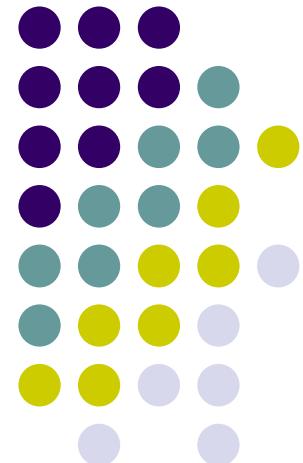


Audit & Assurance

Topic 8: Employee Costs
Podcast



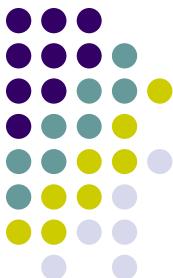
Employee Costs: Learning outcomes



With respect to **employee costs (ie wages and salaries)** you should be able to:

- **identify** internal controls for an organisation in a given scenario
- explain the **nature of internal controls** and why they are important.
- show how specified internal controls in a payroll system **mitigate risk**, including cyber risks, and state their limitations
- identify internal control **deficiencies** in a given scenario

The Audit Process



Employee costs – what's included?



Wages – may vary each week. Often paid by the hour. Overtime common.

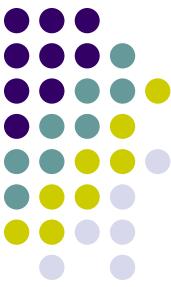
Salaries – often fixed for a year. Same each month. Overtime possible, but less common.

Tax – PAYE and NIC deducted at source

Other deductions (non-statutory) – pension, union fees etc

Gross = *before deductions*

Net = *amount paid to employees after deductions*

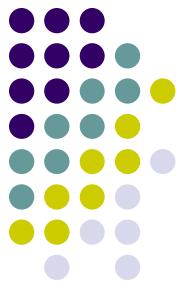


Employee costs

1. **Calculating** wages and salaries
2. **Recording** of wages and salaries and deductions
3. **Payment** of wages and salaries

Wages and salaries are often a very significant cost to the business, they can be complicated to record and susceptible to fraud. They are therefore often a high risk area i.e. important to the auditor.

The Employee costs - Risks and controls



1. Risks (what can go wrong?) **(if there are no controls)**
2. Control objective
3. Control
4. Tests of control (by auditor)



Matrix – approach to controls

	CLIENT		AUDITOR
Wages & Salaries	Risks	Control Objectives	Controls
1. Calculating			
2. Recording			
3. Payment			

1. Calculating wages and salaries

– What Could Go Wrong? (Risks)



- The company may pay employees too much money (eg false overtime)
- The company may pay employees who have not been at work
- The company may pay employees who have left



Control Objectives

- Employees are only paid for work completed
- Gross pay has been calculated correctly and authorised
- Net pay has been calculated correctly



Examples of Control Activities

- Recording of hours worked by timesheets, clocking in and out arrangements
 - Authorisation of
 - New starters
 - Leavers
 - Changes in pay rates
 - Overtime
- by management



Examples of Control Activities

- Review wages in comparison to **budget**
- Appropriate level of staffing and **segregation of duties**
- Maintenance of **personnel records** (**held by HR**) and regular checking of wages and salaries details to personnel records
- Changes to personnel records are **authorised**
- **Non-statutory deductions** are authorised
- Authorisation of **changes in pay rates** (**eg pay rise**)
- **Reliable software** or trained personnel calculate



Tests of Controls

- Review wages against budget: Inspect budget vs actual report for evidence of review
- Observe that the wages and salary summary is approved for payment.
- Confirm that procedures are operating for authorising changes in rates of pay, overtime, and holiday pay.
- Inspect evidence that staff only start being paid when they join the company, and are removed from the payroll when they leave the company by inspecting payroll the month before and month after a sample of new starters.
- Inspect documents confirming that the engagement of new employees and discharges have been confirmed in writing.



Question

The following system of time records exists at Shepherd Limited. Staff members are required to fill in a manual timesheet as they arrive, stating the time of arrival and as they leave, stating the time of departure. Staff members are then paid an hourly rate on the basis of this record.

Which of the following outcomes could arise from this system?



Question

- A. Employees may be paid at an inappropriate rate
- B. Employees may be paid for work they have not completed
- C. Wages may be paid to the wrong employee.
- D. Employee deductions (e.g. income tax and other deductions) may be inappropriate



Question

- A. Employees may be paid at an inappropriate rate
- *B. **Employees may be paid for work they have not done**
- C. Wages may be paid to the wrong employee.
- D. Employee deductions (e.g. income tax and other deductions) may be inappropriate

2. Recording of wages and salaries and deductions



Risks (**what could go wrong?**):

- The various elements of employee cost **might not be recorded correctly**
- Amounts paid to employees **might not be reflected in the cash books (Cr)**
- Pay **might not be recorded correctly** in the nominal ledger (**employee cost a/c**) **(Dr)**



Control Objectives

- **Gross and net pay and deductions are accurately recorded on the payroll**
- **Wages and salaries paid are recorded correctly in the bank and cash records**
- **Wages and salaries are correctly recorded in the nominal ledger**



Control Activities

- Use of suitably trained personnel and/or software systems
- Checks of payroll system output and compare to original inputs (clock cards/personnel records)
- Bank reconciliations performed
- Payroll reconciliation between ledger and payroll output



Question

Personnel and wages records at Simonston Brothers Ltd are maintained by Sam, the wages clerk, on a personal computer. Sam calculates the hours worked by each employee on a weekly basis, based on that employee's clock cards and enters them on the computer.

The payroll software, using data from personnel records in respect of wage rates and deductions, produces the weekly payroll and a payslip for each employee.



Question

- Sam prepares a cheque requisition for the total net pay for the week, which is sent to the company accountant together with a copy of the payroll. The accountant draws up the cheque, made payable to cash, and has it countersigned by a director. The wages clerk takes the cheque to the bank and uses the cash to prepare the wage packets.
- Which **two** of the following are deficiencies which exist in the wages system?



Question

- A. Sam records the salaries and organises the pay packets
- B. There is no authorisation of the payroll
- C. The wages cheque is countersigned by a director
- D. The payroll and the time recording system are separate



Question

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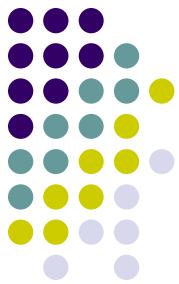
3. Payment of wages and salaries – Risks



Risks (**what could go wrong?**):

- People who are **not employees** are paid
- Those who **are employees** are not paid
- Incorrect amounts are paid to **tax authorities**

Payment of wages and salaries – Control objectives



Control Objectives

- The correct employees are paid, the correct amounts at the correct time
- The correct amounts are paid to the tax authorities



Control Activities (Examples)

Payments by cash or cheque

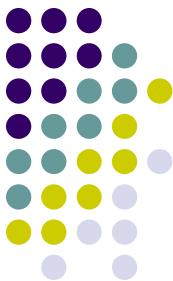
- **Segregation of duties**
 - Preparing the payroll
 - Filling of pay packets and writing cheques
 - Distribution of wages
- Custody of cash/cheques
- Security of pay packets and cheques
- Prompt banking of unclaimed wages
- Verification of identity
- Signed for on receipt
- Inspect cash security procedures



Tests of Controls (Examples)

Payments by bank transfer

- Observe segregation of duties
- Check for unsuccessful bank transfers
- Observe checking procedures
- Examine signatures (real and digital)
- Inspect documents for evidence of approval by authorised person



Tests of Controls (Examples)

- Review for evidence of matching (eg signature)
- Review sample of bank reconciliations
- Review reconciliations
- Run dummy transaction for IT systems (eg phantom employee)



Question

Waterloo Ltd uses temporary employees frequently. Which of the following controls would best ensure that employees are only paid for work they have performed?

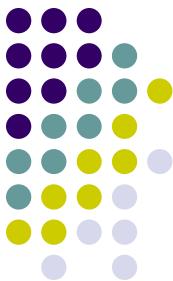
- A Temporary staff records should be maintained for each member of temporary staff
- B Temporary staff should complete work schedules, which are authorised by their supervisor
- C Temporary staff pay should be authorised by the human resources manager
- D Temporary staff should be paid by direct transfers to their bank accounts



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Homework

- Read chapter 8 of the study manual
- Seminar question next week (Week 9) is Blake
- Audit simulation – Payroll

https://blackboard.uwe.ac.uk/bbcswebdav/orgs/ACC/simulations/auditsim_0919_xg/auditsim_web/auditsim_files/intro.html

Go to:

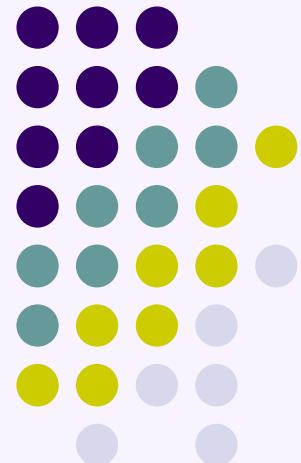
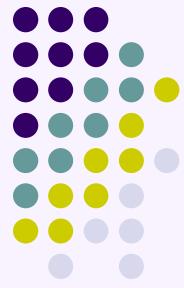
“Virtual Desk and Filing System” (top right)

Play and watch the video Interim visit Sheridan AV’s - Payroll

- **Action** – identify internal control deficiencies

Audit & Assurance

Audit Evidence

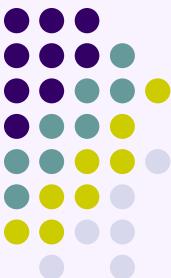


The Audit Process: Evidence and Reporting



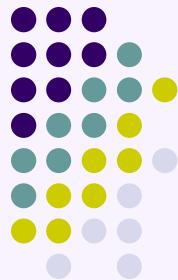
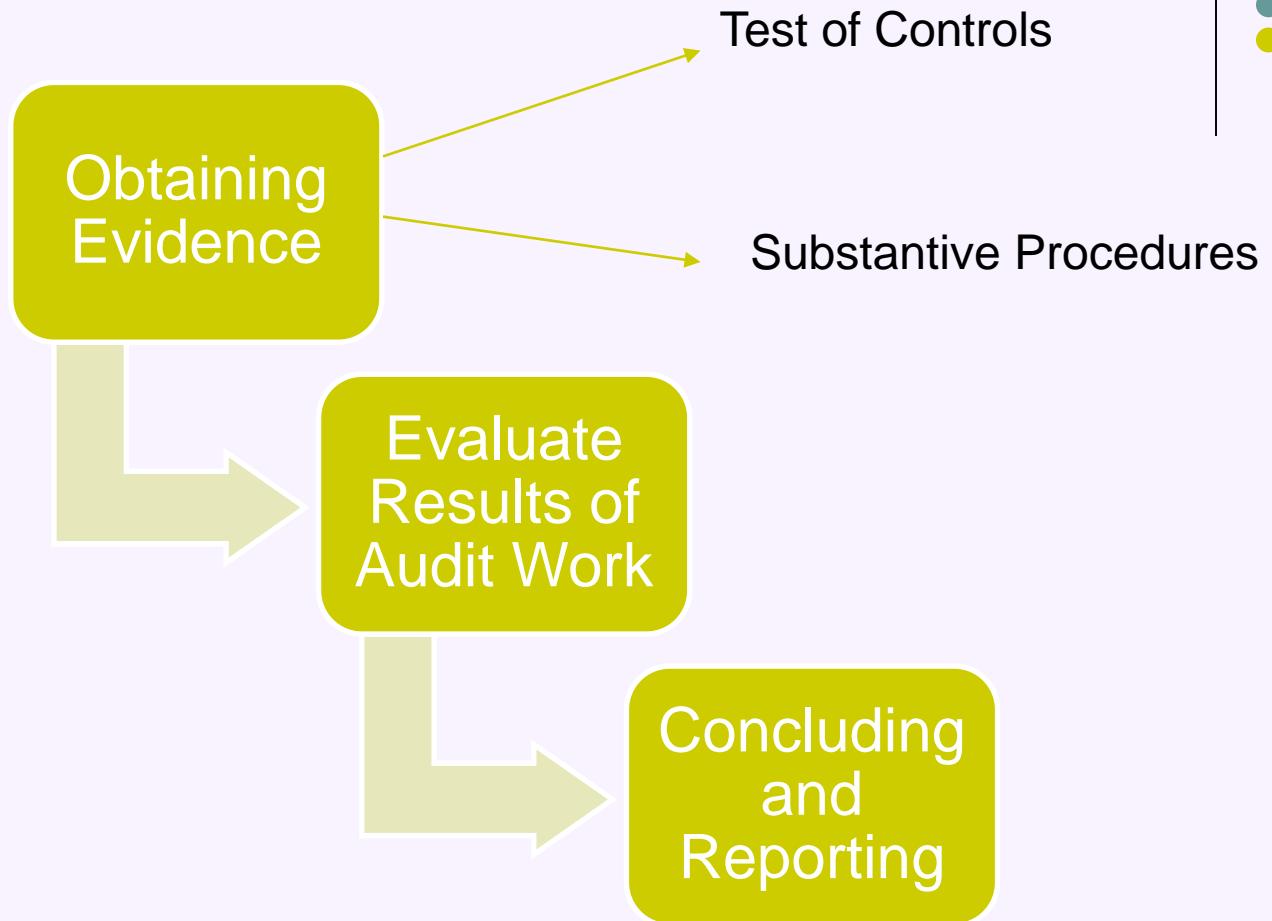
By the end of studying this topic, you should be able to:

- Compare the different methods of obtaining evidence, including tests of control and substantive procedures.
- Identify when tests of controls and substantive audit procedures would be used
- Identify and explain the financial statement assertions that apply to classes of transactions, account balances and disclosures
- Identify the contents of the audit report
- Explain the difference between a modified audit report and a modified audit opinion, and identify which conclusion would be appropriate given a particular set of circumstances

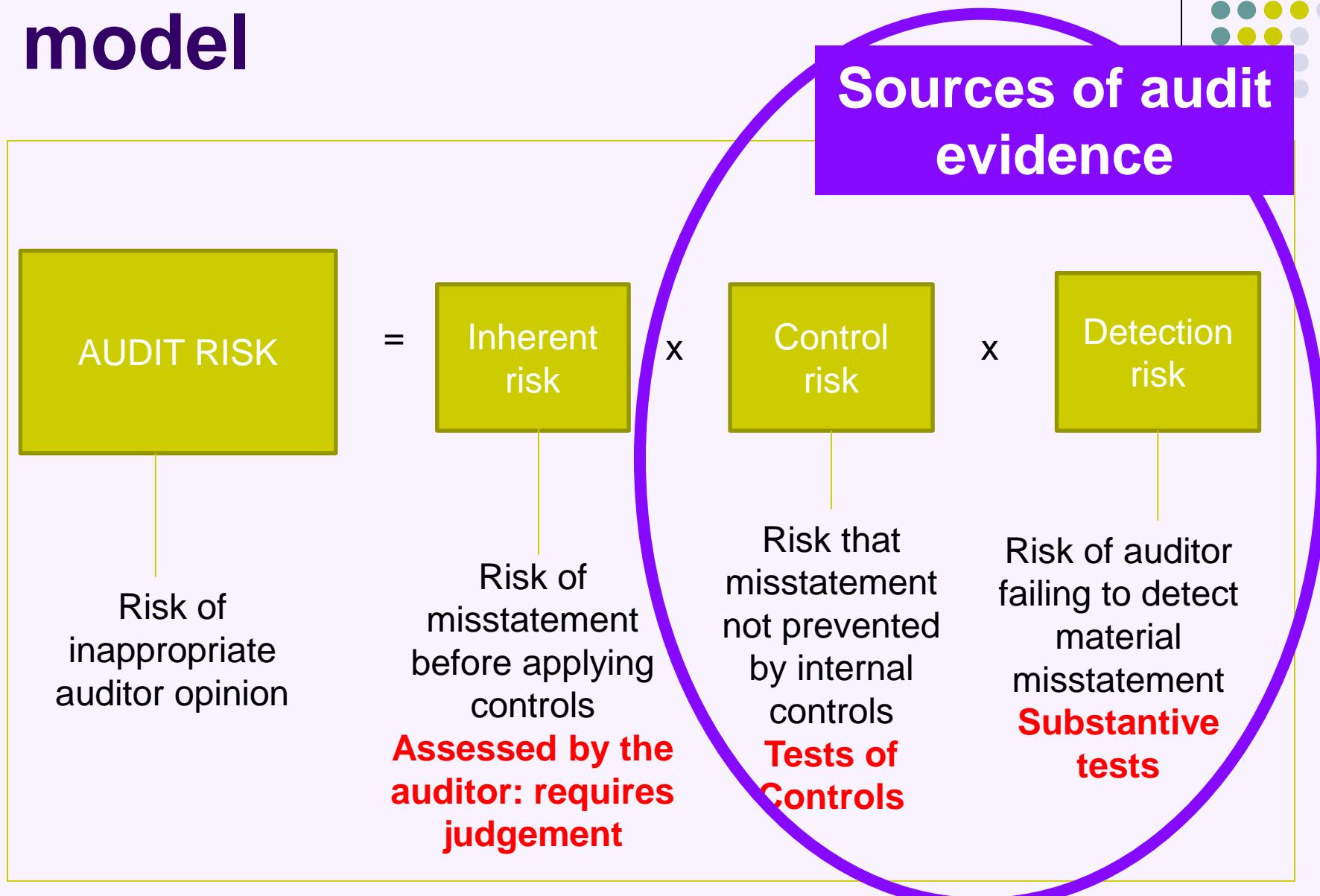


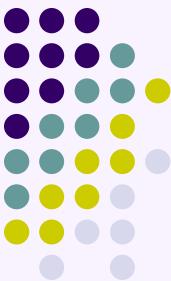
The Audit Process





Reminder: The audit risk model





Audit Evidence

Information used by the auditor to give **reasonable assurance** in arriving at the conclusion on which the opinion is based.

ISA 500, Audit Evidence.

Audit evidence includes both the information contained within the **accounting records** (**internal**) underlying the financial statements, and **other information** gathered by the auditors, such as confirmations from *third parties* (**external**).



Audit Evidence

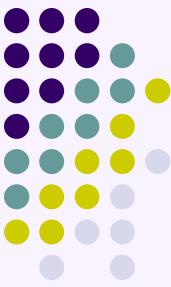
- ISA 500 requires auditors to ‘obtain **sufficient appropriate** audit evidence to be able to draw reasonable conclusions on which to base the audit opinion’
- Audit evidence is gathered from a variety of sources – remember auditors **do not** look at **all information** that might exist; audit work is carried out on a **test basis (a sample)**



Sufficient (Quantity/Enough)

Depends on factors such as

- Risk
- Materiality
- Level of assurance given – Higher the level needs more evidence



Appropriate (Quality)

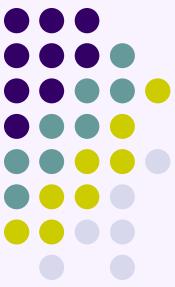
Reliable

Source:

- Auditor generated more reliable than via client
- Third Party more reliable than produced by the client

Format:

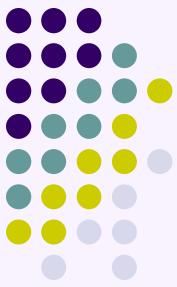
- Written more reliable than verbal
- Original more reliable than a copy



Question 1

Which is the more reliable evidence (and why)

- (1) A sales invoice
- (2) A purchase invoice

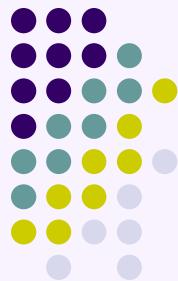


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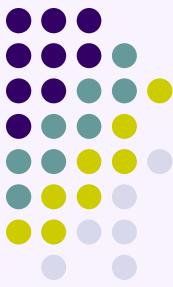
Purchase invoice is produced by the supplier who is a third party.



Question 2

Which is the more reliable evidence (and why)

- 1) The client explains their assumptions in coming to a legal provision to you in person.
- 2) The client puts their assumptions in coming to a legal provision in an email.

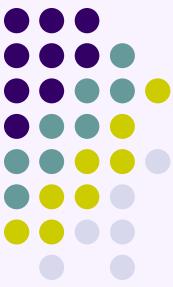


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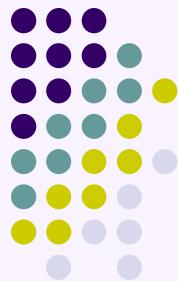
The email is written and so cannot be denied or misinterpreted at a later date.



Question 3

Which is the more reliable evidence (and why)

- 1) A bank statement from a client's file
- 2) A certificate received directly from the bank confirming the client's account balances

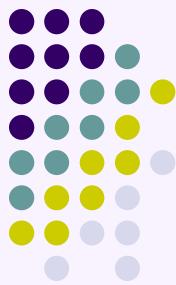


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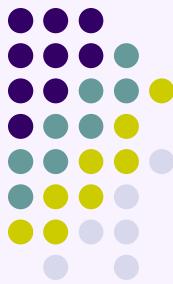
A certificate received directly from the bank can't be held back or altered by the client.



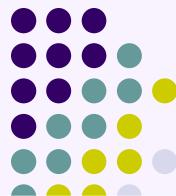
Appropriate (Quality)

Relevant – in that it proves one or more of the financial statement assertions.

Financial Statement 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.
- Each assertion needs to be **substantiated** by gathering separate audit evidence appropriate to that assertion



Assertions - Classes of transactions (P&L)

Assertion	Description
Occurrence	Transactions recorded have occurred and pertain to the entity
Completeness	All transactions have been recorded
Accuracy	Amounts and other data have been recorded appropriately
Cut-Off	Transactions have been recorded in the correct period
Classification	Transactions have been recorded in the proper accounts
Presentation	Appropriately described with relevant disclosures



Assertions - Account Balances (SOFP)

Assertion	Description
Existence	Assets, liabilities and equity exist
Rights & Obligations	The entity controls the rights to assets and liabilities are the obligation of the entity
Completeness	All assets, liabilities and equity have been recorded
Accuracy, valuation allocation	Assets, liabilities and equity are recorded at appropriate amounts
Classification	Balances have been recorded in the proper accounts
Presentation	Appropriately described with relevant disclosure

Illustration of Financial Statement Assertions

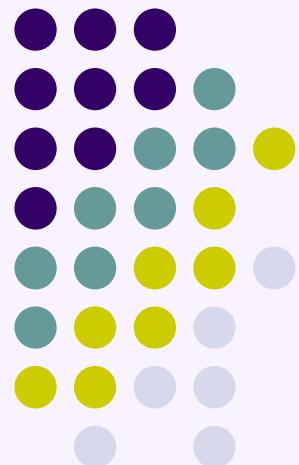
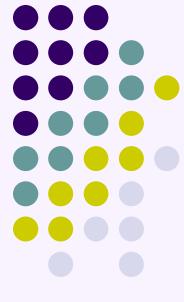


A company has a piece of machinery held for a number of years in financial statements at £25,000.

- Does it exist? – View it
- Is it owned by company? – See invoice?
- Is machinery complete? – Are the others in factory not listed in accounting records?
- Is it valued correctly? – Invoice, recalculate depreciation, consider impairment
- Is it classified correctly? – Is it machinery?
- Is it presented correctly? – Review disclosures.

