*.

– The purchase consideration should reflect the fair value of total consideration paid and payable, and there is a risk that the amount shown in the calculation is not complete, for example, if any deferred or contingent consideration has not been included.
– The non-controlling interest has been measured at fair value. This is permitted by IFRS 3, and the decision to measure at fair value can be made on an investment by investment basis. The important issue is the basis for measurement of fair value. If the client is a listed company, then the market value of its shares at the date of acquisition can be used and this is a reliable measurement. If the client is not listed, then management should have used estimation techniques according to the fair value hierarchy of inputs contained in IFRS 13 *Fair Value Measurement*. This would introduce subjectivity into the measurement of non-controlling interest and goodwill and the method of determining fair value must be clearly understood by the auditor.
– The net assets acquired should be all identifiable assets and liabilities at the date of acquisition. Some form of due diligence investigation should have been performed, and one of the objectives of this would be to determine the existence of assets and liabilities, even those not recognised in the individual financial statements. There is a risk that not all acquired assets and liabilities have been identified, or that they have not been appropriately measured at fair value, which would lead to over or understatement of goodwill and incomplete recording of assets and liabilities in the consolidated financial statements.
– IAS 38 requires that goodwill is tested annually for impairment regardless of whether indicators of potential impairment exist.

Evidence

- Agreement of the purchase consideration to the legal documentation pertaining to the acquisition, and a review of the documents to ensure that the figures included in the goodwill calculation are complete.
- Agreement of the purchase consideration to the bank statement and cash book of the acquiring company
- Review of board minutes for discussions relating to the acquisition, and for the relevant minute of board approval.
- A review of the purchase documentation and a register of significant shareholders of to confirm the 20% non-controlling interest.
- If the subsidiary's shares are not listed, a discussion with management as to how the fair value of the non-controlling interest has been determined and evaluation of the appropriateness of the method used.
- If the subsidiary's shares are listed, confirmation that the fair value of the non-controlling interest has been calculated based on an externally available share price at the date of acquisition.
- A copy of any due diligence report relevant to the acquisition, reviewed for confirmation of acquired assets and liabilities and their fair values.
- An evaluation of the methods used to determine the fair value of acquired assets, including the property, and liabilities to confirm compliance with IFRS 3 and IFRS 13.

<u>Goodwill impairment</u>

- Look for indicators of goodwill impairment for example one of the subsidiaries has suffered a 25% reduction in revenue
- In another question, A trading division relating to one-third of a subsidiary's net assets is held for sale at the year end. Any goodwill relating to this trading division should be reclassified out of goodwill and into the disposal group of assets held for sale. It may be a subjective and complex process to determine how much of the subsidiary's goodwill should be allocated to the trading division which is held for sale. It may be that no goodwill is attached to this trading division, but this should be confirmed through further audit procedures.

<u>Procedures on goodwill *initially* recognised with contingent considertion (can't include impairment procedures then!)</u>

- Obtain the legal purchase agreement and confirm the date of the acquisition as being the date that control of Subsidiary passed to parent
- From the legal purchase agreement, confirm the consideration paid, and the details of the contingent consideration, including its amount, date potentially payable, and the factors on which payment depends.
- Agree the cash payment to cash book and bank statements.
- Review the board minutes for discussion regarding, and approval of the purchase
- Obtain the due diligence report prepared by the external provider and confirm the estimated fair value of net assets at acquisition.
- Ask management to recalculate the contingent consideration on a discounted basis, and confirm goodwill is recognised on this basis in the consolidated financial statements.

Cost of investment

According to the schedule provided by the client, the cost of investment comprises three elements. One matter to consider is whether the cost of investment is complete.

It appears that no legal or professional fees have been included in the cost of investment (unless included within the heading 'cash consideration'). Directly attributable costs should be included per IFRS 3 *Business Combinations*, and there is a risk that these costs may be expensed in error, leading to understatement of the investment.

The cash consideration of $2·5 million is the least problematical component. The only matter to consider is whether the cash has actually been paid. Given that subsidiary was acquired in the last month of the financial year it is possible that the amount had not been paid before the year end, in which case the amount should be recognised as a current liability on the statement of financial position (balance sheet). However, this seems unlikely given that normally control of an acquired company only passes to the acquirer on cash payment.

IFRS 3 states that the cost of investment should be recognised at fair value, which means that deferred consideration should be discounted to present value at the date of acquisition. If the consideration payable at the yearend has not been discounted, the cost of investment, and the corresponding liability, will be overstated.

Contingent consideration should be accrued if it is probable to be paid. Here the amount is payable if revenue growth targets are achieved over the next four years. The auditor must therefore assess the probability of the targets being achieved, using forecasts and projections of revenue. Such information is inherently subjective, and could have been manipulated in order to secure the deal and maximise consideration. Here it will be crucial to be sceptical when reviewing the forecasts, and the assumptions underlying the data.

Audit evidence

- Agreement of the monetary value and payment dates of the consideration per the client schedule to legal documentation signed by vendor and acquirer.
- Agreement of $2·5 million paid to the bank statement and cash book prior to year end. If payment occurs after yearend confirm that a current liability is recognised on the individual company and consolidated statement of financial position (balance sheet).
- Board minutes approving the payment.
- Recomputation of discounting calculations applied to deferred and contingent consideration.
- Agreement that the discount rate used is pre-tax, and reflects current market assessment of the time value of money (e.g. by comparison to weighted average cost of capital).
- Revenue and profit projections checked for arithmetic accuracy.
- A review of assumptions used in the projections, and agreement that the assumptions are comparable with the auditor's understanding of the business.

Disposal of a subsidiary disposed off at a profit during the year

Derecognition of assets and liabilities

On disposal, all of its assets and liabilities which had been recognised in the Group financial statements should have been derecognised at their carrying value, including any goodwill in respect of the company.

There is therefore a risk that not all assets, liabilities and goodwill have been derecognised leading to overstatement of those balances and an incorrect profit on disposal being calculated and included in Group profit for the year.

Profit consolidated prior to disposal

There is a risk that the disposed subsidiary's income for the year has been incorrectly consolidated. It should have been included in Group profit up to the date that control passed and any profit included after that point would mean overstatement of Group profit for the year.

Calculation of profit on disposal

There is a risk that the profit on disposal has not been accurately calculated, e.g. that the proceeds received have not been measured at fair value as required by IFRS 10 *Consolidated Financial Statements*, or that elements of the calculation are missing.

Classification and disclosure of profit on disposal

IAS 1 *Presentation of Financial Statements* requires separate disclosure on the face of the financial statements of material items to enhance the understanding of performance during the year.

The risk is that the profit is not separately disclosed, e.g. is netted from operating expenses, leading to material misstatement.

Extensive disclosure requirements exist in relation to subsidiaries disposed of, e.g. IAS 7 *Statement of Cash Flows* requires a note which analyses the assets and liabilities of the subsidiary at the date of disposal. There is a risk that not all necessary notes to the financial statements are provided.

Treatment of the disposal in parent company individual financial statements

The parent company's financial statements should derecognise the original cost of investment and recognise a profit on disposal based on the difference between the proceeds and the cost of investment. Risk arises if the investment has not been derecognised or the profit has been incorrectly calculated.

Tax on disposal

There should be an accrual in both the parent company and the Group financial statements for the tax due on the disposal. This should be calculated based on the profit recognised in the parent company. There is a risk that the tax is not accrued for, leading to overstated profit and understated liabilities. There is also a risk that the tax calculation is not accurate.

Procedures to be performed on the disposal of a subsidiary

- Obtain the statement of financial position of the disposed off subsidiary to confirm the value of assets and liabilities which have been derecognised from the Group.
- Review prior year Group financial statements and audit working papers to confirm the amount of goodwill that exists in respect of the disposed off subsidiary and trace to confirm it is derecognised from the Group on disposal.
- Confirm that the Group is no longer listed as a shareholder of the disposed off subsidiary.
- Obtain legal documentation in relation to the disposal to confirm the date of the disposal and confirm that disposed off subsidiary's profit has been consolidated up to this date only.
- Perform substantive analytical procedures to gain assurance that the amount of profit consolidated appears reasonable and in line with expectations based on prior year profit.
- Re-perform management's calculation of profit on disposal in the Group financial statements.

- Agree the proceeds received to legal documentation, and to cash book/bank statements.
- Confirm that the above proceeds is the fair value of proceeds on disposal and that no deferred or contingent consideration is receivable in the future.
- Review the Group statement of profit or loss and other comprehensive income to confirm that the profit on disposal is correctly disclosed as part of profit for the year (not in other comprehensive income) on a separate line.
- Using a disclosure checklist, confirm that all necessary information has been provided in the notes to the Group financial statements.
- Obtain management's estimate of the tax due on disposal, re-perform the calculation and confirm the amount is properly accrued at parent company and at Group level.
- Review any correspondence with tax authorities regarding the tax due.
- Possibly the tax will be paid in the subsequent events period, in which case the payment can be agreed to cash book and bank statement.

Parent company's individual F/S

- Obtain the parent company's statement of financial position to confirm that the cost of investment is derecognised.
- Using prior year financial statements and audit working papers, agree the cost of investment derecognised to prior year's figure.
- Re-perform the calculation of profit on disposal in the parent company's financial statements.
- Reconcile the profit on disposal recognised in the parent company's financial statements to the profit recognised in the Group financial statements.

Associates

Associates are accounted for under IAS 28 *Investments in Associates and Joint Ventures*, which states that an entity with joint control of, or significant influence over, an investee shall account for its investment in an associate or a joint venture using the equity method. If it cannot demonstrate the ability to exercise significant influence, then the investments should be treated as trade investments, and would not be consolidated

Risk arises in relation to any possible impairment of the investment, which may cause it to be overstated in both the individual financial statements of the client, and the Group financial statements.

There is also a disclosure issue, as the Group's share of post-investment profit of the associate should be recognised in profit, and IAS 1 *Presentation of Financial Statements* requires that the profit or loss section of the statement of profit or loss shall include as a line item the share of the profit or loss of associates accounted for using the equity method.

According to IAS 28, if an entity holds, directly or indirectly, 20% or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case. If the holding does not give rise to significant influence, for example, if the shares do not convey voting rights, it should be classified as an investment rather than an associate.

Co-terminous year ends

It is possible that all of the entities within a group will not have **co-terminous reporting periods**. In this case, ISA 600.37 requires the group auditor to evaluate whether appropriate adjustments have been made to the financial statements that are not co-terminous, in accordance with the relevant financial reporting framework. In the case of IFRSs, IFRS 10 requires that the difference between period-end dates of the parent and a subsidiary is **no more than three months**. Adjustments must be made for any significant events which occur between the date of the subsidiary's and the parent's financial statements.

'Support letters'

Tutorial note: Although there are different types and uses of such letters (eg for registering a prospectus), the only reference to them in the THE ADVANCED AUDIT & ASSURANCE EXAM Syllabus and Study Guide is in the context of group audits.

Consolidated financial statements are prepared on a going concern basis when a group, as a single entity, is considered to be a going concern. However, the going concern basis may only be appropriate for certain separate legal entities (e.g. subsidiaries) because the parent undertaking (or a fellow subsidiary) is able and willing to provide support. Many banks routinely require a letter of reassurance from a parent company stating that the parent would financially or otherwise support a subsidiary with cash flow or other operational problems.

As audit evidence:

- Formal confirmation of the support will be sought in the form of a letter of support or 'comfort letter' confirming the parent company's intention to keep the subsidiary in operational existence (or otherwise meet its obligations as they fall due).
- The letter of support should normally be approved by a board minute of the parent company (or by an individual with authority granted by a board minute).
- The ability of the parent to support the company should also be confirmed, for example, by examining the group's cash flow forecast.
- The period of support may be limited (eg to one year from the date of the letter or until the date of disposal of the subsidiary). Sufficient other evidence concerning the appropriateness of the going concern assumption must therefore be obtained where a later repayment of material debts is foreseen.
- The fact of support and the period to which it is restricted should be noted in the financial statements of the subsidiary.

<u>Transnational audit</u>

Transnational audit means an audit of financial statements which are or may be relied upon outside the audited entity's home jurisdiction for the purpose of significant lending, investment or regulatory decisions.

Examples: Private company in UK raising debt finance in Canada; International charity taking donations through various national branches and making grants around the world; Project financial statements for the construction of an electrical generation facility in Nigeria using funds loaned by World Bank

Risk associated with transnational audits

1. Application of auditing standards: Although many countries of the world have adopted International Standards on Auditing (ISAs), not all have done so, choosing instead to use locally developed auditing regulations. In addition, some countries use modified versions of ISAs. This means that in a transnational audit, some components of the group financial statements will have been audited using a different auditing framework, resulting in inconsistent audit processes within the group, and potentially reducing the quality of the audit as a whole.

2.Regulation and oversight of auditors: Similar to the previous comments on the use of ISAs, across the world there are many different ways in which the activities of auditors are regulated and monitored. In some countries the audit profession is self-regulatory, whereas in other countries a more legislative approach is used. This also can impact on the quality of audit work in a transnational situation.

3.*Financial reporting framework:* Some countries use International Financial Reporting Standards, whereas some use locally developed accounting standards. Within a transnational group it is likely that adjustments, reconciliations or restatements may be required in order to comply with the requirements of the jurisdictions relevant to the group financial statements (i.e. the jurisdiction of the parent company in most cases). Such reconciliations can be complex and require a high level of technical expertise of the preparer and the auditor.

4. *Corporate governance requirements and consequent control risk:* In some countries there are very prescriptive corporate governance requirements, which the auditor must consider as part of the audit process. In this case the auditor may need to carry out extra work over and above local requirements in order to ensure group wide compliance with the requirements of the jurisdictions relevant to the financial statements. However, in some countries there is very little corporate governance regulation at all and controls are likely to be weaker than in other components of the group. Control risk is therefore likely to differ between the various subsidiaries making up the group.

JOINT AUDIT

A joint audit is when two or more audit firms are jointly responsible for giving the audit opinion. This is very common in a group situation where the principal auditor is appointed jointly with the auditor of a subsidiary to provide a joint opinion on the subsidiary's financial statements.

Advantages

It can be beneficial in terms of audit efficiency for a joint audit to be conducted, especially in the case of a new subsidiary. A joint audit will allow sufficient resources to be allocated to the audit, assuring the quality of the opinion provided.

If there is a tight deadline, as is common with the audit of subsidiaries, which should be completed before the group audit commences, then having access to two firms' resources should enable the audit to be completed in good time. The audit should also benefit from an improvement in quality. The two audit firms may have different points of view, and would be able to discuss contentious issues throughout the audit process. Joint audits increase competition in the profession. In particular, joint audits have been proposed as a way for 'mid tier' audit firms to break into the market of auditing large companies and groups, which at the moment is monopolized by the 'Big 4'.

Disadvantages

For the client, it is likely to be more expensive to engage two audit firms than to have the audit opinion provided by one firm.

From a cost/benefit point of view there is clearly no point in paying twice for one opinion to be provided. Despite the audit workload being shared, both firms will have a high cost for being involved in the audit in terms of senior manager and partner time.

These costs will be passed on to the client within the audit fee. The two audit firms may use very different audit approaches and terminology. This could make it difficult for the audit firms to work closely together, negating some of the efficiency and cost benefits discussed above. Problems could arise in deciding which firm's method to use, for example, to calculate materiality, design and pick samples for audit procedures, or evaluate controls within the accounting system. It may be impossible to reconcile two different methods and one firm's methods may end up dominating the audit process, which then eliminates the benefit of a joint audit being conducted. It could be time consuming to develop a 'joint' audit approach, based on elements of each of the two firms' methodologies, time which obviously would not have been spent if a single firm was providing the audit

Potentially, problems could arise in terms of liability. In the event of litigation, because both firms have provided the audit opinion, it follows that the firms would be jointly liable. The firms could blame each other for any negligence which was discovered, making the litigation process more complex than if a single audit firm had provided the opinion. However, it could be argued that joint liability is not necessarily a drawback, as the firms should both be covered by professional indemnity insurance.

<u>Very important technical article: GROUP AUDIT</u>

Group auditing often necessitates that the group auditor places considerable reliance on other audit firms. However, ISA 600 doesn't allow the group auditor to wholly outsource responsibility for parts of the audit to another auditor.

To begin at the beginning: acceptance of the assignment

ISA 600 requires the group engagement partner each year formally to assess whether it is appropriate to act as group auditor. If at any point the group engagement partner concludes that they lack the professional skills necessary to form a group audit opinion, they should resign. ISA 600 requires that the group engagement partner resign immediately if there is any significant restriction placed by the parent company management on information made available from within the group (or disclaim opinion if resignation is not legally possible).

ISA 600 (revised and redrafted) extends this responsibility to require that the auditor relying on the third party's work has obtained their own understanding of the specialist area in question, or business of each subsidiary or associate(referred to as 'components' in ISA 600, with that company's auditor referred to as the 'component auditor'). **The group auditor must form their own concurring opinion on any judgmental areas.** This does not require having the same depth of knowledge as the expert/other auditor, but they would need to be able to review the third party's files and have sufficient independent knowledge to understand the work done, the reason for the work and the conclusions from that evidence.

Group audit opinion

The parent company of a group will normally publish its financial statements as an individual company and the group financial statements in the same document, so, the audit opinion will normally be expressed on 'the financial statements of the company and of the group as at...' Although presented asone opinion, it logically contains two separate opinions; one on the entity financial statements of the parent itself and another on the financial statements of the group. ISA prohibits the group auditor from making any reference to the work of any other experts or auditors, as doing so would diminish the credibility of the audit opinion and allow the group auditor to 'pass the buck' for responsibility for part of the audit. You should be prepared to explain this point in the exam. This is an example of where ISA differs from US audit standards, where reference to other auditors conducting some of the work on components is permissible.

Planning work required

Groups often have a number of subsidiaries that are either dormant or immaterial. At a minimum, the group engagement team must develop an understanding of each component of the group and review the financial statements of each subsidiary. Where a component is judged to be material or a significant contributor of inherent risk at the group level, further work will be required to be satisfied that the financial statements of each component, in order to be satisfied that the component is unlikely to introduce errors that could be material at the group level. This work might include:

- Discussing with the component auditor, and/or the management of the component, the business activities that are significant to the group
- Reviewing the more significant parts of the component auditor's working papers
- Discussing with the component auditor the susceptibility of the company's financial statements to material error or deliberate misstatement
- Reviewing the component auditor's documentation of identified significant risks, and the conclusions reached on these risks
- Observing final clearance meetings between the component auditor and the management of the company.