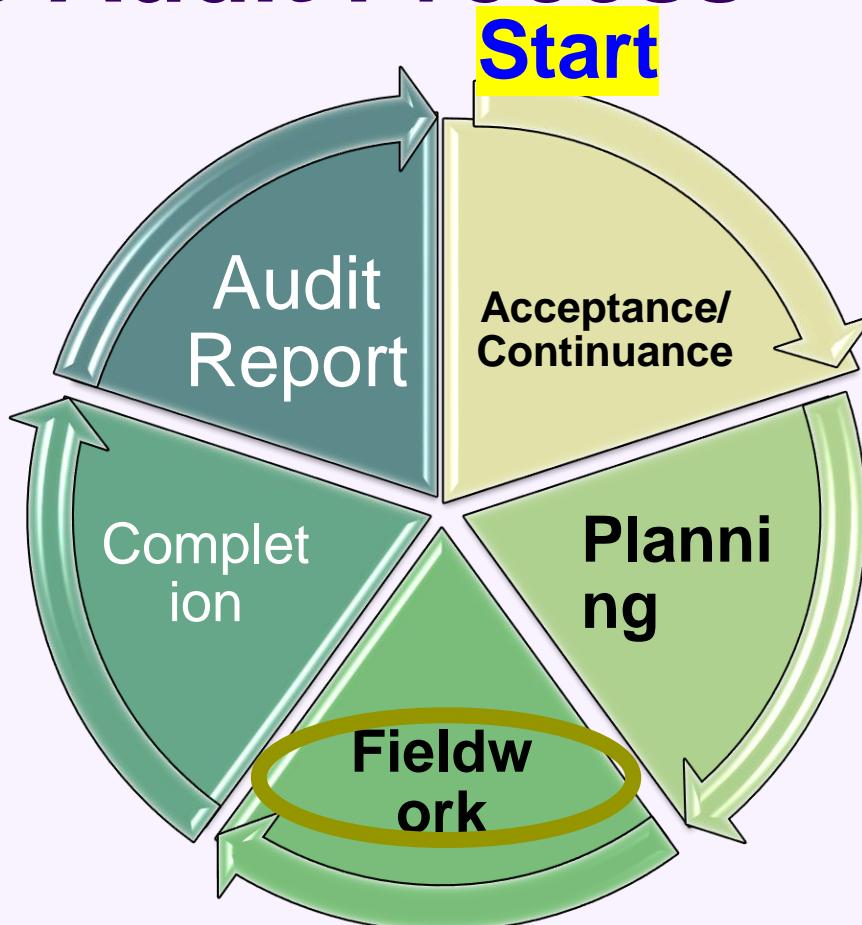
Audit & Assurance

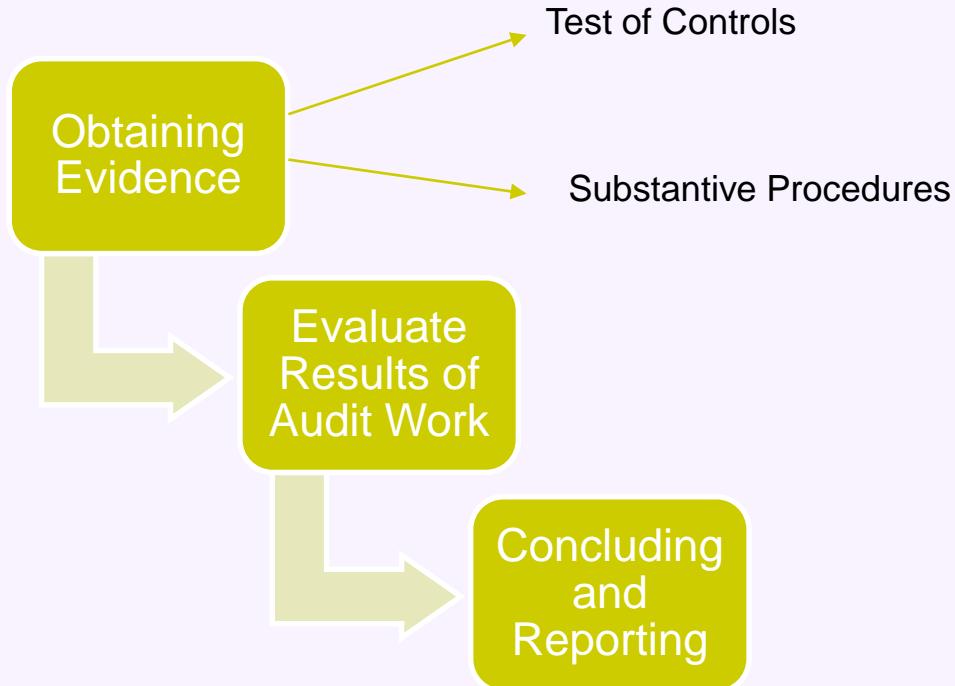
Audit Approach



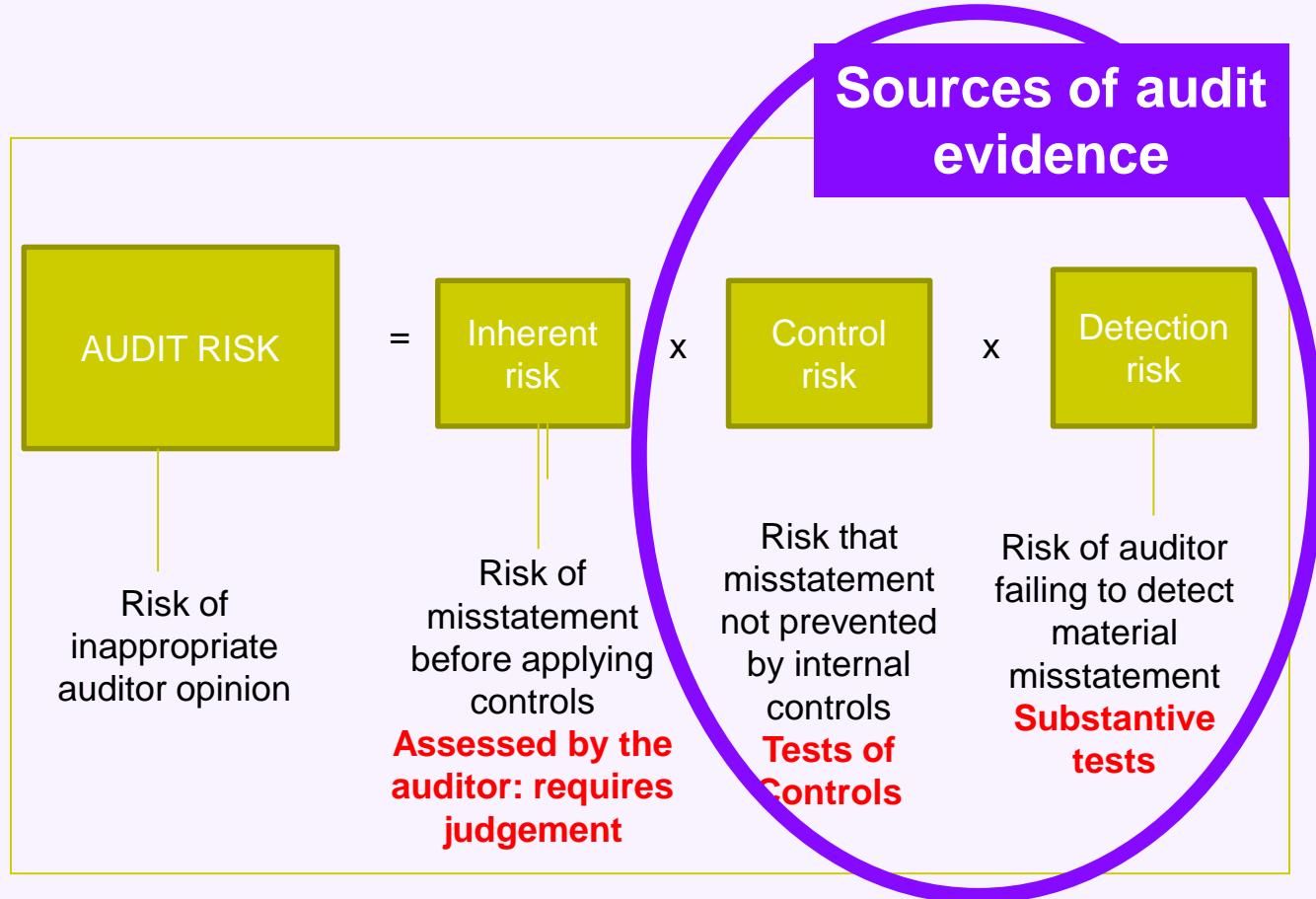
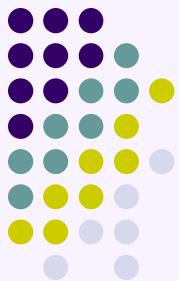


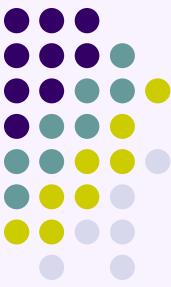
The Audit Process





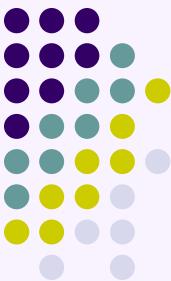
Reminder: The audit risk model





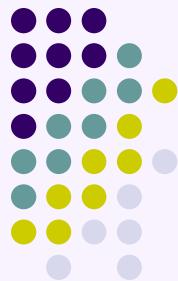
Approach to audit

- Need to assess the extent to which you can rely on controls.
- This will drive the extent and nature of substantive testing.



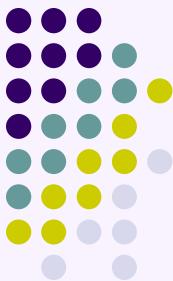
Do we expect controls to be effective?

- Yes – We need to test the controls
- No – No reliance can be placed on controls to prevent or detect a misstatement and so full substantive testing is required



Testing controls

- Controls found to be effective – We can limit substantive testing as there is some confidence controls will prevent or detect misstatements.
- Controls found to be ineffective – Reliance can't be based on controls and so increased substantive testing needed



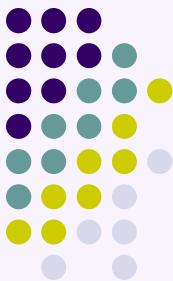
Tests of Control

- By carrying out tests of controls, the auditor is **seeking to rely on** the effective operation of the entity's control system to **help them conclude** that the financial statements give a 'true and fair' view.
- The directors set up the control system to provide reliable financial information (**ie the client is responsible for establishing controls**).
- Auditors assess whether controls have operated as intended by performing **tests of controls** (**ie the auditor is responsible for tests of controls**).



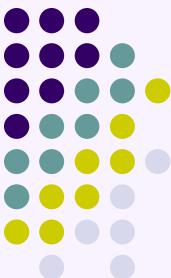
Tests of control

- Test the system that gets the numbers into the financial statements
- Procedures include enquiry, observation and re-performance (will cover in more detail later week 9 and 10)
- Appropriate if control risk is low and using tests of control is a more efficient means of gathering evidence
- The auditor cannot just carry out tests of control due to inherent limitations of controls (see week 5)



Substantive Testing

- Test the numbers in the financial statements
- Procedures include analytical procedures and tests of detail (Weeks 10 and 11)
- As dictated by ISAs must always carry out substantive testing on material items



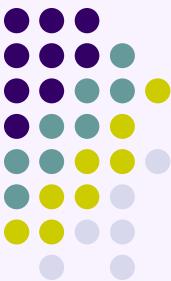
SuperRetail plc is a large retailing operation which has sophisticated point of sale technology and a revenue from sales of £5 billion annually. This represents millions of point of sale transactions.

In order to test the **completeness of revenue** in the financial statements, rather than sample millions of individual transactions and verify them to individual sales receipts, it is going to be significantly more efficient and cost effective for the auditors to test whether the revenue system, with regard to sales recording, operates effectively overall. In this case, the auditors would choose to test controls over revenue recording to establish whether they can rely on the fact that the system worked as it was supposed to and material mistakes in the recording of sales have not occurred.

During the year, SuperRetail plc also invested in new premises for stores. This involved the purchase of three pieces of land. In one case, building work on the new store has started, but in the other two it has not.

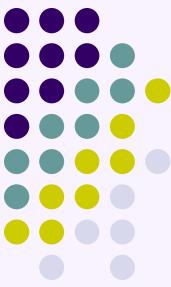
In order to test the **valuation of these additions to non-current assets** in the financial statements, rather than look in detail at the systems surrounding land purchase and building, it will be more efficient and cost effective for the auditors to verify the cost of the land to purchase documentation and the cost of the building to date to the surveyor's reports. This will be a substantive procedure.

In the first instance, the auditors had to consider a vast number of transactions which were all carried out in a normal, routine fashion through a sophisticated system, in the second, a small number of large transactions, which, although they were probably carried out in line with an established company policy, were easily verified by available, third party evidence. Thus the auditors made a judgement about the best way to collect evidence concerning those different assertions.



Example - Audit of inventories

- You could audit inventory by counting it all and working out what it is worth by exhaustive checking to invoices etc – **reliance on tests of details** (substantive approach)
- Alternatively you could look at the client's systems for recording purchases and sales, for checking goods into the warehouse, and for ensuring security of the warehouse site. Should you conclude that the systems are sound you may wish to place **reliance on internal controls**.



Example - Audit of inventories

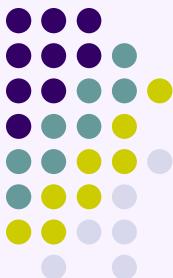
- You could also look at an analysis of inventory over the last few years, consider the normal inventory levels the client carries and their relationship to recent purchases and cost of sales, the basis for overhead and labour recovery, and you might think that, all in all the inventory figure looks about right – **reliance on analytical procedures**
- In practice you are likely to do a combination of all three. Auditing standards require the auditor to carry out some substantive procedures (tests of details or analytical procedures) but **placing reliance solely on internal controls is not an option.**



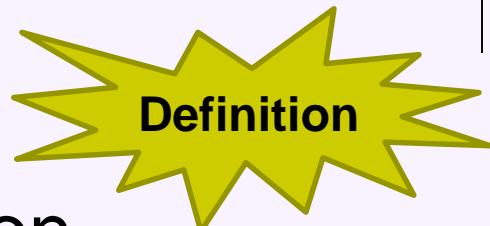
<u>Audit Test</u>	Substantive or Test of Control
1. Agree invoice to GRN (goods received note)	
2. Inspect property	
3. Inspect purchase invoice to ensure it has been approved	
4. Examine bank reconciliation statements and agree reconciling items to supporting documentation	
5. Check accounting ratios for reasonableness	
6. Review and confirm computer password arrangements	
7. Check arithmetic accuracy of invoices	



<u>Audit Test</u>	Substantive or Test of Control
1. Agree invoice to GRN (goods received note)	Substantive
2. Inspect property	Substantive
3. Inspect purchase invoice to ensure it has been approved	Test of control
4. Examine bank reconciliation statements and agree reconciling items to supporting documentation	Substantive
5. Check accounting ratios for reasonableness	Substantive
6. Review and confirm computer password arrangements	Test of control
7. Check arithmetic accuracy of invoices	Substantive



Data Analytics



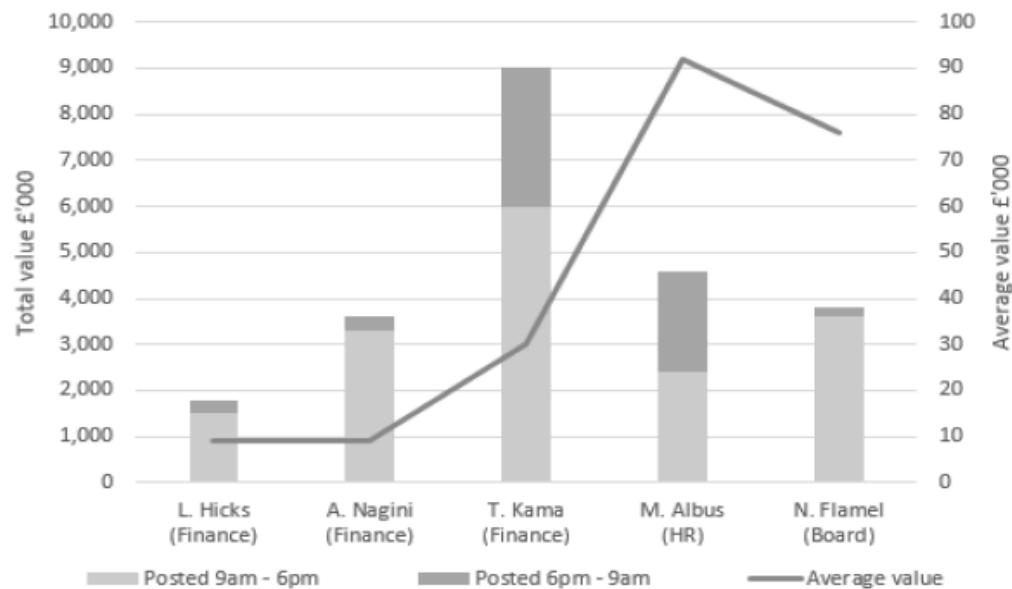
Data analytics is the examination of data to try to identify patterns, trends or correlations.

Auditors, in some cases, can now examine 100% of the population. The auditor doesn't need to select a sample.

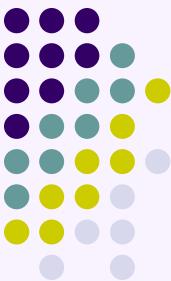
Increases the importance of controls



You are working on the external audit of Bunty Ltd (Bunty) for the year ending 31 March 2020. Your firm's data analytics software has produced the following dashboard, relating to journal entries, using data provided by Bunty.



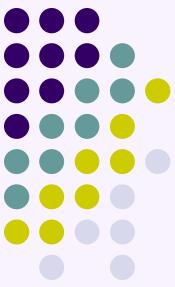
Using the dashboard, identify and explain the matters which you consider require further investigation.



Solution Notes

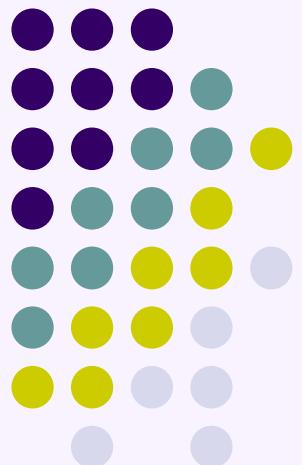
Matters for further investigation :

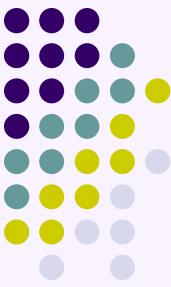
- Kama/Albus have high proportion of journals posted outside working hours - Increased risk of fraud or unauthorised transactions
- Albus/Flamel have journals of high average value – This may include material transactions that are required to be examined
- Journals posted by HR / Board are likely to be non-routine transactions - Increased risk of error or fraud and may indicate management override.
- High value of journals by Kama - Consider if this is consistent with Kama's role



Audit & Assurance

Evaluation, Concluding and Reporting

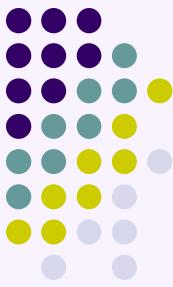




Evaluate Results

The auditor should consider whether the evidence gathered on the audit so far meets the basic rules

- Relevant – Audit evidence to support all financial statement assertions for given class of transactions or balance.
- Reliability – Has any evidence come to light to cast doubt over reliability of evidence e.g Doubts over management integrity.
- Sufficient – If not auditor should attempt to find further evidence and consider implication on audit opinion.



The Audit Report

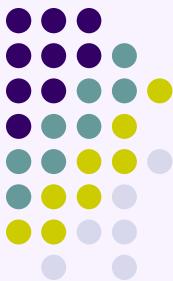
- Reports the conclusion of the audit – auditor's **opinion** as to whether or not the financial statements are '**true and fair**'
- Opinion provides **reasonable assurance**, expressed positively

Reminder - there are two types of assurance engagement conducted by practitioners:

- **Reasonable assurance** engagement
- **Limited assurance** engagement

The key distinctions are:

- **the sufficiency of the evidence sought** and
- **the type of opinion given.**



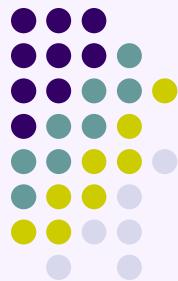
Content of the Audit Report

(For an unmodified audit report)

The Companies Act 2006 requires the auditors to state **explicitly whether or not** in their opinion the annual financial statements give **a true and fair view**.

Must explicitly opine on:

- The state of the company's affairs
- The company's profit or loss
- Whether compliant with the financial reporting framework
- Whether compliant with legal requirements of CA06
- Whether information in the directors' report is consistent with the financial statements.

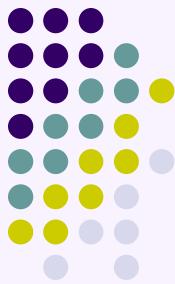


Content of the Audit Report

Implied opinions:

- Adequate accounting records have been kept
- Returns adequate for the audit have been received from branches not visited
- Financial statements agree with the accounting records and returns
- All information and explanations have been received as they think necessary
- Particulars of loans and other transactions in favour of directors and others have been correctly disclosed in the financial statements.

The main components of an audit report

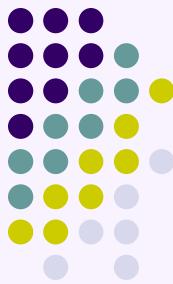


See textbook and audit report for Tesco plc

- Title
- Addressee
- Auditor's opinion paragraph
- Basis for opinion
- Going concern section, where applicable
- Key audit matters
- Other information

Must be signed by the senior auditor in their own name

The main components of an audit report



- Respective responsibilities of auditors and directors
- Opinion on other matters e.g. is the Directors' Report consistent with the financial statements
- Any matters on which the auditor is required to report on **by exception**
- Name of engagement partner
- Signature of engagement partner
- Address of auditors
- Date

Must be signed by the senior auditor in their own name

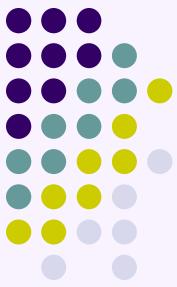


Key Audit Matters

ISA (UK) 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

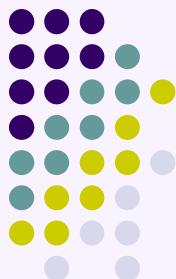
Key audit matters are '**matters of most significance**' to the audit. The auditor is required to provide further information about:

- how it applied **materiality** in the audit
- which matters are key matters. These are the areas of the audit that were risky, and **which needed the most audit work/attention.**



AUDIT REPORT: WHAT ARE THE OPTIONS?

OPINION



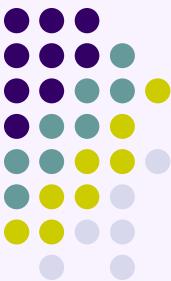
Audit Report

Unmodified Opinion

Modified Opinion

Satisfied that evidence obtained is sufficient and appropriate and supports the view presented in the financial statements

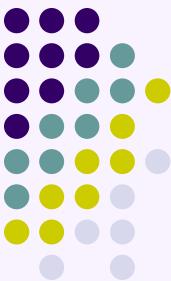
Either not satisfied with the sufficiency or appropriateness of the evidence, or has issues with the content of the financial statements



Unmodified Audit Opinion

If the auditor considers that the financial statements are **true and fair** they can issue an **unmodified audit opinion**





Modified Audit Opinion

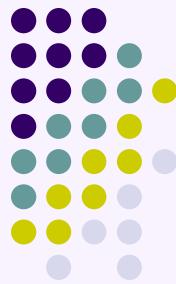
Two circumstances:

Financial statements are
**not true and fair -
disagreement**

Not enough evidence to
determine whether or not
the financial statements
are true and fair –
limitation of scope



Important Consideration in What Type of Report to Issue



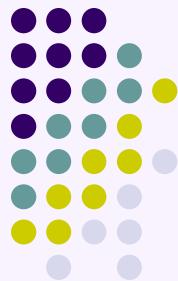
When an item is misstated or there is a lack of evidence the resulting report depends on how material it is.

MATERIAL

- Is an issue limited to a small number of areas, which can be considered in reading all of the financial statements.

MATERIAL
AND
PERVASIVE

- Is the issue so widespread or fundamental to the understanding of the financial statements they are effectively meaningless



Types of Opinion: Misstatement (Not True and Fair)

‘Except for’ factors to consider:

- Error restricted to one or two (maybe) areas
- **Amount just above the materiality threshold**

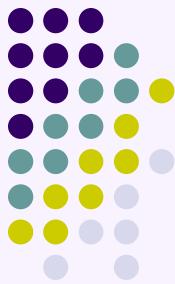
Example: ‘In our opinion, except for inventory, the financial statements are true and fair’.

‘Adverse’ factors to consider:

- So material it is considered **PERVASIVE**
- Very large misstatement or affecting lots of areas

Example: ‘In our opinion the financial statements are not true and fair’.

Types of Opinion: Limitation of Scope



'Except for' factors to consider

- Error restricted to one or two (maybe) areas
- Just above the materiality threshold

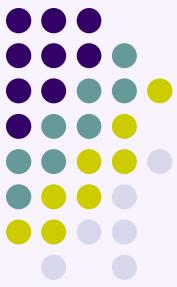
'Disclaimer' factors to consider

- So material it is considered **PERVASIVE**
- We cannot give an opinion



Modified Opinion Summary

	Auditor's judgement about the pervasiveness of the effects or possible effects on the financial statements	
Nature of Matter Giving Rise to the Modification	Material but Not Pervasive	Material and Pervasive
Financial statements are materially misstated (disagreement)	Modified opinion ('Except for')	Adverse opinion
Inability to obtain sufficient appropriate audit evidence (limitation on scope)	Modified opinion ('Except for')	Disclaimer of opinion



AUDIT REPORT: WHAT ARE THE OPTIONS?

2. THE REPORT

Modified Report vs Modified Opinion

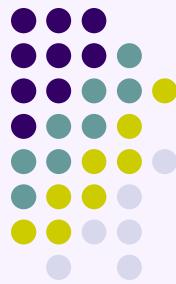


The **audit opinion** section is only one part of the **audit report**.

The audit **OPINION** may be either:

- An **unmodified audit opinion**: (ie the auditor is satisfied that the evidence obtained supports a true and fair view).
- A **modified audit opinion**: (ie the auditor is either not satisfied with: (i) the evidence; or (ii) the content of the financial statements).

Modified Report vs Modified Opinion



A modified **REPORT** will occur where either:

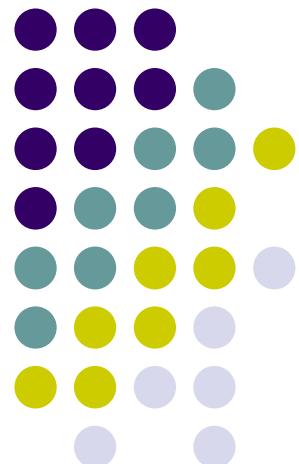
1. There is a modified audit **opinion**, as an extra paragraph is added explaining basis of modified opinion.
2. **Additional paragraphs** have been added to the audit report (but not in the audit opinion section) that draw the attention of the reader to important issues (e.g. an **emphasis of matter paragraph**).

This does **not** indicate that the financial statements are not true and fair.

More in this in your Advanced Auditing module...

Audit & Assurance

Topic 9A
Evidence and Sampling
Podcast 1



Required Reading:



Chapters 11 & 13, ICAEW 'Assurance' textbook

The Audit Process





Evidence and Sampling

By the end of studying this topic, you should be able to:

- Describe the procedures for obtaining evidence.
- Recognise the strengths and weaknesses of particular forms of evidence
- Recognise when sufficient, appropriate evidence has been obtained such that a conclusion can be drawn
- Understand nature and methods of audit sampling

Lecture plan



Podcast 1

1. Audit evidence (revision)
2. Audit of accounting estimates
3. Inventories

Podcast 2

4. CAATs
5. Substantive analytical procedures
6. Data analytics
- 7 PPE

Podcast 3

8. Intangibles
9. Receivables
10. Audit sampling

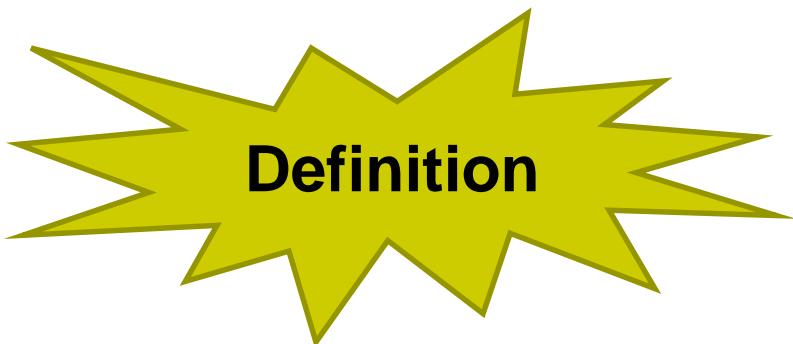


Additional Reading

- Self study - Chapters 9, 10 and 12 cover the topics Internal Audit, Documentation and Written Representations.
- We have covered these topics throughout the module (e.g. internal audit – controls; written representation – evidence; documentation – throughout)
- Reading these chapters will bring together and deepen your understanding of these topics

1.

Audit Evidence (week 4)



Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based

ISA 500, Audit Evidence.

Audit evidence includes both the information contained within the **accounting records** underlying the financial statements, and **other information** gathered by the auditors, such as confirmations from *third parties*.

Sufficient Appropriate Audit Evidence (week 4)



Quality of Evidence	
External	More reliable than evidence sourced from the entity
Auditor	Evidence is more reliable if sourced directly by the auditors
Entity	Entity generated evidence is more reliable when control systems operate effectively
Written	More reliable than oral evidence
Original	More reliable than photocopies

Obtaining audit evidence – audit procedures



- Inspect (assets and documents)
- Observe (eg segregation of duties)
- Inquiry (of management)
- External confirmation (eg from bank or suppliers)
- Recalculation (eg adding up invoice)
- Reperformance (eg with CAAT)
- Analytical procedures (substantive)

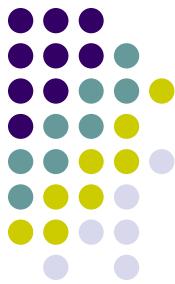
Evidence gathering audit procedures



There are more different ways evidence can be obtained by the auditor (use **active verbs** if asked for audit procedures)

- Vouch
- Agree
- Reconcile
- Cast
- Review
- Ascertain
- Trace
- Compare
- Obtain

Scoping – Tesco audit report: 2020 Deloitte



“Our Group audit was **scoped** by obtaining an understanding of the Group and its environment, including Group-wide controls, and assessing the **risks of material misstatement** at the Group level.”

“Our audit scoping provides **full scope audit coverage** of 96% (2018/19: 95%) of revenue and 92% (2018/19: 94%) of net assets.”

2. Audit of Accounting Estimates



Examples:

Inventory valuation

Depreciation

Provisions
e.g. warranty

Less reliable
evidence available

- Not a result of transactions with third parties
- Based on management judgement

Risk of
management bias



Audit of Accounting Estimates

Requires **professional scepticism**

ISA 540 Auditing Accounting Estimates sets out the appropriate audit approach.