The group auditor as the repository of information

The group engagement team's role brings information flowing to them that is useful to disseminate around the group. This includes materiality (see below)and matters such as related party relationships, which may be unknown at the component level, because two subsidiaries may be unaware of each other's existence. The group auditor asks each component auditor for known related party relationships and then communicates a collated list of all related party relationships to each component auditor.

Materiality

At the planning stage, the group engagement partner must determine several figures for materiality for each component part of the group (ISA 600:21).

	Group	**Parent**	**Each component**
Financial statements materiality	Group auditor	Group auditor	Component auditor
Materiality for the consolidation package as a whole	Group auditor	Group auditor	Group auditor
Level of reduced materiality for sensitive figures	Group auditor	Group auditor	Group auditor
Performance materiality	Group auditor	Group auditor	Group auditor

Performance materiality is the figure below that any errors in the financial statements may be considered trivial. The component auditor will be required to communicate to the group auditor a summary of all unadjusted errors in the consolidation package.

It is common in larger group audits for the financial statements to be prepared using a consolidation package of information that is sent to the parent company by each component company. This will omit many of the disclosures that will be in the eventual entity financial statements. The component auditor may, therefore, be required to issue a special audit opinion on the truth and fairness of the consolidation package. This opinion is likely to be addressed to the directors of the component company, or may be addressed to the group auditor directly. In order to minimise the risk of several accidental or deliberate errors in the financial statements together exceeding group materiality, component materiality figures will normally be significantly lower than the group materiality figure, even for the largest component companies.

Example 1

Imagine that financial statements materiality is taken to be 10% of profit or loss for each entity within a group and performance materiality is set at 0.5%of profit. Imagine that a group has a parent company and two components, one of which is profit making and one of which is loss making:

$'000s	**Parent**	**Subsidiary 1**	**Subsidiary 2**	**Group**
Profit	2,000	12,000	(8,000)	6,000
Component materiality @ 10%	200	1,200	800	600
Performance materiality @ 0.5%	10	60	40	30

If subsidiary 1 were audited by another firm using the same materiality calculation method as the parent, an unadjusted error of $10m would correctly result in issuance of an unmodified audit opinion on the financial statements of that individual company.

However, the effect of losses elsewhere in the group would mean that although this error would not be material at the component level, it would be material at the group level. Since it is only likely to be the parent auditor who has this overview of the group, the group engagement team must communicate materiality figures to component auditors in advance of audit work commencing.

In this example, the maximum component materiality figure that the group auditor could communicate to the component auditors would be 600, but it would be wise to select a lower figure than this, in order to reduce to a tolerable level the risk of errors in both component companies together exceeding 600.In the exam, if you are given extracts from draft financial statements, it’s often a good start to recommend and briefly explain a figure for materiality.

Communication between auditors

ISA 600 in its revised form contains extensive new requirements on the communication between parent and component auditor. In addition to practical matters such as materiality, the required format of the consolidation package, deadlines and contact details, the group auditor must communicate a number of matters at the planning to the component auditor, including:

- Related party relationships known anywhere around the group
- Identified significant risks, whether due to error or fraud
- Methodology to be used for impairment testing of goodwill. Audit of estimates is subjective and so it's essential that the group auditor's preferred method is used throughout the group. Be prepared to explain this in Paper THE ADVANCED AUDIT & ASSURANCE EXAM.

Matters that the component auditor must communicate to the group auditor will include: any known related party relationships and related party transactions

- Any indications of management bias
- Any significant risks to the truth and fairness of the component financial statements, work done on these risks and the conclusions reached
- All intra-group transactions, period end balances and allowances forum realised profit
- Any observed non-trivial failure to observe relevant laws and regulations
- All observed control weaknesses, flagging significant weaknesses separately
- Any known events after the reporting date.

Audit of the consolidation process

Once the group engagement partner is satisfied that the individual financial statements within the group are free from material misstatement, attention can now shift to audit of the consolidation process good news for exam purposes is that this stage of the audit is very similar regardless of the specific company, so good marks can be obtained largely by memorising the risks and responses below.

Principal risks arising in the consolidation process include errors or omissions arising during:

- Transcription of figures from individual financial statements to consolidation workings
- Classification of components (e.g. Associate, subsidiary)
- Cancellation of intra-group trading, cancellation of intra-group balance sand allowance for unrealised profit on intra-group transfers
- Recognition of impairment of purchased positive goodwill
- Determination of fair values being used on acquisition
- Arithmetical inaccuracy in the consolidation process
- Identification and disclosure of related party relationships and transactions
- Foreign currency translation from functional currency of components to reporting currency of the group.

The most reliable evidence on completeness and accuracy of consolidation adjustments in a large group is likely to be determining whether the client's accounting systems adequately flags transactions with fellow group companies. The process is still likely to be highly substantive in nature and will probably include these tests of detail:

- line-by-line agreement of all items from audited component financial statements (or consolidation packages submitted to head office) to the consolidation schedules
- detailed discussion with management on the reason for classification of each component
- sample testing of known intra-group transactions to ensure that they have been eliminated in the client's consolidation
- recalculation of all significant workings, such as goodwill, non-controlling interests and foreign currency translation.

Principal audit procedures that are performed on the consolidation process.

ISA 600 firstly requires that the auditor shall obtain an understanding of the group-wide controls and the consolidation process. This includes an evaluation of instructions given by group management to components of the group. The operating effectiveness of controls over the consolidation process will be tested.

The audit procedures will mainly focus on adjustments made on consolidation. For example, significant adjustments such as goodwill calculations and impairments are recalculated, underlying assumptions checked for validity, and the authorisation of the adjustment should be checked. Adjustments should be agreed to underlying documentation, and where relevant, to prior year audited financial statements or audit working papers

The elimination of inter-company transactions is usually a key feature of the consolidation process. Reconciliations of intercompany balances should be arithmetically checked, and unrealised profits should be recalculated for accuracy.

Figures included in the consolidation schedules should be agreed back to audited financial statements of all components. Disclosures made in the notes to the group financial statements should also be agreed back to the individual component's financial statements where relevant, for example disclosures on related parties.

Audit procedures will be needed to verify that subsidiary balances have been included where relevant at fair value in the consolidated financial statements. For example, properties may be held at cost in the individual financial statements of the component, but should be consolidated at fair value. The auditor may consider the need to engage an expert to provide evidence on fair values, especially if the amounts involved are material. The audit of fair values is crucial as it forms the basis of the goodwill calculation.

The accounting policies of all components of the group should be checked for consistency, as additional adjustments may be necessary to bring the components into line with group accounting policies.

The deferred tax consequences of consolidation and fair value adjustments should be reviewed for completeness, and calculations re-performed for accuracy.

Where the group has investments in non-controlling interests, additional procedures will be necessary to check the validity of treating the investments as associates and/or joint ventures, such as verification of the percentage shareholding by a review of purchase documentation or obtaining copies of the register of significant investors from the investee companies. The consolidation schedule should be arithmetically checked by casting and cross-casting.

Final review of financial statements

The group audit opinion may be signed on some date on or after the audit opinions on material components are signed. Once the component auditor has issued their opinion, their responsibility for reporting on the impact on events after the reporting date is greatly diminished, yet there may be material events that could be material in the group financial statements. The group engagement team will normally agree in advance with the auditor of significant components that an update on events is given by the component auditor to the group engagement partner immediately before the group audit opinion is signed. It is the responsibility of the group engagement team to ensure that material events are reported.

Reporting to management and the board

In addition to the usual requirements for reporting to those charged with governance (the 'management letter'), ISA 600:49 requires the group engagement partner also to report to management on any concerns that they had about possible fraud anywhere in the group, any restrictions on information made available by component management and any concerns that they had about the quality of work performed by any component auditor.

In addition to the audit report to shareholders, the group auditor is required by ISA 600 to report on a group-wide basis to group management and separately to those charged with governance at a group level, such as the audit committee of the board. This split communication echoes the requirements of ISA 260Communication with Those Charged with Governance to produce different letters to different levels of management.

The report to management will include details of all observed instances of non-trivial fraud and all non-trivial deficiencies in internal controls around the group.

The report to those charged with governance, most probably the audit committee, will include:

- ✓ An overview of the audit approach insofar as it affects component auditors
- ✓ Any doubts that the group auditor may have about the quality of work performed by the component auditor, giving the group auditor a potentially awkward need to publicly question the skills of a fellow professional.
- ✓ Any limitations on audit scope anywhere within the group
- ✓ Any suspected fraud where management is suspected of involvement.

Summary

ISA 600 represents a significant extension of the responsibilities of both group auditor and component auditor compared with the previous ISA. It is likely to be a controversial standard in practice, and it is therefore likely to be in many Paper THE ADVANCED AUDIT & ASSURANCE EXAM exams.Understanding and memorising the key points of the standard is a very good use of study time when preparing for the Paper THE ADVANCED AUDIT & ASSURANCE EXAM exam. The table below outlines come of the other audit risks that may be present with an overseas subsidiary, along with some possible audit procedures to mitigate those risks

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Audit risk	Procedures
Potential misstatement due to the effects of high inflation. IAS 29 requires financial statements to be restated in terms of measuring units current at the end of the reporting period, and a gain or loss on the net monetary position included within net income	• Confirm that financial statements have been correctly restated • Check that disclosures have been made in line with IAS 29
Subsidiary may have been audited by component auditors.	Need to consider the extent to which their work can be relied upon, as per ISA 600
Different accounting framework may have been used by subsidiary	Confirm the accounting framework used, and that accounting policies are consistent with the rest of the group
Possible difficulty in the parent being able to exercise control, eg due to political instability, or laws and regulations	Need to consider whether there is still control, and whether it is correct to produce group accounts per IFRS 3
Currency restrictions limiting payment of profits to the parent	• Need to consider whether there is still control • Need to consider impact on parent's status as a going concern

End of technical article

The review stage of audit- key points

Before the audit report is signed, the auditor needs to know that the work is finished and that all necessary issues have been dealt with. The easiest way to do this is to use a series of checklists:

- The audit plan should be reviewed, to verify that all issues raised have been resolved.
- An Accounting Standards Checklist will be completed, forcing the auditor to consider every possible accounting issue that could affect the client's Financial Statements.
- Additional checklists may be necessary (e.g. Company Law) to make sure that any other issues have been fully considered

All audit work should be subject to review. This is a basic quality control requirement of ISA 220, *Quality Control for an Audit of Financial Statements*, and serves to ensure that sufficient appropriate audit evidence has been obtained in respect of transactions and balances included in the financial statements.

In performing a file review, the reviewer should consider the sufficiency of evidence obtained and may need to propose further audit procedures if evidence is found to be insufficient or contradictory. ISA 230, *Audit Documentation* requires that documentation of the review process includes who reviewed the audit work completed and the date and extent of such review.

Typically, the auditor will present the client with a list of misstatements (often referred to as the 'audit error schedule'), quantifying the amount of each misstatement, and proposing the necessary adjustment to the financial statements. The proposed adjustment may be in the form of a journal entry, an amendment to the presentation of the financial statements, or a correction to a disclosure note. When management makes the necessary adjustments to the financial statements, the auditor should confirm that the adjustments have been made correctly.

Final analytical procedures

Before the audit report is signed, it is sensible to do some final analysis of the Financial Statements (e.g. ratio analysis) – just to make sure that the auditor is confident in the audit opinion.

There are 2 main reasons for this final analysis:

- The Financial Statements may have been adjusted during the audit as mistakes were found, so the final figures may never have been analyzed or been subject to ratio analysis.
- The auditor will have learned more about the company during the audit, so is in a better position at the end of the audit to analyze the figures and understand trends in ratios.

One of the objectives of the auditor in complying with ISA 520 (analytical procedures) is to design and perform analytical procedures near the end of the audit that assist in forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

The analytical procedures performed at this stage of the audit are not different to those performed at the planning stage – the auditor will perform ratio analysis, comparisons with prior period financial statements and other techniques to confirm that trends are as expected, and to highlight unusual transactions and balances that may indicate a risk of misstatement.

The key issue is that, near the end of the audit, the auditor should have sufficient audit evidence to explain the issues highlighted by analytical procedures, and should therefore be able to conclude as to the overall reasonableness of the financial statements.

When the analytical procedures performed near the end of the audit reveal further previously un-recognized risk of material misstatement, the auditor is required to revise the previously assessed risk of material misstatement and modify the planned audit procedures accordingly. *This means potentially performing further audit procedures in relation to matters that are identified as high risk.*

As well as reviewing the main elements of the financial statements, the auditor must at this stage carefully review the notes to the financial statements for completeness and compliance with the applicable financial reporting framework. In many situations, this will be the first opportunity for the auditor to review this information, as clients often prepare the notes to the financial statements towards the end of the audit process.

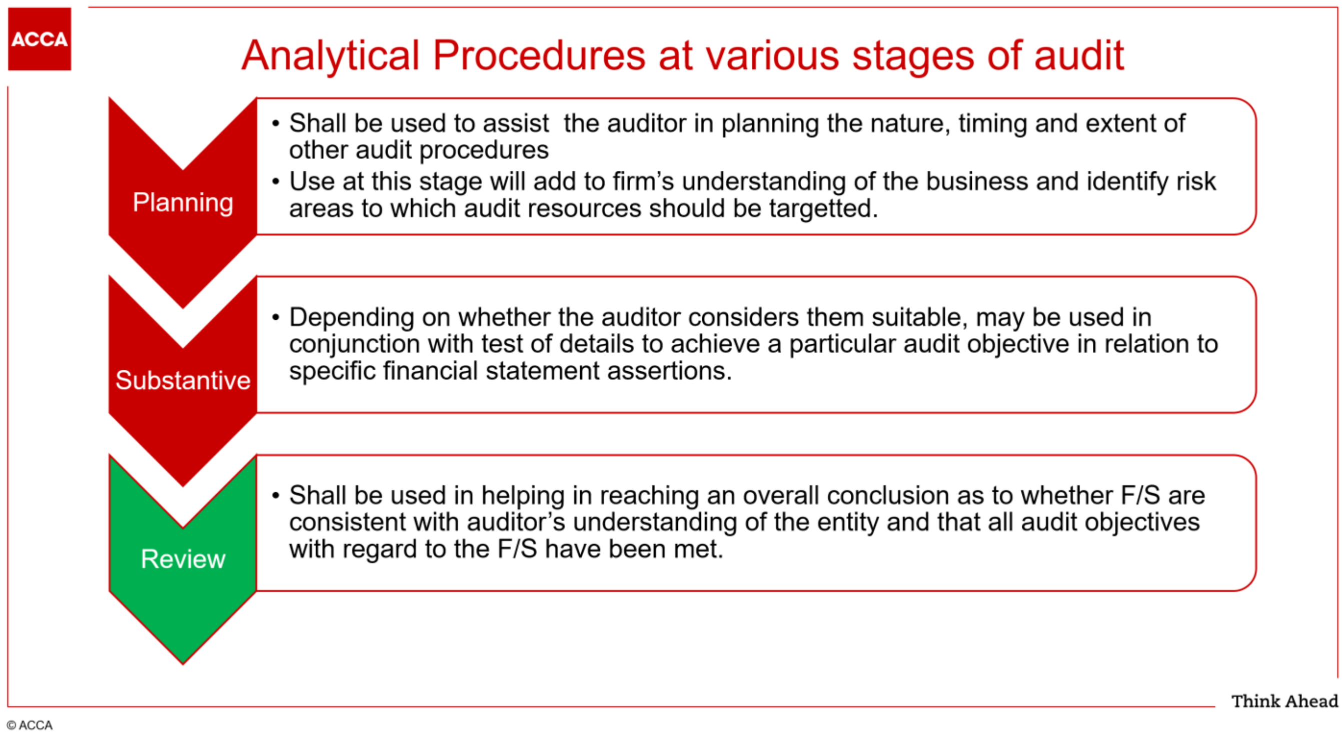
At this stage, the auditor should also read the other information to be issued with the financial statements for consistency with the financial statements.

This is important as inconsistencies may have implications for the auditor's report. Specific items of other information are subject to specific regulation in some jurisdictions – for example, in the UK and Ireland the auditor's report must state whether the Directors' Report is consistent with the financial statements.

Overall Review of evidence obtained

An overall review includes the following:

1. Review of **financial statements, analytical procedures**	– Any irregularity in compliance with the applicable laws and regulations – ISA 520 Analytical Procedures requires the application of analytical procedures, **at the overall review stage** to conclude whether the financial statements as a whole are consistent with the auditors' knowledge of the business
2. Sufficiency and appropriateness of audit evidence	**The review ensures that:** – The financial statements have been prepared using **acceptable accounting policies** and are **applied consistently** and are appropriate for the entity's business – The information included in the financial statements and the results of operations are **compatible** with the auditor's knowledge of the entity's business – **Adequate disclosures** are made wherever appropriate – The financial statements **comply with all statutory and other requirements** relevant to the entity's business – The conclusions drawn on the basis of the audit procedures carried


ACCA
Analytical Procedures at various stages of audit
Planning
• Shall be used to assist the auditor in planning the nature, timing and extent of other audit procedures
• Use at this stage will add to firm's understanding of the business and identify risk areas to which audit resources should be targetted.
Substantive
• Depending on whether the auditor considers them suitable, may be used in conjunction with test of details to achieve a particular audit objective in relation to specific financial statement assertions.
Review
• Shall be used in helping in reaching an overall conclusion as to whether F/S are consistent with auditor's understanding of the entity and that all audit objectives with regard to the F/S have been met.
Think Ahead
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Going concern review

Going concern basis of accounting

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Management's Responsibilities

Management should assess going concern in order to decide on the most appropriate basis for the preparation of the financial statements.

IAS 1 *Presentation of Financial Statements (revised)* requires that where there is significant doubt over an entity's ability to continue as a going concern, the uncertainties should be disclosed in a note to the financial statements.

Where the directors intend to cease trading, or have no realistic alternative but to do so, the financial statements should be prepared on a 'break up' basis.
Thus the main focus of the management's assessment of going concern is to ensure that relevant disclosures are made where necessary, and that the correct basis of preparation is used.

Auditor's Responsibilities
The auditor's responsibility is to consider the appropriateness of the management's use of the going concern assumption in the preparation of the financial statements and to consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in a note.

The auditor should also consider the length of the time period that management have looked at in their assessment of going concern.

The auditor will therefore need to come to an opinion as to the going concern status of an entity but the focus of the auditor's evaluation of going concern is to see whether they agree with the assessment made by the management *(whether they agree with the basis of preparation of the financial statements, or the inclusion in a note to the financial statements, as required by IAS 1, of any material uncertainty).*

Indicators of going concern problems

Events or Conditions That May Cast Significant Doubt on the Entity's Ability to Continue as a Going Concern

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).
• Labor difficulties.
• Shortages of important supplies.
• Emergence of a highly successful competitor.

Other
• Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions.
• 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

Any mitigating factors?

The significance of such events or conditions often can be mitigated by other factors.

For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital.

Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

These risk assessment procedures are likely to be an important issue and have an impact on planning the audit. These procedures allow for more timely discussions with management, including a discussion of management's plans and resolution of any identified going concern issues.

Auditor's procedures

When going concern problems are discovered, the auditor is required by IAS 570 to carry out additional procedures.

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern through performing additional audit procedures, including consideration of mitigating factors.

These procedures shall include:

Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment. *Their assessment is then evaluated.*	- Analyzing and discussing cash flow, profit and other relevant forecasts with management. - Analyzing and discussing the entity's latest available interim financial statements. - Reading the terms of debentures and loan agreements and determining whether any have been breached. - Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties. - Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications. - Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds. - Evaluating the entity's plans to deal with unfilled customer orders. - Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern. - Confirming the existence, terms and adequacy of borrowing facilities. - Obtaining and reviewing reports of regulatory actions. - Determining the adequacy of support for any planned disposals of assets - Analyzing and discussing cash flow, profit and other relevant forecasts
Evaluating Management's Plans for Future Actions	Evaluating management's plans for future actions may include inquiries of management as to its plans for future action, including, for example, its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital. In addition to the procedures above, the auditor may compare: - The prospective financial information for recent prior periods with historical results; and

	- The prospective financial information for the current period with results achieved to date. Where management's assumptions include continued support by third parties, whether through the subordination of loans, commitments to maintain or provide additional funding, or guarantees, and such support is important to an entity's ability to continue as a going concern, the auditor may need to consider requesting written confirmation (including of terms and conditions) from those third parties and to obtain evidence of their ability to provide such support.
Written Representations	The auditor may consider it appropriate to obtain specific written representations in support of audit evidence obtained regarding management's plans for future actions in relation to its going concern assessment and the feasibility of those plans.

Impact on opinion and audit report

Matters relating to going concern may be determined to be key audit matters, and a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern is, by its nature, a key audit matter.

Auditor's conclusions

<table>
<tr>
<td colspan="2">Use of going concern basis of accounting is appropriate
but
a material uncertainty exists relating to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
In auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary.</td>
<td colspan="2">Use of Going Concern Basis of Accounting Is Inappropriate
When the use of the going concern basis of accounting is not appropriate in the circumstances, management may be required, or may elect, to prepare the financial statements on another basis (e.g., liquidation basis). The auditor may be able to perform an audit of those financial statements provided that the auditor determines that the other basis of accounting is acceptable in the circumstances.</td>
</tr>
<tr>
<td><u>If</u> adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern"
(a) Draw attention to the note in the financial statements that discloses the matters
(b) 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 that the auditor's opinion is not modified in respect of the matter.
Example
Material Uncertainty Related to Going Concern</td>
<td><u>If</u> adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:
Express a modified opinion (Qualified or Adverse as appropriate)

In the Basis for Opinion section of the report, state that a material uncertainty exists that may cast doubt on entity's ability to continue as a going concern and that F/ S do NOT adequately disclose this matter</td>
<td>The financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion</td>
<td>The auditor may be able to express an unmodified opinion on those financial statements, provided there is adequate disclosure therein about the basis of accounting on which the financial statements are prepared, but may consider it appropriate or necessary to include an Emphasis of Matter paragraph</td>
</tr>
</table>

We draw attention to Note 6 in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, 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.			

Subsequent events Review

Events after the balance sheet date		
ADJUSTING	**NON-ADJUSTING**	
↓	↓	
Provide additional evidence of conditions existing at the balance sheet date	Concern conditions which did not exist at the balance sheet date	
↓	↙	↘
Adjust the financial statements to reflect the event	Impacts going concern	Does not impact going concern
	↓	↓
	Adjust the financial statements to present on an alternative basis(break-up basis)	Do not adjust the financial statements
		↓
		If important to users understanding disclose in a note: nature of event estimate of financial effect

Subsequent events are defined as those events occurring between the date of the financial statements and the date of the auditor's report, and also facts discovered after the date of the auditor's report.

Auditor's responsibilities in relation to subsequent events.

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

The auditor has an active duty to perform audit procedures designed to identify, and to obtain sufficient appropriate evidence of all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements.

These procedures should be performed as close as possible to the date of the auditor's report, and in addition, representations would be sought on the date that the report was signed.

Procedures would include:

- Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- Reading minutes, if any, of the meetings of the entity's owners, management and those charged with governance that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
- Reading the entity's latest subsequent interim financial statements, if any
- The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Where a material subsequent event is discovered, the auditor should consider whether management have properly accounted for and disclosed the event in the financial statements in accordance with IAS 10 *Events After the Reporting Period*.

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

The auditor does not have any responsibility to perform audit procedures or make any enquiry regarding the financial statements or subsequent events after the date of the auditor's report.

In this period, it is the responsibility of management to inform the auditor of facts which may affect the financial statements.

When the auditor becomes aware of a fact which may materially affect the financial statements, the matter should be discussed with management.

If the financial statements are appropriately amended then a new audit report should be issued, and procedures relating to subsequent events should be extended to the date of the new audit report.

If management do not amend the financial statements to reflect the subsequent event, in circumstances where the auditor believes they should be amended, a qualified or adverse opinion of disagreement should be issued.

Facts discovered after the financial statements have been issued.

After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, if, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

(a) Discuss the matter with management and, where appropriate, those charged with governance;

(b) Determine whether the financial statements need amendment; and, if so,

(c) Inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall:

(a) Carry out the audit procedures necessary in the circumstances on the amendment.

(b) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.

Communicating with those charged with governance

Matters to Be Communicated –ISA 260 and 265

Auditor's responsibilities in relating to F/S	- Forming and expressing an opinion on the F/S (in accordance with ISAs) - Auditor's responsibility to determine and communicate KAM - This does not relieve the management and TCWG of their responsibilities re F/S
Planned scope and timing of audit	- Significant risks identified by the auditor and how auditor plans to address them - Auditor's approach to internal control relevant to audit - Application of concept of materiality - Use of auditor's expert (if needed) - If applicable, discussion about planned use of internal auditor's work - Discussions about entity's objectives, strategies, related business risks -
Significant findings from the audit	- Auditor's views about accounting policies, accounting estimated, F/S disclosures - Significant difficulties encountered during the audit (delays in receiving information, unavailability of info etc) - Significant matters that were discussed with the management - Written representations that the auditor is requesting - Circumstances that affect form and content of auditors report (for example modified opinion, KAM, EOMP etc) - Any other significant matter -
Auditor independence (listed companies)	- Auditor has complied with relevant ethical requirements - All relationships that may have an impact on independence (including total fee charged during the period for audit and non-audit services) - Safeguards that have been applied to eliminate or reduce these threats

Key Audit Matters

Key audit matters: 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.

Objectives: The objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.

Determining KAM

The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

1. Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised).
2. Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
3. The effect on the audit of significant events or transactions that occurred during the period.
4. Other considerations

Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised).	ISA 260 (Revised) requires the auditor to communicate with those charged with governance about the significant risks identified by the auditor. The auditor may also communicate with those charged with governance about how the auditor plans to address areas of higher assessed risks of material misstatement. ISA 315 (Revised) explains that the auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. Revision to the auditor's risk assessment and re-evaluation of the planned audit procedures with respect to a particular area of the financial statements (i.e., a significant change in the audit approach, for example, if the auditor's risk assessment was based on an expectation that certain controls were operating effectively and the auditor has obtained audit evidence that they were not operating effectively throughout the audit period, particularly in an area with higher assessed risk of material misstatement) may result in an area being determined as one requiring significant auditor attention.
Significant auditor judgments relating to areas in the financial statements that involved significant management	ISA 260 (Revised) requires the auditor to communicate with those charged with governance the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

judgment, including accounting estimates that have been identified as having high estimation uncertainty.	In many cases, this relates to critical accounting estimates and related disclosures, which are likely to be areas of significant auditor attention, and also may be identified as significant risks.
The effect on the audit of significant events or transactions that occurred during the period.	Events or transactions that had a significant effect on the financial statements or the audit may be areas of significant auditor attention and may be identified as significant risks. For example, the auditor may have had extensive discussions with management and those charged with governance at various stages throughout the audit about the effect on the financial statements of significant transactions with related parties or significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual. Management may have made difficult or complex judgments in relation to recognition, measurement, presentation or disclosure of such transactions, which may have had a significant effect on the auditor's overall strategy. Significant economic, accounting, regulatory, industry, or other developments that affected management's assumptions or judgments may also affect the auditor's overall approach to the audit and result in a matter requiring significant auditor attention.
Other considerations	Other considerations that may be relevant to determining the relative significance of a matter communicated with those charged with governance and whether such a matter is a key audit matter include: • The importance of the matter to intended users' understanding of the financial statements as a whole, in particular, its materiality to the financial statements. • The nature of the underlying accounting policy relating to the matter or the complexity or subjectivity involved in management's selection of an appropriate policy compared to other entities within its industry. • The nature and materiality, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements due to fraud or error related to the matter, if any. • The nature and extent of audit effort needed to address the matter, including: ✓ The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any. ✓ The nature of consultations outside the engagement team ✓ regarding the matter. • The nature and severity of difficulties in applying audit procedures, evaluating the results of those procedures, and obtaining relevant and reliable evidence on which to base the auditor's opinion, in particular as the auditor's judgments become more subjective.

	• The severity of any control deficiencies identified relevant to the matter. • Whether the matter involved a number of separate, but related, auditing considerations. For example, long-term contracts may involve significant auditor attention with respect to revenue recognition, litigation or other contingencies, and may have an effect on other accounting estimates.

Communicating Key Audit Matters
The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters,"
The introductory language in this section of the auditor's report shall state that:

(a) Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements [of the current period]; and

(b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

Key Audit Matters Not a Substitute for Expressing a Modified Opinion

The auditor shall not communicate a matter in the Key Audit Matters section of the auditor's report when the auditor would be required to modify the opinion in accordance with ISA 705 (Revised) as a result of the matter.

Descriptions of Individual Key Audit Matters
The description of each key audit matter in the Key Audit Matters section of the auditor's report shall include a reference to the related disclosure(s),
if any, in the financial statements and shall address:

- 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.

Interaction between Descriptions of Key Audit Matters and Other Elements Required to Be Included in the Auditor's Report

A matter giving rise to a modified opinion in accordance with ISA 705 (Revised), or a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a 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 Key Audit Matters section of the auditor's report. Rather, the auditor shall:
(a) Report on these matter(s) in accordance with the applicable ISA(s);
and
(b) Include a reference to the Basis for Qualified (Adverse) Opinion or the Material Uncertainty Related to Going Concern section(s) in the Key Audit Matters section.

Form and Content of the Key Audit Matters Section in Other Circumstances

If the auditor determines, depending on the facts and circumstances of the entity and the audit, that there are no key audit matters to communicate, the auditor shall include a statement to this effect in a separate section of the auditor's report under the heading "Key Audit Matters."

Communication with Those Charged with Governance

The auditor shall communicate with those charged with governance:

(a) Those matters the auditor has determined to be the key audit matters;

or

(b) If applicable, depending on the facts and circumstances of the entity and the audit, the auditor's determination that there are no key audit matters to communicate in the auditor's report.

Evaluation of misstatements

During the completion stage of the audit, the effect of uncorrected misstatements must be evaluated by the auditor, as required by ISA 450 Evaluation of Misstatements Identified during the Audit. In the event that management refuses to correct some or all of the misstatements communicated by the auditor, ISA 450 requires that the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. Therefore a discussion with management is essential in helping the auditor to form an audit opinion.

ISA 450 also requires that the auditor shall communicate with those charged with governance about uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report.

Each of the matters included in the schedule of uncorrected misstatements will be discussed below and the impact on the audit report considered individually and in aggregate.

Important terms regarding misstatements

To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.

- **Factual misstatements** are misstatements about which there is no doubt.
- **Judgmental misstatements** are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.
- **Projected misstatements** are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn.

Misstatement which might be material by nature

The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than affect the evaluation include the extent to which the misstatement:

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
- Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;

- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management);

Auditor's work

– The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements.

– If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement

– Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with ISA 320 to confirm whether it remains appropriate in the context of the entity's actual financial results.

– The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:
  (a) The size and nature of the misstatements)
  (b) The effect of uncorrected misstatements related to prior periods

The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation.

The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

Technical article: Evaluation of misstatements

The completion stage of the audit is when the auditor reviews the work performed and considers the implications for the auditor's report. A crucial part of this review is the evaluation of misstatements found during the audit. This article describes and discusses the requirements of ISA 450, *Evaluation of Misstatements Identified during the Audit* and provides some examples of the application of the ISA in the context of the Advanced Audit and Assurance exam.

ISA 450 – OBJECTIVES AND DEFINITIONS

According to ISA 450, the objectives of the auditor are to evaluate:

- The effect of identified misstatements on the audit, and
- The effect of uncorrected misstatements, if any, on the financial statements

A misstatement occurs when something has not been treated correctly in the financial statements, meaning that the applicable financial reporting framework, namely IFRS, has not been properly applied. Examples of misstatement, which can arise due to error or fraud, could include:

- An incorrect amount has been recognised – for example, an asset is not valued in accordance with the relevant IFRS requirement.
- An item is classified incorrectly – for example, finance cost is included within cost of sales in the statement of profit or loss.
- Presentation is not appropriate – for example, the results of discontinued operations are not separately presented.
- Disclosure is not correct or misleading disclosure has been included as a result of management bias – for example, a contingent liability disclosure is missing or inadequately described in the notes to the financial statements.

SPECIFIC REQUIREMENTS AND APPLICATION OF ISA 450

ISA 450 requires that 'the auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial'.

The auditor should set a monetary benchmark below which misstatements are considered to be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. The application notes to ISA 450 make it clear that 'clearly trivial' is not another expression for 'not material.' The auditor will need to use judgement to decide whether matters are clearly trivial, and this may be affected by a range of issues including but not limited to the monetary size of the matter, for example, the level of audit risk being applied in the situation.

ISA 450 also requires that 'The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements.'

Simply put, this means that the auditor keeps a note of all misstatements (other than those which are clearly trivial), raises them with management and asks for the misstatements to be corrected in the financial statements.

It is useful, when evaluating misstatements and in making requests to management for misstatements to be corrected, to consider and apply the framework as laid out in ISA 450, which categorises misstatements as follows:

- **Factual misstatements** are misstatements about which there is no doubt. An example would be a clear breach of an IFRS requirement meaning that the financial statements are incorrect, for instance if a necessary disclosure is missing – for example, non-disclosure of EPS for a listed company.
- **Judgmental misstatements** are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate. There are of course many examples of using judgement in financial reporting, for instance, when determining the fair value of non-current assets, the level of disclosure necessary in relation to a contingent liability, or the recoverability of receivables.
- **Projected misstatements** are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn.

For the auditor it is important to distinguish between these types of misstatements in order to properly discuss them with management, and ask for the necessary corrections, where relevant, to be made. For example, with a factual misstatement, there is little room for negotiation with management, as the item has simply been treated incorrectly in the financial statements. With judgemental misstatement there is likely to be more discussion with management. The auditor will need to present their conclusion based on robust audit evidence, in order to explain the misstatement which has been uncovered, and justify a recommended correction of the misstatement.

With projected misstatements, because these are based on extrapolations of audit evidence, it is normally not appropriate for management to be asked to correct the misstatement. Instead, a projected misstatement should be evaluated to consider whether further audit testing is appropriate.

CORRECTION OF MISSTATEMENTS

Management is expected to correct the misstatements which are brought to their attention by the auditor. If management refuses to correct some or all of the misstatements, ISA 450 requires the auditor to obtain an understanding of management's reasons for not making the corrections, and to take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

EVALUATING THE EFFECT OF UNCORRECTED MISSTATEMENTS

The auditor is required to determine whether uncorrected misstatements are material, individually or in aggregate. At this point the auditor should also reassess materiality to confirm whether it remains appropriate in the context of the entity's actual financial results. This is to ensure that the materiality is based on up to date financial information, bearing in mind that when materiality is initially determined at the planning stage of the audit, it is based on projected or draft financial statements. By the time the auditor is evaluating uncorrected misstatements at the completion stage of the audit, there may have been many changes made to the financial statements, so ensuring the materiality level remains appropriate is very important.

Some misstatements may be evaluated as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than materiality for the financial statements as a whole. Examples include, but are not restricted to the following:

- Misstatements which affect compliance with regulatory requirements
- Misstatements which impact on debt covenants or other financing or contractual arrangements
- Misstatements which obscure a change in earnings or other trends
- Misstatements which affect ratios used to evaluate the entity's financial position, results of operations or cash flows
- Misstatements which increase management compensation

- Misstatements which relate to misapplication of an accounting policy where the impact is immaterial in the context of the current period financial statements, but may become material in future periods

COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

ISA 450 requires the auditor to communicate uncorrected misstatements to those charged with governance and the effect that they, individually or in aggregate, will have on the opinion in the auditor's report. The auditor's communication shall identify material uncorrected misstatements individually and the communication should request that uncorrected misstatements be corrected. The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, and possible implications in relation to future financial statements. Perhaps the key issue here is that that auditor should discuss the potential implications for the auditor's report, which is likely to contain a modified opinion, if material misstatements are not corrected as requested by the auditor.

In addition the auditor is required to request a written representation from management and, where appropriate, those charged with governance with regard to whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole.

DOCUMENTATION

Finally, ISA 450 requires certain documentation in relation to misstatements:

- The amount below which misstatements would be regarded as clearly trivial
- All misstatements accumulated during the audit and whether they have been corrected, and
- The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

This is an important part of the audit working papers, as it shows the rationale for the auditor's opinion in relation to material misstatements.

CONCLUSION

Candidates preparing for the Advanced Audit and Assurance exam should ensure that they are familiar with the requirements of ISA 450 as ultimately in forming an opinion on the financial statements the auditor must conclude on whether reasonable assurance has been obtained that the financial statements as a whole are free from material misstatements and this conclusion takes into account the auditor's evaluation of uncorrected misstatements.