Risk assessment procedures should identify risk of **material** misstatement due to accounting estimates.

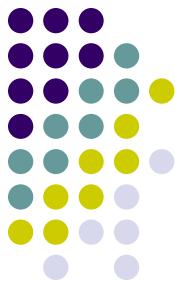
- **Estimation uncertainty** is a key risk (ie inherent lack of precision in measurement).



Audit of Accounting Estimates

Method	Example
Test the process management used to estimate the figure and the data upon which the estimate is based	Compare estimate with past experience, check the calculation and consider any factors that would have affected the current year figure
Use a 'point estimate'	There may be standard models available for comparison. Compare with range estimates
Review events occurring up to the date of the auditor's report (ie post year end)	More evidence may be available after the balance sheet date
Test effectiveness of any controls over the estimate plus substantive procedures (e.g. analytical procedures)	Appropriate if there are controls over the estimation and if the estimate is derived from the routine processing of data

3. Inventory: Procedures to Obtain Evidence



Assertions

- Rights and Obligations
- Existence
- Completeness
- Accuracy, Valuation and Allocation
- Classification
- Presentation

What audit evidence can we obtain to support these assertions?

Inventory – Risks of Material Misstatement (what can go wrong?)



- Inventory that **does not exist** may be included in the financial statements (**existence**) = overstatement
- **Not all inventory may be included** in the financial statements = understatement (**completeness**)
- Inventory may be included in the financial statements at full value when it is **obsolete or damaged** - cost v NRV (**valuation**)
- Inventory may be included in the financial statements **at the wrong value** - (**valuation**)
- Inventory **that belongs to third parties** may be included in the financial statements (**rights**)
- Inventory **that has already been sold** may be included in the financial statements - (**cut-off**)



Inventory Count (Stock count)

- Most entities will carry out an inventory count at the year-end
- Auditors will evaluate and test the controls over inventory counting
- Auditors will usually attend the inventory count to test controls and perform substantive procedures
- *Some companies may have a perpetual inventory system which means regular inventory counts are less necessary*



Controls over Inventory Count

- Refer to your lectures on internal control for information on controls over inventory counts
- Refer also to textbook chapter 13 for example controls over inventory counts

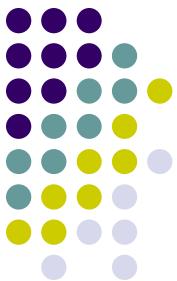


Cost Vs NRV

Indications inventory might be **impaired** include:

- An increase in cost or **fall in sales price**
- **Physical deterioration** (can be observed at inventory count)
- **Obsolescence** of product (older inventories)
- Loss leader strategy (artificially **low prices**)
- **Production errors**

Auditors should compare cost to NRV – see chapter 13 of textbook for example



Cost v NRV - Example

	£ per unit
Selling price	200
Transport cost to customer	(35)
Completion costs	<u>(40)</u>
NRV per unit on inventory	<u>125</u>



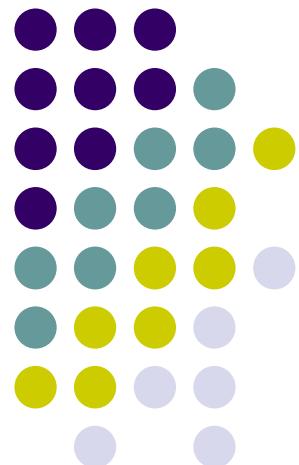
Cost v NRV - Example (cont)

<u>Inventory cost per unit</u>	£ <u>per unit</u>
Raw materials	50
Production labour	25
Production overheads variable	10
Production overheads fixed	<u>60</u>
Total cost per unit	<u>145</u>

Conclusion – write down inventory from 145 to its NRV of 125

Andromeda Industries

Inventory Count



Andromeda Industries - Question



Inventory count

Andromeda's raw materials and finished goods inventory are stored in **12 warehouses** across the country.

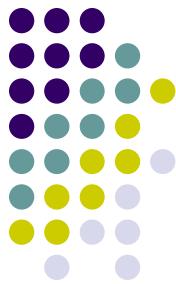
Each of these warehouses is expected to contain **material** levels of inventory at the year end. It is expected that there will be no significant work in progress held at any of the sites.

Each count will be supervised by a member of Andromeda's **internal audit** department and the counts will all take place on 31 December, when all movements of goods in and out of the warehouses will cease.

Requirement

Describe **audit procedures** you would perform during the audit of Andromeda **BEFORE** and **DURING** the inventory counts.

Andromeda Industries - solution



Before inventory count

- Review prior year audit files
- Discuss inventory count with management (new warehouses; control issues)
- Select sample of warehouses to attend inventory count
- Review inventory count instructions from management

Andromeda Industries - solution

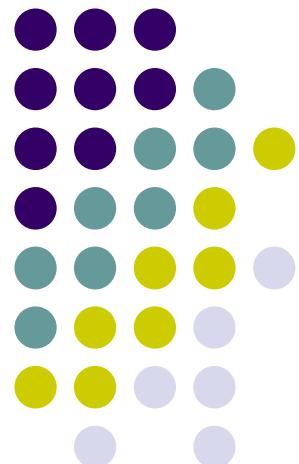


During inventory count

- **Observe** counting to confirm procedures
- **Sample** inventory and perform test counts
- **Confirm** procedures for identifying damaged and slow moving goods
- **Observe** that all inventory movements have ceased
- **Obtain** copies of all sequentially numbered inventory sheets for follow-up testing
- **Note** last GRN and delivery note (cut-off)

Audit & Assurance

Topic 9A
Evidence and Sampling
Podcast 2



Lecture plan



Podcast 1

1. Audit evidence (revision)
2. Audit of accounting estimates
3. Inventories

Podcast 2

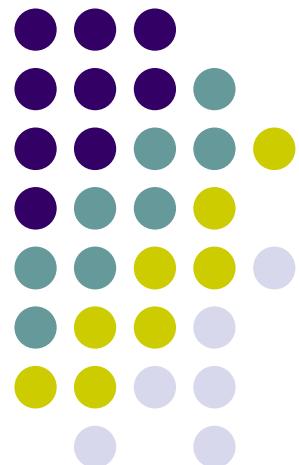
4. CAATs
5. Substantive analytical procedures
6. Data analytics
- 7 PPE

Podcast 3

8. Intangibles
9. Receivables
10. Audit sampling

Andromeda Industries

Inventory Count



Andromeda Industries - Question



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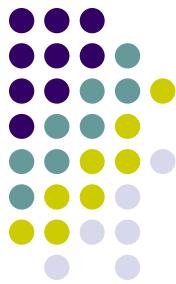
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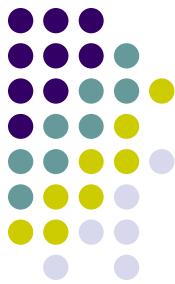
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Computer Assisted Audit Techniques (CAATs)



- Auditors may use 'Computer Assisted Audit Techniques' (CAATs)
 - Test data
 - Audit software
- To identify procedures that auditors may use CAATs for, think of normal audit procedures and consider whether the information can be obtained from the client's computer system

Computer Assisted Audit Techniques (CAATs)



	AUDITOR	COMPANY
Using test data (eg dummy transactions)	DATA	SOFTWARE
Using audit software	SOFTWARE	DATA



Test Data (ie. auditor's data)

Tests controls within the client's accounting system:

1. Identify controls within the client's system
2. Decide upon the test data to use:
 - Dummy data
 - Real data
 - Dummy data run through a copy of the system
3. Run the test data
4. Compare results with expectations
5. Conclude on whether controls are operating effectively



Test Data - Examples

- An invoice which does not **cast** (add up) should be rejected by the system
- An invoice with an **incorrect supplier code** should be rejected
- Valid entries should be **correctly posted** to the appropriate account
- A sales order which would exceed customer's **credit limit** should be rejected by the system.

Audit Software (auditor's software)



Interrogates the client's system and analyses selected information

- Extract a sample according to specified criteria
e.g. balances over a certain amount
- Calculate ratios and select those outside expectations
- Check calculations performed by the system
- Prepare reports such as budget figures compared with actual figures
- Can test whole population



- Delphic Ltd is a wholesaler of furniture. Delphic buys the furniture from six major manufacturers and sells them to over 600 different customers ranging from large retail chain stores to smaller owner-controlled businesses.
- The receivables balance includes customers owing up to £125,000 to smaller balances of about £5,000, all with many different due dates for payments and credit limits. All information is stored on Delphic's computer systems.
- You are the audit senior in charge of the audit of the receivables balance. For the first time at this client, you have decided to use audit software. Staff at Delphic are happy to help the auditor, although they cannot confirm completeness of systems documentation, and warn that the systems have very old operating systems in place, limiting file compatibility with more modern programs.



Procedure

Cast the debtors ledger to ensure it agrees with the total on the debtors control account.

Compare the balance on each debtor account with its credit limit to ensure this has not been exceeded.

Review the balances in the debtors ledger to ensure no balance exceeds total sales to that customer.

Calculate debtor days for each month end to monitor control of debtors over the year.

Stratify debtors balances to show all material items and select appropriate sample for testing.

Produce an aged debtors analysis to assist with the identification of bad debts.

Reason for procedure

To ensure the completeness and accuracy of recording of items in the debtors ledger and control account.

To check for violation of system rules.

To check for unreasonable items in the ledger.

To obtain new/relevant statistical information.

To select items for audit testing.

To assist with debtors valuation testing.



5. Analytical Procedures

Analytical Procedures can be used at three different stages of the audit:

- *Beginning* – **Preliminary AP (as part of planning)**
- *Middle* – **Substantive AP (gathering audit evidence as part of substantive procedures. Auditors are not required to do this by ISA)**
- *End* – **Review AP (part of audit completion)**



Analytical Procedures

- ISA 520 *Analytical Procedures* gives detail on using analytical procedures in the audit process

Remember: it is compulsory at the planning stage to use analytical procedures

- Substantive procedures are required to be performed on all material balances, this **may** include **substantive** analytical procedures

Factors to Consider When Using Analytical Procedures



Factor	Issues to consider
Suitability	More applicable for large volumes of predictable data. Need to consider whether other audit procedures are available which would provide corroboration or further evidence (Benchmarks)
Reliability of data	The source of information, comparability of information, nature and relevance of information, whether there are appropriate controls over data
Precision	The accuracy with which results can be predicted and the extent to which information can be disaggregated
Acceptable difference	Influenced by materiality and required assurance: higher risk, lower tolerance to differences



Income Statement Items

- Revenue, purchases and employee costs are tested predominantly through **tests of controls** (Topics 6, 7 & 8)
- Also involve use of **analytical procedures** as amounts are usually of a predictable nature and involve large volumes of transactions.
- **The level of risk** associated with income statement items would affect whether other substantive procedures were required in addition to analytical procedures (e.g. tracing transactions through to invoices and payments)

Examples of data for comparison



- Interim financial information
- Budgets
- Management accounts
- Non-financial information
- Industry information
- Tax returns
- Board minutes

Analytical Procedures: Things to Consider



- If significant differences from expectations occur, the auditor needs to investigate this.
- Management responses need to be corroborated otherwise other audit procedures would need to be performed
- Effectiveness of the client's controls will affect the reliability of the data



6. What is Data Analytics?

Definition

The process of inspecting, cleaning, transforming, analysing and modeling data with the goal of highlighting useful information, suggesting conclusions, and supporting decision making.

Data analytics is an analytical process by which insights are extracted from operational, financial, and other forms of electronic data internal or external to the organisation.



Data Analytics

Data analytics insights can be historical, real-time, or predictive and can also be:

- **risk-focused** (e.g. controls effectiveness, fraud, waste, abuse, policy/regulatory noncompliance); or
- **performance-focused** (e.g. increased sales, decreased costs, improved profitability)

Example: PwC **Halo** system



Data Analytics - examples

Example 1

Extract from client's accounting system all sales transactions (credits) where the corresponding debit entry is neither receivables nor cash.

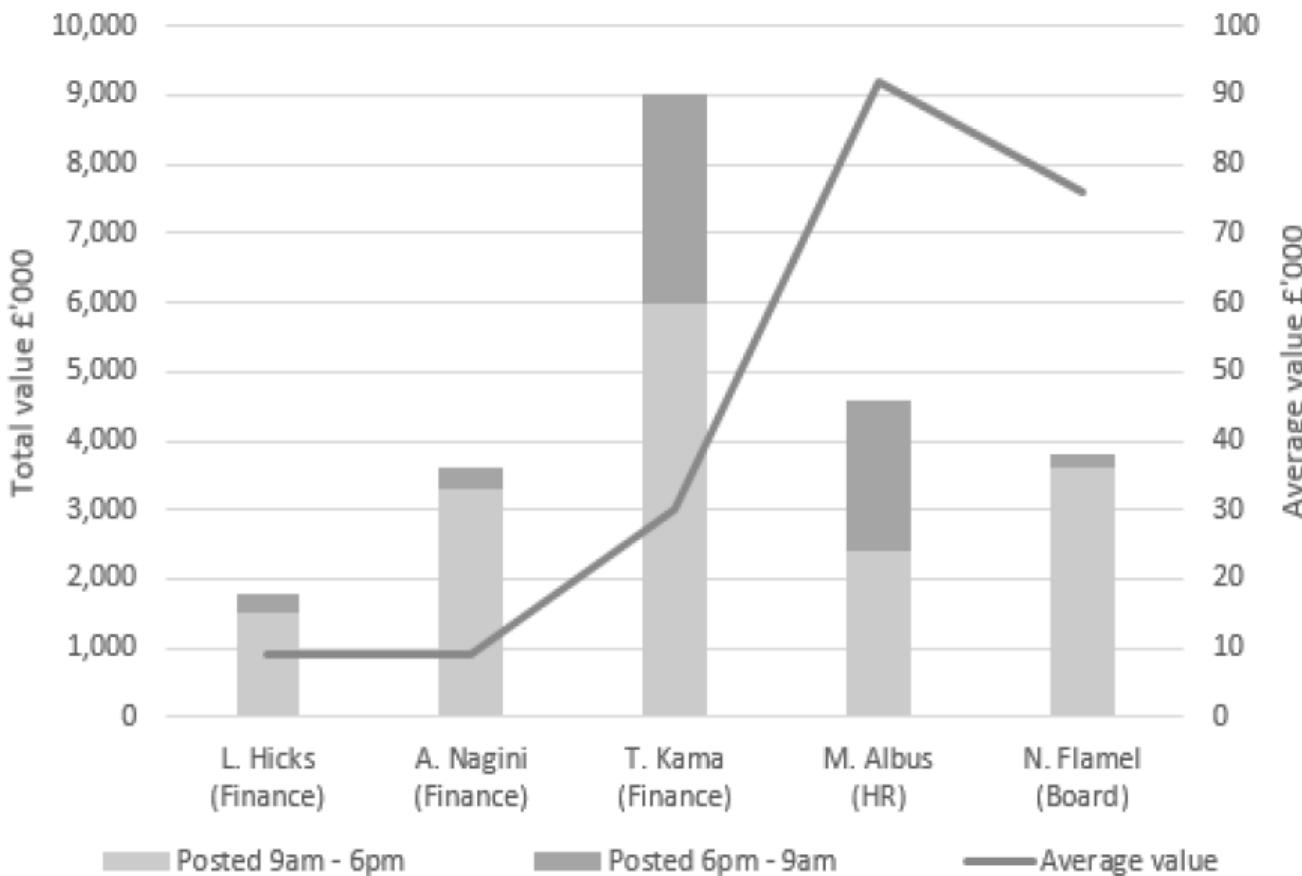
Example 2

Extract from client's accounting system all journal entries which are:

Dr PPE

Cr Any expense a/c

Data Analytics - Week 4 revision



The dashboard shows the total value (analysed by time of posting), average value and department for each employee who has posted journals during the year.

Using the dashboard, identify and explain the matters which you consider require further investigation. **(4 marks)**

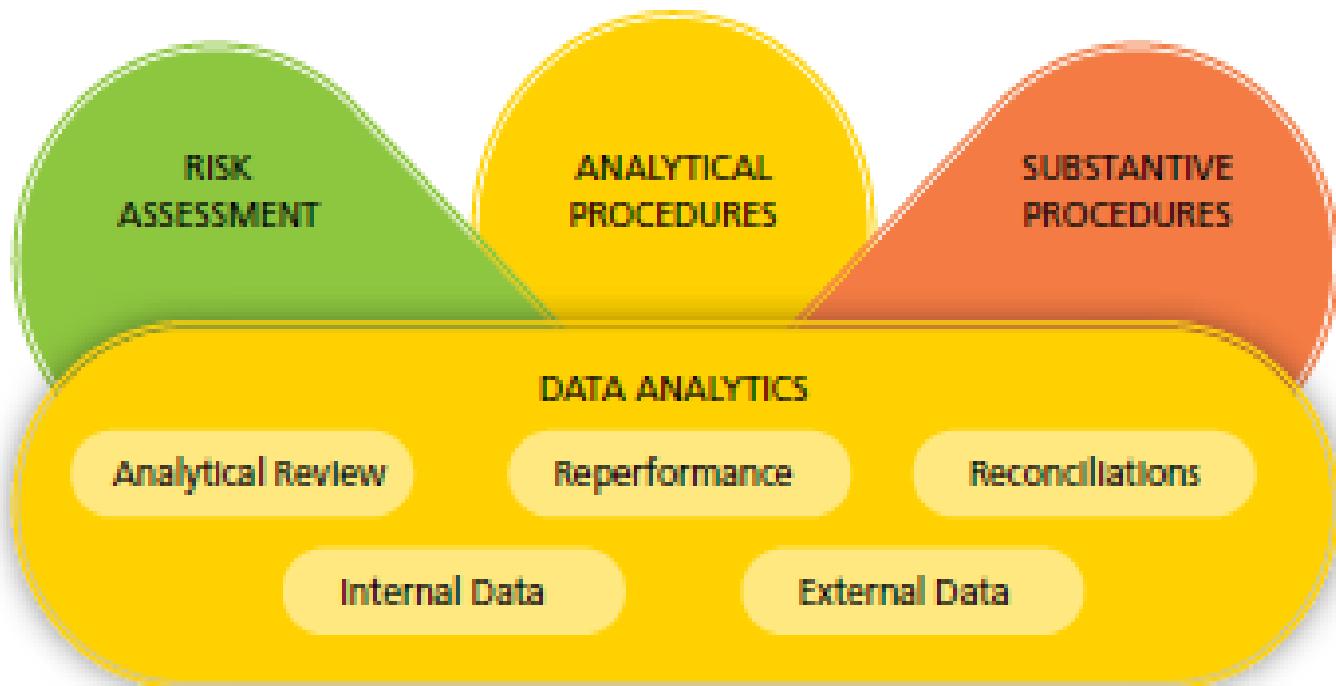
Data Analytics



DATA ANALYTICS – IMPACT ON AUDIT QUALITY

Use of data analytics on larger sets of audit-relevant data is much broader than traditional analytical procedures.

AUDIT PROCEDURES FOR OBTAINING AUDIT EVIDENCE



7. PPE



PPE: Assertions

- Existence
- Rights and Obligations
- Completeness
- Accuracy, Valuation and Allocation
- Classification
- Presentation

What audit evidence can we obtain to support these assertions?



PPE: Risks of Misstatement

- The company **may not own (or control)** the assets (**rights**)
- The assets **may not exist** or may have been sold (**existence and rights**)
- Assets **may be omitted** (**completeness**)
- Assets may be **overvalued** either by **inflating cost or valuation**, or by **undercharging depreciation** (**valuation**)
- The assets may be **incorrectly presented** in the financial statements (**presentation**)

PPE - Procedures to Obtain Evidence



Rights (assets) and Obligations (liabilities):

- Inspect ownership documents available for non-current assets
- Review sales invoices for any ‘disposals’ (assets sold within the year) to ensure ownership has been transferred

Existence

- Physically inspect assets

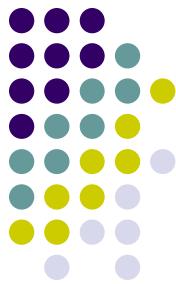
Procedures to Obtain Evidence



Completeness (understatement)

- Obtain a schedule of non-current assets
- Agree total per schedule to draft financial statements and accounting records (nominal ledger)
- Select a sample of assets physically present on site and ensure they are included on schedule
- Confirm additions (new assets purchased during the year) have been correctly included in the schedule

Procedures to Obtain Evidence



Valuation

- Agree the **cost** of a sample of assets included in the schedule to purchase invoices
- Agree the **opening accumulated depreciation** to prior year audit file (assuming your firm was the auditor in the prior year)
- **Re-calculate annual depreciation** charge for a sample of assets and agree rate used to depreciation policy
- Re-calculate depreciation charged on **disposed** assets and re-calculate profit or loss on sale of the assets



PPE – areas to test

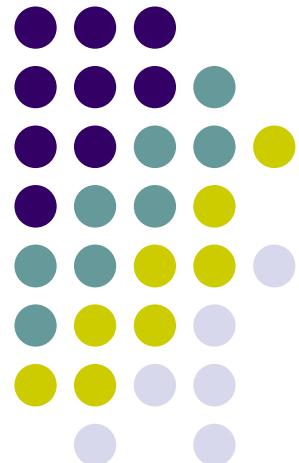
- **Additions**
- **Disposals**
- **Depreciation**
- **Opening balances**
- **Impairment**

1 Non-Current Assets

	Property	F&F	Plant & Machinery	Comp Equipment	Total
Cost b/fwd	975,000	265,000	488,276	89,900	1,818,176
Additions	250,000	30,000	72,410		352,410
Disposals		(5,000)		(2,400)	(7,400)
Cost c/fwd	<u>1,225,000</u>	<u>290,000</u>	<u>560,686</u>	<u>87,500</u>	<u>2,163,186</u>
Depreciation b/fwd	385,725	91,838	370,696	41,378	889,637
Charge for year	24,500	51,131	35,525	37,587	148,743
Elimination on disposal		(3,844)		(2,000)	(5,844)
Depreciation c/fwd	<u>361,225</u>	<u>139,125</u>	<u>335,171</u>	<u>76,965</u>	<u>912,486</u>
NBA @ 31/03/2020	<u>863,775</u>	<u>150,875</u>	<u>225,515</u>	<u>10,535</u>	<u>1,250,700</u>
NBA @ 31/03/2019	<u>617,559</u>	<u>106,318</u>	<u>189,826</u>	<u>6,087</u>	<u>919,790</u>
	2% cost	15% RB	25% RB	33% cost	

Pippa Burgers Co

PPE



Pippa Burgers Co - Solution



In the past, Pippa Burgers received negative press reports over the condition of its fast-food restaurants, with comments suggesting they are old fashioned and tired looking.

Therefore, during the year ended 31 March 20X7, Pippa undertook a full review of all its property and equipment and carried out **extensive refurbishments** to the majority of its restaurants.

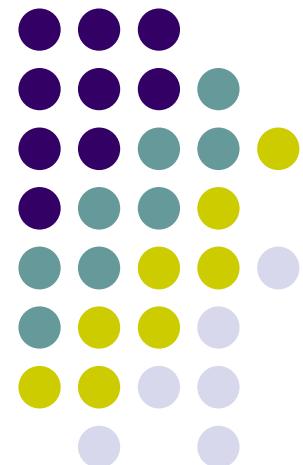
This review resulted in a significant amount of the older fixtures and fittings being **disposed** of and a significant amount of **capital expenditure** was invested in all remaining restaurants.

Requirement

Describe the **substantive procedures** you should perform to obtain sufficient and appropriate audit evidence in relation to Pippa's property, plant and equipment.

Audit & Assurance

Topic 9A
Evidence and Sampling
Podcast 3



Lecture plan



Podcast 1

1. Audit evidence (revision)
2. Audit of accounting estimates
3. Inventories

Podcast 2

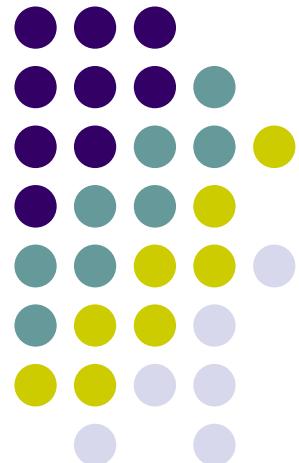
4. CAATs
5. Substantive analytical procedures
6. Data analytics
- 7 PPE

Podcast 3

8. Intangibles
9. Receivables
10. Audit sampling

Pippa Burgers Co

PPE



Pippa Burgers Co - Solution



In the past, Pippa Burgers received negative press reports over the **condition** of its fast-food restaurants, with comments suggesting they are old fashioned and tired looking.

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Requirement

Describe the **substantive procedures** you should perform to obtain sufficient and appropriate audit evidence in relation to Pippa's property, plant and equipment.

Pippa Burgers Co - Solution



Additions

- Obtain a breakdown of additions
- Confirm sample of additions to invoice
- Confirm additions are capital (not expenses)
- Physically inspect to confirm existence
- Inspect maintenance account for PPE items

Disposals

- Obtain a breakdown of disposals
- Confirm sample of disposals and agree to invoice to confirm sales proceeds
- Recalculate profit/loss on disposal

Pippa Burgers Co - Solution



Depreciation

- Recalculate depreciation for sample
- Review disclosures

Opening balances

- Agree opening balances to prior year audit file

Impairment

- Confirm additions are PPE (not expenses)
- Physically inspect for damage or faults
- Make enquiries of management and board minutes for evidence of impairment

Intangible Assets: Procedures to Obtain Evidence

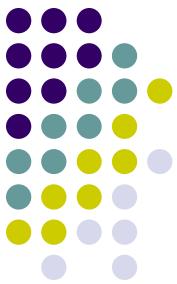


Assertions

- Rights and Obligations
- Existence
- Completeness
- Accuracy, Valuation and Allocation
- Classification
- Presentation

What audit evidence can we obtain to support these assertions?

Intangible Assets: Examples



Purchased goodwill – acquisition of another business

Purchased – eg brands, patents, licences

Internally generated – eg development costs

Intangible Assets – Risks of Misstatement



- **Expenses may be capitalised** (included within intangible assets) incorrectly (**valuation**)
- Intangible assets may be incorrectly recognised if the company does not own the rights to the asset (**rights**)
- Intangible assets may be carried at the wrong cost or valuation due to **incorrect amortisation (valuation)**
- Impairment reviews not being carried out appropriately (**valuation**)

Intangible Assets: Procedures to Obtain Evidence



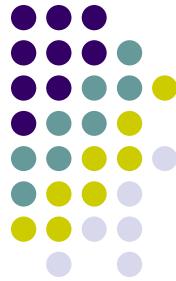
Rights and Obligations

- Agree a sample of intangible assets to purchase invoices (**if purchased**)
- Agree to **legal** documents (eg intellectual property rights)

Existence

- Examine schedule of **additions** to ensure only capital items have been included

Intangible Assets: Procedures to Obtain Evidence



Completeness

- Obtain a schedule of intangible assets
- Agree the figure per the schedule to draft financial statements and nominal ledger
- Confirm **additions** (new assets purchased during the year) have been correctly included in the schedule
- Confirm **internal costs** relating to intangibles (eg **development costs**)

Intangible Assets: Procedures to Obtain Evidence



Valuation

- Obtain client calculations of impairment reviews and re-perform calculations
- Assess reasonableness of assumptions used in impairment reviews
- Assess whether any conditions that may indicate impairment are present in the client
- Consider whether a specialist is required to value the asset
- Re-calculate amortisation charge for a sample of assets

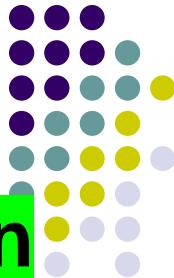


9. Receivables

Significant Risks:

- Debts are **uncollectable** (valuation) **Can't pay**
- Debts are **contested** by customers
(existence, rights and obligations) **Won't pay**
- What **external / third party evidence** is available to support these assertions?