Written by a member of the P7 examining team

Audit opinion & Audit Report

An exam focused overview

Misstatements in the F/S

1. Communicate to management and ask them to adjust
2. If they refuse , obtain an understanding of reasons for their refusal to adjust
3. Communicate to TCWG
4. If still uncorrected, opinion might be affected of they are material (can be material individually or in aggregate)
5. For listed client, QCR before issuing the audit report
    a) The reviewer will review the F/S, the proposed audit report and the working papers
    b) He will ensure adequate documentation for any judgments made by the auditor in making the opinion
    c) He will ensure adequate communication has been done with TCWG

An exam focused overview

Audit Opinion

Unmodified opinion

Auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Modified opinion (Qualified; Adverse; Disclaimer)

- Qualified (When an uncorrected misstatement or inability to get SAE is material)
- Adverse (When an uncorrected misstatement is material and pervasive)
- Disclaimer (When an inability to get SAE is material and pervasive)

Audit Opinion: uncorrected misstatements

Immaterial	Material - 2% of Total Assets - 5% of Profit before tax - 1% of Revenue - Material by nature!	Material & pervasive - Not confined to one element of F/S - One element BUT it's a substantial portion of the F/S - Related to a Disclosure which is fundamental to users' understanding
Unmodified opinion	Modified opinion *Qualified, 'Except for'*	Modified opinion *Adverse*
In our opinion, the financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of ABC Company as of December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.	*In our opinion,* ***except for*** *the effects of the matter described in the Basis of Qualified Opinion paragraph the financial statements present fairly, In all material respects, (or give a true and fair view of) the financial position of ABC Company as at December 31, 20X1 and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.*	*In our opinion, because of the significance of the matter discussed in the Basis of Adverse Opinion paragraph, the consolidated* ***financial statements do not present fairly*** *(or do not give a nature and fair view of) the financial position of ABC Company and its subsidiaries as at December 31, 20X1 and (of) their financial performance and their cash flows for the year then ended in accordance with International Financial Reporting Standards.*

Think Ahead

Audit Opinion: inability to get sufficient appropriate evidence

Immaterial	Material - 2% of Total Assets - 5% of Profit before tax - 1% of Revenue - Material by nature!	Material & pervasive - Not confined to one element of F/S - One element BUT it's a substantial portion of the F/S - Related to a Disclosure which is fundamental to users' understanding
Unmodified opinion	Modified opinion *Qualified, 'Except for'*	Modified opinion *Disclaimer*
In our opinion, the financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of ABC Company as of December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.	*In our opinion,* ***except for*** *the effects of the matter described in the Basis of Qualified Opinion paragraph the financial statements present fairly, In all material respects, (or give a true and fair view of) the financial position of ABC Company as at December 31, 20X1 and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.*	*Because of the significance, of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly,* ***we do not express an opinion*** *on the financial statements*

Think Ahead

An exam focused overview

Emphasis of matter paragraph (EOMP)
A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.
Circumstances where EOMP may be necessary

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action. Contingent liability disclosure
- To highlight a correctly given disclosure regarding the fact that the F/S have been made on an alternate (break up basis)
- Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.

Other Matter Paragraph(OMP)
A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report

Examples of circumstances in which an Other Matter Paragraph may be necessary

Prior Period Financial Statements Audited by a Predecessor Auditor

Prior Period Financial Statements Not Audited

Auditor's report on F/S prepared in accordance with a fair presentation framework

1. Title
2. Addressee
3. Opinion
4. Basis for opinion
5. Key Audit Matters
6. Other information in the document containing the F/S
7. Responsibilities of management & TCWG
8. Auditor's responsibilities for audit of F/S
9. Report on other legal and regulatory requirements
10. Engagement partner's name
11. Signatures
12. Auditor's address
13. Date

Impact of various issues on the audit report

1. Title
2. Addressee
3. Opinion: If modified, heading changes to name of modified opinion, wording of opinion changes
4. Basis for opinion:If modified, heading changes to Basis for Qualified/Adverse/Disclaimer; need to explain nature, amount, impact of issue and the relevant accounting standard
5. If needed, Material uncertainty re. going concern paragraph will be placed here.
6. Key Audit Matters
7. If needed, EOMP can be placed either here or before KAM
8. If needed, OMP will be placed here
9. Other information in the document containing the F/S: any uncorrected inconsistencies in other information will be explained here. This paragraph will then be moved from here to underneath the Basis for opinion paragraph.
10. Responsibilities of management & TCWG
11. Auditor's responsibilities for audit of F/S
12. Report on other legal and regulatory requirements
13. Engagement partner's name
14. Signatures
15. Auditor's address
16. Date

Questions on audit reports in Paper THE ADVANCED AUDIT & ASSURANCE EXAM typically fall into two distinct types: critical appraisal of an audit report that has already been written; or explanation of how matters will affect an audit opinion

Form of opinion

Unmodified opinion	The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.
Modified opinion	If the auditor: (a) concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or (b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor shall modify the opinion in the auditor's report in accordance with ISA 705 (Revised).

Key terms

Inability to obtain appropriate and sufficient evidence:

The auditor cannot obtain sufficient appropriate audit evidence on which to base the opinion. The auditor's inability to obtain sufficient appropriate audit evidence is also referred to as a limitation on the scope of the audit and could arise from:

- Circumstances beyond the entity's control (e.g. accounting records destroyed)
- Circumstances relating to the nature or timing of the auditor's work (e.g. the timing of the auditor's appointment prevents the observation of the physical inventory count).
- Limitations imposed by management (e.g. management prevents the auditor from requesting external confirmation of specific account balances).

Pervasiveness

Pervasive – A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:
(i) Are not confined to specific elements, accounts or items of the financial statements;
(ii) If so confined, represent or could represent a substantial proportion of the financial statements; or
(iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.

Pervasiveness is a matter that confuses many candidates as; once again, it is a matter that requires professional judgment. In this case the judgment is whether the matter is isolated to specific components of the financial statements, or whether the matter pervades many elements of the financial statements, rendering them unreliable as a whole.

The bottom line is that if the auditor believes that the financial statements may be relied upon in some part for decision making then the matter is material and not pervasive. If, however, they believe the financial statements should not be relied upon at all for making decisions then the matter is pervasive.

Material misstatement of the financial statements

They may arise in relation to:

- **The appropriateness of the selected accounting policies**. For example, the valuation of inventories at cost instead of the lower of cost or net realisable value as prescribed by IAS 2, Inventories.
- **The application of the selected accounting policies**. For example, the valuation of non-current assets is done using the cost model for one financial year, and in the next year the same assets are valued using the revaluation model. Furthermore, during the third year, the cost model is adopted to value the same non-current assets.
- **The appropriateness or adequacy of disclosures in the financial statements**. For example the financial statements of a manufacturing company prepared under IFRS, do not include all of the disclosures relating to revenue recognition and non-current assets

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:

a) The financial statements adequately disclose the significant accounting policies selected and applied;
b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
c) The accounting estimates made by management are reasonable;
d) The information presented in the financial statements is relevant, reliable, comparable, and understandable;
e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Unmodified opinion – The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.
If the auditor:

(a) Concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
(b) Is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor shall modify the opinion in the auditor's report in accordance with ISA 705.

Types of Modified Opinions

There are three types of modified opinions, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion.

The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
(b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Determining the Type of Modification to the Auditor's Opinion

		Form and Content of the Auditor's Report When the Opinion Is Modified
Qualified Opinion	The auditor shall express a qualified opinion when: (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.	the auditor shall use the heading "Qualified Opinion," the auditor shall state in the opinion paragraph that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph: (a) The financial statements present fairly, in all material respects (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework; or (b) The financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework. When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter(s) ..." for the modified opinion.
Adverse Opinion	The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.	the auditor shall state in the opinion paragraph that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion paragraph: (a) The financial statements do not present fairly (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework; or (b) The financial statements have not been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.

Disclaimer of Opinion	The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.	When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall state in the opinion paragraph that: (a) Because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion; and, accordingly. (b) The auditor does not express an opinion on the financial statements.

Basis for Opinion

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by ISA 700 (Revised):

1. Amend the heading "Basis for Opinion" to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and

2. Within this section, include a description of the matter giving rise to the modification.

If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures), the auditor shall include in the Basis for Opinion section a description and quantification of the financial effects of the misstatement, unless impracticable.

If it is not practicable to quantify the financial effects, the auditor shall so state in this section.

If there is a material misstatement of the financial statements that relates to qualitative disclosures, the auditor shall include in the Basis for Opinion section an explanation of how the disclosures are misstated.

If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:

- Discuss the non-disclosure with those charged with governance
- Describe in the Basis for Opinion section the nature of the omitted information; and
- include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.

When the auditor expresses a qualified or adverse opinion, the auditor shall amend the statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion to include the word "qualified" or "adverse", as appropriate.

When the auditor disclaims an opinion on the financial statements, the auditor's report **shall not** include these elements:

- A reference to the section of the auditor's report where the auditor's responsibilities are described; and
- A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the Basis for Opinion section the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof.

ISA 700: FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS

The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.	In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework: (a) The financial statements adequately disclose the significant accounting policies selected and applied; (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate; (c) The accounting estimates made by management are reasonable; (d) The information presented in the financial statements is relevant, reliable, comparable, and understandable; (e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and (Ref: Para. A4) (f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.
The auditor's evaluation as to whether the financial statements achieve fair presentation shall include consideration of: (a) The overall presentation, structure and content of the financial statements; and (a) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.	

Auditor's report

Title	The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor
Addressee	The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement.
Auditor's opinion	Heading "Opinion." The Opinion section of the auditor's report shall also: (a) Identify the entity whose financial statements have been audited; (b) State that the financial statements have been audited; (c) Identify the title of each statement comprising the financial statements; (d) Refer to the notes, including the summary of significant accounting policies; and (e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

	Wording *In our opinion, the accompanying financial statements present fairly, in all material respects, […] in accordance with [the applicable financial reporting framework]* ***or*** *In our opinion, the accompanying financial statements give a true and fair view of […] in accordance with [the applicable financial reporting framework]*
Basis for opinion	The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that: 1. States that the audit was conducted in accordance with International Standards on Auditing; 2. Refers to the section of the auditor's report that describes the auditor's responsibilities under the ISAs; 3. Includes 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 International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* (IESBA Code); and 4. States 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	Where applicable, the auditor shall report in accordance with ISA 570 (Revised)
Key Audit Matters	For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with ISA 701. *"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."* [*Description of each key audit matter in accordance with ISA 701.*]
Other information	Where applicable, the auditor shall report in accordance with ISA 720.
"Responsibilities of Management/TCWG for the Financial Statements."	This section of the auditor's report shall describe management's responsibility for: - Preparing the financial statements in accordance with the applicable financial reporting framework, 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; - Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

Auditor's responsibilities for the audit of F/S The description of the auditor's responsibilities for the audit of the financial statements shall be included: (a) Within the body of the auditor's report; (b) Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix; or (c) By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so	This section of the auditor's report shall: (a) 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. b) 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; and (c) State that misstatements can arise from fraud or error, and provide a definition or description of materiality in accordance with the applicable financial reporting framework. (d) State that, as part of an audit in accordance with ISAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and (e) Describe an audit by stating that the auditor's responsibilities are: ✓ To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; ✓ To design and perform audit procedures responsive to those risks; ✓ and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. ✓ To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. ✓ To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management. ✓ To 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 entity's ability to continue as a going concern. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the opinion. The auditor's conclusions are based on the audit evidence obtained p to the date of the auditor's report. However, future events or conditions may cause an entity to cease to continue as a going concern. ✓ To evaluate the overall presentation, structure and content of the financial statements, including the disclosures.

	The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall: - State that the auditor communicates 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 the auditor identifies during the audit; - For audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and - State that, from the matters communicated with those charged with governance, the auditor determines 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.
"Report on Other Legal and Regulatory Requirements"	In some jurisdictions, the auditor may have additional responsibilities to report on other matters that are supplementary to the auditor's responsibilities under the ISAs For example, the auditor may be asked to report certain matters if they come to the auditor's attention during the course of the audit of the financial statements. Alternatively, the auditor may be asked to perform and report on additional specified procedures, or to express an opinion on specific matters, such as the adequacy of accounting books and records, internal control over financial reporting or other information. Auditing standards in the specific jurisdiction often provide guidance on the auditor's responsibilities with respect to specific additional reporting responsibilities in that jurisdiction
Name of the Engagement Partner	
Signature of the auditor	
Auditor's address	
Date of the auditor's report	

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ISA 706 :EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT

Emphasis of Matter paragraph :A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Emphasis of Matter Paragraphs in the Auditor's Report

If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

- The auditor would not be required to modify the opinion in accordance with ISA 705 (Revised) as a result of the matter; and
- When ISA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report. (When ISA 701 applies, the use of Emphasis of Matter paragraphs is not a substitute for a description of individual key audit matters.)

There may be a matter that is not determined to be a key audit matter in accordance with ISA 701 (i.e., because it did not require significant auditor attention), but which, in the auditor's judgment, is fundamental to users' understanding of the financial statements (e.g., a subsequent event). If the auditor considers it necessary to draw users' attention to such a matter, the matter is included in an Emphasis of Matter paragraph in the auditor's report in accordance with this ISA.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

(b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and

(c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are

1. An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
2. A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
3. Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
4. A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.
5. When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.
6. When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events)

Other Matter paragraph – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Other Matter Paragraphs in the Auditor's Report

If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the auditor shall include an Other Matter paragraph in the auditor's report, provided:

(a) This is not prohibited by law or regulation; and

(b) When ISA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading.

Circumstances in Which an Other Matter Paragraph May Be Necessary

1. **Relevant to Users' Understanding of the Audit:** In the rare circumstance where the auditor is unable to withdraw from an engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a limitation on the scope of the audit imposed by management is pervasive,the auditor may consider it necessary to include an Other Matter paragraph in the auditor's report to explain why it is not possible for the auditor to withdraw from the engagement.

2. **Relevant to Users' Understanding of the Auditor's Responsibilities or the Auditor's Report:** Law, regulation or generally accepted practice in a jurisdiction may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon.

3. **Reporting on more than one set of financial statements:** An entity may prepare one set of financial statements in accordance with a general purpose framework (e.g., the national framework) and another set of financial statements in accordance with another general purpose framework (e.g., International Financial Reporting Standards), and engage the auditor to report on both sets of financial statements. If the auditor has determined that the frameworks are acceptable in the respective circumstances, the auditor may include an Other Matter paragraph in the auditor's report, referring to the fact that another set of financial statements has been prepared by the same entity in accordance with another general purpose framework and that the auditor has issued a report on those financial statements.

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

a. That the financial statements of the prior period were audited by the predecessor auditor;
b. The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
c. The date of that report.

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

Placement of EOMP and OMP

The placement of an Emphasis of Matter paragraph or Other Matter paragraph in the auditor’s report depends on the nature of the information to be communicated, and the auditor’s judgment as to the relative significance of such information to intended users compared to other elements required to be reported

EOMP:

1. immediately following the Basis of Opinion section to provide appropriate context to the auditor’s opinion : When the Emphasis of Matter paragraph relates to the applicable financial reporting framework,
2. May be presented either directly before or 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. The auditor may also add further context to the heading “Emphasis of Matter”, such as “Emphasis of Matter – Subsequent Event”, to differentiate the Emphasis of Matter paragraph from the individual matters described in the Key Audit Matters section

Other Matter Paragraphs

- When a Key Audit Matters section is presented in the auditor’s report and an Other Matter paragraph is also considered necessary, the auditor may add further context to the heading “Other Matter”, such as “Other Matter – Scope of the Audit”, to differentiate the Other Matter paragraph from the individual matters described in the Key Audit Matters section.
- 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.

Quality control procedures prior to issuing the audit report

ISA 220 *Quality Control for an Audit of Financial Statements* and ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Agreements* require that an engagement quality control reviewer shall be appointed for audits of financial statements of listed entities.

The audit engagement partner then discusses significant matters arising during the audit engagement with the engagement quality control reviewer.

The engagement quality control reviewer must review the financial statements and the proposed auditor's report, in particular focusing on the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's opinion is appropriate.

The audit documentation will be carefully reviewed, and the reviewer is likely to consider whether procedures performed in relation to risky balances were appropriate.

Any modification to the auditor's report will be scrutinised, and the firm must be sure of any decision to modify the report, and the type of modification made.

The engagement quality control reviewer should ensure that there is adequate documentation regarding the judgements used in forming the final audit opinion, and that all necessary matters have been brought to the attention of those charged with governance.

The auditor's report must not be signed and dated until the completion of the engagement quality control review.

Assurance & No-Assurance Engagements

Elements of an assurance engagement:

The definition of an assurance engagement is set out below but you should be familiar with it from your earlier auditing studies.

An **assurance engagement** is one where a professional accountant evaluates or measures a subject matter that is the responsibility of another party against suitable criteria, and expresses an opinion which provides the intended user with a level of assurance about the subject matter.

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

Each assurance engagement is classified on two dimensions:

Dimension 1	Dimension 2
Either a reasonable assurance engagement or a limited assurance engagement:	**Either an attestation engagement or a direct engagement**
Reasonable assurance: An Assurance engagement in which the Practioner reduces engagement risk to an acceptably low level in the circumstances of the engagement as the basis for the practitioner's conclusion. The practitioner's conclusion is expressed in a form that conveys the practitioner's opinion on the outcome of the measurement or evaluation of the underlying subject matter against criteria. **Limited assurance engagement:** An assurance engagement in which the practitioner reduces engagement risk to a level that	**Attestation engagement** Attestation engagement is an engagement in which a practitioner is appointed to issue a written communication to convey **a conclusion about the dependability of the assertion** from the accountant who performs the attestation engagement. It involves the following: – Examining, reviewing and performing agreed-upon procedures on the subject matter of an assertion – Issuing a written communication which expresses a conclusion about the reliability of written assertions prepared by a separate party Examples of attestation engagements – Verifying compliance with applicable laws and regulations. – Verifying internal control over financial reporting. – Verifying accounting for reporting on grants and contracts. – IT / system audit. – Examining financial forecasts and projections.

is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement as the basis for expressing a conclusion in a form that conveys whether, based on the procedures performed and evidence obtained, a matter(s) has come to the practitioner's attention to cause the practitioner to believe the subject matter information is materially misstated. The nature, timing and extent of procedures performed in a limited assurance engagement is limited compared with that necessary in a reasonable assurance engagement but is planned to obtain a level of assurance that is, in the practitioner's professional judgment, meaningful. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential.

In all cases, the practitioner is attesting that something is correct or fairly stated, from the work they have carried out.

Direct reporting engagement

A direct reporting engagement involves the following:

- **an independent examination of financial information** or other information that has been prepared for use by another party
- **engaging party may or may not make a written assertion or a set of assertions** (e.g. the engaging party may not state that the financial statements follow IAS. However, the examining party will still need to state which standards have been used)
- expressing an opinion in accordance with the agreed terms of the engagement

In a direct reporting engagement, the accountant is engaged to make enquiries into the accounts, organisation or activities of an entity.