Receivables: Audit Procedures



- Perform a trade receivables **circularisation** of a sample of year-end balances (**see later**)
- Check receipt of **cash after year end**
- Inspect the **aged receivables report** to identify any slow moving balances
- Confirm validity of sales to **despatch notes**
- Test company's controls over **issue of credit notes** and **write-offs of irrecoverable debts**
- Trace sales invoices just before year end to year end receivables balance (cut off test)



Aged analysis of receivables

	Customer	Current 1-30 days	30-60 days	60-90 days	Over 90 days	TOTAL
1	Bristol Audio Ltd				£48,000.00	£48,000.00
2	Musicalogy Ltd	£54,768.00				£54,768.00
3	Sidhuzain Indoor Events Ltd		£100,836.00			£100,836.00
4	DigiSound Ltd	£73,975.20				£73,975.20
5	Happyshine Home Systems			£115,248.00		£115,248.00
6	Sidhuzain Indoor Events Ltd				£7,800.00	£7,800.00
7	Zen AV Ltd	£360,060.00				£360,060.00
8	Innershine Ltd				£42,360.00	£42,360.00
9	Tempohead Ltd	£92,436.00				£92,436.00
10	Movies Redefined Ltd	£69,660.00				£69,660.00
11	Livyng DIY Ltd.				£21,840.00	£21,840.00
TOTAL WHOLESALE SALES		£650,899.20	£100,836.00	£115,248.00	£120,000.00	£986,983.2

Receivables: Audit Procedures (cont)



- Calculate average receivables days and compare this to prior year.
- Review the reconciliation of sales ledger control account to the sales ledger list.
- Select a sample of despatched notes before and just after the year end and follow through to the sales invoice to ensure they are recorded in the correct accounting period.

See textbook for example of receivables audit.

*See solution to **Dashing Co** question.*

Confirmations from Customers / Receivables Circularisations



- Auditors would obtain direct confirmation from a sample of customers (*ISA 505: External Confirmations*)
- The client needs to request the information (as hopefully customers wouldn't divulge confidential information to unauthorised parties)

Assertions: existence & rights and obligations
- Auditor would normally send the request – more reliable evidence if auditor generated

Confirmations from Customers / Receivables Circularisations



- **Positive** confirmation – requests customer to reply confirming the amount owed at the balance sheet date

More reliable evidence provided

- **Negative** confirmation – customer replies only if they disagree with the amount owed

*See solution to **Dashing Co** question for circularisation procedures*



Circularisation of receivables

CONFIRMATION LETTERS - Please see attachments.

RECEIVABLE CHOSEN	AMOUNT	LETTER SENT	REPLY RECEIVED	COMMENTS
Tempohead Ltd	£92,436	10 April 2021	3 May 2021	
Livvng DIY Wholesaler Ltd	£21,840	10 April 2021	29 April 2021	
Innershine Wholesaler Ltd	£42,360	10 April 2021	15 May 2021	
Zen AV Wholesaler	£360,060	10 April 2021	13 May 2021	
Bristol Audio Ltd	£48,000	10 April 2021	NO REPLY RECEIVED	



Selecting a Receivables sample

- Need to consider in particular:
 - Old, unpaid accounts
 - Accounts written off during the period
 - Accounts with credit balances
 - Accounts settled in round sum amounts
- Also need to consider:
 - Large balances (overstatement risk)
 - Accounts with nil balances (understatement risk)

Assurance providers will need to perform further work where disagreements arise (or no reply is received)



Aged analysis of receivables

“Virtual Desk and Filing System”

“Interim Visit – Sales Systems – documents and resources”

Go through the following video:

“Sheridan AV: Aged Debtor Analysis”

Note: Debtors = Receivables

https://blackboard.uwe.ac.uk/bbcswebdav/orgs/ACC/simulations/auditsim_0919_xg/auditsim_web/auditsim_files/intro.html



10. Audit Sampling - Definition

Audit sampling is the application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.

Applies to:

- Tests of details
- Tests of controls

Sampling Risk



- Likelihood (ie probability) that the decision based on the sample differs from the decision that would have been made if the entire population were examined
- Caused by selecting a **non-representative sample**
- Can be controlled by:
 - Determining an appropriate sample size
 - Ensuring that all items have an equal likelihood of selection (or probability of selection proportional to size)
 - Evaluating sample results in order to control risk



Non-sampling risk

- Likelihood that an incorrect conclusion is drawn for reasons unrelated to the sample
- Most common cause is mistakes in evaluating sample items



Approaches to Sampling

- **Statistical sampling** applies laws of probability in selecting sample items and evaluating sample results
 - Allows audit team to control exposure to sampling risk
- **Non-statistical sampling** (eg judgement sampling) does not allow audit team to control exposure to sampling risk
- Both statistical sampling and non-statistical sampling are appropriate under GAAS

Effect of Factors on Sample Size



Factor	Effect on sample size	Explanation
Population size	Insignificant	As population is larger sample increases but will normally be insignificant
Expected rate of deviation (Expected misstatement)	Direct	As auditors expect higher level of deviations or misstatements in population, need to sample more items
Tolerable rate of deviation (Tolerable misstatement)	Inverse	As auditors tolerate lower levels of deviations (or misstatements), need to sample more items
Sampling risk	Inverse	As auditors wish to reduce chance of incorrect decisions, need to sample more items
Population variability	Direct	As population is more variable, need to sample more items to obtain representative sample
Risk of material misstatement	Direct	As auditors expect higher level of risk in population, need to sample more items to reduce detection risk



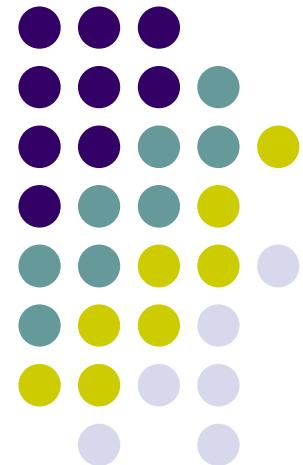
Homework

- Read study manual – Chapters 11 and 13
- Cragg – attempt question for Synchronous session on Monday
- Questions on CANVAS

Audit & Assurance

Topic 5 - Internal Controls

Podcast 1
Introduction to Internal Controls



Required Reading:

Chapter 5, ICAEW 'Assurance' textbook





Learning outcomes

On completion of this section you should be able to:

- State the reasons for organisations having effective systems of controls
- Understand the nature of internal controls
- Identify inherent limitations of a system of internal controls
- Understand how internal controls can be documented
- Identify the components of internal control
- Identify factors which contribute to an effective control environment
- Identify types of control activity
- Distinguish between general controls and application controls
- Identify internal control deficiencies

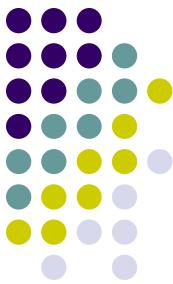
Lecture Plan – Internal Control



- Reasons
- Nature
- Limitations
- Documentation

The Audit Process





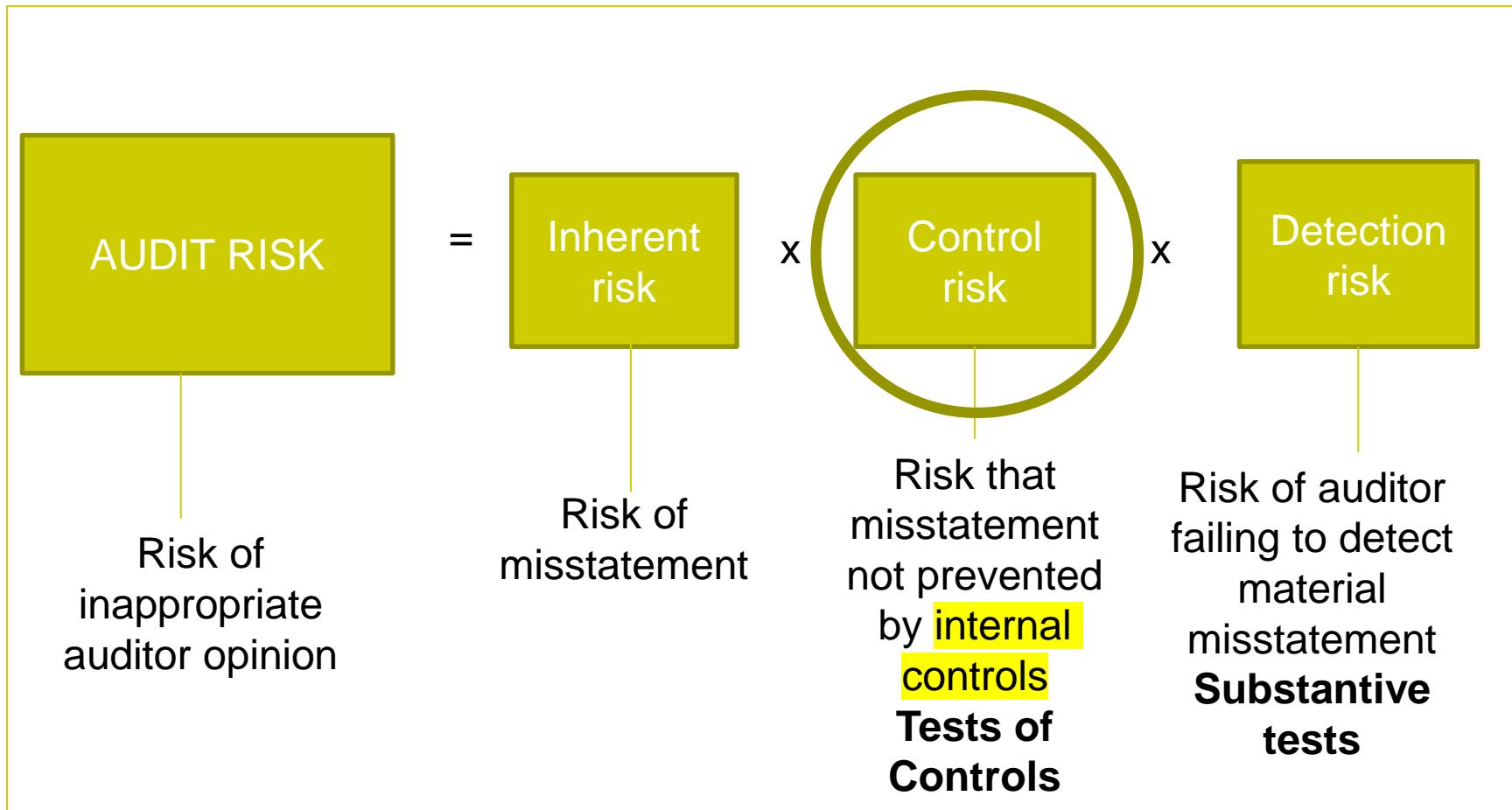
Terminology

Two levels:

- (1) Financial statements as a whole.
- (2) “**Classes of transactions** and **account balances**.” (eg revenue, cost of sales, PPE, payables, inventory).

Financial Statement Line Items (**FSLI**) are the same as (2) above.

The audit risk model





Internal Controls

Definition of 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:

- Effectiveness and efficiency of **operations**.
- Reliability of **financial reporting**.
- Compliance with applicable **laws and regulations**.

The term “controls” refers to any aspects of one or more of the **components** of internal control.

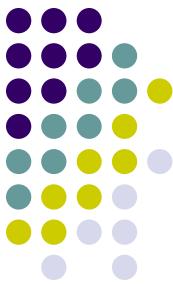


Internal Controls

Key question for auditors:

How does management control the business?

Reasons for internal controls



The reasons for internal controls include:

- Preventing and detecting fraud and error
- Minimising and mitigating the company's business risks
- Ensuring the continuing effective functioning of the company
- Ensuring the company complies with relevant laws and regulations



Directors' responsibility

It is the **directors' responsibility** to:

- prepare reliable **financial statements** and keep accurate **accounting records**.
- design and implement such **internal controls** as they deem necessary to prepare the financial statements



Control risk

Reminder:

Control risk - the risk that a misstatement could occur within a class of transactions, account balance or disclosure that will be **not be prevented or detected** by the entity's internal controls



Points to Note

- Controls may be:
 - **preventative** (designed to prevent an error / fraud) or
 - **detective** (designed to identify and correct an error / fraud).
- Auditors need to identify which controls are relevant to them.
- How much reliance the auditor places on internal controls depends on the auditor's 'expectation' of the effectiveness of controls – **professional judgement** required.

Limitations of Internal Controls



All internal control systems have some inherent **limitations**. In other words, the internal controls **cannot guarantee** efficiency or eliminate the risk of fraud and error entirely.

Internal controls cannot completely eliminate the risks to a business.

- **Think about your own work experience:**
- **Could you steal from your company? Is it easy / difficult? Why?**

Limitations of internal controls



Limitation	Explanation
Human element	Some controls are only as good as the people operating them. If a mistake is made on implementing the control, or staff lack integrity, then the control may be ineffective
Collusion	Two or more people colluding together to bypass a control (eg segregation of duties)
Unusual transactions	Controls are generally designed to deal with what routinely happens. For an unusual transaction, the control may not be relevant or exist.

Auditor's Reliance on Internal Controls



Due to the inherent limitations of internal controls, the auditor **cannot rely on internal controls entirely**, as the sole source of evidence. Some substantive tests are therefore required for each class of transactions or account balance. (**even if there are strong internal controls**).

The auditor will always initially test the adequacy of the entity's internal controls. However auditors are **not required to rely on internal controls**. Wholly substantive testing is permitted (but may be inefficient).

Auditor's Duty to Report on Internal Control Deficiencies



ISA 265 - *Communicating deficiencies in internal control to those charged with governance and management.*

The auditor should report significant deficiencies in internal controls to those charged with governance and management:

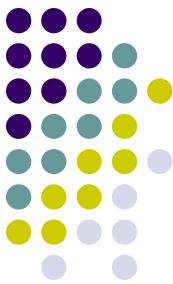
- If come to light during normal audit procedures
- No external disclosure is required

Obtaining information about controls



- Manuals of internal controls and copies of internal controls policies, or minutes of meetings of the risk assessment group.
- Access the controls in previous years and therefore any prior deficiencies
- Obtain knowledge by talking to staff operating the internal controls
- Observation - the auditor will watch operations at a company to identify the control activities being put into action.

Documentation of internal controls



1. Narrative notes

These are good for:

- Short notes on simple systems
- Background information

They are less good when things get more complex when diagrams tend to take over.

2. Questionnaires and checklists

3. Diagrams

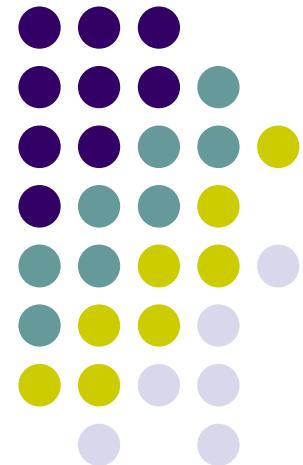
- Flowcharts
- Organisation charts

Audit & Assurance

Topic 5 - Internal Controls

Podcast 2

Components of Internal Control



Learning outcomes



On completion of this section you should be able to:

- State the reasons for organisations having effective systems of controls
- Understand the nature of internal controls
- Identify inherent limitations of a system of internal controls
- Understand how internal controls can be documented
- Identify the **components** of internal control
- Identify factors which contribute to an effective **control environment**
- Identify types of **control activity**
- Distinguish between **general controls** and **application controls**
- Identify internal **control deficiencies**

Lecture plan



- Components of internal control:
 - Control environment
 - Risk assessment
 - Information system
 - Control activities
 - Monitoring controls

Auditors are trying to assess:

- How effective are the internal controls
- Can we rely on the internal controls (for each FSLI)

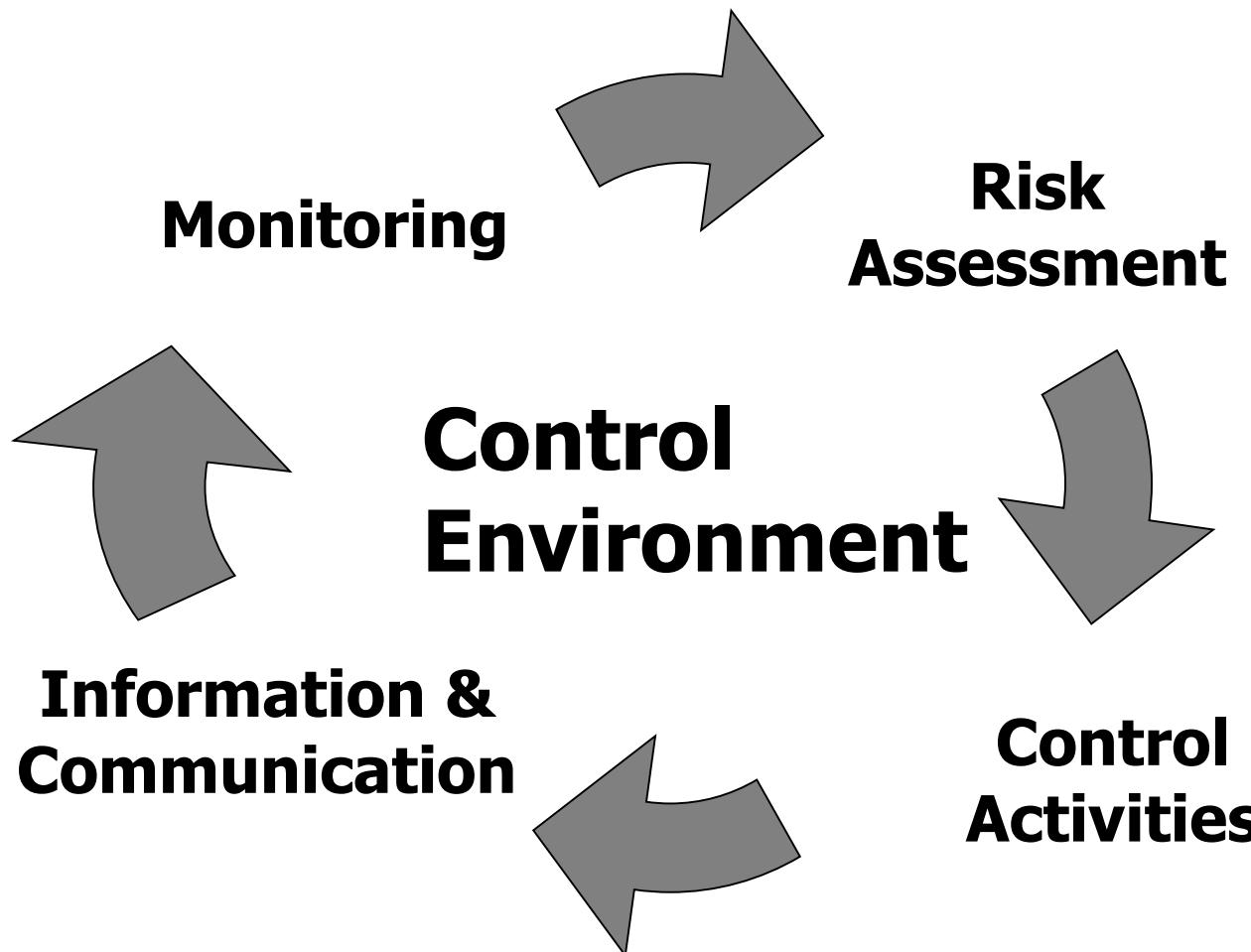
Components of Internal Control



ISA315 identifies five components of internal control:

1. The Control Environment
2. Business Risk and the Entity's Risk Assessment Process
3. The Information System Relevant to Financial Reporting
4. Control Activities
5. Monitoring of Controls

Internal Control Framework... Five Inter-Related Components





1. The Control Environment

Control environment: The control environment includes the governance and management functions and the attitudes, awareness and actions of **those charged with governance and management** concerning the entity's internal control and its importance in the entity.

The control environment sets the **tone at the top** of an organisation, influencing the control consciousness of its people.

The **control environment is therefore very important to the auditors** and they will **evaluate it as part of their risk assessment process**. If the control environment is **strong**, then auditors will be more inclined to **rely on the controls** system in the entity than if it is weak.



Control Environment

- Effective organisations set a positive “**tone at the top**”.
- Factors include the integrity, **ethical** values and **competence** of employees, and management’s philosophy and operating style.
- **Examples of soft controls:**
 - Management philosophy
 - Organisational structure
 - Communication
 - Competency and integrity of employees



Audit Committees

The audit committee is an important aspect of the **control environment** of the company. It is a **sub-committee of the board of directors** responsible for overseeing an entity's **internal control structure, financial reporting and compliance with relevant laws and regulations**.

- The audit committee is comprised of **non-executive directors**.
- It is a requirement for UK listed companies* under the rules of the **UK Corporate Governance Code**.

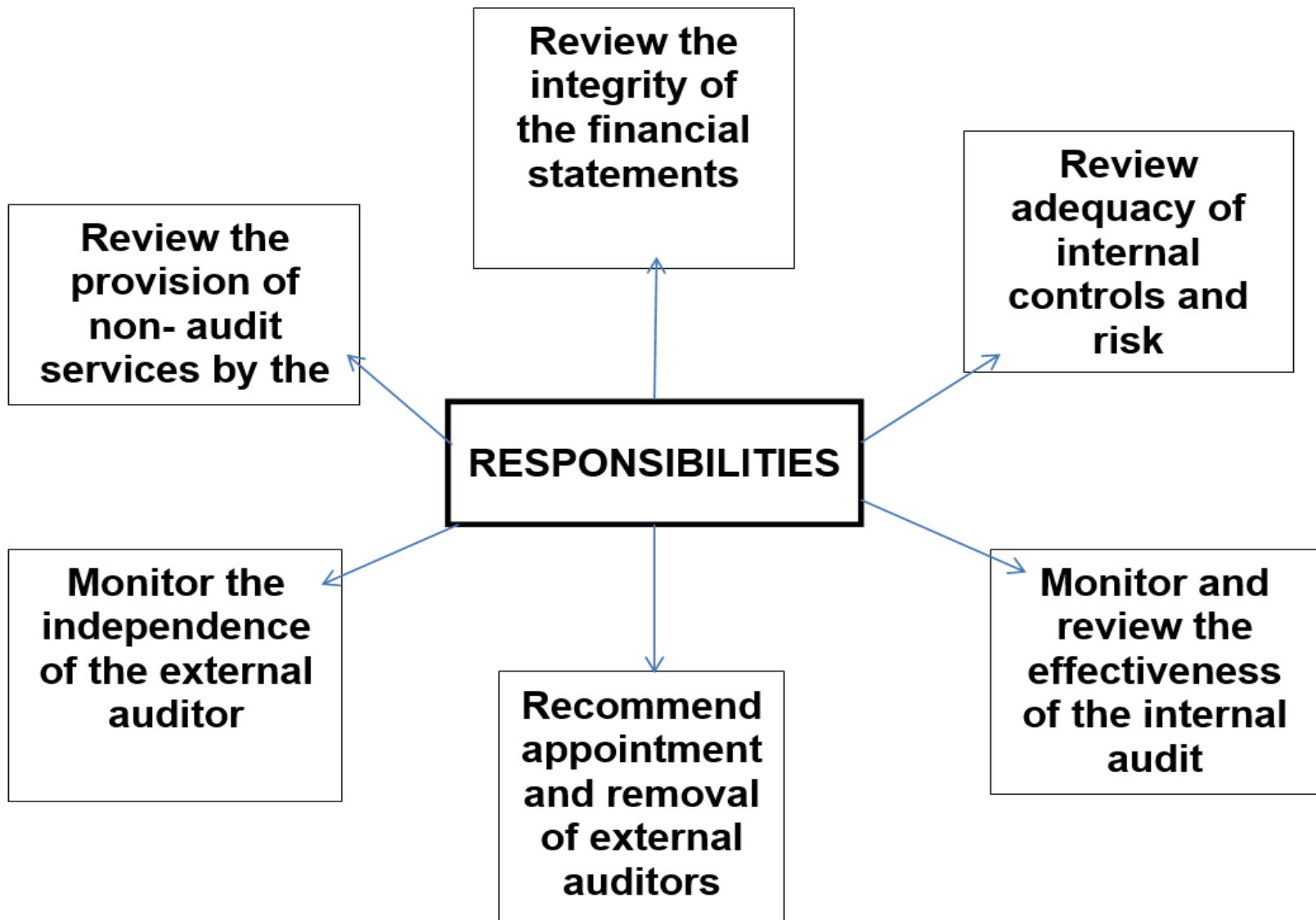
***Note on Practice:** this is aimed at larger companies. Whilst it is good practice, it is not really practical or necessary for **smaller companies** to have an audit committee.



The Audit Committee in Practice

- Legal requirements mean that audit committees have to explain **how they have assessed the effectiveness of the external audit process.**
- This requirement comes at a time that many audit committees in the FTSE 350 are also pondering the timing of **audit tenders.**
- This requirement reinforces the audit committee's responsibility for reviewing the external audit process **on behalf of shareholders.**

Audit Committee's Responsibilities



2. Business Risk and the Entity's Risk Assessment Process



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.

Entity's risk assessment process: A component of internal control that is the entity's process for **identifying business risks relevant to financial reporting objectives** and deciding about **actions to address those risks**, and the results thereof.



Risk Assessment

- **Risks** are internal & external **events** (economic conditions, staffing changes, new systems, regulatory changes, natural disasters, etc.) that **threaten the accomplishment of objectives**. (**Risk register**)
- **Risk assessment** is the process of identifying, evaluating, and deciding how to **identify and manage** these events...
 - *What is the likelihood (ie probability) of event occurring?*
 - *What would be the impact (ie size) if it were to occur?*
 - *What can we do to prevent or reduce the risk?*

Is the client identifying & assessing risks properly?

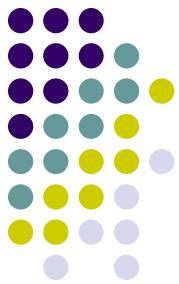
Entity's Risk Assessment Process



Internal controls are implemented by management to manage business risks.

Assurance providers, particularly **auditors**, focusing on the financial statements, are interested in business risk because issues which pose threats to the business may in some cases also be a risk of the **financial statements being misstated**.