The following table summarises the differences between an attestation engagement and a direct reporting engagement:

Attestation	Direct reporting
Assurance is provided on the written assertion, or set of assertions, made by one party, responsible for a matter of accountability, to another party.	Assurance is provided irrespective of whether the written assertion, or set of assertions, is made.
An audit of historical financial statements is an example of an attestation engagement where management makes an assertion e.g. the financial statements give a true and fair view and are free of material misstatements.	A direct reporting engagement is a kind of review engagement where opinion is provided but not always on the assertions made by the engaging party. Due diligence review is an example of a direct reporting engagement.
The assurance engagement risk is reduced to an acceptably low level.	The assurance engagement risk is reduced to a moderate level.
Comparatively extensive audit procedures are performed. Audit procedures generally comprise inspection, observation, confirmation, recalculation, re performance, analytical procedures and enquiry.	Comparatively limited audit procedures are performed. Procedures generally comprise enquiry and analytical procedures.
"Reasonable assurance" is provided.	"Limited assurance" is provided.
The opinion is expressed positively such as "in our opinion subject matter conforms in all material respects to criteria."	The opinion is expressed negatively such as "nothing has come to our attention that causes us to believe that subject matter does not conform in all material respects to criteria."

Audit-related services and an audit of historical financial statements

The following table summarises the difference between the two types of services:

Audit of historical financial statements	**Audit related services**
Audit provides reasonable assurance	**Review**: offers limited but negative assurance. **Agreed-upon procedures**: no assurance, only factual findings. **Compilation**: no assurance.
The auditor decides the scope of the work to be carried out in an audit.	**Review:** reviewer decides the scope of audit. **Agreed-upon procedures**: client entity decides the scope **Compilation**: client entity decides the scope of work.
In many countries, an audit is required by law (for large and public companies).	These services are not required by law.
Audit risk i.e. risk of mistakes, omissions or incorrect disclosures is lower in audit as compared to other engagements.	Risk of mistakes, omissions etc. is greater in review and other services than in audit, as generally less work is carried out or concentrated on certain areas.
Cost is higher than cost of review and other services.	Cost is significantly less than cost of audit.

Agreed-upon procedures

Agreed-upon procedures assignment*. In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. The recipients of the report must form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.*
Agreed upon procedures assignments are discussed in ISRS 4400 Engagements to perform agreed-upon procedures regarding financial information.

In an 'agreed-upon procedures' engagement, the auditor is **engaged to perform certain procedures which have been agreed between the auditor, the entity and any other interested third party** e.g. fraud investigations, verifying accounts payables, verifying accounts receivables and verifying non-financial data, such as waiting times in hospitals.
The procedures applied in an agreed-upon procedures engagement may include the following:

– enquiry and analysis
– recomputation, comparison and other clerical accuracy checks
– observation
– inspection
– obtaining confirmations

In an agreed upon procedure engagement, **auditor does not express his opinion**; instead **he gives only the factual findings.**

Agreed upon procedures engagements are required in the following circumstances for example:

- investigating fraud or irregularity
- verifying insurance claims
- reporting on non-financial data e.g. number of units sold

Compilation engagements- Compilation does not provide assurance; it only gives compiled information.

A compilation of financial statements is an accounting service:

- In which **an accountant prepares or assists in preparing financial statements**;
- **Without expressing any assurance** that the statements are accurate and complete.

In other words, it is an engagement which **requires more accounting expertise than auditing expertise** and involves collecting, classifying and summarising financial information. Data is presented in a manageable and understandable form without a requirement to test the assertions underlying that information.

Examples

- Preparing financial statements
- Calculating taxable income

Review engagements

Many clients (for whom audit is not compulsory) require some assurance on their financial statements. However, they do not want to incur the heavy cost of audit. For these clients, a review engagement may be the appropriate service to provide this assurance. This is because review provides limited assurance that the financial statements are reasonable and one can believe in them.

Generally, when a client approaches a bank for a loan, the bank asks for a review report.

THE ADVANCED AUDIT & ASSURANCE EXAM Specific

The objective of a review engagement is to enable the auditor to obtain moderate assurance as to whether the financial statements have been prepared in accordance with an identified financial reporting framework. This is defined in ISRE 2400
Engagements to Review Financial Statements.
In order to obtain this assurance, it is necessary to gather evidence using analytical procedures and enquiries with management. Detailed substantive procedures will not be performed unless the auditor has reason to believe that the information may be materially misstated.

The auditor should approach the engagement with a high degree of professional scepticism, looking for circumstances that may cause the financial statements to be misstated.

As a result of procedures performed, the auditor's objective is to provide a clear written expression of negative assurance on the financial statements. In a review engagement the auditor would state that 'we are not aware of any material modifications that should be made to the financial statements….'
This is normally referred to as an opinion of 'negative assurance'.

Negative assurance means that the auditor has performed limited procedures and has concluded that the financial statements appear reasonable. The user of the financial statements gains some comfort that the figures have been subject to review, but only a moderate level of assurance is provided. The user may need to carry out additional procedures of their own if they want to rely on the financial statements.

In comparison, in an audit, a high level of assurance is provided. The auditors provide an opinion of positive, but not absolute assurance. The user is assured that the figures are free from material misstatement and that the auditor has based the opinion on detailed procedures.

The objective of a review engagement is to enable a practitioner to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the practitioner's attention that causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework

The assurance provided in review engagements is limited and negative i.e. the practitioners (those carrying out review engagements) are required to state in their report whether anything has come to their attention that causes them to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework.

Negative assurance concentrates on the fact that the practitioner is stating that from the limited work he has carried out, everything looks reasonable and plausible. There is no detailed testing, hence using the phrase,**‘ nothing comes to our attention to believe that the accounts do not give a true and fair view’.**

The procedures to be performed in a review engagement will vary depending on the specific requirements of the engagement. They are generally based on:

– **gaining an understanding** of the client’s activities, including knowledge of the accounting practices of the industry or area in which the client operates
– **enquiry** into the entity’s accounting principles and practices, the entity’s procedure from recording of transactions and events to preparing the financial statements and all material assertions in the financial statements
– **analytical review** The whole premise behind a **review** is that the **auditor does not do the detailed testing** to gain positive assurance that the figures are true and fair. **He is just looking to ensure that they are plausible and reasonable under the circumstances.**

ISRE (International Standard on Review Engagements) 2400 Engagements to review financial statements contains guidance on review engagements.

ISRE 2400.7
For the purpose of expressing negative assurance in the review report, the practitioner should obtain sufficient appropriate evidence primarily through inquiry and analytical procedures to be able to draw conclusions.

ISRE 2400.8
The procedures required to conduct a review of financial statements should be determined by the practitioner having regard to the requirements of this ISRE, relevant professional bodies, legislation, regulation and, where appropriate, the terms of the review engagement and reporting requirements.

Many of the requirements of the ISRE are similar to the requirements of an audit.

Planning
Obtain knowledge of the business
Same materiality requirements
Using the work of others

Evidence
Document all important matters
Apply judgement in determining nature, timing and extent of procedures
Enquire about subsequent events
Extend procedures if material misstatements are suspected

Review of interim financial information performed by the independent auditor of the entity

This subject is covered by ISRE 2410 *Review of interim financial information performed by the independent auditor of the entity*.

Interim financial information is financial information that is prepared and presented in accordance with an applicable financial reporting framework and comprises either a complete or a condensed set of financial statements for a period that is shorter than the entity's financial year.

In many countries, listed companies are required to publish quarterly or half-yearly interim financial information which has been reviewed by a professional accountant. In order to comply with this, companies may appoint professional accountants (who may or may not be the company's auditors) to review the interim financial information.

The review of interim financial information enables the accountant to express a conclusion on whether, based on the review, anything has come to his attention that causes him to believe that the interim financial information has not been prepared, in all material respects, in accordance with an applicable financial reporting framework.

If, during the review, the accountant comes across matters that require modification in order for the information to be presented in conformity with the international financial reporting framework, he should communicate with the engaging party about the modifications required.

THE ADVANCED AUDIT & ASSURANCE EXAM Specific

The auditor should perform analytical procedures in order to discover unusual trends and relationships, or individual figures in the interim financial information, which may indicate a material misstatement.

Procedures should include the following:

- Comparing the interim financial information with anticipated results, budgets and targets as set by the management of the company.
- Comparing the interim financial information with:
  - Comparable information for the immediately preceding interim period,
  - The corresponding interim period in the previous year, and
  - The most recent audited financial statements.

- Comparing ratios and indicators for the current interim period with those of entities in the same industry.

- Considering relationships among financial and non-financial information. The auditor also may wish to consider information developed and used by the entity, for example, information in monthly financial reports provided to the senior management or press releases issued by the company relevant to the interim financial information.

- Comparing recorded amounts or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably

expected to exist based on the accountant's understanding of the entity and the industry in which the entity operates.
- Comparing disaggregated data, for example, comparing revenue reported by month and by product line or operating segment during the current interim period with that of comparable prior periods.

The auditor should obtain an understanding of the entity and its environment as it relates to both the interim review and final audit.

The key elements of the review will be:
Enquiries of accounting and finance staff
Analytical procedures
Ordinarily procedures would include:
- Reading the minutes of meetings of shareholders, those charged with governance and other appropriate committees
- Considering the effect of matters giving rise to a modification of the audit or review report, accounting adjustments or unadjusted misstatements from previous audits
- If relevant, communicating with other auditors auditing different components of the business
- Analytical procedures designed to identify relationships and unusual items that may reflect a material misstatement
- Reading the interim financial information and considering whether anything has come to the auditors' attention indicating that it is not prepared in accordance with the applicable financial reporting framework
- Agreeing the interim financial information to the underlying accounting records

Auditors should make enquiries of members of management responsible for financial and accounting matters about:
- Whether the interim financial information has been prepared and presented in accordance with the applicable financial reporting framework
- Whether there have been changes in accounting policies
- Whether new transactions have required changes in accounting principle
- Whether there are any known uncorrected misstatements
- Whether there have been unusual or complex situations, such as disposal of a business segment
- Significant assumptions relevant to fair values
- Whether related party transactions have been accounted for and disclosed correctly
- Significant changes in commitments and contractual obligations
- Significant changes in contingent liabilities including litigation or claims
- Compliance with debt covenants
- Matters about which questions have arisen in the course of applying the review procedures
- Significant transactions occurring in the last days of the interim period or the first days of the next
- Knowledge or suspicion of any fraud
- Knowledge of any allegations of fraud Knowledge of any actual or possible non-compliance with laws and regulations that could have a material effect on the interim financial information
- Whether all events up to the date of the review report that might result in adjustment in the interim financial information have been identified
- Whether management has changed its assessment of the entity being a going concern

The auditor should evaluate discovered misstatements individually and in aggregate to see if they are material.
The auditor should obtain **written representations** from management that it acknowledges its responsibility for the design and implementation of internal control, that the interim financial information is prepared and presented in accordance with the applicable financial reporting framework and that the effect of uncorrected misstatements are immaterial (a summary of these should be attached to the representations). The auditor should also obtain representations that all **significant facts** relating to **frauds or non-compliance with law and regulations** has been disclosed to the auditor and that all **significant subsequent events** have been disclosed to the auditor.

The auditor should read the other information accompanying the interim financial information to ensure that it is not inconsistent with it.
If the auditors believe a matter should be adjusted in the financial information, they should **inform management** as soon as possible. If management does not respond within a reasonable time, then the auditors should inform those charged with governance. If they do not respond, then the auditor should consider whether to modify the report or to withdraw from the engagement and the final audit if necessary. If the auditors uncover fraud or non-compliance with laws and regulations, they should communicate that promptly with the **appropriate level of management**. The auditors should communicate matters of interest arising to those charged with governance.

Due diligence review

Due diligence reviews are a specific type of review engagement. A typical due diligence engagement is where an advisor (often an audit firm) is engaged by one company planning to take over another to perform an assessment of the material risks associated with the transaction (including validating the assumptions underlying the purchase), to ensure that the acquirer has all the necessary facts and that the perceived business opportunities are in fact real. This is important when determining purchase price.
Similarly, due diligence can also be requested by sellers.

An accountant may be asked to perform a due diligence review of the company, unit or other assets, as the case may be acquired in mergers and acquisitions. The accountant is supposed to identify risks such as the risk of non-disclosure of any relevant information and non-disclosure of any liability. The accountant can review target companies and comment on whether it is worth investing into these companies.

- Financial due diligence (a review of the financial position and obligations of a target to identify such matters as covenants and contingent obligations)
- Operational and IT due diligence (extent of operational and IT risks, including quality of systems, associated with a target business)
- People due diligence (key staff positions under the new structure, contract termination costs and cost of integration)
- Regulatory due diligence (review of the target's level of compliance with relevant regulation)
- Environmental due diligence (environmental, health and safety and social issues in a target)

Matters to be considered before accepting a due diligence assignment

1. **Competency of firm**: the audit firm should have the experience and skill to perform the review
2. **Independence issues**: as required in any assurance assignment, the accountant should be independent of both the parties
3. **Sufficiency of resources**: whether the firm has adequate manpower to perform the engagement
4. **Degree of confidentiality:** who the assignment will be performed for and who will see the results
5. **Scope of work:** what areas are to be concentrated on
6. **Purpose of the acquisition** e.g. whether the acquiring company is interested in acquiring the company (i.e. the share capital) or its trading assets. This is because the auditor will accordingly concentrate his work on that particular area, if any.
7. **Planning due diligence assignments.** In due diligence assignments, the scope of the work should be written down in the engagement letter and agreed to by both the accountant and the client. The engagement letter should also include the following:

- scope of work
- a clear demarcation of the responsibilities of the management and the accountant
- a clarification of interim report requirements
- confidentiality

Apart from the usual considerations of the audit / review plan, **a due diligence plan should include preparing a list of required information and the people to be interviewed**

In due diligence, the accountant analyses the information supplied by the target company and interviews a member of the management of the target company. In order to do this more effectively, the required information and interviewees should be identified well in advance and included in the plan. The target company needs to be informed well in advance about the required information and the interviewees required so that the company can make these resources available.

In a review engagement, the auditor will rely more heavily on procedures such as **enquiry and analytical review** than on more detailed substantive testing.

A typical due diligence review could include enquiries into:
- Structure, including how the target is owned and constituted and what changes will be necessary
- Financial health, based on a detailed examination of past financial statements and an analysis of the existing asset base
- Credibility of the owners, directors and senior managers, including validation of the career histories of all the main players in the business
- Future potential, reflected in the strengths of its products or services and the probability of earnings growth over the medium to long term
- Assessment of the risk to the acquiring business, in terms of their markets, strategy and likely future events
- The business plan, in terms of how realistic it is, how solid the assumptions used are and how well it conveys the potential

Extracted from past exams

Need of due diligence/ Purpose of a 'due diligence' review

1. Before purchasing a company, it is crucial that the purchaser undertake a comprehensive survey of the business in order to avoid any operational or financial surprises post-acquisition. Due diligence can simply be seen as 'fact finding', and as a way to minimise the risk of making a bad investment

2. Investigative due diligence is the process by which information is gathered about a target company, for the purpose of ensuring that the acquirer has full knowledge of the operations, financial performance and position, legal and tax situation, as well as general commercial background. Essentially the aim is to uncover any 'skeletons in the closet' and therefore to reveal any potential problem areas before a decision regarding the acquisition is made.

3. Verification of specific management representations: the vendor may make representations to the potential acquirer which it is essential to verify.

4. Identification of assets and liabilities: From an accounting perspective it is crucial that all of the assets of the target company are identified. This is important because internally generated intangibles such as customer databases, trade dress, and brand names are unlikely to be recognised in the individual company statement of financial position (balance sheet), but should be identified and valued for the purpose of calculating goodwill on acquisition. As these assets are, by definition, without physical substance, only a detailed due diligence investigation will uncover them.

As well as being important for the goodwill calculation, it is crucial to identify these assets as they represent 'hidden wealth' within the target company, and should be taken into account when negotiating the acquisition price.

5. Contingent liabilities must also be identified, as the acquirer will need to understand the likelihood of the liability crystallising, and the potential financial consequence.

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6. Operational issues: One of the key benefits of due diligence is to discover problems or risks within the entity. These risks may not necessarily arise in the context of a contingent liability, but could instead be operational issues such as high staff turnover, or the need to renegotiate contract terms with suppliers or customers. The directors of the acquiring company will need to carefully consider whether such matters constitute deal breakers, in which case the investment would be considered too risky and so would not go ahead. Alternatively, the risks uncovered could be useful in negotiation to reduce the consideration paid, or the target company could be asked to provide assurance that these problems will be resolved pre acquisition.

7. Acquisition planning: The due diligence investigation will also assess the commercial benefits, and potential drawbacks, of the acquisition. On the positive side, it will highlight matters such as expected operational synergies to be created post acquisition, and potential economies of scale to be exploited. On the downside there will be acquisition expenses to pay, costs in terms of reorganisation and possible redundancies, as well as the important but hard to quantify issue of change management. The due diligence provider may be able to offer recommendations as to the best way to integrate the new company into the group.

8. Management involvement: Due diligence investigations can be performed internally, by the directors of the acquiring company. However, this can be time consuming, and the directors may lack sufficient specialist knowledge to perform the investigation. Therefore one of the purposes of an externally provided due diligence service is to reduce time spent by the directors on fact finding, leaving more time to focus on strategic matters to do with the acquisition and on running the existing group.

9. Credibility: An external investigation will also provide an independent, impartial view on the situation, enhancing the credibility of the investment decision, and the amount paid for the investment.

Scope of a due diligence assignment compared to an audit

When conducting a due diligence assignment, the scope is focused, as discussed above, primarily on fact finding. This means that although the most recent set of financial statements will form a crucial source of information, the investigation will draw on a much wider range of sources of information, including:

- Several years prior financial statements
- Management accounts
- Profit and cash flow forecasts
- Any business plans recently prepared
- Discussions with management, employees and third parties.

The aim of due diligence, in contrast to an audit, is NOT to provide assurance that financial data is free from material misstatement, but rather to provide the acquirer with a set of information that has been reviewed. Consequently no detailed audit procedures will be performed unless there are specific issues which either cause concern, or have been specifically selected for further verification.

For example, the acquirer may specifically request that the due diligence exercise provides an estimate of the valuation of acquired intangible assets, as discussed above.

The type of work performed will therefore be quite different, as a due diligence investigation will primarily use analytical procedures as a means of gathering information. Very few, if any substantive procedures would be carried out, unless they had been specifically requested by the client.

Due diligence is much more 'forward looking' than an audit. Much of the time during a due diligence investigation will be spent assessing forecasts and predictions. In comparison audit procedures only tend to cover future events if they are directly relevant to the yearend financial statements, for example, contingencies, or going concern problems.

In contrast to an audit, when it is essential to evaluate systems and controls, the due diligence investigation will not conduct detailed testing of the accounting and internal control systems, unless specifically requested to do so.

Difference between due diligence and audit

Requirements
Year end audits are legally required for all limited companies exceeding the minimum audit thresholds. They are also subject to strict regulations in the guise of International Standards of Auditing.

Due diligence is initiated at the request of directors and subject to fewer prescribed rules. An outline of the processes that should be followed can be found in: ISRE 2400 Engagements to Review Financial Statements; ISRS 4400 Engagements to Perform Agreed upon Procedures Regarding Financial Information; ISAE 3400 The Examination of Prospective Financial Information; and ISAE 100 Assurance Engagements.

Audience
An audit opinion is offered to the shareholders of the business subject to audit.
In contrast, the reports from due diligence engagements are provided to the directors of the company.

Form of Assurance
The opinion offered on an audit is one of reasonable assurance. This means that sufficient, appropriate evidence has been gathered to support an opinion as to whether the accounts are free from material misstatement.

Absolute assurance cannot be given for reasons such as: the use of accounting estimates; the nature of fraud (i.e. it is hidden); and the necessary use of audit sampling.

As the timescale for a due diligence review is often relatively short but wide in scope clients may not always request the expression of an opinion. However the accountant will be engaged to report upon certain criteria requested specifically by the client. If sought, the assurance offered would be limited assurance.

Wording of Opinion
In an audit report a positive statement of opinion is offered as to whether the accounts are – or are not – a true and fair representation of the position and performance of the business under scrutiny.

In a limited assurance report a negative statement of opinion is given. This indicates whether anything has come to light during the review to indicate a departure from the criteria initially agreed with the client.

Evidence
During an audit evidence is usually gathered using a mixture of analytical review, enquiry, inspection of documentation, observation of procedures, and recompilations of certain balances.

During due diligence evidence is restricted, at least initially, to analytical review and enquiry. Further corroborative evidence might be sought if any material concerns were identified.

Due diligence conclusion

Due diligence is a specific example of a direct reporting assurance engagement. The form of the report issued in this type of engagement is covered by ISAE 3000 *Assurance Engagements other than Audits or Reviews of Historical Financial Information*, and ISRE 2400 *Engagements to Review Historical Financial Statements* also contains relevant guidance.

The main difference between a review report and an audit report is the level of assurance that is given. In a review report a conclusion is expressed in a negative form. The conclusion would start with the wording 'based on our review, nothing has come to our attention...'
This type of conclusion is used because the nature of a due diligence review is that only limited assurance has been obtained over the subject matter. The procedures used in a review engagement are mainly enquiry and analytical review which can only provide limited assurance.

In comparison, in an audit of historical information, the auditor will use a wide variety of procedures to obtain evidence to give reasonable assurance that the financial statements are free from material misstatement. This means that an opinion expressed in a positive form can be given.

Prospective Financial Information

Basic Understanding

Forecasts: A financial forecast consists of prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and cash flows.

Projections: A financial projection consists of prospective financial statements that present, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and cash flows. A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation, as in response to a "what if?" scenario.

The key difference between a forecast and a projection is the nature of the assumptions. In a forecast, the assumptions represent the company's expectations of actual future events. A projection is used when the assumptions desired are not those believed to be most likely (essentially, the "what if?"scenario).

Definitions

Prospective financial information (PFI):'financial information based on assumptions about events that may occur in the future and possible actions by an entity.'

'Assumptions about future events' can be in the form of a forecast or a projection, or a combination of both.
Assumptions for a probable future event are highly subjective in nature and can vary from situation to situation.

'**A forecast** means PFI prepared on the basis of assumptions as to future events which the management expects to take place and the actions the management expects to take as of the date the information is prepared (best-estimate assumptions).'

A projection means prospective financial information prepared on the basis of:

- Hypothetical assumptions about future events and management actions which are not necessarily expected, e.g. entities in a start-up phase or considering a major change in the nature of operations or
- A mixture of best-estimate and hypothetical assumptions.

A forecast is usually made for a period of no more than one year. Unlike a forecast, a projection is made generally for a period of more than one year. Usually, it is made for the period ranging from two to twenty years.
There are two other terms commonly associated with PFI:

Hypothetical illustration. PFI based on assumptions about uncertain future events and management actions which have not yet been decided on.

Target. PFI based on assumptions about the future performance of the entity.

Listed companies should have procedures that allow them to generate reliable PFI, compare it to market expectations, publish it when necessary and subsequently report actual performance against it.

Prospective financial information can include financial statements or one or more elements of financial statements and may be prepared:

(a) As an internal management tool, for example, to assist in evaluating a possible capital investment; or

(b) For distribution to third parties in, for example:

   (i) A prospectus to provide potential investors with information about future expectations.

   (ii) An annual report to provide information to shareholders, regulatory bodies and other interested parties.

   (iii) A document for the information of lenders which may include, for example, cash flow forecasts.

Matters to consider before accepting the assignment

- The exact components of the prospective financial information
- The form of the assurance report that is required – in an assurance engagement the nature and wording of the expected opinion should be discussed.
- The intended recipient of the report
- Limiting liability (if applicable)
- Deadlines
- Availability of evidence
- Professional regulation – firm should discuss the kind of procedures that will be undertaken, and confirm that they will be complying with relevant professional guidance, for example: ISAE 3000 *Assurance Engagements other than Audits or Reviews of Historical Financial Information and* ISAE 3400 *The Examination of Prospective Financial Information*
- Engagement administration: fee, personnel to be assigned to the assignment, complaints procedure

Matters to consider and include in the term of engagement for prospective financial information

Management's responsibilities	The terms of the engagement should set out management's responsibilities for the preparation of the business plan and forecast financial statements, including all assumptions used, and for providing the auditor with all relevant information and source data used in developing the assumptions. This is to clarify the roles and reduce the scope for any misunderstanding.
The intended use of the report , for example, is it intended for internal or external use?	This will establish the potential liability to third parties, and help to determine the need and extent of any liability disclaimer that may be considered necessary.
The elements to be included in the review and report	The extent of the review should be agreed. For example, determine whether they are being asked to report just on the forecast financial statements. This will help to determine the scope of the work involved and its complexity.
The period covered by the forecasts	This should be confirmed when agreeing the terms of the engagement, as assumptions become more speculative as the length of the period covered increases, making it more difficult to substantiate the acceptability of the figures, and increasing the risk of the engagement.

The nature of the assumptions used	It is crucial to determine the nature of assumptions, especially whether the assumptions are based on best estimates or are hypothetical. This is important because ISAE 3400 *The Examination of Prospective Financial Information* states that the auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.
The planned contents of the assurance report	The engagement letter should confirm the planned elements of the report to be issued, to avoid any misunderstanding with management. In particular, it clarify that their report will contain a statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information, and an opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework

Level of assurance provided

Prospective financial information is difficult to give assurance about because it is **highly subjective** and this makes it a difficult area to examine and report on. Hence the level of assurance provided is **negative**, as opposed to external audits, which examine historical financial information, and where the assurance provided is reasonable.

Guidance on reporting on it is given in ISAE 3400 *the examination of prospective financial information*.
The ISAE suggests that the auditor express an opinion including:

– A statement of **negative assurance** as to whether the **assumptions** provide a reasonable basis for the prospective financial information.
– An opinion as to whether the prospective financial information is **properly prepared** on the basis of the assumptions and the relevant reporting framework.
– Appropriate **caveats as to the achievability** of the forecasts.

Due to the nature of PFI, the audit firm will be unable to conclude on whether the results forecast will be achieved. Also there may be insufficient evidence available to conclude that the assumptions are free from material misstatement. Therefore, the audit firm can generally only provide a limited level of assurance.

The audit firm will normally provide negative assurance. This means they will state that "nothing has come to their attention" which causes them to believe that the assumptions are not a reasonable basis for the forecast.

<u>Examination procedures</u>

General:

- The auditor should obtain sufficient appropriate evidence as to whether management's *assumptions* on which the PFI is based are *not unreasonable*.
- The auditor should obtain *a sufficient knowledge of the business* to be able to evaluate whether the assumptions are justified.
- The auditor should review whether information is *properly prepared on the basis of the assumptions*.
- The auditor should review whether the information is *properly presented* and all material assumptions are *adequately disclosed*.
- The auditor should review whether the PFI is prepared on a *consistent basis with historical financial statements*, using appropriate accounting policies. The historical information will be used as a yardstick to assess the assumptions underlying the information.
- Obtain backing schedules for the information, cast and ensure they are numerically accurate. Re-perform calculations to confirm the arithmetic accuracy of the forecast financial statements.
- Obtain management representation with regard to the completeness and accuracy of information and assumptions used. Also this should contain a statement that it is management's responsibility to produce the information.
- Identify and document internal controls over the process. Consider the role played by the internal audit department.
- Consider the accuracy of forecasts prepared in prior periods by comparison with actual results and discuss with management the reasons for any significant variances.
- Perform analytical procedures to assess the reasonableness of the forecast financial statements. For example, finance charges should increase in line with the additional finance being sought.
- Consider the reasonableness of forecast trends in the light of auditor's knowledge of business and the current and forecast economic situation and any other relevant external factors.
- Whether the forecast under review is based on forecasts regularly prepared for the purpose of management or whether it has been separately and specially prepared for the immediate purpose
- Whether the forecast under review represents the management's best estimate of results which they reasonably believe can and will be achieved rather than targets which the management have set as desirable
- The extent to which profits are derived from activities having a proven and consistent trend and those of a more irregular, volatile or unproven nature
- How the forecast takes account of any material extraordinary items and prior year adjustments, their nature, and how they are presented

- Whether adequate provision is made for foreseeable losses and contingencies and how the forecast takes account of factors which may cause it to be subject to a high degree of risk, or which may invalidate the assumptions

Specific matters

The following list of procedures may also be relevant when assessing prospective financial information. The auditor should undertake the review procedures discussed above in addition to these.

Profit forecasts

Verify projected **income figures to suitable evidence. This may involve:

- Comparison of the basis of projected income to similar existing projects in the firm
- Review of current market prices for that product or service

Verify projected **expenditure figures to suitable evidence. There is likely to be more evidence available about expenditure in the form of:

- Quotations or estimates provided to the firm
- Current bills for things such as services which can be used to reliably estimate
- Market rate prices, for example, for advertising
- Interest rate assumptions can be compared to the bank's current rates
- Costs such as depreciation should correspond with relevant capital expenditure projections

Capital expenditure

The auditor should check the capital expenditure for **reasonableness**. For example, if the projection relates to buying land and developing it, it should include a sum for land.

Projected costs should be **verified to estimates and quotations where possible

The projections can be reviewed for **reasonableness, including a comparison with prevailing **market rates** where such information is available (such as for property)

Cash forecasts

The auditors should review cash forecasts to ensure the **timings involved are **reasonable**.

The auditor should check the cash forecast for **consistency with any profit forecasts (income/expenditure should be the same, just at different times)

Forensic Accounting

Forensic accounting is the term used to describe the type of engagement. It is the whole process of carrying out a forensic investigation, including preparing an expert's report or witness statement, and potentially acting as an expert witness in legal proceedings.

Forensic investigation is a part of a forensic accounting engagement. Forensic investigation is the process of gathering evidence so that the expert's report or witness statement can be prepared. It includes forensic auditing, but incorporates a much broader range of investigative techniques, such as interviewing witnesses and suspects, imaging or recovering computer files including emails, physical searches of premises etc.

Forensic auditing is the application of traditional auditing procedures and techniques in order to gather evidence as part of the forensic investigation.

Objectives of a forensic investigation

- The first objective is to decide if a deliberate fraud has actually taken place.
- Secondly, the investigation will aim to discover the perpetrator(s) of the fraud, and ultimately to assist in their prosecution. The investigation will gather evidence, which may include an interview with the suspected fraudster, which can then be used in criminal procedures against the individual(s) concerned.
- Thirdly, the investigation should quantify the financial loss

TYPES OF INVESTIGATION

The forensic accountant could be asked to investigate many different types of fraud. It is useful to categorise these types into three groups to provide an overview of the wide range of investigations that could be carried out. The three categories of frauds are corruption, asset misappropriation and financial statement fraud.

Corruption

There are three types of corruption fraud: conflicts of interest, bribery, and extortion. Research shows that corruption is involved in around one third of all frauds.

- In a conflict of interest fraud, the fraudster exerts their influence to achieve a personal gain which detrimentally affects the company. The fraudster may not benefit financially, but rather receives an undisclosed personal benefit as a result of the situation. For example, a manager may approve the expenses of an employee who is also a personal friend in order to maintain that friendship, even if the expenses are inaccurate.
- Bribery is when money (or something else of value) is offered in order to influence a situation.
- Extortion is the opposite of bribery, and happens when money is demanded (rather than offered) in order to secure a particular outcome.

Asset misappropriation

By far the most common frauds are those involving asset misappropriation, and there are many different types of fraud which fall into this category. The common feature is the theft of cash or other assets from the company, for example:

- Cash theft – the stealing of physical cash, for example petty cash, from the premises of a company.
- Fraudulent disbursements – company funds being used to make fraudulent payments. Common examples include billing schemes, where payments are made to a fictitious supplier, and payroll schemes, where payments are made to fictitious employees (often known as 'ghost employees').
- Inventory frauds – the theft of inventory from the company.
- Misuse of assets – employees using company assets for their own personal interest.

Financial statement fraud

This is also known as fraudulent financial reporting, and is a type of fraud that causes a material misstatement in the financial statements. It can include deliberate falsification of accounting records; omission of transactions, balances or disclosures from the financial statements; or the misapplication of financial reporting standards. This is often carried out with the intention of presenting the financial statements with a particular bias, for example concealing liabilities in order to improve any analysis of liquidity and gearing.

Forensic accounting engagements are agreed-upon procedures engagements, not assurance engagements. The forensic accountant will not provide an assurance opinion – that is the role of the auditor when reviewing the amount of loss included in the financial statements.

This will normally involve determining an appropriate value or quantifying a loss as discussed above; this is quite distinct from an assurance engagement in which the engagement team would review an amount determined by the client.

As an agreed-upon procedures engagement, the forensic accountant will normally prepare a report for the client that sets out their findings, based on the scope agreed in the engagement letter. This report may be addressed to management, often in the case of a fraud, or to the insurer.

It may be that a witness statement/report for submission to the court/arbitrator is required in addition to or instead of a report to the client.

Stages Involved

Accepting the investigation	The forensic accountant must initially consider whether their firm has the necessary skills and experience to accept the work. Forensic investigations are specialist in nature, and the work requires detailed knowledge of fraud investigation techniques and the legal framework. Investigators must also have received training in interview and interrogation techniques, and in how to maintain the safe custody of evidence gathered. Additional considerations include whether or not the investigation is being requested by an audit client. If it is, this poses extra ethical questions, as the investigating firm would be potentially exposed to self-review, advocacy and management threats to objectivity. Unless robust safeguards are put in place, the firm should not provide audit and forensic investigation services to the same client. Commercial considerations are also important, and a high fee level should be negotiated to compensate for the specialist nature of the work, and the likely involvement of senior and experienced members of the firm in the investigation.
Planning the investigation	Planning will commence with a meeting with the client in which the engagement team will develop an understanding of the issue/events (the fraud, theft etc) and actions taken by the client since it occurred. A key part of planning is to confirm exactly what format the output is required in, and exactly what matters are required to be covered within it. At this stage any key documentation will be obtained and scrutinised – for example, the insurance policy, the partnership agreement, the evidence that led to the discovery of the fraud, etc. The team will agree with the client, what access to other information or personnel will be required and this will be arranged. Based on the above, the team will design procedures that enable them to meet the requirements of the client, as agreed. This may or may not include test of controls, depending on the circumstances. There would be no need to tests control when valuing a business for a matrimonial dispute. However, testing controls will be key to determining how a fraud took place. The investigating team must carefully consider what they have been asked to achieve and plan their work accordingly. The objectives of the investigation could include: – Identifying the type of fraud, its duration, and how it was committed – Identifying the parties involved in the fraud – Quantifying the financial loss suffered due to the fraud – Gathering evidence to be used in court proceedings – Providing recommendations to avoid the recurrence of the fraud The investigators should also consider the best way to gather evidence – the use of computer assisted audit techniques, for example, is very common in fraud investigations.