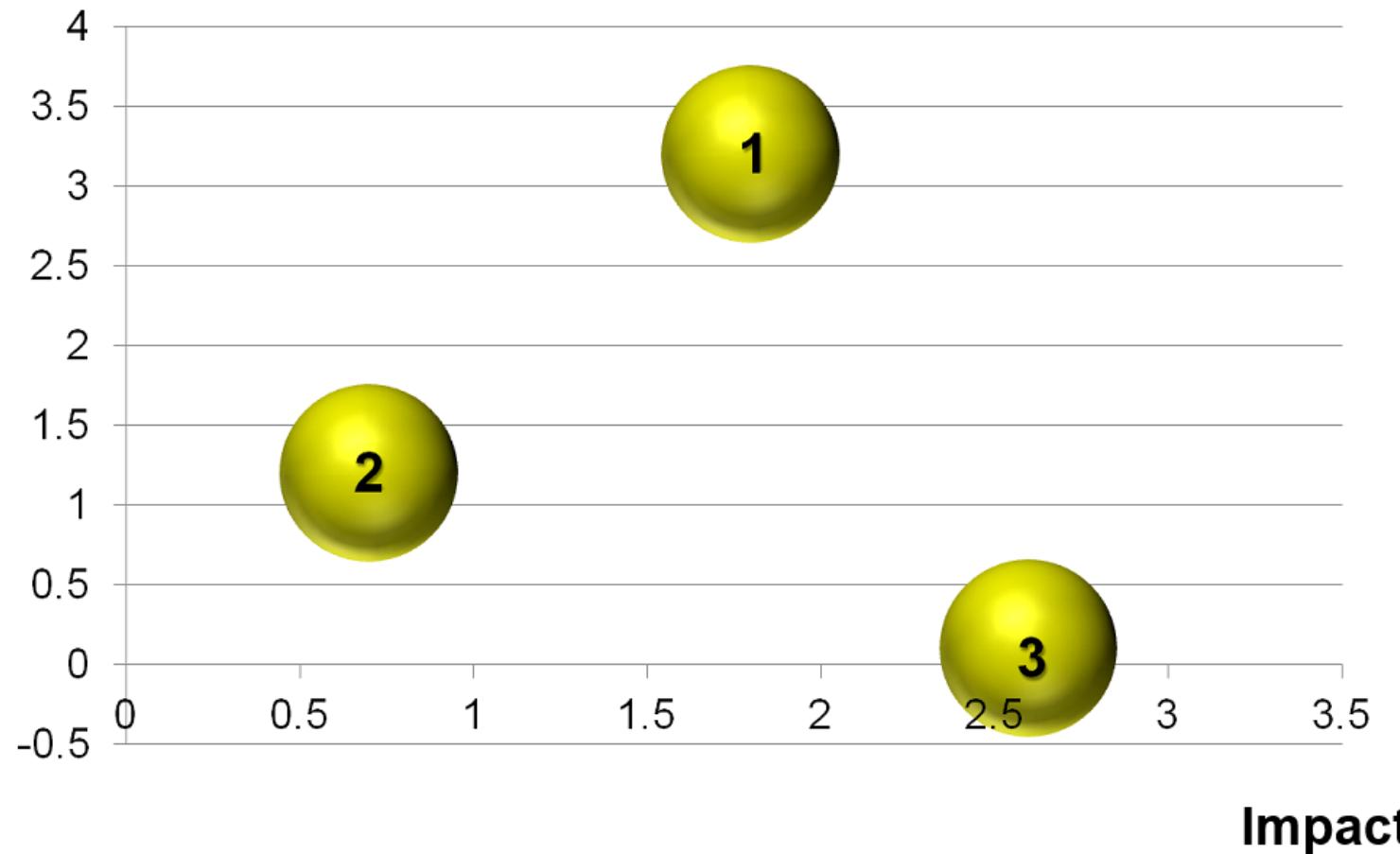
Entity's Risk Assessment Process



Example Risk Matrix



Probability





3. The **information system** relevant to financial reporting

This is the **accounting system** and the **internal control system**.

A component of internal control that includes the financial reporting system. This consists of the procedures and records established to **initiate, record, process and report** entity transactions and to maintain records for the related assets, liabilities and equity.

The auditor will be concerned with the reliability of these systems.



The information system relevant to financial reporting

The **auditors** will be interested in:

- The **classes of transactions** that are significant to the entity's financial statements
- The **procedures** by which transactions are initiated, recorded, processed, corrected and reported
- The related **accounting records and supporting information**
- How the information system **captures** events other than transactions that are significant to the financial statements
- The **process of preparing the financial statements**

Why are they interested in these things?

To ensure transactions are accurately and fully recorded.



4. Control Activities

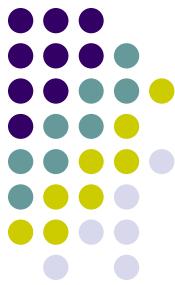
Control activities are those activities initiated by those charged with governance to safeguard the company assets by detecting and preventing fraud and error.

Control activities: are the policies and procedures that help ensure that management directives are carried out.

Each particular internal control may also prevent an error occurring (**preventative control**), or may identify that an error has occurred and correct it (**detective control**).

Examples of control activities

IMPORTANT



- Authorisation
- Performance reviews
- Information processing
- Segregation of duties
- Physical controls



Types of control activity

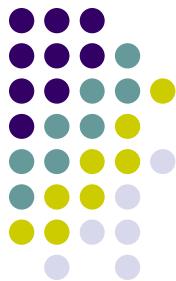
Type of control	Explanation	Examples
Authorisation	Approval of transactions and documents	For example: overtime should be approved by departmental manager; purchase orders by the purchasing manager.
Performance reviews	Comparing actual performance to budgets, forecasts and prior period	A review highlights and explains any unexpected variances. This reduces the likelihood of errors or deliberate misstatement.
Information processing	Controls to check the accuracy, completeness and authorisation of transactions	The two broad groupings of information systems control activities are application controls and general IT controls.



Types of control activity

Type of control	Explanation	Examples
Segregation of duties	Using different individuals for authorising, processing and maintaining custody of assets	The person who opens the post should not also do the banking. The staff who record the transactions should not carry out the reconciliations
Physical controls	Physical security of assets Access authorisation for computer files Periodic counting and checking to control accounts	Ensuring the company safe is locked at all times Ensure payroll software has password to prevent unauthorised access Physical count of petty cash or inventory

Information processing **IT controls**



The internal controls in an IT environment include both **manual procedures** and **procedures designed into software**. Such manual and computer control procedures comprise two types of control.

Application controls: Manual or automated procedures that typically operate at a **business process level**.

Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records.

Application controls relate to **input, processing or output data**.

General controls: Policies and procedures that **relate to many applications** and support the effective function of application controls by helping to ensure the continued proper operation of information systems.

Examples of application controls



Controls over input completeness	One-for-one checking of processed output to source documents.
Controls over input accuracy (eg downloading of data)	Programs to check data fields: <ul style="list-style-type: none">• Digit verification (as expected)• Reasonableness test (in total)• Existence checks (eg customer name)• Permitted range (not over permitted value)
Controls over input authorisation	Manual & automatic checks ensure input: <ul style="list-style-type: none">• Authorised (eg digital signature)• Input by authorised personnel (ie digital signature)
Controls over processing of inputs	eg screen warnings preventing early logout

Examples of general controls

Development of computer applications	Standards over systems design, programming and documentation
Prevention or detection of unauthorised changes to programs (eg adding additional unauthorised code)	<ul style="list-style-type: none">• Password protection• Restricted access to central computer• Virus checks• Back-up copies
Testing and documentation of program changes	<ul style="list-style-type: none">• Testing procedures• Documentation of new systems• Approval of changes by users
Controls to prevent unauthorised changes to data files	<ul style="list-style-type: none">• Passwords
Controls to ensure continuity of operations (catastrophe risk)	<ul style="list-style-type: none">• Storing extra copies• Disaster recovery procedures• Back-up power sources





MCQ – Types of control

The financial controller reconciles the receivables ledger to the receivables ledger control account monthly.

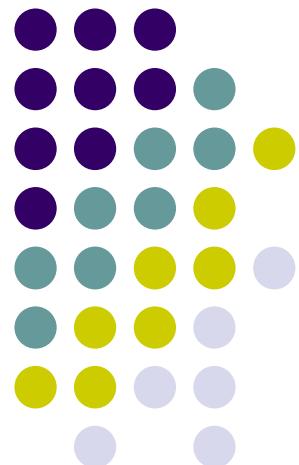
Select the type of control activity.

- A Performance review
- B** Information processing
- C Segregation of duties
- D Authorisation

Cyber Security

*“There are two types of companies:
those that have been hacked, and those
who don’t know they have been
hacked.”*

John Chambers, ex-CEO of Cisco

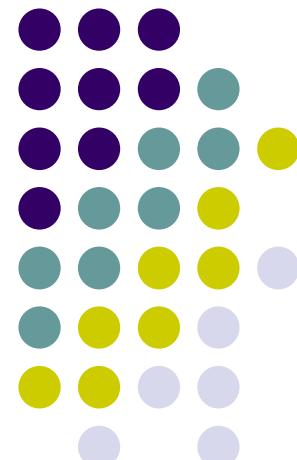


Cyber Security - definition

Cyber security:

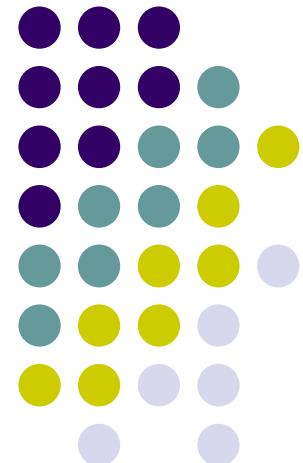
**The protection of systems, networks and data
in cyberspace.**

This definition can be extended to include the protection of data from **unauthorised modification**, disclosure or destruction, and the protection of the information system from the **degradation or non-availability of services** – in other words, system failure.



Cyber Security - risks

- **Human threats** (eg hackers)
- **Fraud** (dishonest use of computer systems)
- **Sabotage**
- **Viruses** (spread through network and supply chain)
- **Malware** (hostile or intrusive software)
- **Denial of service** (encryption and ransom)



Cyber Security - controls

Prevention - (eg systems access controls; passwords)

Detection – (a log of unauthorised changes to software or data)

Deterrence – (deter misuse eg legal sanctions or dismissal)

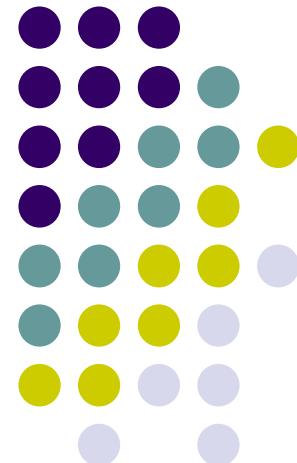
Recovery procedures – (eg back-up files, business continuity)

Threat avoidance – (eg redesigning the system)

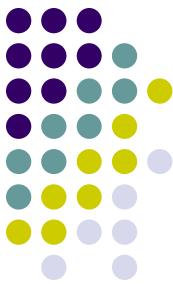
Compliance procedures for staff – (eg procedures policies)

Physical and environmental security – (eg prevent unauthorised access)

Network management – (protecting integrity of the system including from other network stakeholders such as customers and suppliers)



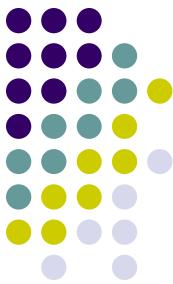
MCQ – Types of control



The receivables ledger clerk posts invoices to the receivables ledger. The cash book clerk posts cash receipts to the receivables ledger

- A Performance review
- B Information processing
- C Segregation of duties
- D Authorisation

MCQ – Types of control



The receivables ledger clerk posts invoices to the receivables ledger. The cash book clerk posts cash receipts to the receivables ledger

- A Performance review
- B Information processing
- C*** Segregation of duties
- D Authorisation



5. Monitoring of controls

- Internal control systems must be monitored by management to assess their effectiveness... *Are they operating as intended?*
- **Ongoing monitoring** is necessary to react dynamically to changing conditions... *Have controls become outdated, redundant, or obsolete?*
- An entity should review its overall control system to ensure that it still meets its objectives.

Monitoring of controls



Auditors will often produce a **report to management and those charged with governance** at the end of an audit, outlining any **deficiencies** they have observed in internal controls. Auditors are also **required by ISAs** to identify control deficiencies observed to those charged with governance.



MCQ – Monitoring controls

Which **TWO** of the following are activities which would be used to monitor controls?

- A Management's review of whether bank reconciliations are being prepared on a timely basis
- B Internal auditors' evaluation of whether the sales team are following company policy regarding customer discounts
- C Authorisation of purchase invoices before they are paid
- D Authorisation of purchase orders by the department manager



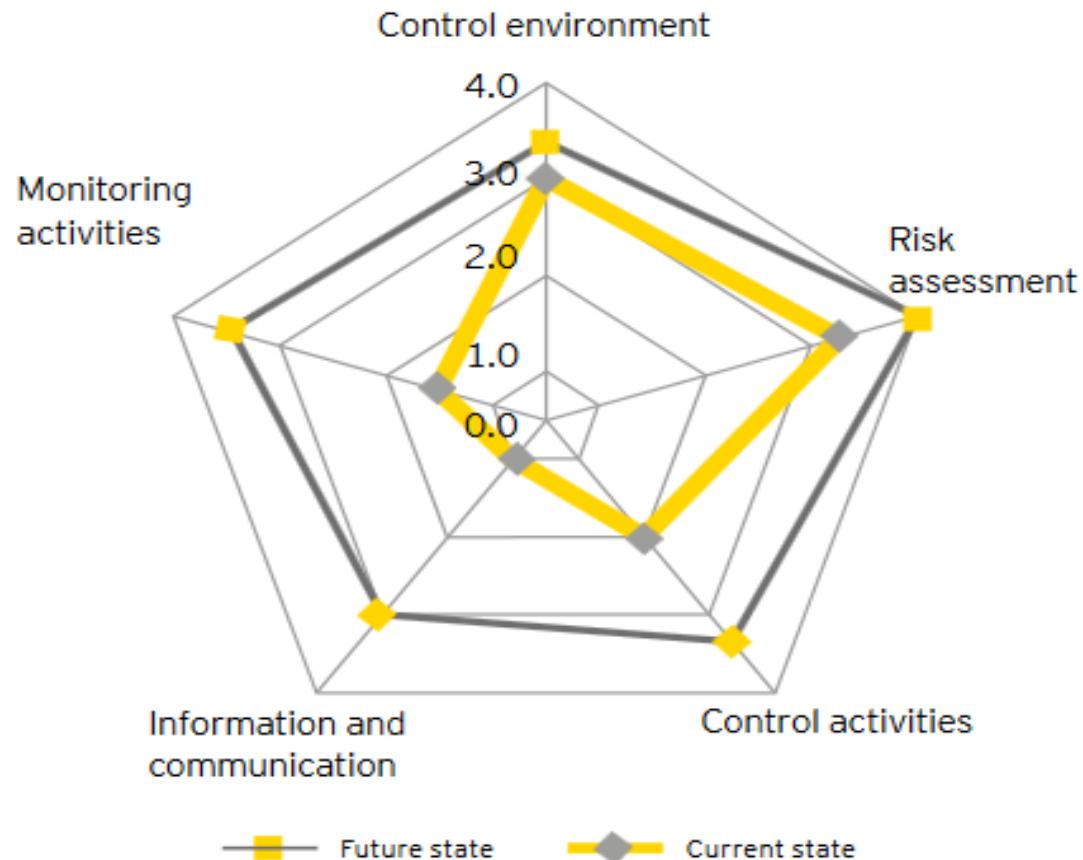
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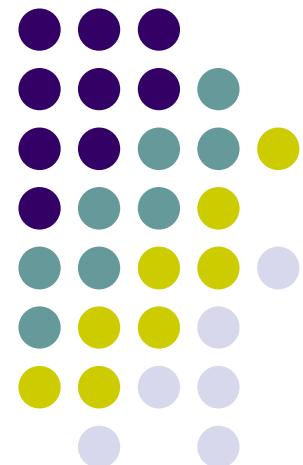
Internal controls



Audit & Assurance

Topic 5 - Internal Controls

Podcast 3
Question Practice





Lecture Plan

- Internal control deficiencies
- Question – Saturn
- Question – Meta

Internal control deficiencies

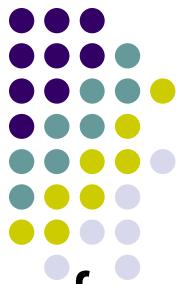


Deficiencies can be:

- Wrong controls
- Right controls - but badly operated (eg wrong person or wrong timing)
- No controls (omitted controls)

Once you can identify control risks in a scenario be able to suggest controls (improved or new controls) that will mitigate those risks.

Question – Saturn Ltd



During the audit of revenue recording processes of your client Saturn Ltd, you discovered that, on several occasions, goods had been despatched by Saturn Ltd, but the relevant customers had not been asked to sign the delivery notes when they received the goods.

Required

Prepare a draft note outlining the possible consequences of this deficiency in internal control and making recommendations to avoid the deficiency in future.



Question – Saturn Ltd

During the audit of revenue recording processes of your client Saturn Ltd, you discovered that, on several occasions, goods had been despatched by Saturn Ltd but the relevant customers had not been asked to sign the delivery notes on receipt of the goods.

Required

Prepare a draft note outlining the **possible consequences** of this deficiency in internal control and making **recommendations** to avoid the deficiency in future.

Question – Saturn Ltd



Hint

Ask - what can go wrong?

Saturn Ltd - Answer

Potential consequences of the deficiency:

- There will be no proof that the customers have received the goods despatched
- Customers may refuse to pay invoices although they have received the goods
- Potential disputes and loss of goodwill
- Risk of fraud or theft of goods by delivery staff if they realise the lack of control
- Possible impact on cash flows and results due to cost of replacing goods or issuing credit notes.



Saturn Ltd - Recommendations



- All despatches signed for by the customer
- Copy of signed despatch note retained by customer and Saturn or its courier
- Signed copy to be filed with copy sales invoice/order
- Digital signature for goods received
- Regular checks made to ensure all despatches have been signed for
- Any not signed for investigated
- Employees trained in procedures and remind employees of procedures
- Monitoring of procedures to ensure followed.

Question - Meta



A supermarket, Meta plc, holds inventories at several large depots located in different regions of the UK.

Inventories are stored in large secure cages – one cage for each type of product. A store person is responsible for the inventory of each cage and each store person is responsible for a number of cages. When goods are delivered to, or removed from, each cage, the store person responsible completes a duplicate form of inventory movements. One copy is retained by the store person and one copy is sent to the accounts department. Upon receipt of the inventory movement form, one of the accounts department clerks enters this into the IT system and this updates the continuous inventory records. There is a password for each accounts clerk.

Every six months there is an inventory count by the store people responsible for the cages to reconcile the total of the physical inventory in each cage with the continuous inventory IT records provided by the accounts department.

Each cage has a lock and only the store person responsible for the cage and the depot manager have keys.

The depot manager can access all cages and has all passwords so he or she can check on inventory totals.



Question - Meta

Requirements

- (a) Explain the internal control deficiencies.
- (b) Identify the internal controls that could be set up to address each deficiency.

Hint

- Ask - what can go wrong?
- How can anyone steal assets, without being prevented or detected?

Internal control – approach to questions



Annotate the scenario in the question paper with key features of the accounting system and internal controls (using different highlighting colours or circling, underlining etc) for each of the following:

- **People** (individuals by name, their job title, or groups/departments)
- **Documents** (eg invoices, GRNs, order forms, inventory listings)
- **Processes** (eg data input, recording, delivery, receiving goods)
- **Controls** (eg authorisation, approval, checks)

Internal controls –

Why? Who? What? How? When?



WHY? (*purpose of control*)

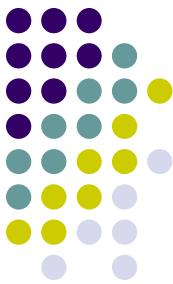
- Why is a control needed?
- Fraud/error
- Prevent/detect
- Understatement/overstatement

WHO? (*right person*)

- Competence/relevance (Right function eg FD for finance issues)
- Seniority (seniority appropriate to control or process eg FD or accounts clerk)
- Segregation of duties (multiple roles – eg same person has control of asset and records)
- Independent check (person operating control, not self-checking)

Internal controls –

Why? Who? What? How? When?



WHAT? (*right control*)

- Appropriate to purpose
- Identify type of control (performance review, info processing, segregation of duties, authorisation, physical control)
- Omitted control (see types)
- Deficiency in control design

HOW? (*applied correctly*)

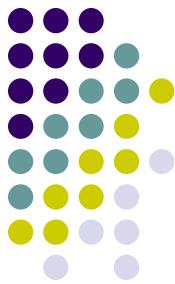
- Correctly implemented (right control, but badly implemented?)
- Control effectiveness (right outcomes – detecting errors?)
- Manual control (judgement needed) or IT control (high volumes)

Internal controls –

Why? Who? What? How? When?

WHEN? (*right timing*)

- Early enough in process (eg to prevent fraud before it occurs)
- Frequency appropriate (daily; weekly; monthly)
- Over what period is control applied (all year?)
- Cut-off (year-end procedure)



Internal controls –

Why? Who? What? How? When?

WHEN? (*right timing*)

- Early enough in process (eg to prevent fraud before it occurs)
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Internal controls – Annotating the question

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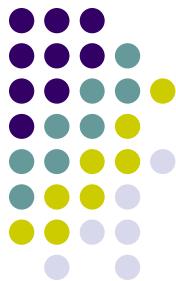
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Meta - Answer



(a) Deficiency	(b) Internal controls
<p>The depot manager can access all inventories (as he has a key) and the inventory records (as he has all passwords). He therefore has management override over segregation of duties controls.</p> <p>He can therefore misappropriate assets and alter records to conceal this.</p>	Limit his/her access to passwords. Where the depot manager does access inventory records, this should be automatically recorded (in a manner that he cannot access) and reviewed periodically by senior managers.
<p>Inventory count is carried out by each store person and therefore there is no independent check as each store person is checking his/her own inventory.</p>	The inventory count to be carried out by an employee other than the store person responsible for that cage.

Meta – Answer (cont)



(a) Deficiency	(b) Internal controls
<p>The duplicate forms of inventory movements is prepared by the store person and could therefore be altered by him/her before a copy is sent to the accounts department. The accounts department copy cannot therefore be relied on as an independent record.</p>	<p>Receipts of inventory for each cage should be recorded earlier in the process (before reaching the store person).</p> <p>The record of inventory movements should also be made by an independent person who should also send a copy to the accounts department without the store person having access to it.</p>



Actions before next week

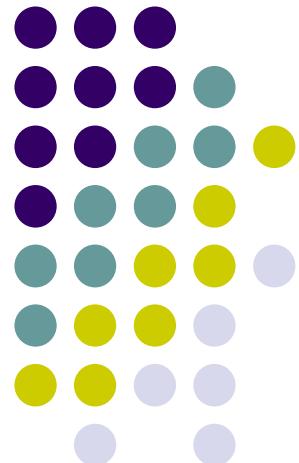
- Complete required reading – chapter 5 of the text book. ICAEW Assurance.

Prepare questions for next week's synchronous session.

- Do one (short questions)
- Kingsgate Car Park

ACFI210 - Audit & Assurance

Introduction to Ethics





Ethics

By the end of studying this topic, you should be able to:

- Explain why ethics are important to accountants
- Recognise the importance of and identify threats to integrity, objectivity and independence
- Identify safeguards for maintaining integrity, objectivity and independence
- Suggest sensible measures to resolve ethical conflicts
- Discuss the nature and importance of confidentiality
- Recognise risks to confidentiality and identify steps to prevent accidental disclosure of information



Ethics – Lecture coverage

- Codes of Professional ethics (Chapter 14)
- Integrity, objectivity and independence (Chapter 15)
- Confidentiality (Chapter 16)

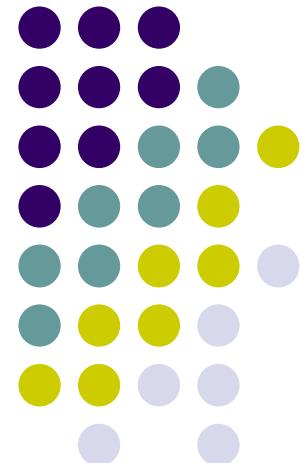


The Audit Process

Required Reading:

- Chapters 14,15 & 16 of 'Assurance' Study Manual
- Attempt exercises within each chapter

Introduction to Ethics

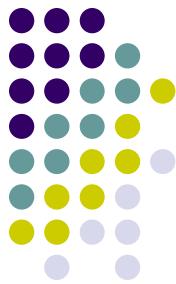


Professional ethics – The need for ethics



- Ethics is about “**doing the right thing**”.
- In general terms, ethics is a set of **moral principles** and **standards of correct behaviour**.
- Professional accountants have a responsibility to consider the **public interest**. Personal **self-interest** must not prevail over these duties.
- **Unethical** doesn’t necessarily mean **illegal**.

Importance of ethics to accountants



- Accountants hold positions of trust with investors, managers, employees, banks and other stakeholders relying on their work.



Ethical codes

Ethical codes aim to:

- Ensure that qualified and trainee accountants observe proper standards of professional conduct.
- Help the accountancy profession act in the public interest by providing appropriate regulation to members.

Failure to observe the applicable ethical standards may result in disciplinary action.



Sources of ethical guidance

Codes of professional ethics are issued by most professional bodies. Principles apply to all members whether or not they are in practice.

- International Federation of Accountants (IFAC) – code applies to all professional accountants
- ACCA/CIMA/ICAEW etc will have their own code based on IFAC
- Financial Reporting Council (FRC) Ethical Standard: applies to UK auditors.

Approaches to ethical guidance

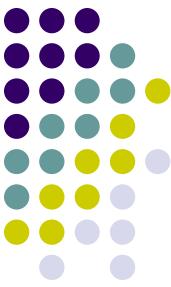


Principles based

Or

Rules based

A largely principles based approach is taken by most professional bodies, including IFAC and FRC, however there are some specific rules incorporated.



Principles based

- Encourages the accountant to use judgement
- Requires compliance with the spirit of the guidance
- Flexible, so can be applied to new, unusual or rapidly changing situations
- Can still incorporate some rules



Rules based

- May be easier to follow because it is objective
- Needs frequent updating to ensure the guidance applies to new situations
- May encourage interpretation of the requirements too narrowly in order to get around the spirit of the requirements



Example - Rule vs Principle

Rule – Can't accept any gifts of £20 or above

Can therefore accept 1,000 gifts of £19.99 without breaking the rule

Principle – Can't accept any gifts that could be seen as a bribe

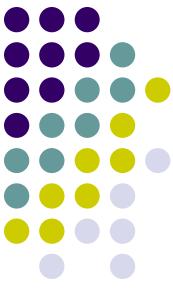
Fundamental Principles – IESBA

(International Ethics Standards Board for Accountants) Code



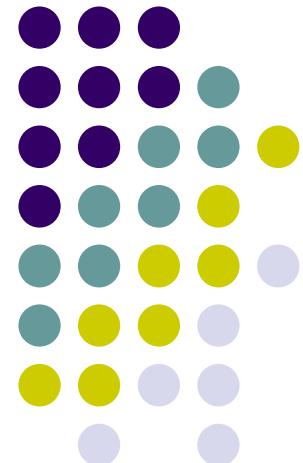
Principle	Explanation
Integrity	To be honest in professional relationships
Objectivity Independence	To not allow bias or undue influence to override professional judgements
Professional competence and due care	To maintain professional knowledge and skill at the level required to provide a competent, up to date service
Confidentiality	To respect the confidentiality of information acquired through professional relationships
Professional behaviour	To comply with relevant regulations and avoid discrediting the profession

ICAEW's Disciplinary and Appeal Committees



Audit & Assurance

Threats to Independence





Independence

- Assurance providers should **be, and be seen to be** independent.
- The highest degree of independence is required for audit engagements.
- Independence is a state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgement.