Gathering evidence	Forensic engagements will include a detailed and wholesale review of all documentation and electronic evidence available. The opinion given by the expert accountant must be reasoned, and backed up by evidence. Their opinion cannot be objective if only based on what they are told; they must corroborate that information. To be awarded marks in the exam, your procedures cannot be vague. They must be specific enough that the engagement team could actually follow your instructions. For example, it would not be sufficient to write 'interview the suspect'. You must suggest questions that should be asked of the suspect in interview, depending on the circumstances in the scenario. For example, the suspect could be asked to explain their job role and what access that gives them to systems, cash, inventory etc. This also applies when recommending enquires of or discussions with management – it must be clear in your answer what it is the engagement team should ask of them, eg have they informed the police, has the suspect been suspended, have they informed the insurer etc. Equally it is not sufficient to suggest the use of computer assisted auditing techniques (CAATs). You must specify how the CAATs could be used. For example, data matching bank accounts used for paying suppliers with bank accounts for paying employees, exception reports identifying employees who are not taking holiday, etc. In order to design appropriate procedures you must identify the type of forensic accounting engagement, and the specific type of fraud, insurance or negligence claim. For example, quantifying the theft of goods will be very different from quantifying a loss from payroll or 'ghost employee' fraud or loss of profits following a business interruption (as discussed above). *In order to gather detailed evidence, the investigator must understand the specific type of fraud that has been carried out, and how the fraud has been committed. The evidence should be sufficient to ultimately prove the identity of the fraudster(s), the mechanics of the fraud scheme, and the amount of financial loss suffered. It is important that the investigating team is skilled in collecting evidence that can be used in a court case, and in keeping a clear chain of custody until the evidence is presented in court.* If any evidence is inconclusive or there are gaps in the chain of custody, then the evidence may be challenged in court, or even become inadmissible. Investigators must be alert to documents being falsified, damaged or destroyed by the suspect(s). Evidence can be gathered using various techniques, such as: • Testing controls to gather evidence which identifies the weaknesses, which allowed the fraud to be perpetrated • Using analytical procedures to compare trends over time or to provide comparatives between different segments of the business • Applying computer assisted audit techniques, for example to identify the timing and location of relevant details being altered in the computer system • Discussions and interviews with employees • Substantive techniques such as reconciliations, cash counts and reviews of documentation The ultimate goal of the forensic investigation team is to obtain a confession by the fraudster, if a fraud did actually occur. For this reason, the investigators are likely to avoid deliberately confronting

	the alleged fraudster(s) until they have gathered sufficient evidence to extract a confession. The interview with the suspect is a crucial part of evidence gathered during the investigation. With reference to court proceedings (see below) evidence may also be gathered to support other issues which would be relevant in the event of a court case. Such issues could include: • The suspect's motive and opportunity to commit fraud • Whether the fraud involved collusion between several suspects • Any physical evidence at the scene of the crime or contained in documents • Comments made by the suspect during interviews and/or at the time of arrest • Attempts to destroy evidence. **Audit procedures examples-to be read NOT learnt!** The specific procedures which would be performed as part of a forensic audit will depend on the specific nature of the investigation. However, using a fraud investigation as an example, the following would normally apply. • Develop a profile of the entity under investigation including its personnel • Identify weaknesses in internal control procedures and basic record keeping, e.g. banker conciliations not performed • Perform trend analysis and analytical procedures to identify significant transactions and significant variations from the norm • Identify changes in patterns of purchases/sales, particularly where a limited number of suppliers/customers are involved • Identify significant variations in consumption of raw materials and consumables, particularly where consumption appears excessive • Identify unusual accounts and account balances, e.g. closing credit balances on debit accounts and *vice versa* • Review accounting records for unusual transactions and entries, e.g. large numbers of accounting entries between accounts, transactions not executed at normal commercial rates • Review transaction documentation (e.g. invoices) for discrepancies and inconsistencies • Once identified trace the individual responsible for fraudulent transactions • Obtain information regarding all responsibilities of the individual involved • Inspect and review all other transactions conducted by the individual of a similar nature • Consider all other aspects of the business which the individual is involved with and perform further analytical procedures targeting these areas to identify any additional discrepancies
Reporting	The client will expect a report containing the findings of the investigation, including a summary of evidence and a conclusion as to the amount of loss suffered as a result of the fraud. The report will also discuss how the fraudster set up the fraud scheme, and which controls, if any, were circumvented. It is also likely that the investigative team will recommend improvements to controls within the organization to prevent any similar frauds occurring in the future
Court proceedings	The investigation is likely to lead to legal proceedings against the suspect, and members of the investigative team will probably be involved in any resultant court case. The evidence gathered during the investigation will be presented at court, and team members may be called to court to describe the evidence they have gathered and to explain how the suspect was identified. It is imperative that the members of the investigative team called to court can present their evidence clearly and professionally, as they may have to simplify complex accounting issues so that non-accountants involved in the court case can understand the evidence and its implications.

	THE ROLE OF AN EXPERT WITNESS An expert witness is quite different to any other witness in court proceedings. Most witnesses are 'witnesses of fact', ie they can only provide evidence on what they saw, did or heard. Most importantly, they cannot give their opinion on any of the matters about which they give evidence. By contrast, an expert witness is specifically called to give their opinion on a particular matter. An accountant can be called to give evidence as a professional witness, ie a witness of fact, or an expert witness. In order to give evidence as an expert witness they must be just that, an expert. They must be able to demonstrate a level of expertise that means their opinion is valuable to the court. This means not only expertise in accountancy, but also expertise in the particular area of accountancy that they are giving evidence on. A witness will provide a written report/statement to the court, and may also be required to attend court to give live evidence, in person, and be cross-examined by the 'other side'. However, not all forensic engagements will require evidence to be submitted to a court. Often, the engagement will simply require a report for the client's own purposes or sometimes a report for use by the insurer. Either way, a key skill necessary in being a successful forensic accountant is the ability to explain complex accounting concepts in simple terms to someone who is not themselves an accountant, whether that be as an expert witness explaining matters to the judge or jury, or when explaining matters to the client. Forensic accounting integrates investigative, accountancy, and communication skills. **Following are some of the main duties of the forensic accountant as an expert witness:** **1.** To exercise reasonable skill and care in helping the court on matters within their expertise **2.** To comply with any relevant code of ethics, Civil Procedure Rules and court orders **3.** To provide assistance so as to enable the court to deal with cases in accordance with the overriding objective. However, such overriding duty does not mean that experts should act as mediators between the parties or intrude upon the role of the court in deciding facts. **4.** To provide an independent opinion that is free from any litigation pressures. The forensic accountant should neither engage in the role of an advocate nor promote the viewpoint of the party by whom he is paid. If any matters fall outside the purview of an expert's expertise, he should disclose such matters without delay and refrain from providing an opinion in relation to such matters.

How is a forensic investigation different from an audit?

Whilst many of the techniques used in a forensic investigation will be similar to those used in an audit the different objectives and risks involved will require some differences in approach.

Materiality	In many investigations there will be no materiality threshold.
Timing	Clearly less predictable than audit Timing of procedures needs to be unpredictable
Documentation	Needs to be reviewed more critically than on an audit The example in this section shows what an experienced fraud investigator might identify in a fraudulent invoice.
Interviews	It may be appropriate to interview a suspected fraudster in the hope of obtaining an admission but this entails some problems: • Challenging and requires a high skill level • Legal issues including the risk of being sued for defamation
Computer-aided techniques	Data mining is a key part of many investigation processes. It allows the accountant to access and analyse thousands or millions of transactions that have passed through an accounting system, and identify, say. Unusual trends far more quickly than by traditional documentary analysis.100% of an entity's transactions can be checked for characteristics such as date. Time, amount, approval, payee etc. If possible, data should be gathered prior to the initial field visit to reduce the risk of the data being compromised.

<u>Application of ethical principles to a fraud investigation</u>

IFAC’s *Code of Ethics for Professional Accountants* applies to all ACCA members involved in professional assignments, including forensic investigations. There are specific considerations in the application of each of the principles in providing such a service.

Integrity

The forensic investigator is likely to deal frequently with individuals who lack integrity, are dishonest, and attempt to conceal the true facts from the investigator. It is imperative that the investigator recognises this, and acts with impeccable integrity throughout the whole investigation.

Objectivity

As in an audit engagement, the investigator’s objectivity must be beyond question. The report that is the outcome of the forensic investigation must be perceived as independent, as it forms part of the legal evidence presented at court. The

investigator must adhere to the concept that the overriding objective of court proceedings is to deal with cases fairly and justly.
Any real or perceived threats to objectivity could undermine the credibility of the evidence provided by the investigator.

This issue poses a particular problem where an audit client requests its auditors to conduct a forensic investigation. In this situation, the audit firm would be exposed to threats to objectivity in terms of advocacy, management involvement and self review.

The advocacy threat arises because the audit firm may feel pressured into promoting the interests and point of view of their client, which would breach the overriding issue of objectivity in court proceedings. Secondly, the investigators could be perceived to be involved in management decisions regarding the implications of the fraud, especially where the investigator acts as an expert witness. It is however the self-review threat that would be the most significant threat to objectivity. The self review threat arises because the investigation is likely to involve the estimation of an amount (i.e. the loss), which could be material to the financial statements.

For the reasons outlined above, *The Code* states that the firm should evaluate threats and put appropriate safeguards in place, and if safeguards cannot reduce the threats to an acceptable level, then the firm cannot provide both the audit service and the forensic investigation.

Professional competence and due care
Forensic investigations will involve very specialist skills, which accountants are unlikely to possess without extensive training.
Such skills would include:

- Detailed knowledge of the relevant legal framework surrounding fraud,
- An understanding of how to gather specialist evidence,
- Skills in the safe custody of evidence, including maintaining a clear 'chain' of evidence, and
- Strong personal skills in, for example, interview techniques, presentation of material at court, and tactful dealing with difficult and stressful situations.

It is therefore essential that forensic work is only ever undertaken by highly skilled individuals, under the direction and supervision of an experienced fraud investigator. Any doubt over the competence of the investigation team could severely undermine the credibility of the evidence presented at court.

Confidentiality
Normally accountants should not disclose information without the explicit consent of their client. However, during legal proceedings arising from a fraud investigation, the court will require the investigator to reveal information discovered during the investigation. There is an overriding requirement for the investigator to disclose all of the information deemed necessary by the court.

Outside of the court, the investigator must ensure faultless confidentiality, especially because much of the information they have access to will be highly sensitive.

Professional behaviour

Fraud investigations can become a matter of public interest, and much media attention is often focused on the work of the forensic investigator. A highly professional attitude must be displayed at all times, in order to avoid damage to the reputation of the firm, and of the profession. Any lapse in professional behaviour could also undermine the integrity of the forensic evidence, and of the credibility of the investigator, especially when acting in the capacity of expert witness.

During legal proceedings, the forensic investigator may be involved in discussions with both sides in the court case, and here it is essential that a courteous and considerate attitude is presented to all parties.

Forensic audit and accounting is a rapidly-growing area. The major accountancy firms all offer forensic services, as do a number of specialist companies. The demand for these services arises partly from the increased expectation of corporate governance codes for:

- Company directors to take seriously their responsibilities for the prevention and detection of fraud, and also from
- Governments concerned about risks arising from criminal funding of terrorist groups.

Audit of performance information in the public sector

Technical Article: Performance Information in the Public Sector

The syllabus and study guide for THE ADVANCED AUDIT & ASSURANCE EXAM (INT), *Advanced Audit and Assurance* (and SGP adapted paper) includes a section entitled 'The audit of performance information (pre-determined objectives) in the public sector'. This article is intended to provide insight into this syllabus area and explain some of the issues of which candidates should be aware when studying this aspect of the syllabus.

BACKGROUND

While the specifics will vary from country to country, in general public sector organisations are funded wholly or partly by the government, and in turn by the tax payers in a particular jurisdiction. Public sector organisations may include hospitals and other health care facilities such as ambulance services, schools and universities, the police force and organisations responsible for public transport and the road network. In some cases, such as the UK university sector, organisations do charge for services provided but still rely on government funding to support their activities.

The government as well as other stakeholders will pay close attention to the performance of these organisations to evaluate whether public funds are being used appropriately. The organisations should aim to demonstrate that public monies allocated to them are being used effectively, that specific targets are being met, and that appropriate decisions are being made in respect of long term planning. Essentially the management and those charged with governance of a public sector organisation need to show that the organisation is meeting its objectives and performing its role in society, and performance information is likely to be required in order for this to be demonstrated. If a public sector organisation is not performing well then its funding may be cut and its management may be replaced; in extreme situations the organisation may even be shut down.

This is supported by guidance issued by the public sector board of IFAC which notes that the primary function of governments and most public sector entities is to provide services to constituents. Consequently, their financial results need to be assessed in the context of the achievement of service delivery objectives. Reporting non-financial as well as financial information about service delivery activities, achievements and/or outcomes during the reporting period is necessary for a government or other public sector entity to discharge its obligation to be accountable.
An example of how this is implemented is given below, taken from the UK's National Health Service (NHS) website:

> In the NHS, performance monitoring should:
>
> - help to define performance targets/goals across the key aspects of service delivery, including management of resources (personnel, infrastructure), customer service and financial viability
> - provide a comprehensive picture of the organisation's progress towards achieving its performance targets/goals
> - provide an early indication of emerging issues/cost pressures that may require remedial action
> - indicate where there is potential to improve the cost effectiveness of services through comparison with other organisations
>
> *Source:* ***www.institute.nhs.uk/quality_and_service_improvement_tools/***

MEASURING PERFORMANCE INFORMATION

Candidates will be familiar with the concept of Key Performance Indicators (KPIs) which are widely used by private sector organisations in relation to non-financial information such as social and environmental reporting; there have been several examination requirements in past THE ADVANCED AUDIT & ASSURANCE EXAM exams focusing on this syllabus area. In the public sector the same principles apply in that target KPIs will be established as a performance objective and the organisation's performance against the target KPIs will be measured.

Performance measures should be measurable and relevant if they are to be effective. Measurability means trying to ensure that there is consistency in how performance information is captured and reported. The measures should be clearly defined and unambiguous, but measurability is sometimes difficult where the subject matter of the performance information is subjective in nature. For example for an ambulance service it would be quite easy to measure the average time taken for an ambulance to respond to an emergency as this is quantifiable, but more difficult to measure the patient's satisfaction with the service provided as this is based on the patient's opinion.
An issue linked to measurability is the existence of data to generate the performance information. Much of the work involved in setting up a good system for reporting on performance information is focussed on ensuring the completeness and accuracy of supporting information and that the information is sufficiently robust to withstand scrutiny.

Relevance means that the performance information addresses a valid concern and public sector organisations should consider the specific needs of their stakeholders in developing relevant performance measures. Continuing to using the UK's NHS as an example, identified stakeholders who regularly review the NHS performance information include:

- The government department responsible for health services
- Medical staff
- NHS management team and non-executive committee members
- Patients
- Private companies who supply to the NHS
- Academics and students researching the NHS

The NHS therefore has to produce a range of performance measures relevant to the needs of this wide range of stakeholders. Different stakeholders have different needs, for example patients may focus on the effectiveness of a certain medical procedure, whereas management may focus on the cost of providing that procedure. Therefore a very wide range of performance information may be required yet it would be pointless to set targets and produce performance information on an issue which is not relevant to any stakeholder.

THE AUDIT OF PERFORMANCE INFORMATION

It is worth reiterating the difference between the audit of performance information and performance auditing as both are likely to occur in the public sector. Candidates are reminded that the audit of performance information is concerned with the audit of reported performance information against predetermined objectives. The auditor's role here is usually to report on the credibility, usefulness and accuracy of the reported performance. Performance auditing is related to the evaluation of how the public sector body is utilising resources and often focuses on determining how the public sector body is achieving economy, efficiency and effectiveness, sometimes referred to as value for money auditing. It is the former that is the focus of this area of the THE ADVANCED AUDIT & ASSURANCE EXAM syllabus.

In some jurisdictions it is part of the audit requirement for public sector organisations that the auditor should report on performance information. In jurisdictions where this is not a requirement, the auditor may be asked to perform a separate engagement to the financial statement audit, the objective of which is to report specifically on the performance information. In either case, the auditor will need to plan procedures in much the same way as in a conventional audit scenario. Candidates are therefore encouraged to apply their existing knowledge of audit planning (risk assessment) and evidence gathering techniques to this type of information. The auditor is still looking to ultimately report on the validity of the information included in this respect. The auditor may find the principles of ISAE 3000 *Assurance Engagements other than Audits or Reviews of Historical Financial Information* provide a useful framework for planning and performing the work on performance information.

As with any engagement to provide assurance, this would likely start with an understanding of the entity to ensure knowledge of the predetermined performance measures, an evaluation of the systems and controls used to derive and capture the performance information and also performing substantive procedures on the reported measures. The auditor will also need to understand the rationale behind the measures that are being reported on, considering the relevance and suitability of them in terms of the objectives of the public sector organisation in order to help assess the usefulness of the information being provided.

Audit procedures may include:

- Tests of controls on the systems used to generate performance information
- Performing analytical review to evaluate trends and gauge the consistency of the information
- Discussion with management and other relevant individuals, for example those responsible for the reporting process
- Review of minutes of meetings where performance information has been discussed
- Confirmation of performance information to source documentation; this may be performed on a sample basis
- Recalculation of quantitative performance information measures

Of course, the procedures must be specifically tailored to the performance information subject to the audit. Further as in any audit, the working papers must contain a summary of findings and clear conclusions on the procedures that have been performed.

Important characteristics of useful performance information

- Relevant to the needs of stakeholders
- Comparable to measures of other similar organisations
- Measurable: some measure may be more subjective than others. Being subjective means they cannot be measured precisely and involve judgment.
- Reliable: the quality of information needs to be considered (this includes the source of information, internal control over the process of generating information etc.)

REPORTING ON PERFORMANCE INFORMATION

There is no specific format or wording that is prescribed by international regulations for reporting on public sector performance information, though in some jurisdictions the national regulators may issue country-specific requirements.

Generally, the auditor will provide a conclusion on whether the public sector entity has achieved its objectives as shown by the reported performance information and concludes on the information itself. This conclusion may be in the form of a reasonable assurance conclusion – ie an opinion is expressed, or may be in the form of a negative assurance conclusion – ie no opinion is expressed. Essentially, in the absence of any jurisdiction specific requirements, the auditor will agree the type of conclusion with the public sector organisation and usually its regulating body.

Often the performance information will be provided as part of the public sector organisation's integrated report, in which case the auditor's conclusion will be included within the integrated report.

CONCLUSION

The audit of performance information in public sector organisations can be approached in a similar way to the audit of KPIs in private sector organisations, and conventional audit techniques can be employed, though they will need to be tailored to the specific measures that are subject to audit. In approaching scenarios based on this syllabus area, candidates are encouraged to apply their understanding of audit techniques to the specific information in the question and to avoid vague and unfocussed remarks.

Written by a member of the THE ADVANCED AUDIT & ASSURANCE EXAM examining team

Social and Environmental issues

BASIC OVERVIEW

Over the past 20 years, there has been a rapid growth in companies:

- Accepting that they have some responsibility for the social and environmental impacts of their operations
- Reporting social and environmental performance, both using narrative and data.

As such, a company may make statements in their Annual Report (e.g. that their operations are based on sustainability) and provide performance data that shareholders and other stakeholders may want someone to check, and issue an opinion on. Whilst this "audit" work is not the same as an audit of financial information, and is likely to be carried out by specialists, many accountancy firms provide such services.

Procedures may include:

- Advising the company on the key performance indicators ("metrics") to present
- Checking these statistics using available evidence and typical audit procedures
- Reading board minutes to verify stated policies are true
- Assessing whether related costs (e.g. clean-up, alteration of an asset to make it more environmentally sound, development of "greener" products) are expense or asset in nature
- Assessing environmental provisions and contingencies for accuracy
- Assessing whether new environmental regulations (or social expectations) mean that some assets have been impaired
- Assessing the impact of social and environmental matters on the future viability of the company.

IMPORTANT TERMS:

ENVIRONMENTAL AUDIT: WHAT?

An environmental audit, and the production of an environmental report, enables an organization to demonstrate its responsiveness to all the sources of concern outlined above. Except in some highly regulated situations (such as water), the production of an environmental audit is voluntary. The production of such a report, however, ensures that an organization has systems in place for the collection of data that can also be used in its environmental reporting.

An environmental audit typically contains three elements:

1. Agreed metrics (what should be measured and how),
2. Performance measured against those metrics, and
3. Reporting on the levels of compliance or variance.

The problem, however, and the subject of most debate, is what to measure and how to measure it. As an environmental audit isn't compulsory, there are no mandatory audit standards and no compulsory auditable activities. So an organization can engage with a social and environmental audit at any level it chooses (excepting those in regulated industries for which it is mandatory). Frameworks do exist, such as the data-gathering tools for the Global Reporting Initiative (GRI), AA1000, and the ISO 14000 collection of standards, but essentially there is no underpinning compulsion to any of it.