IFAC approach to independence issues



1. Identify threats (e.g. wife of audit staff works for the client)
2. Evaluate the significance of threat (e.g. does she work in finance?)
3. Identify and apply safeguards (replace member of audit team)

Safeguards are steps the accountant takes to eliminate the threat or reduce to an acceptable level. If



Safeguards

- Safeguards are steps the accountant takes to eliminate the threat or reduce to an acceptable level.
- If no safeguards are available, the accountant should
 - Eliminate the interest or activities causing the threat
 - If this is not possible, decline and discontinue the engagement

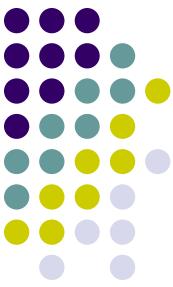
Types of Threat to Independence



- **Self-interest** threat
- **Self-review** threat
- **Advocacy** threat
- **Familiarity** threat
- **Intimidation** threat
- **Management** threat

Threats identified
by the IFAC code

Additional threat
identified by FRC



Self interest

Self-interest threat



The threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behavior



Self interest threats examples

- Financial interest in client
- Large fee income from client
- Overdue fees/loan outstanding with client
- Partner on client's board
- Contingent fees
- Business relationship
- Family and personal relationships
- Gifts and hospitality
- Dual employment



Self review threats

Self-Review Threats



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



Self review examples

- Preparing financial statements
- Client's staff member joins auditor
- Internal audit
- Tax
- Systems implementation



Advocacy threat

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



Advocacy examples

- Represent client in tax tribunal
- Legal services
- Contingent fees
- Corporate finance (selling client)



Familiarity threat

Familiarity Threat

Familiarity Threat occurs when, by virtue of a close relationship with a client, its directors, officers or employees, an auditor becomes too sympathetic to the client's interests.



Familiarity examples

- Family relationships at client
- Recruitment (audit staff join client)
- Long association
- Audit partner joins client

Intimidation threat



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



Intimidation examples

- Actual/threatened litigation
- Family relationship
- Close business relationships
- Audit partner joins client
- Actual/threatened physical violence

Management threat (added by FRC)



The auditor becomes closely aligned with the views and interests of management.

Examples

Representative of client's board

Taking on a management responsibilities

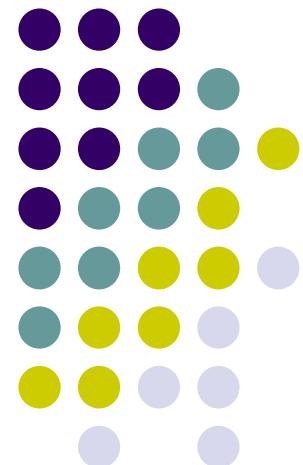


Approach to ethical problems

- (1) Identify ethical threats
- (2) Assess significance
- (3) Apply safeguards

Scenarios of audit clients

- a) What is threat to independence and why?
- b) What would a reasonable safeguard be?





Example 1

Bow (an audit client) has been recently struggling with it's volume of transactions and needs a new accounting system. They have asked for our help in selecting and implementing a new system



Example 1

Management threat – management of responsible for safeguarding assets and implementing controls

Self review threat – would be unlikely to point out problems with the system

Safeguard - Refuse the request



Example 2

Dave Smith has been engagement partner on the audit of Kent (an audit client) for 10 years now and has become close friends with the finance director whom he regularly plays golf with



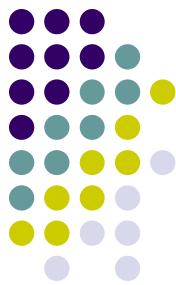
Example 2

Familiarity threat – may be too trusting

Intimidation threat – may not want to upset a friend

Self interest threat – Golf may be a bride

Safeguard – Rotate the partner



Example 3

Osmond (an audit client) has lost their financial controller and have asked can our firm help preparing financial statements



Example 3

Self review – Would be unlikely to point out errors in work own work

Safeguard – Could perhaps do using separate teams if was a mechanical nature and no management decisions or judgements were taken



Example 4

RyanJet (a new audit client), has offered all members of the audit team a free flight up to the value of £300 as a thank you for the audit



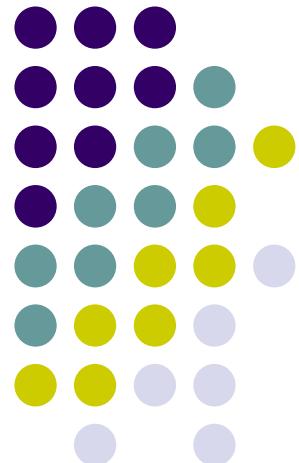
Example 4

Self interest threat – This could be seen as a bribe, team may feel pressure to deliver a clean opinion in hope of repeated future gifts.

Safeguard – Politely decline

Audit & Assurance

Resolving Ethical Conflicts





Important

Read detail of threats to independence and safeguards contains the detail from FRC's ethical guidance

ICAEW Assurance Study Manual Chapter 15
Section 2



Resolving ethical conflicts

- Now you've absorbed the detail of how FRC ethical standard deals with common ethical issues.
- Remember ethical guidance for accountants is principles based, so when an ethical problem is identified need to consider principles as well as detailed guidance.



Resolving ethical conflicts

Framework for consideration

Relevant facts

Relevant parties

Ethical issues involved

Fundamental principles related to the matter

Established internal procedures

Alternative courses of action



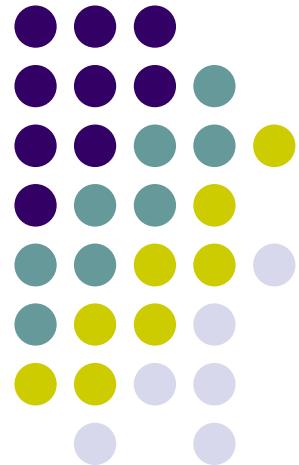
Resolving ethical conflicts

The individual accountant should then consider the most appropriate course of action. If this is not clear the accountant may need to refer the matter in the following order

- 1st – Try to resolve internally first (e.g. Ethics partner)
- 2nd – Externally (e.g. ICAEW ethics helpline)

Audit & Assurance

Confidentiality





Importance of confidentiality

- Confidentiality is a fundamental principle in the IFAC code of ethics
- A key factor in the auditor/client relationship is trust
- If the client doesn't trust the auditor they may not provide all of the information that the auditor requires in order to form their opinion on the financial statements
- The auditor has a duty of confidentiality which must not be breached except in certain circumstances



Risks to confidentiality

A professional accountant should be aware of the risks to confidentiality at all times. Accidental disclosure is a key risk.

It's important to keep client information confidential:

- In social environments
- Within the firm
- After the end of a business relationship
- When changing employment/acquiring a new client

Accountants need to avoid improper use of client information

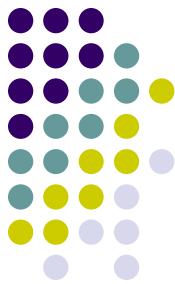


Safeguards

Physical and electronic security measures should be put in place to avoid disclosure. Firms should ensure that all who work on their behalf are trained in and understand:

- The importance of confidentiality
- The importance of identifying any confidentiality and conflict of interest issues
- The procedures in place for identifying confidentiality and conflict of interest issues

Disclosure of confidential information



The code of ethics allows for 3 circumstances when otherwise confidential information should be disclosed

- Permitted by law and authorised by client
- Disclosure required by law (e.g. money laundering/suspected terrorist activity)
- Professional right/duty to disclose (e.g. so the accountant to defend oneself in court)

TAKE LEGAL ADVICE!



Right to disclose

- When client permission is obtained
- Where disclosure is in the public interest
- To defend the firm in court



Duty to disclose

- If ordered to disclose by a court
- If required by a regulator e.g. Financial conduct Authority
- Suspicions of money laundering should be reported to the national crime agency
- Suspicions of terrorist activities should be reported to the police



Money Laundering

Includes any money considered as being a proceed from crime. Examples include:

Keeping customer overpayments

Non-compliance with a regulation to save money

Criminal offences under the Companies Act
e.g. an illegal loan to a director

Money Laundering Regulations (2007)



- It's an offence to not report suspicions of money laundering to the appropriate authority.
- Not considered a breach on confidence.
- Must not advise the client a report has been made (tipping off)
- Each firm has a money laundering reporting officer (MLRO) who is responsible for making the disclosure.



Conflicts of interest

- Nothing out of order in an accountant having two clients whose interests conflict.
- Expertise in a particular sector seen as a selling point.
- Guidance is to inform both clients of situation and receive written consent to act (with safeguards)



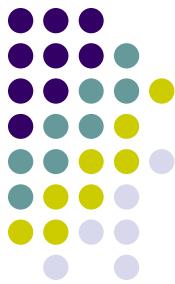
Case Study

- Arthur Young – Auditors of Pepsi
- Ernst and Whinney – Auditors of Coca Cola

1989 these merged to become EY

Result was Coca Cola and Pepsi being uncomfortable with the conflict and EY had to give up Pepsi.

Conflicting client interests – safeguards



- Separate teams
- Information barriers
 - no overlap between teams
 - Physical separation of teams
 - Procedures for maintaining security of paper and electronic records
- Confidentiality agreements
- Review of application of safeguards by an independent partner



Question

Whilst carrying out the year-end audit of Club Ltd (deadline one month after the reporting date), you discover a substantial trading debt due from another client, Diamond Ltd.

Although it has not been made public, you are aware that Diamond Ltd is in serious financial difficulties and the bank is considering appointing a receiver.

The directors of Club Ltd have made no bad or doubtful debt provision against the amount due from Diamond Ltd.

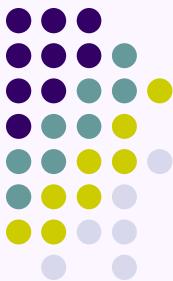


Solution

- Can't disclose condition of Diamond to Club without breaching duty of confidentiality towards Diamond
- Could also contribute towards the collapse of Diamond since Club might take steps towards obtaining the debt
- Ignoring the information and giving an unqualified audit report breaches of the statutory auditor's duty under the Companies Act!
- Need to come to this conclusion with further work, last resort delay sign off until situation crystallises.

Audit & Assurance

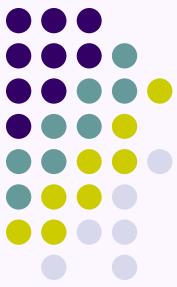
Materiality



The Audit Process

By the end of studying this topic, you should be able to:

- Understand the concept of materiality in audit
- Discuss the concept of planning materiality and demonstrate how it is applied
- Understand the audit risk model and its individual components
- Identify audit risks in a given scenario



The Audit Process

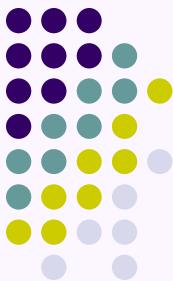
Required Reading:

- Remainder of chapter 3 of 'Assurance' Study Manual
- Attempt exercises within each chapter



The Audit Process





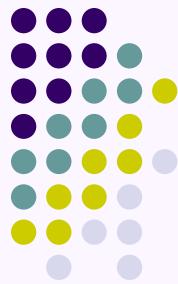
Terminology

Two levels:

- (1) Financial statements as a whole.
- (2) “**Classes of transactions** and **account balances**.” (eg revenue, cost of sales, PPE, payables, inventory).

*Note: You may see (2) above referred to as *Financial Statement Line Items* – these are the same.*

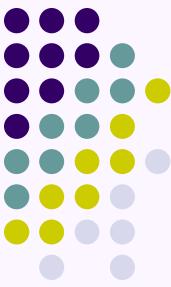
Importance of materiality in the audit



The standard audit report sets out the scope of an audit stating that the engagement involves

‘....reasonable assurance that the financial statements are free from material misstatement...’

The concept of materiality plays a key role in an audit engagement.



Materiality

Materiality is defined as an expression of the relative significance of a particular matter in the context of the financial statements as a whole.

A matter is material if its omission or misstatement could influence the economic decision of users taken on the basis of the financial statements.



Materiality example

I'm going to buy shares in M&S for £5.00 each

<u>Key Financials</u>	
Revenue	£57,887m
Profit in year	£6,147m
Net assets	£12,325m

Would I still buy the shares for that amount if an error was found after year end for

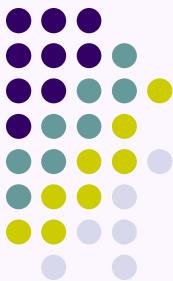
- a) £100,000?
- b) £10,000M?
- c) £200M?

It's subjective,
and assessment
can vary!!



Using materiality

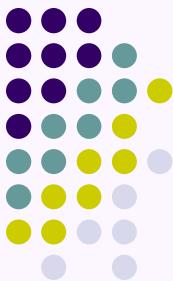
- At the planning stage, materiality drives the level of work to be carried out e.g. whether to test a balance at all, sample sizes.
- During the audit, materiality influences the evaluation of audit evidence e.g. if the auditor discovers a material misstatement then an adjustment to the financial statements should be requested.



Materiality at the Planning Stage

- Feeds in to the audit plan, helps the auditor to decide:
 - How many and what items to examine
 - Whether to use sampling techniques
 - What level of misstatement is likely to lead to the auditor to consider the financial statements do not give a true and fair view

The auditor designs audit procedures to reduce risk of giving inappropriate opinion



Planning Materiality

- Materiality levels are a key part of audit planning. The materiality level set at the planning stage is called **planning materiality**.
- However, during the audit, the materiality level is **regularly reviewed** and may be changed. This may be due to:
 - Draft financial statements being altered (due to material misstatement or revision of estimates).
 - External factors may cause **changes in risk estimates**.



Materiality

ISA 320 Materiality in Planning and Performing an Audit

- Materiality is considered **throughout** the audit in particular when:
 - Identifying the risks of material misstatement
 - Determining the nature, timing and extent of audit procedures
 - Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditors' report



Performance materiality

- The amount set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financials statements as a whole.

Application of performance materiality



- You're reviewing trade receivables for which the material error has been set at £100,000. So we need to gain assurance we don't miss a number of errors that cumulatively could mean trade receivables in materially misstated.
- Therefore we test all balances or movements over say £25,000 as missing 4 of these could leave a material misstatement.



Identifying materiality

Deciding on whether a matter is material or not depends on the auditor's judgement. An item, error or misstatement may be:

Material by nature (what it is) e.g. transactions between directors and the company

Material by size



Material by size

Different firms have different methods but for purpose of the module we'll use the following guidelines:-

- 5%-10% of profit before tax
- 0.5%-1% of revenue
- 1%-2% of total assets

Could pick the lowest, or an average, or dependent on item under audit e.g. expenses (profit before tax) and receivables (total assets)



Exercise – Determining materiality

Bilko Ltd has made a loss before tax for the year of £300,000.

Requirement

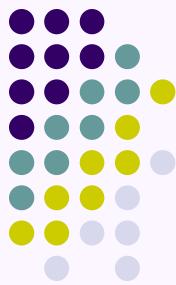
Explain how the auditor of Bilko Ltd should determine planning materiality and state the factors that should be considered in setting the materiality level.



Exercise – Moderate answer

Given the loss before tax, auditors are unable to use profit before tax which is the most usual measure for materiality.

They may use gross profit, revenue or total assets instead.



Exercise – Reasonable answer

Given the loss before tax, auditors are unable to use profit before tax which is the most usual measure for materiality.

They may use gross profit, revenue or total assets instead.

A combination of these measures could also be considered to see if they give a consistent materiality figure.

Exercise – Very good answer

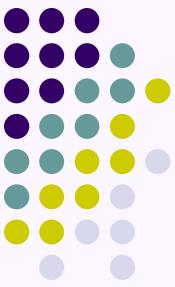
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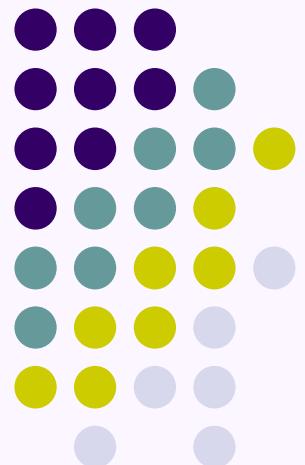
Materiality also has qualitative aspects to it and, when a company makes a loss, the auditor would need to consider other aspects such as:

- potential impact of any misstatement on bank covenants
- risks of insolvency or corporate distress
- whether a misstatement could turn loss into a profit



Audit & Assurance

Materiality Part 2





Materiality

The IASB's framework for the Preparation and Presentation of Financial Statements states that:

*'a matter is material if its omission or misstatement could **influence** the economic decisions of users taken on the basis of financial statements'*

Materiality depends on the **size** and **nature** of the misstatement – it is a matter of **judgement** for the auditor



Performance materiality

- The amount set by the auditor at less than materiality for the financial statements as a whole.
- Reduces to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financials statements as a whole.
- Gives a **margin of safety** that undetected misstatements are less likely to exceed materiality as a whole.



Performance materiality

- Driven by risk, the higher the risk the lower performance materiality must be set.
- Means do more audit work than if concept of performance materiality didn't exist.
- Setting of performance materiality uses professional judgement to take into account qualitative aspects.

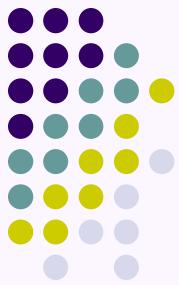


Qualitative materiality: Things to Consider in Assessing Risk

Qualitative factors affecting materiality include:

- Whether it is a first-year audit engagement
- Deficiencies in controls
- Material misstatements in prior years
- Risk of fraud
- Significant management turnover
- Unusually high market pressures
- Sensitivity of covenants in loan agreements
- Effect of changes in results on earnings trends

Summary – What makes an item material

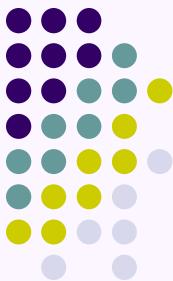


- Nature (what is it) e.g. transactions with directors.
- Value (size)
- Impact e.g. converts a profit to loss.

Performance Materiality – A Worked Example



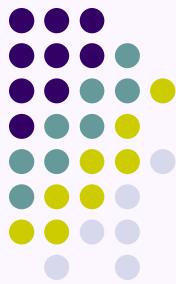
- Total Assets = £20m
- Trade Receivables = £5m
- Planning Materiality = $\text{£20m} \times 2\% = \text{£400,000}$
- Trade Receivables Materiality = $\text{£5m}/\text{£20m} \times \text{£400,000} = \text{£100,000}$
- So due to risky nature may test all items greater than 25% (judgemental) i.e. £25,000



Projected total misstatement

- If due to sampling we tested £2.5m of total trade receivables of £5.0m (half population)
- If total misstatements were greater than £50,000 (half of £100,000) further work required.
- As it appears the figure may be materially misstated.
- So further testing would be done on other half of population

Assessing Material Misstatement



- At the end of the audit the misstatements identified during the audit should be summarised into a schedule of uncorrected misstatements.
- Then extrapolate audit sample results into the related population to assess whether the impact on the financial statements as a whole is **material**.

Section from Auditor's Report of Tesco PLC



Materiality

We have determined materiality based on 0.13% of revenue. Our determined materiality is 8.3% of continuing profit before tax before exceptional items and amortisation of acquired intangibles and 0.6% of net assets.

In the prior year materiality was determined on the basis of 4.3% of continuing profit before tax before exceptional items and amortisation of acquired intangibles. Prior year materiality equated to 0.14% of prior year revenue. The change in the benchmark year on year is due to the impact of COVID-19 on the profitability of the group as a whole.



Which of the following most closely defines ‘performance materiality’?

- A 5% - 10% of profit before tax
- B An expression of the relative significance of a particular matter in the context of financial statements as a whole
- C The amount set by the auditor whereby its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements
- D The amount set by the auditor to reduce to an appropriately low level the probability that the aggregate of uncorrected misstatements exceeds materiality for the financial statements as a whole



Which of the following most closely defines ‘performance materiality’?

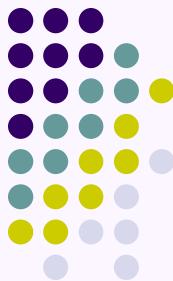
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- D The amount set by the auditor to reduce to an appropriately low level the probability that the aggregate of uncorrected misstatements exceeds materiality for the financial statements as a whole

Which of the following statements is TRUE?



- A Materiality is always calculated as a percentage of profit before tax
- B Materiality should be established at the start of the audit and revised during the audit if necessary
- C Materiality should be established by the client at the planning stage of the audit
- D Materiality is defined as the amount whereby its omission or misstatement in the financial statements would influence the auditor's economic decisions

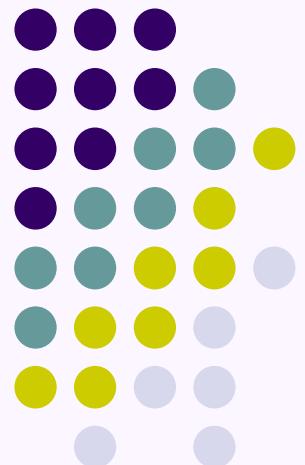
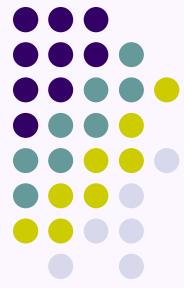
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Audit & Assurance

Audit Risk

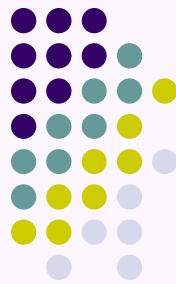




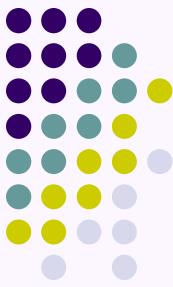
The Audit Process



Importance of Risk Assessment



- Auditors usually adopt a risk-based approach to auditing.
- Risk is assessed at planning stage but re-assessed continually throughout the audit
- Effective risk assessment should:
 - Make the audit more efficient with work directed to likely problem areas
 - Lead to fewer inappropriate opinions
 - Result in fewer negligence claims against the auditor.

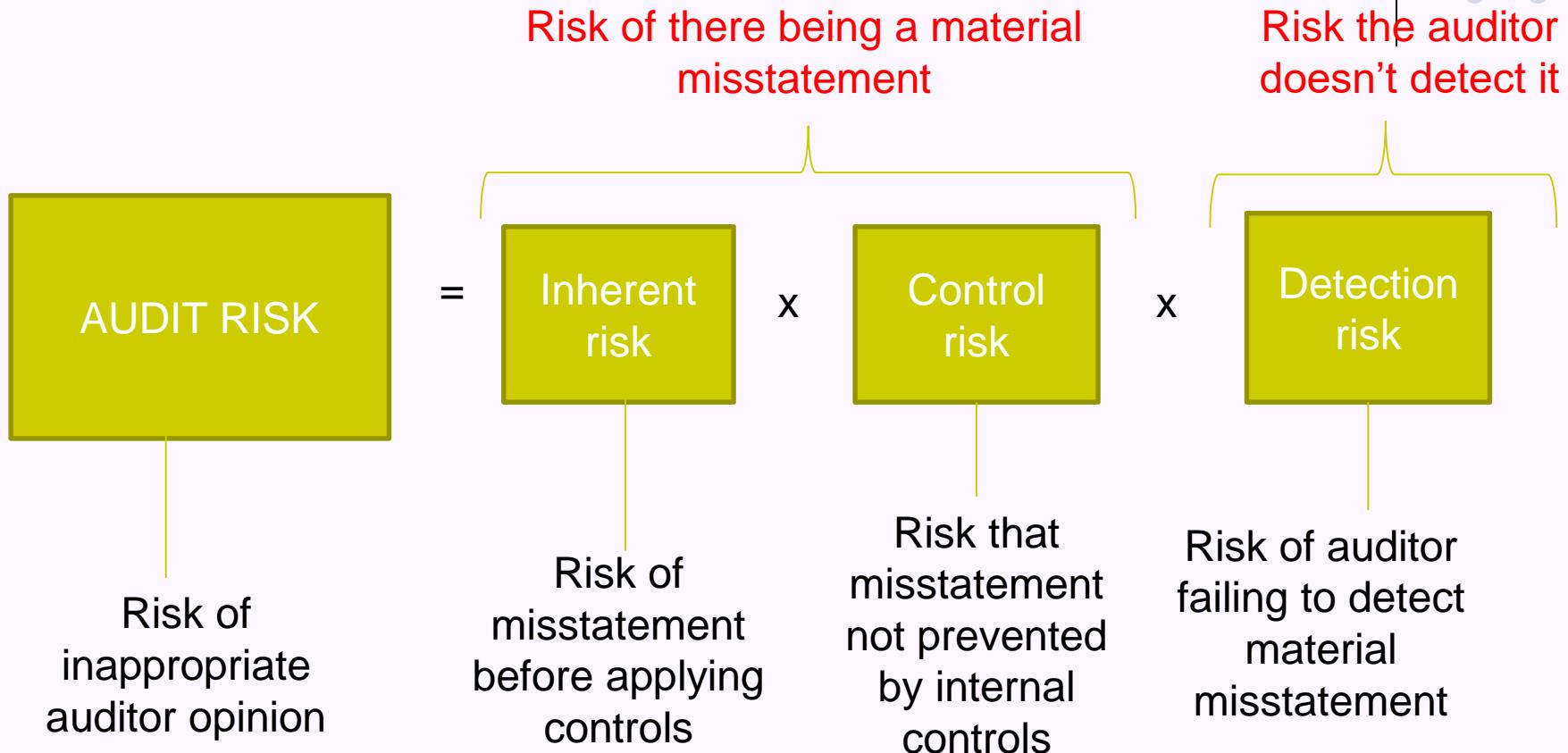


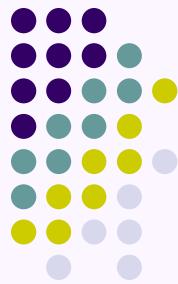
Audit Risk

Audit risk is the risk that the auditor expresses an incorrect opinion.

e.g. states the financial statements show a true and fair view when actually there is a material misstatement

The Audit Risk Model

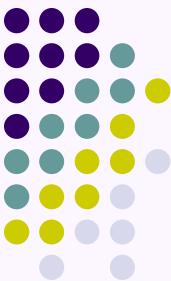




Inherent Risk

The susceptibility of a transaction, account balance or disclosure to material misstatement, irrespective of the controls in place. Can be 3 different levels:-

- Industry level – Affects the whole industry e.g. highly regulated such as banking.
- Entity level – Affects the whole entity e.g. profit related bonus so incentive to misstate.
- Balance level – Isolated to a particular account balance e.g. items complex or subjective (Inventory)



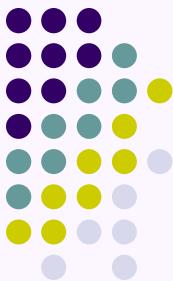
Inherent risk – More Examples

- Amount includes an estimate
- Significant / Important figure
- Entity is having financial difficulties / seeking finance / incentive to manipulate figures
- Complex accounting requirements
- Management integrity
- Management competence and experience
- Unusual pressures on management
- Nature of entity's business/industry
- Significant risk events (eg acquisition)
- Nature of industry
- Complexity of information system
- Use of judgement by management



Audit Risk – Control Risk

Control Risk – The risk that a material misstatement would not be prevented, detected or corrected by the accounting and internal control systems



Assessing Control Risk

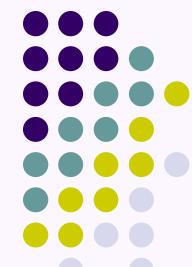
- Identify existing controls
- Identify the absence of key controls
- Determine potential material misstatements that could result
- Consider the possibility of compensating controls

We will look at internal controls in detail later in the module.