In practice, the metrics used in an environmental audit tend to be context specific and somewhat contested. Typical measures, however, include measures of emissions (e.g. pollution, waste and greenhouse gases) and consumption (e.g. of energy, water, non-renewable feed stocks).

Together, these comprise the organization's environmental footprint. Some organizations have a very large footprint, producing substantial emissions and consuming high levels of energy and feed stocks, while others have a lower footprint. One of the assumptions of environmental management is that the reduction of footprint is desirable, or possibly of 'unit footprint': the footprint attributable to each unit of output. If a target is set for each of these then clearly a variance can be calculated against the target. Some organizations report this data – others do not. It is this ability to pick and choose that makes voluntary adoption so controversial in some circles.

A recent trend, however, is to adopt a more quantitative approach to the social and environmental audit. The data gathered from the audit enables metrics to be reported against target or trend (or both). It is generally agreed that this level of detail in the report helps readers better understand the environmental performance of organizations.

An **environmental management system (EMS)** is a system for managing an organization's overall risk associated with its environment, encompassing the organizational elements, the planning and the resources involved in developing, implementing and maintaining the organization's policy in this area.

Environmental Issues and External Auditors

Environmental issues cannot be ignored by external auditors. Potential impacts on the financial statements may arise from:

(a) The application of environmental laws and regulations;
(b) The operation of processes that may cause pollution or the use of hazardous substances;
(c) The holding of an interest in land and buildings that have been contaminated by previous occupants; or
(d) Dependence on a major customer segment whose business is threatened by environmental pressures.

Substantive procedures-DETAILS

The auditor may perform substantive testing to obtain evidence in relation to environmental matters. Below are some suggested procedures from IAPS 1010 *the Consideration of environmental matters in the audit of financial statements*. It is not intended that all of the procedures will be appropriate in any particular case. In many cases, the auditor may judge it unnecessary to perform any of these procedures.

General: *Documentary review*

1. Consider minutes from meetings of directors, audit committees, or any other subcommittees of the board specifically responsible for environmental matters.

2. Consider publicly available information regarding any existing or possible future environmental matters.

3. Where relevant, consider:

(a) Reports by environmental experts about the entity, such as site assessments, due diligence investigations or environmental impact studies;

(b) Internal audit reports and other internal reports dealing with environmental matters;

(c) Reports issued by, and correspondence with, regulatory and enforcement agencies;

(d) Publicly available registers or plans for the restoration of soil contamination;

(e) Environmental performance reports issued by the entity; and

(f) Correspondence with the entity's lawyers.

4. Obtain written representations from management that it has considered the effects of environmental matters on the financial statements, and that it:

(a) Is not aware of any material liabilities or contingencies arising from environmental matters, including those resulting from illegal or possibly illegal acts;

(b) Is not aware of environmental matters that may result in a material impairment of assets; or

(c) If aware of such matters, has disclosed to the auditor all related facts.

Assets: *Asset impairment*

Enquire about any planned changes in capital assets, for example, in response to changes in environmental legislation or changes in business strategy and their impact on the valuation of those assets or the company as a whole.

For any asset impairments related to environmental matters that existed in previous periods, consider whether the assumptions underlying a write-down or related carrying values continue to be appropriate.

Liabilities, provisions and contingencies: *Completeness*

Enquire about policies and procedures operated to identify liabilities, provisions or contingencies arising from environmental matters.

Enquire about events or conditions that may give rise to liabilities, provisions or contingencies arising from environmental matters, for example

- Penalties or possible penalties arising from breaches of environmental laws and regulations; or
- Claims or possible claims for environmental damage.

For property abandoned, purchased, or closed during the period, enquire about requirements or intentions for site clean-up and restoration.

For property sold during the period and in prior periods, enquire about any liabilities relating to environmental matters retained by contract or by law.

Accounting estimates

For liabilities, provisions, or contingencies related to environmental matters, consider whether the assumptions underlying the estimates continue to be appropriate.

Disclosure: Review the adequacy of any disclosure of the effects of environmental matters on the financial statements.

Measuring and reporting on social and environmental performance

Many companies attempt to measure social and environmental performance by setting targets or key performance indicators (KPIs), and then evaluating whether they have been met. The results are often published to enable a comparison to be made year on year or between companies. But it can be difficult to measure social and environmental performance for a number of reasons.

First, targets and KPIs are not always precisely defined. For example, Osprey Co may state a target of reducing environmental damage caused by its operations, but this is very vague. It is difficult to measure and compare performance unless a target or KPI is made more specific, for example, a target of reducing electricity consumption by 5% per annum.

Second, targets and KPIs may be difficult or impossible to quantify, with Osprey Co's planned KPI on employee satisfaction being a good example. This is a very subjective matter, and while there are methods that can be used to gauge the levels of employee satisfaction, whether this can result in a meaningful statistic is questionable.

Third, systems and controls are often not established well enough to allow accurate measurement, and the measurement of socio-environmental matters may not be based on reliable evidence. In Osprey Co's case, it may not be possible to quantify how much toxic chemical has been leaked from the factory.

Finally, it is hard to compare these targets and KPIs between companies, as they are not strictly defined, so each company will set its own target. It will also be difficult to make year on year comparisons for the same company, as targets may change in response to business activities. For example, if Osprey Co were to expand its operating, its energy and water use would increase, making its performance on environmental matters look worse. Users would need to understand the context in order to properly appraise why a target had not been met.

Impact of Big Data and Data Analytics on Audit

Big data- a simple explanation

Big data refers to our ability to collect and analyze the vast amounts of data we are now generating in the world.

Take this business example: Wal-Mart is able to take data from your past buying patterns, their internal stock information, your mobile phone location data, social media as well as external weather information and analyze all of this in seconds so it can send you a voucher for a BBQ cleaner to your phone – but only if you own a barbeque, the weather is nice and you currently are within a 3 miles radius of a Wal-Mart store that has the BBQ cleaner in stock. That's scary stuff, but one step at a time, let's first look at why we have so much more data than ever before.

In the world of 'Big Data' we talk about the 4 Vs that characterize big data:

Volume – the vast amounts of data generated every second

Velocity – the speed at which new data is generated and moves around (credit card fraud detection is good example where millions of transactions are checked for unusual patterns in almost real time)

Variety – the increasingly different types of data (from financial data to social media feeds, from photos to sensor data, from video capture to voice recordings)

Veracity – the messiness of the data (just think of Twitter posts with hash tags, abbreviations, typos and colloquial speech)

Big data and data analytics- potential impact on audit

The massive volumes of data now available inside and outside companies, and the power of new data analytics technologies, are fundamentally changing the audit.

Both internal and external auditors are combining big data and analytics, and greater access to detailed industry information, to help them better understand the business, identify risks and issues, and deliver enhanced quality and coverage while providing more business value. Information and insights that may be relevant to board members now extend far beyond traditional financial transactional data in a company's general ledgers and extends into data from email, social media, video, voice, texts—mountains of unstructured data. Insights gleaned from such data can and should extend beyond risk assessment.

The use of data analytics probably has not advanced as rapidly in external financial statement auditing as it has in internal auditing, where many organizations use continuous auditing and continuous monitoring of data to identify risks and anomalies as part of their system of internal control. But data analytics has the potential to transform external auditing just as it has changed internal auditing.

The power of data analytics could make it possible for external financial statement auditors to improve audits by:

- Testing complete sets of data, rather than just testing samples.
- Aiding risk assessment through identification of anomalies and trends, perhaps even through comparison to industry data, pointing auditors toward items they need to investigate further.
- Providing audit evidence through comprehensive analysis of organizations' general ledger systems.
- Data analytics, combined with traditional auditing techniques, will give auditors a better understanding of their clients.

The profession needs to achieve a "quantum leap" to redesign audit processes using today's technology, rather than using information technology to computerize legacy audit plans and procedures.

Existing auditing standards that are the framework for audit procedures need to be modified to incorporate the concepts of Big Data and "continuous auditing" and encourage auditors to use technologies that increase assurance beyond minimum required levels.

Advances in data science can be applied to perform more effective audits and provide new forms of audit evidence. Audit data analytics methods can be used in audit planning and in procedures to identify and assess risk by analyzing data to identify patterns, correlations, and fluctuations from models. These methods can give auditors new insights about the entity and its risk environment and improve the quality of analytical procedures in all phases of the audit.

Technology permits the creation of Big Data that can be analyzed to improve auditors' knowledge about the transactions and balances underlying the financial statements. This can help them obtain better evidence for their audit opinions and understand fundamental causes of restatements, fraud, and going-concern issues.

Thanks to technology, audit procedures such as bank confirmations, analytical procedures, and journal-entry testing do not have to be performed on-site by local audit teams. Instead, these tasks can be outsourced to remote teams of specialists and third-party providers, creating opportunities for auditors to focus on higher-risk areas and the potential for fraud.

Technology permits more frequent or continuous monitoring of transactions by external auditors. Auditors can benefit from being able to spread audit work throughout the year rather than only during "busy season," identifying potential issues earlier, and having the ability to modify audit plans in response. Companies can benefit from improved audit quality and client service. Continuous reporting and web-based availability of financial information is replacing periodic issuance of financial statements, which may lead to the requirement for continuous audit assurance, the white paper found.

Barriers to integrating big data and data analytics into audit

There are a number of barriers to the successful integration of big data and analytics into the audit.

The first is data capture: if auditors are unable to efficiently and cost-effectively capture company data, they will not be able to use analytics in the audit. Companies invest significantly in protecting their data, with multilayered approval processes and technology safeguards. As a result, the process of obtaining client approval for provision of data to the auditors can be time-consuming. In some cases, companies have refused or have been reluctant to provide data, citing security concerns.

Moreover, auditors encounter hundreds of different accounting systems and, in many cases, multiple systems within the same company. Data extraction has not historically been a core competency within audit, and companies don't necessarily have this competency either. This results in multiple attempts and a lot of back and forth between the company and the auditor on data capture.

Today, extraction of data is primarily focused on general ledger data. However, embracing big data to support the audit will mean obtaining sub-ledger information, such as revenue or procurement-cycle data, for key business processes. This increases the complexity of data extraction and the volumes of data to be processed.

While it is reasonably easy to use descriptive analytics to understand the business and identify potential risk areas, using analytics to produce audit evidence in response to those risks is a lot more difficult. One problem with relying on analytics to produce audit evidence relates to the "black box" nature of the way in which analytics works, with algorithms or rules used to transform data and produce visualizations or reports. When the auditor gets to this stage, they need to find the appropriate balance between applying auditor judgment and relying on the results of these analytics.

The value of integrating big data and analytics into the audit will only be realized when used by auditors to influence the scope, nature and extent of the audit. This will require them to develop new skills focused on knowing what questions to ask of the data, and the ability to use analytics output to produce audit evidence, draw audit conclusions and derive meaningful business insights.

Professional skepticism

In recent years regulatory bodies including the International Auditing and Assurance Standards Board (IAASB) and the UK Financial Reporting Council (FRC) have issued documents highlighting the importance of professional scepticism in an audit of financial statements. The objective of this article is to explain the importance of professional scepticism as an essential part of the auditor's mindset, and to consider the reasons why approaching an audit with an attitude of professional scepticism is becoming increasingly important.

WHAT IS PROFESSIONAL SCEPTICISM?-TECHNICAL ARTICLE

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 evidence.

ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* contains more guidance on how and why the auditor should act with an attitude of professional scepticism. ISA 200 contains a specific requirement in relation to professional scepticism:

The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.

This overall objective is the fundamental driver for the relevant learning outcomes within the Paper THE ADVANCED AUDIT & ASSURANCE EXAM syllabus, namely:

- To discuss the importance of professional scepticism in planning and performing an audit (B1e), and
- To assess whether an engagement has been planned and performed with an attitude of professional scepticism, and evaluate the implications .

The application paragraphs of ISA 200 contain more guidance on what is meant by applying professional scepticism when conducting an audit:

Professional scepticism includes being alert to, for example:

- *Audit evidence that contradicts other audit evidence obtained.*
- *Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.*
- *Conditions that may indicate possible fraud.*
- *Circumstances that suggest the need for audit procedures in addition to those required by the ISAs.* (ISA 200 A.18).

Essentially, ISA 200 requires the use of professional scepticism as a means of enhancing the auditor's ability to identify risks of material misstatement and to respond to the risks identified. Professional scepticism is closely related to fundamental ethical considerations of auditor objectivity and independence. Professional scepticism is also linked to the application of professional judgment by the auditor. An audit performed without an attitude of professional scepticism is not likely to be a high quality audit. At its core the application of professional scepticism should help to ensure that the auditor does not neglect unusual circumstances, oversimplify the results from audit procedures or adopt inappropriate assumptions when determining the audit response required to address identified risks, all of which should improve audit quality.

HOW DOES THE AUDITOR APPLY PROFESSIONAL SCEPTICISM?

The auditor is likely to apply professional scepticism at various stages from client acceptance and at various points during the audit process, and some typical examples are given below:

- *When assessing engagement acceptance* – at this stage the auditor should consider whether the management of the intended audit client acts with integrity and whether there are any matters that may impact on the auditor being able to act with professional scepticism if they accept the engagement, such as ethical threats to objectivity.
- When performing risk assessment procedures – an auditor should be sceptical when performing risk assessment procedures at the planning stage of the audit. For example, when discussing the results of analytical procedures with management, the auditor should not accept management's explanations at face value, and should obtain corroboratory evidence for the explanations offered.
- *When obtaining audit evidence* – the auditor should be ready to challenge management, especially on complex and subjective matters and matters that have required a degree of judgement to be exercised by management. The reliability and sufficiency of evidence should be considered, especially where there are risks of fraud. There may also be specific issues arising during an audit which impacts on professional scepticism – for example, if management refuses the auditor's request to obtain evidence from a third party. The auditor will have to consider how much trust can be placed on evidence obtained from management – for example, evidence in the form of enquiry with management or written representations obtained from management. ISA 200 states that '*a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional scepticism or allow the auditor to be satisfied with less than persuasive audit evidence when obtaining reasonable assurance*'.
- *When evaluating evidence* – the auditor should critically assess audit evidence and be alert for contradictory evidence that may undermine the sufficiency and appropriateness of evidence obtained.

The auditor should also apply professional scepticism when forming the auditor's opinion, by considering the overall sufficiency of evidence to support the audit opinion, and by evaluating whether the financial statements overall are a fair presentation of underlying transactions and events.

Ultimately, the application of professional scepticism should reduce detection risk because it enhances the effectiveness of applied audit procedures and reduces the possibility that the auditor will reach an inappropriate conclusion when evaluating the results of audit procedures.

SPECIFIC APPLICATIONS OF PROFESSIONAL SCEPTICISM

Fraud

ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements,* specifically refers to professional scepticism stating that '*when obtaining reasonable assurance, the auditor is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls and recognising the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud*' (ISA 240.8).

ISA 240 goes on to state a specific requirement for the auditor: '*The auditor shall maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance*' (ISA240.12).

The application paragraphs of ISA 240 emphasise the importance of assessing the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance. In addition, ISA 240 states that '*management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional scepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information*' (ISA 240.A17). This is significant in that ISA 240 reminds the auditor that when management provides the auditor with audit evidence – be that in the form of answers to enquiries, written representations or other forms of documentary evidence – the auditor should carefully consider the integrity of that evidence and whether additional corroboratory evidence should be obtained from a more reliable source.

Other aspects of an audit where professional scepticism may be important

The IAASB has issued a Staff Questions and Answers document entitled *Professional Scepticism in an Audit of Financial Statements*, which outlines some of the areas of the audit where the use of professional scepticism may be important. These are outlined below and largely relate to areas of the audit that are complex, subjective or highly judgmental.

- Accounting estimates – this can include fair value accounting estimates, the use of significant assumptions by management in developing accounting estimates, and reviewing the judgements and decisions used by management for management bias in developing accounting estimates.
- Going concern – the auditor should review management's assessment of going concern and whether management's plans are feasible, this being particularly important where there is a significant doubt over the entity's ability to continue as a going concern.
- Related party relationships and disclosures – it can be difficult to obtain information on related parties, as knowledge may be confined to management meaning that the auditor may have to rely on management to identify all related parties The auditor should also be sceptical when assessing the business rationale behind related party transactions.
- Consideration of laws and regulations – the auditor should be alert throughout the audit for indications that there may have been a suspected non-compliance with laws and regulations.

THE INCREASING IMPORTANCE OF PROFESSIONAL SCEPTICISM

The IAASB Staff Questions and Answers document contains a foreword by Arnold Schilder, IAASB chairman, which emphasises the increasing need for auditors to apply professional scepticism. One reason for this is the increased use of judgment and subjectivity in management's financial reporting decisions. This is due to the application of International Financial Reporting Standards (IFRS), which are largely principle-based, and often require the preparers of financial statements to exercise significant judgment when making decisions on accounting treatments.

The global financial crisis of 2008–2009 also focused attention on professional scepticism. Auditors in many jurisdictions were criticised for not applying sufficient professional scepticism at that time, particularly in relation to the audit of fair values, related party transactions and going concern assessments. One of the reasons for the IAASB issuing the Staff Questions and Answers document was to re-emphasise the importance of professional scepticism especially in the audit of financial statements where there is a high risk of material misstatement due to financial distress.

The UK's Financial Reporting Council (FRC) has issued a Briefing Paper on professional scepticism which suggests that professional scepticism is the cornerstone of audit quality. It proposes that the auditor should actively look for risks of material misstatement, and that this is only possible when a high degree of knowledge of the audited entity's business and the environment in which it operates is obtained. The document contains proposals for how audit firms can encourage audit teams to approach audits with a sceptical mindset, and it considers that some audit firms may need to change their culture to allow this to happen.

The IAASB's Work Plan for 2015–16, *Enhancing Audit Quality and Preparing for the Future* – issued in December 2014 – prioritises the issues that impact on audit quality, including group audits, quality control, and professional scepticism. It is clear the professional scepticism is to stay on the agenda of the regulatory authorities for some time to come, as it is so intrinsically linked to other key audit issues such as audit quality, ethics and independence and, ultimately, the confidence that the public has in the auditing profession.

CONCLUSION

The IAASB states that 'the need for professional scepticism cannot be overemphasised' and that 'adopting and applying a sceptical mindset is ultimately a personal and professional responsibility to be embraced by every auditor'. Given the increasingly complex and subjective nature of IFRS requirements, auditors must be confident to challenge management on a range of matters relevant to the preparation of the financial statements and the IAASB and national bodies such as the FRC are keen to support auditors in the application of professional scepticism. This, they believe, is an essential element of quality control, and in safeguarding the credibility of the audit opinion.

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