Detection Risk

- Detection Risk – The risk that the auditor's procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, either individually or when aggregated with misstatements in other balances or classes.
- Detection Risk in part under the control of auditors can lower it by doing more work on those areas.

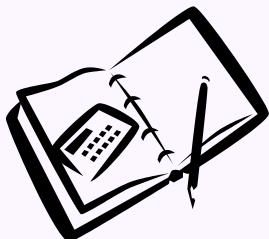

$$\text{Audit Risk} = \text{Risk of material misstatement} + \text{Detection Risk}$$



Company

Inherent
Risk

Control
Risk



Detection
Risk



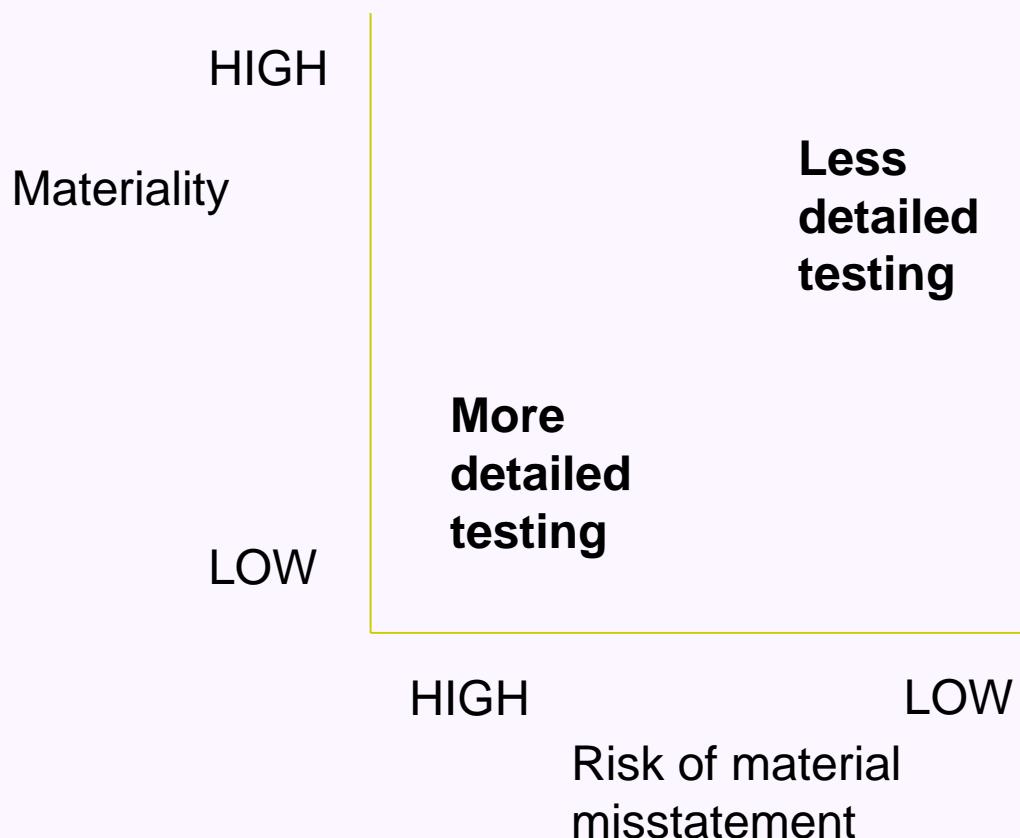
Auditors



Audit Risk – Detection Risk

Inherent Risk	Control Risk	Detection Risk	How?
High	High	Needs to be lowered	More detailed tests, bigger samples, more senior staff.
Low	Low	Can be lowered	Less detailed testing, smaller samples, more junior (cheaper) staff.

Materiality, detection risk and testing levels





Identifying and Assessing Risks

ISA 315 states 'the objective of the auditor is to **identify and assess the risks of material misstatement... through understanding the entity and its environment**'. Auditors need to:

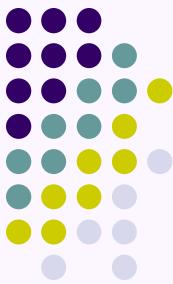
1. Identify risks
2. Assess the risks and relate them to what can go wrong in the financial statements
3. Consider whether the risks are **of a magnitude** that could result in a material misstatement
4. Consider **likelihood** of risks causing a material misstatement

Identifying and Assessing Risks: How?

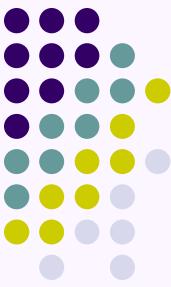


- Identify the essential resources of the business and determine which are the most at risk
- Identify possible liabilities that may arise
- Review the risks that have arisen in the past
- Consider any additional risks imposed by new objectives or new external factors
- Seek to anticipate change by considering problems and opportunities on a continuing basis

Conditions that may increase risk



- Changes to operating environment
- New key management / staff
- New information systems
- Rapid growth
- New technology
- New products and/or activities
- Corporate restructuring
- Overseas operations



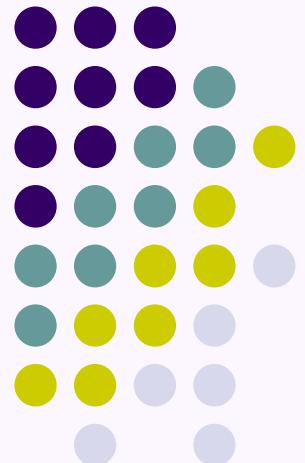
Summary

- Audit Risk is comprised of inherent risk, control risk and detection risk
- The auditor controls the level of detection risk by adjusting how much work they do. They plan audit procedures to reduce the overall audit risk to an acceptably low level
- The auditor assesses the risk through understanding the entity



Audit & Assurance

Related Parties and Fraud and Error





The Audit Process





Related Parties

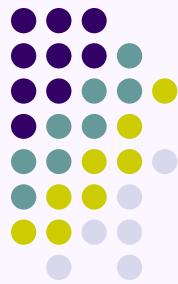
- A related party is an individual or organisation who is influenced by, or has influence over the entity. Transactions with related parties might take place for reasons other than the entity's normal business.
- There is nothing wrong with this and is very normal.
- However these may occur on 'non-arms length' basis and as such should be brought to the attention of shareholders.

THEY ARE MATERIAL BY NATURE

Auditing Related Party Transactions



- Hard to identify who or what are related parties of an entity.
- Directors may be reluctant to disclose in particular if it's close family members.
- Transactions may not be easy to identify from the accounting systems because can't filter from other transactions.
- Transactions may be concealed for auditors for fraudulent purposes.
- May be low in value as are material by nature.



Fraud and Error

Error – An unintentional misstatement in financial statements, including the omission of amounts or disclosures.

Fraud – An intentional act involving the use of deception to obtain an unjust or illegal advantage



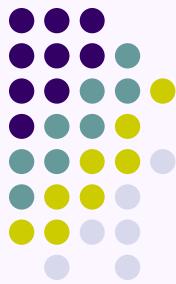
Characteristics of Fraud

ISA 240 Identifies two categories of fraud that are concern to auditors:

Misappropriation of assets – Theft e.g. falsified invoices paid for goods and services not provided.

Fraudulent financial reporting – Intentionally manipulating the financial statements to deceive financial statement users.

Management Responsibility - Fraud and Error

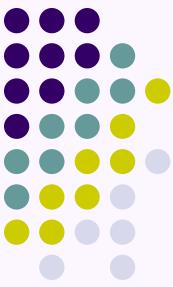


- The primary responsibility for preventing and detection of fraud lies with those charged with those charged with governance and management of the entity
- This should be achieved by the design and implementation of an effective system of internal control.



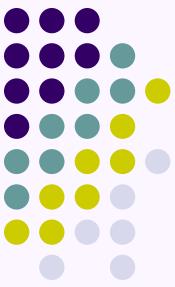
Auditor Responsibility

- Auditors are required to provide reasonable assurance the financial statements are free from material misstatement (which may be caused by fraud or error)
- So must plan, perform and review audits in light of risk of misstatement due to fraud or error.
- There is an avoidable risk some material misstatements due to fraud may be missed due to sophisticated nature of organised crime.



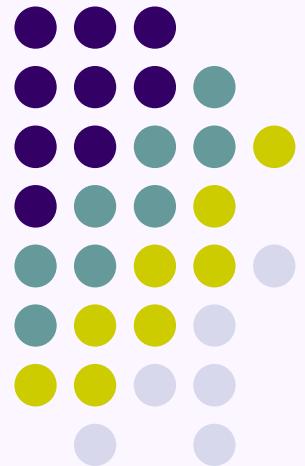
Summary

- Related party transactions and fraud and error are areas which require special attention of the auditor.



Audit & Assurance

Accepting an Assurance Engagement





The Audit Process

By the end of studying this topic, you should be able to:

- Explain the process of accepting assurance engagements
- Outline and discuss the planning process for an engagement including requirements for:
 - The audit strategy
 - The audit plan
- Outline the importance of and procedures involved in understanding the entity
- Define analytical procedures and demonstrate how they are applied in the planning process



The Audit Process

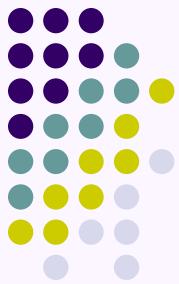
- Can we accept an audit?
 - Acceptance (week 2)
 - Ethical Issues (week 10)
- Planning
 - Risk assessment (week 2 and 3)
 - Control assessment (weeks 5-7)
- Evidence gathering (week 8 and 9)
- Review and completion (ACFI301)
- Audit reporting (ACFI301)



The Audit Process



Methods of obtaining an engagement



- Advertising in line with professional standards
- Invitation to tender

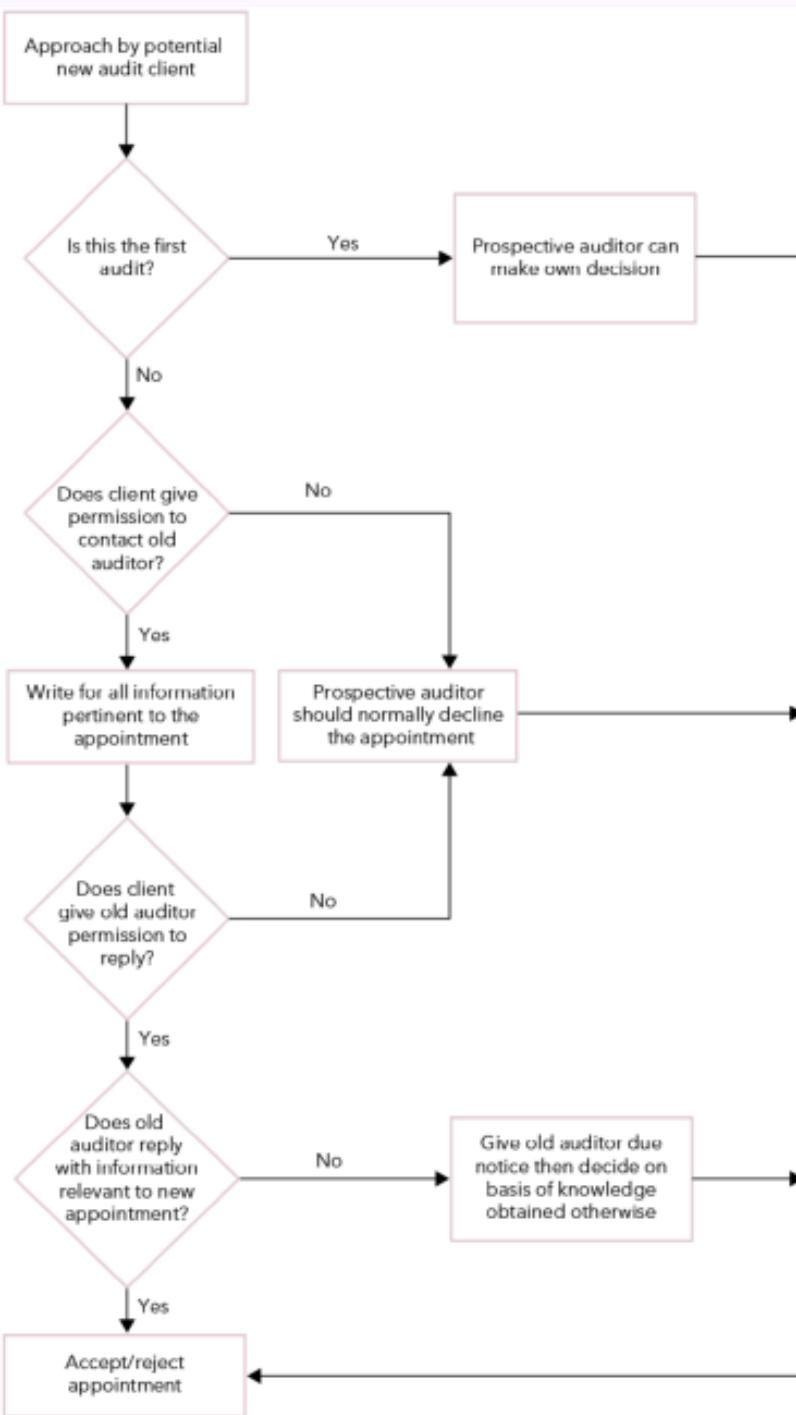
Considerations prior to acceptance



Factors to consider before accepting:

- Are we professionally qualified (legally and ethically) to act?
- Have we communicated with existing/previous auditors?
- Do we have adequate resources available?
- Have we fulfilled Money Laundering Regulations (2007)
- Have we assessed the level of management integrity?
- Have we assessed the level of risk?

Appointment Decision Chart





Money Laundering Check

Also known as client due diligence. Correct identification needs to be obtained before appointment to comply with Money Laundering Regulations 2007

- Individuals – Photographic identification and other documents confirming name and address
- Companies – Identification from Companies House

Client identification must be kept for minimum of 5 years after relationship elapses.



Integrity of Management

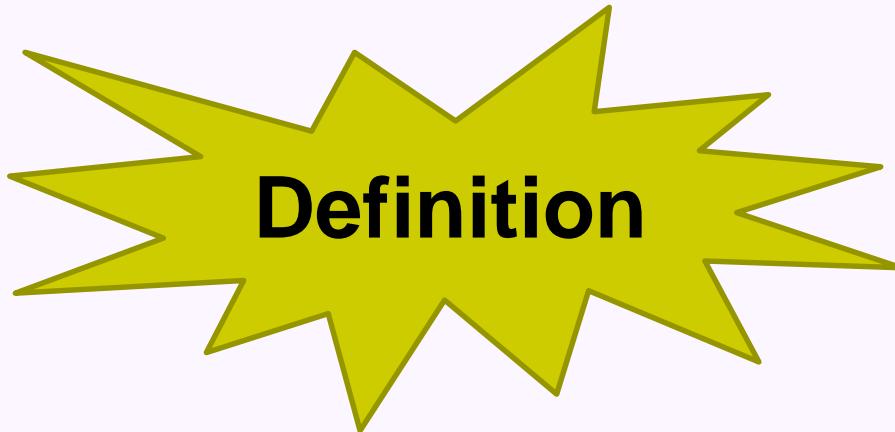
*(required to be considered by ISA 220 Quality Control
for an Audit of Financial Statements)*

Why consider integrity?

- Particularly important where management dominated by one or a small number of people
- Increased risk of management override or misstatement
- Increases the risk of giving the wrong opinion
- Reputation of assurance provider may be at risk if associated with clients lacking integrity



Audit Risk



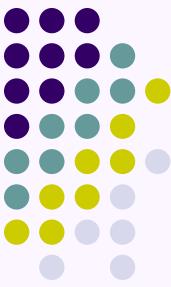
Audit risk is the risk that the auditor expresses an incorrect opinion

Things to Consider Before Accepting An Audit Engagement



Risk of giving an inappropriate opinion

Low Risk	High Risk
Good long term prospects	Poor recent or forecast performance
Well-financed	Possible lack of finance
Conservative accounting policies	Aggressive accounting policies or lack of integrity
Competent, honest management	Lack of finance director
Few unusual transactions	Significant unexplained or unusual transactions



Audit Risk

Risk of giving inappropriate opinion

- Where risk is assessed as anything other than low, specific risks need to be identified and **documented**.
- Need to **document** responses to risks
- Fees should reflect the level of risk



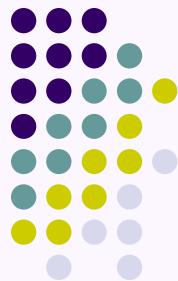
SPORTSDIRECT.COM



Mike Ashley's business, which filed its latest set of accounts without an auditor, has been turned down by each Big Four firm in its search to appoint an auditor capable of picking through its books.

The firm, which declined to comment on the matter, was required by law to have a new auditor in place by the end of its annual general meeting last week, but no agreement was made.

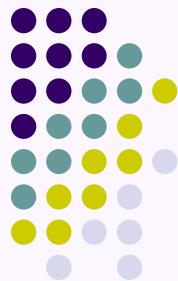
In an unprecedented development, Ashley has been forced to ask the government what would happen if Sports Direct becomes the first listed business to fail to appoint an auditor.



Case Study – Woods Limited

We work for a small firm in Liverpool, it has 3 partners and 8 staff in it's audit department.

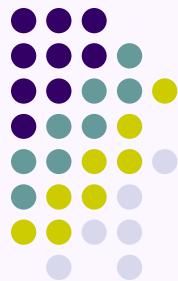
We have been approached to tender by the Woods Ltd, discuss any question marks surrounding the acceptance of Woods as a client



Case Study - Woods Limited

An old school friend of ours runs a haulage company has just removed his previous auditors after a disagreement over the valuation of a provision.

They have depots with assets in 40 locations across the UK, due to poor working conditions Woods is experiencing very high staff turnover and accounts team is largely made up of temporary staff.



Case Study – Woods Limited

Old school friend – Independence?

Removed auditor after disagreement –
Integrity?

40 locations - Resources of a small firm?

High staff turnover – Lack of functioning
controls and high chance of error

Sources of Information About New Clients



Client

- Management accounts
- Internal audit reports
- Financial statements

External

- Credit ratings
- Bankers
- Laws and regulations
- Internet search

Previous Auditor



Accepting an Audit Engagement

- Ensure outgoing auditors have been properly removed in accordance legal requirements
- Ensure new appointment is valid
- Ensure **engagement letter** is in place

If outgoing auditors are still owed fees, new auditors can still accept appointment

Once appointed, new auditors should obtain all client books and papers from outgoing auditors



Audit engagement letter

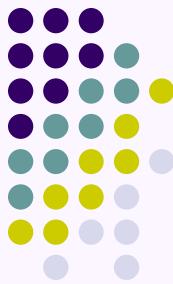
- Define the extent of firm's and management's responsibilities
- Minimise potential for misunderstanding between client and firm
- Provide written confirmation of the firm's
 - Acceptance of appointment
 - Scope of engagement
 - Form of report
- Send to all clients
- Send as soon as possible after appointment
- Review each year if an update is required

Contents of an engagement letter – MUST INCLUDE

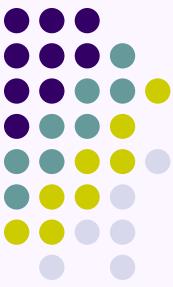


- Objectives of work/auditor's responsibilities
- Management's responsibilities
- Scope of work
- Form of any reports
- Level of access to books and records
- Reporting framework

Contents of an engagement letter – MAY INCLUDE

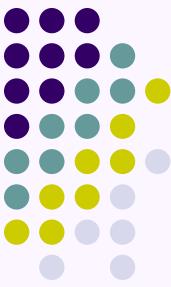


- Inherent limitations of the engagement
- Arrangements for planning the audit
- Expectations regarding management representation letter (*more on this later in the module*)
- Confidentiality and restricted circulation/use of report
- Basis for fees and billing arrangements



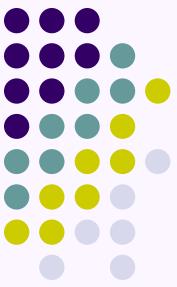
Example of Engagement Letter

- Section 3 of chapter 2 of core textbook



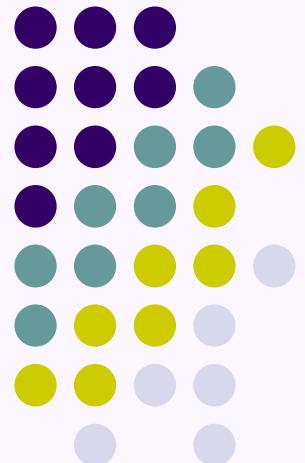
Summary

- Before accepting an engagement, the auditor must carry out certain procedures to make sure there aren't any ethical reasons why they cannot accept the client.
- The auditor needs to consider the risk of giving an inappropriate opinion – the fee charged to the client needs to reflect the level of risk.
- Need to ensure professional clearance from the outgoing auditors.
- Need to have an engagement letter in place.



Audit & Assurance

Planning: Understanding the Entity

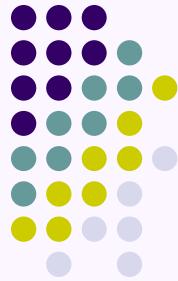




The Audit Process



Reminder of International Standards of Auditing (ISAs)



<https://www.frc.org.uk/auditors/audit-assurance/standards-and-guidance/current-auditing-standards>

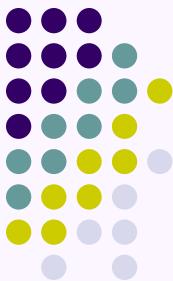


Planning the Audit Assignment

ISA 300: Planning an Audit of Financial Statements

Need to plan an audit to:

- Ensure important areas are considered appropriately
- Identify potential problems and resolve them on a timely basis
- Ensure the assignment is properly managed and organised
- Assign work appropriately
- Organise direction and supervision of team
- Facilitate review of work



Planning the Audit Assignment

ISA 300: *Planning an Audit of Financial Statements*

Planning involves establishing an:

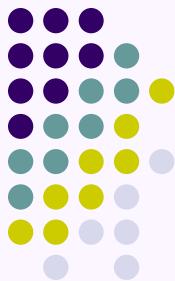
- **Audit Strategy** – Determines scope, timing and direction of audit and determines the development of the audit plan.
- **Audit Plan** – Has an increased level of detail. It sets out the nature, timing and extent of audit procedures needed in order to obtain sufficient and appropriate audit evidence.



Establishing an Audit Strategy

- Identify the relevant characteristics of the engagement (e.g. consideration of relevant financial reporting framework - scope)
- Identify key reporting dates
- Consideration of when work should be carried out
- Consideration of team members availability, skill level and timing of work

Overall Audit Strategy – Key Planning Document



Understanding
the entity's
environment

Risk and
materiality

Understanding the
accounting and internal
control systems

Consequent
nature, timing
and extent of
procedures

Co-ordination, direction,
supervision and review

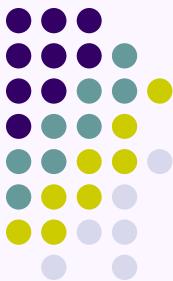
Other matters

See worked in example of overall audit strategy of Kwikstore Ltd (ICAEW Assurance Textbook, Chapter 3, section 1).



Establishing an Audit Plan

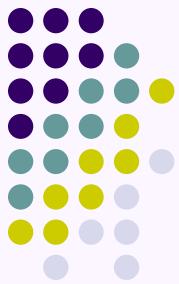
- The audit plan is more detailed than the strategy
- The audit plan shows **how** the strategy will be implemented.
- Audit plan and any changes made to it **must** be documented
- Includes:
 - Risk assessment procedures
 - Outlining audit tests
 - Other procedures to comply with ISAs



The Audit Plan: Why?

- ensure appropriate attention is devoted to important areas of the audit
- identify potential problems and resolve them on a timely basis
- ensure that the audit is properly organised and managed
- assign work to engagement team members properly
- facilitate direction and supervision of engagement team members
- facilitate review of work

Understanding the Entity and its Environment



ISA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment

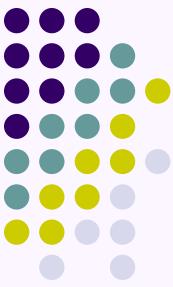
States ‘the objective of the auditor is to **identify and assess the risks of material misstatement, ... through understanding the entity and its environment**’

Understanding the Entity: Why?



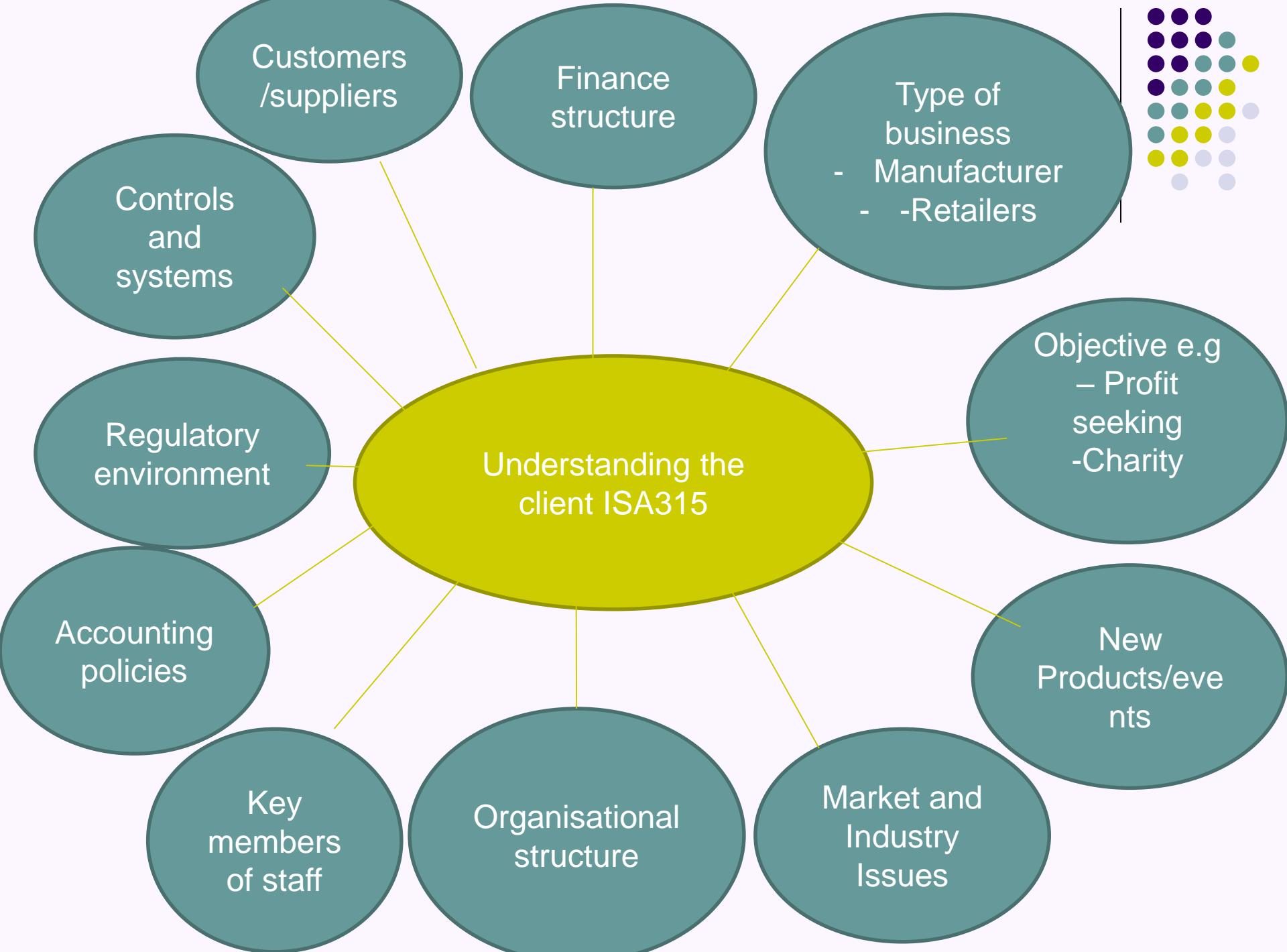
Important to identify problem areas which may cause problems in collecting evidence or drawing conclusions – need to understand the entity

- To identify and assess the risks of material misstatement in the financial statements
- To enable the auditor to design and perform audit procedures
- To develop the audit strategy and plan



Exercise

- You have a new assurance client, what types of things would you want to know before you start planning work that needs to be done.
- Note down some ideas



Understanding the Entity: What?

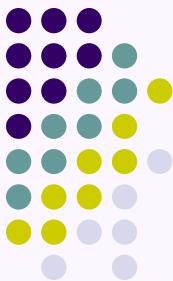


- Industry, regulatory, and other external factors, including applicable reporting framework
- Nature of the entity, including the entity's selection and application of accounting policies
- Objectives and strategies and relating business risks that might cause material misstatement in financial statements
- Measurement and review of the entity's financial performance
- Internal control

Understanding the Entity: Risk Based Auditing at Tesco



- Identified inventory as a risky area: **the auditor needs to understand the business to be able to identify this**
- To know what evidence to gather, they need to understand the business
- Need to understand the size and nature of the business to be able to determine what the users would consider '**material**' (i.e. significant)
- Need to understand the business to be able to identify figures that look '**unusual**' e.g. revenue shouldn't have doubled in the year, inventory turnover shouldn't be 1 day or 100 days – it should be in the region of 10 days

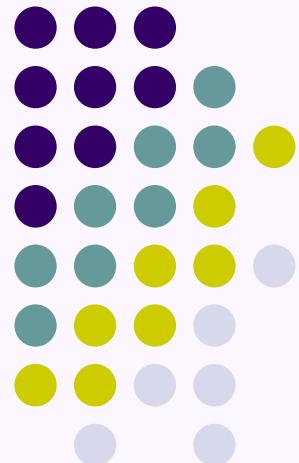


Summary – so far this week

- Things to consider before accepting an audit engagement
- Agreeing the terms of engagement with the client and content of the engagement letter
- Planning the audit – the audit strategy and audit plan
- Understanding the entity at the planning stage
- Using analytical procedures at the planning stage

Audit & Assurance

Planning: Analytical Procedures





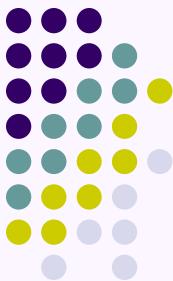
The Audit Process



Understanding the Entity: How?



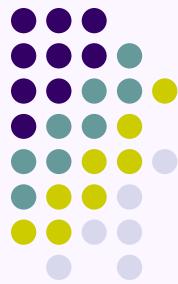
- ISA 315 **requires** auditors to perform certain procedures such as:
 - Making inquiries of management
 - Perform analytical procedures
- Other procedures performed include:
 - Observation and inspection
 - Reviewing prior period knowledge
 - Discussion within the engagement team



Analytical Procedures

Involve the evaluation of financial information through analysis of plausible relationships among financial and non financial data.

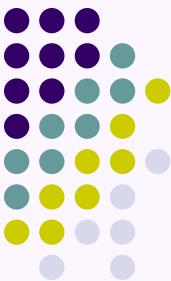
Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are consistent with other relevant information or that differ from expected values by a significant amount.



Exercise

A – Bottle limited had sales £12M in the year. Their pricing structure is to mark up 50% on cost. What would we expect their cost of sales to be?

B – Bottle last year had staff costs of £3M in the year all staff were given a 5% payrise and average staff numbers in the year have increased 100 to 120. What would we expect staff costs to be?



Exercise - Solution

A

	%		£
Sales	150		12M
Cost of Sales	100	= (100/150) x 12M	8M
Mark-up	50	= (50/150) x 12M	4M

B

		£
Prior year staff costs		3M
Staff increased 100-120	= 3M x 1.2	3.6M
5% pay rise	= 3.6M x 1.05	3.78M

We now have an expectation of what we expect Cost of Sales and Staff Costs to be a bottle. A significant variation would flag it as a risky area.



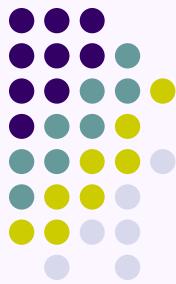
Analytical Procedures

Analytical Procedures at three different stages of the audit:

- *MUST be used in the planning* – **Preliminary AP** (as part of planning)
- *MAY be used in evidence gathering* – **Substantive AP** (gathering audit evidence as part of substantive procedures. Auditors are not required to do this by ISA)
- *MUST be used in the overall conclusion* – **Review AP** (part of audit completion)

Analytical procedures

Limitations



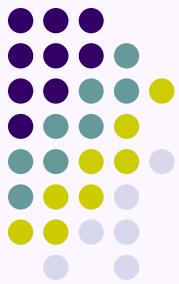
- They require a sound knowledge/experience of the entity which may be limited in a first year audit.
- Experienced staff required to carry them out.
- The quality of analytical procedure depends on the reliability of source data.

Analytical Procedures in Planning the Audit



- ‘Results’ of analytical procedures will direct the auditors to areas where more information is required, where more work is required or to areas of high risk **ENABLES AUDITOR TO ASK BETTER QUESTIONS – DOES NOT GIVE ANSWERS**
- Adapt the audit plan according to results of analytical procedures - determine the nature, timing and extent of audit procedures

How to Perform Analytical Procedures



- Understand the business
- Develop an expectation
- Compare actual to expectation
- Unexpected variations = risk

Sources of Information in Developing Expectations



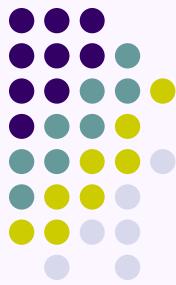
- Interim accounts
- Budgets
- Management accounts
- VAT returns
- Board minutes
- Non-financial information e.g. HR records
- Discussion or correspondence with client
- Industry knowledge



Calculations

- Calculations need to be compared to something. This can be prior year, budget, industry averages or other plausible benchmarks.
- Comparisons can be simple trends such as % changes year on year.
- Ratios can also be helpful

Examples of unusual movements 1



Client offers 30 days credit.

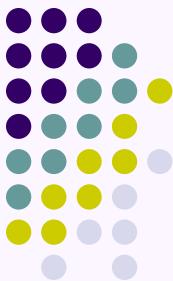
Sales in year 2,400,000

Would have expected $1/12^{\text{th}} \times 2,000,000 = 200,000$

Year end receivables in financial statements is 750,000.

This appears very high....why?

Examples of unusual movements 2



Client is a clothes retailer buys well known brands wholesale and sells them at a mark up

	2021	2020
Sales	2,500,000	2,300,000
Cost of Sales	(1,300,000)	(1,600,000)
Gross Profit	1,200,000	700,000
Gross Profit margin	48%	30.4%

Why has margin increased so much? Sales overstated? Cost of sales understated or is there a genuine commercial reason?



Some Useful Ratios

Gross Profit Margin: Gross profit / Revenue *100%

Net/Operating Profit Margin: Net/Operating profit / Revenue
* 100%

Current Ratio: Current assets / Current liabilities

Gearing Ratio: Net debt / equity *100%

Inventory Turnover: Cost of sales / inventories

Inventory holding period: inventory / cost of sales *365

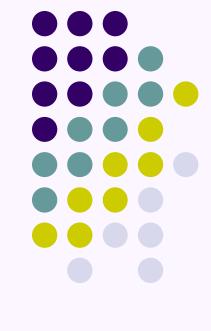
Trade receivables collection period: Trade receivables /
revenue *365

Trade payables payment period: Trade payables / credit
purchases (or cost of sales) *365

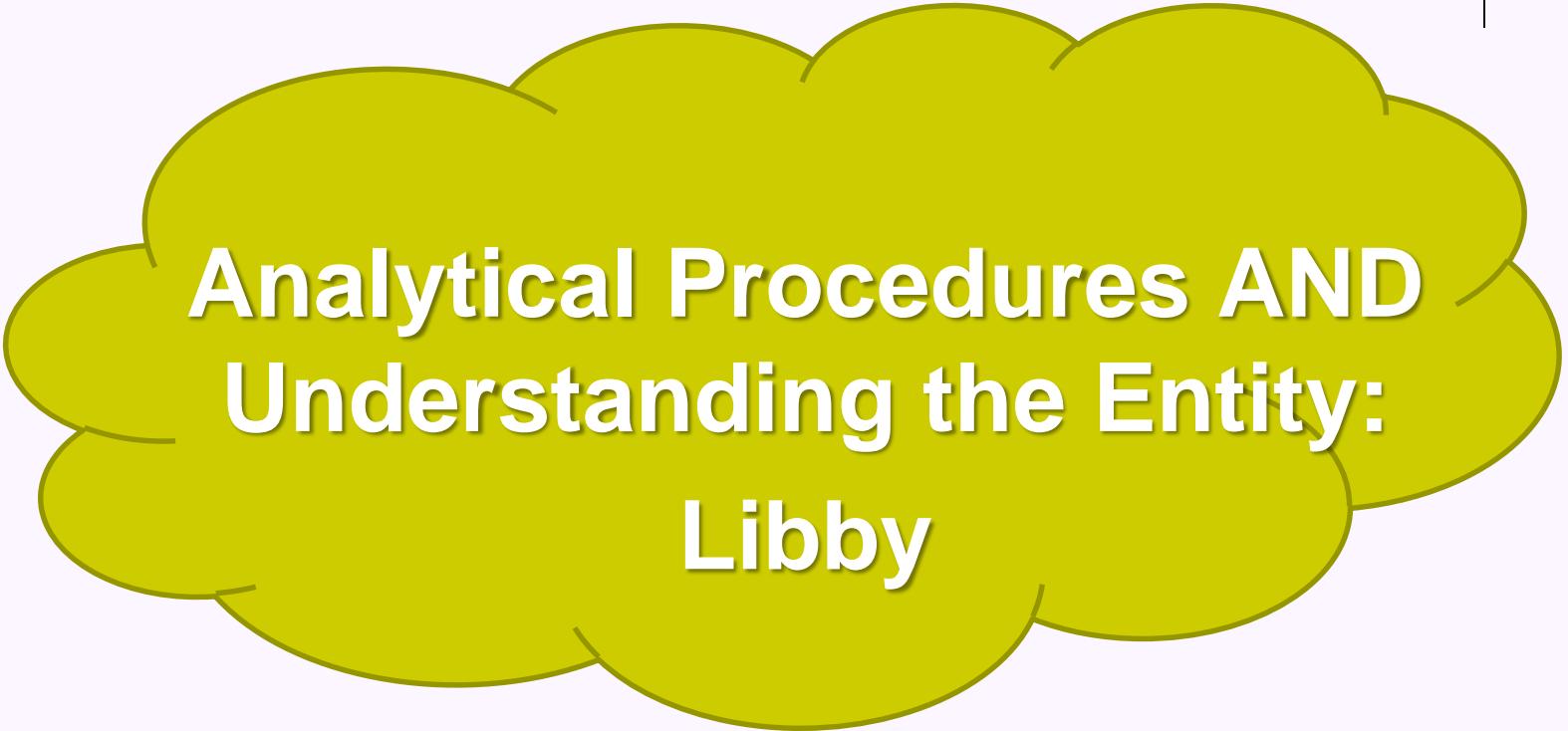
For next week's Synchronous (Live Online Session)



Analytical Procedures:
Gecko Ltd



And..



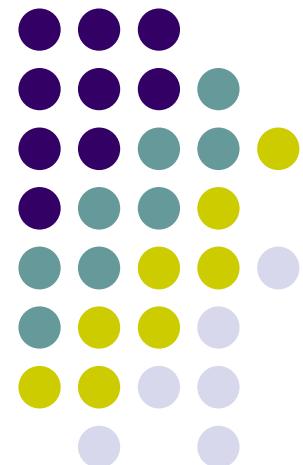
Analytical Procedures AND
Understanding the Entity:
Libby

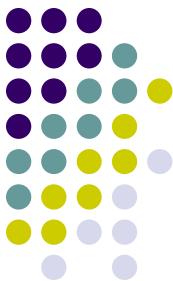
Audit & Assurance

Topic 7

Purchase systems

Podcast 1

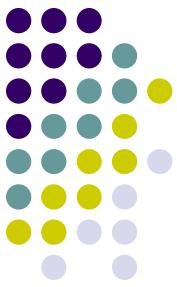




The Purchases System

By the end of studying this topic, you should be able to:

- Identify risks in a purchasing system
- Identify relevant controls to mitigate risk
- Identify tests of controls
- Recognise strengths and weaknesses in a purchases system
- Determine the extent to which tests of controls should be used in a given set of circumstances.



Lecture plan

1. Requisition
2. Ordering
3. Goods inward and recording of invoices
4. Payment
5. Deficiency

NB Purchases is mirror image of revenue system

Required Reading:

Chapter 7, ICAEW 'Assurance' textbook





Terminology

Purchase ledger = Payables ledger

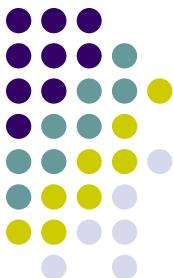
Comprises amounts owed by a company to each supplier for goods (inventories) purchased on credit.

Sales ledger = Receivables ledger

Comprises amounts owed to a company by each customer for goods sold on credit.

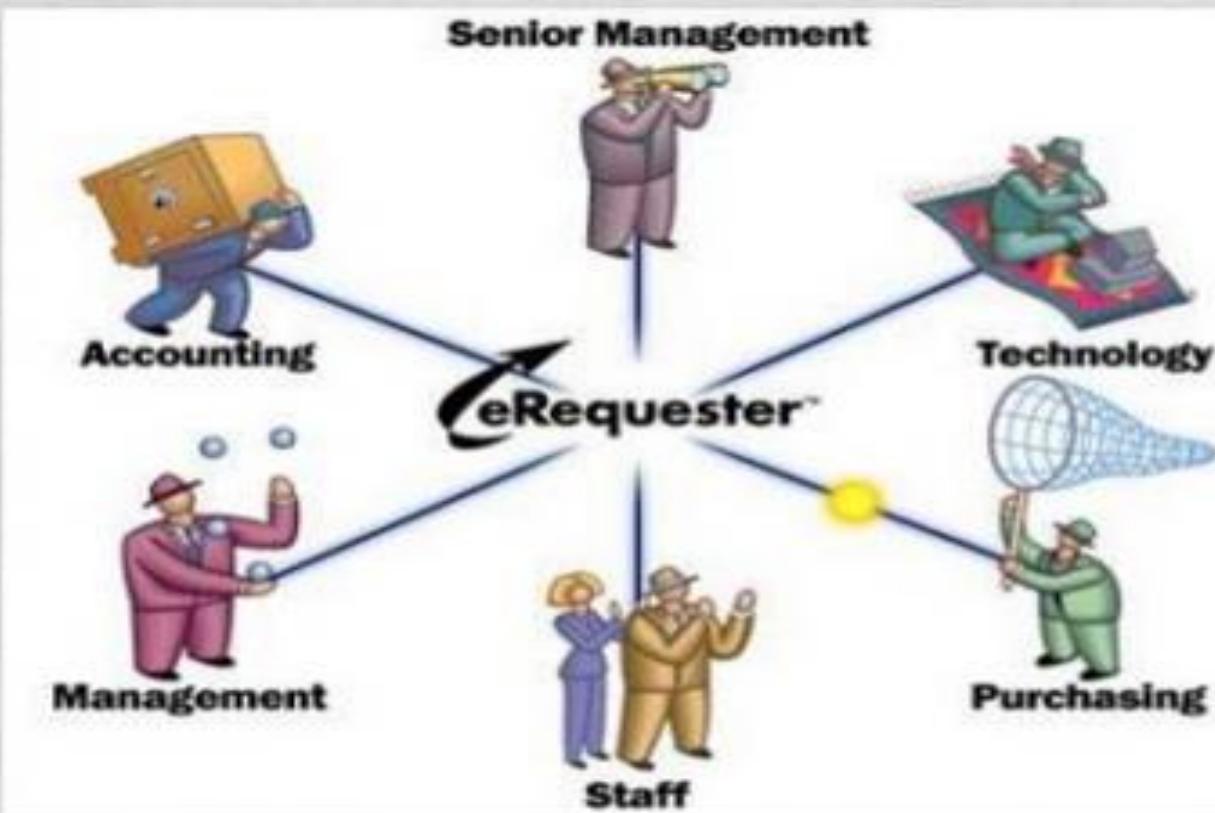
Purchasing = Sourcing = Procurement

The Audit Process





A purchasing system

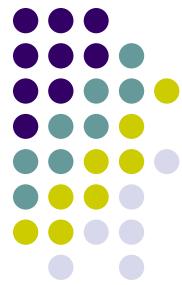




What is a purchasing system?

- A process used by businesses to buy **goods or services**.
- The purchasing system is also called the **procurement system**.
- It manages and controls the entire **acquisition process**: from **requisition**; **order**; **goods receipt**; to final **payment**.
- Purchases; payments; payables; and inventories are all **linked**.
- Purchases mainly **inventories** (but also **PPE**).

Key elements of Purchases System



1. Ordering
2. Goods inward and recording of invoices
3. Payment

The Purchasing system - Risks and controls



1. Risks (what can go wrong?) **(if there are no controls)**
2. Control objective
3. Control
4. Tests of control (by auditor)



Matrix – approach to controls

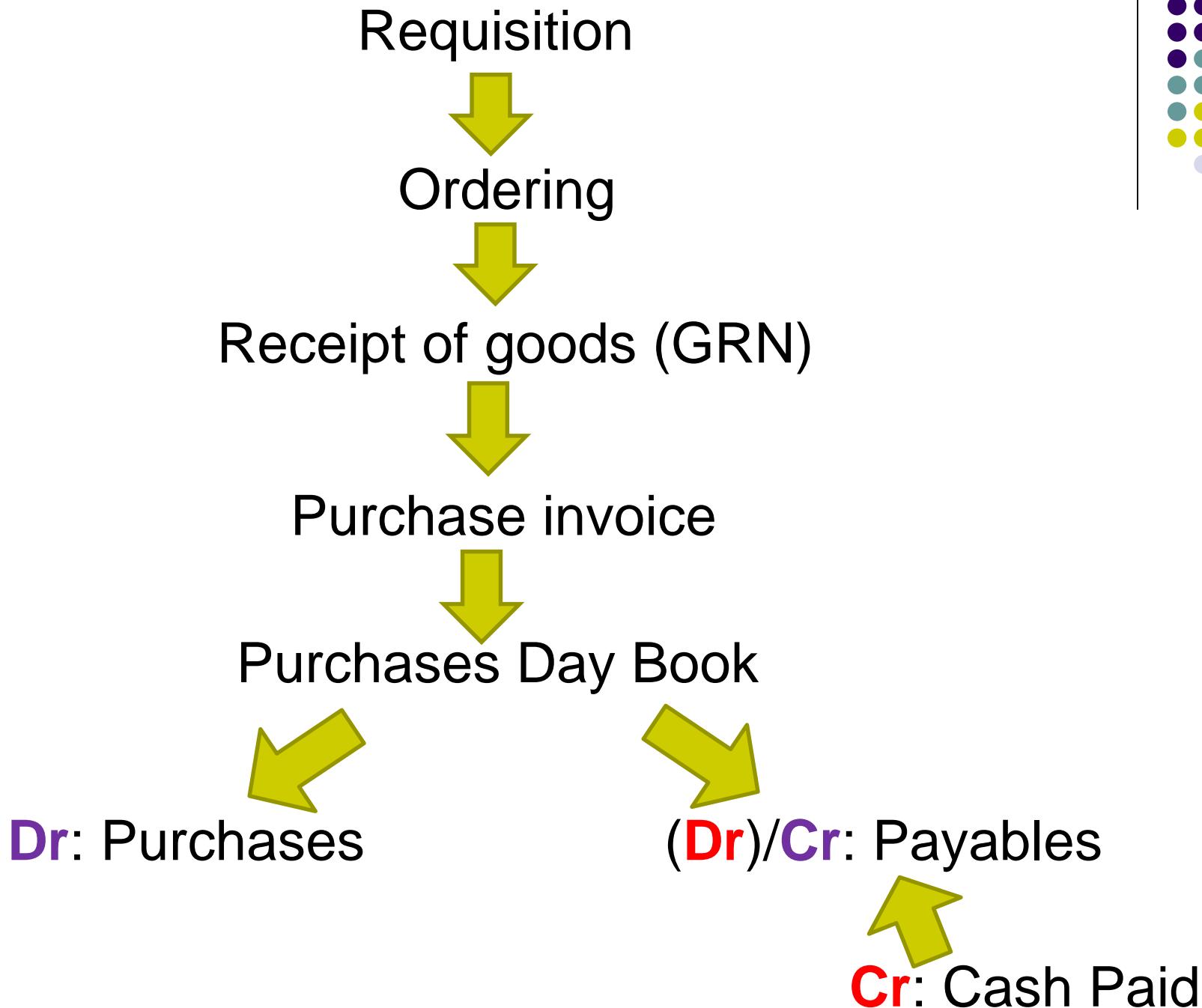
	CLIENT		AUDITOR	
	Risks	Control Objectives	Controls	Tests of Controls
1. Ordering				
2. Goods inward & recording invoices				
3. Payment				

Supplementary Lecture Notes



1. Ordering

Risks	Control Objectives	Controls	Test of controls
Unauthorised purchases may be made for personal use or personal gain	All orders for goods and services are properly authorised and duly processed.	Segregation of duties; requisition and ordering Authorisation of order forms	Observation Review sample of orders for evidence of authorisation
	All orders are for goods and services actually <u>required</u> by the company	Evidence required for purchase before purchase authorised Safeguarding of blank order forms	Check orders are supported by a purchase requisition Review security arrangements over blank orders



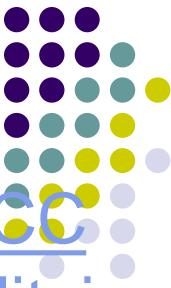


Audit simulation

The following slide has a link to two audit simulation videos relating to purchase systems and payables.

You should watch these before listening to the second podcast.

Audit simulation



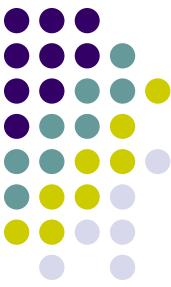
https://blackboard.uwe.ac.uk/bbcswebdav/orgs/ACC/simulations/auditsim_0919_xg/auditsim_web/auditsim_files/intro.html

Go to:

“Virtual Desk and Filing System” (top right)

Play and watch the following videos:

- (1) Interim visit Sheridan AV’s Purchase Process—
documents and resources”
- (2) Final Visit - Payables



Audit simulation

- Listen to the video
- Review supporting notes
- Review supporting documents
- Action point: identify internal control deficiencies for Sheridan AV in each of the two videos above.

1. Purchase Requisition Process



- The need to purchase goods comes from managers in operating departments.
- Purchase reacquisition notes (PRN) identify the goods to be ordered.
- PRN can be hard copy or electronic.
- PRN can be automatic (eg when a reorder level is reached) or manually generated.
- PRN need to be authorised.
- PRN need to be pre-numbered sequentially.
- PRN are sent to purchase order department.

Purchase Requisition form



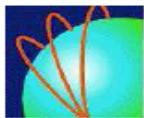
Please contact Purchasing, 703-993-2580, with questions regarding the proper use of this form.

PURCHASE REQUISITION

Sample Sample

835457

Order form



New World Company

Floor 100, 100 Main Street
G.P.O. Box 100, Globecity Globeland, 1000
Telephone: (01) 9999 9999
Fax: (01) 9999 8888

TO: Acme Parts Corporation
1223 Kelton Street
Globecity, Globeland 1000
(via FAX 999/999-9999)

FOB: Vendor/Globecity Globeland

PURCHASE ORDER

SHIP TO: *The New World Company*
2467 Pioneer Road
Globecity, Globeland, 1000
Attn: Shipping/Mary

P.O. Number	NW-01-16366
P.O. Date	Feb/28/2001
Resale No.	SR AC 16-943236
GSA Sale	No
Phone	(999) 999-9999
Contact	John Hancock

SHIP VIA: UPS

TERMS: Net 30 days

ITEM	QUANTITY	PART NUMBER	DESCRIPTION	REQUIRED DATE	U/M	UNIT PRICE	PRICE	QUOTE NO.
001	10	F54749	NW Globe Chassis, 1492 Model	28/02/01	EA	29.50	295.00	Q84645
002	15	F85352	NW Globe Light Kit	28/02/01	EA	19.00	285.00	Q84646
003	6	F84352	NW Globe 30" Oak Stand	28/02/01	EA	30.00	180.00	Q84647
004	20	L86355	NW Atlas Leather-Bound	28/02/01	EA	25.00	500.00	Q84648
005	12	L86362	NW Atlas Young Readers Series	28/02/01	EA	10.00	120.00	Q84649
006	40	A86357	NW Pen Rollerball	28/02/01	EA	7.50	300.00	Q84650
007	25	A86362	NW Pen Fountain	28/02/01	EA	16.00	400.00	Q84651
008	50	A86552	NW Globe Beach Balls, 24"	28/02/01	EA	5.00	250.00	Q84652
009	100	A84352	NW Promotional Calendars	28/02/01	EA	0.10	10.00	Q84653
010	100	A36352	NW Promotional Balloons	28/02/01	EA	0.15	15.00	Q84654

- PURCHASE ORDER NUMBER, PART NUMBER AND QUANTITY MUST SHOW ON EACH CARTON.**
- Two packing sheets must accompany each shipment.
- Protection of Material in Transit. All articles delivered on this order to be packed adequately to prevent any damage in shipment and storage. Use of newsprint and glassine bags prohibited. All packages to be properly identified.
- Seller must execute acknowledgment copy hereof and return to buyer. No other form of acceptance is binding on buyer. Buyer expressly limits acceptance to the terms stated herein and any additional or different terms proposed by seller shall not be binding on buyer, whether or not they would materially alter this order, and are rejected.
- ANY BOX OVER 50 KILOS WILL BE REFUSED.**

P.O. ACKNOWLEDGED BY:

NAME: _____

DATE: _____



NW-01-16366

BUYER: *John Hancock* DATE: Feb/28/2001

SUB-TOTAL	2,355.00
TAX	141.50
TOTAL	2,496.50



2. **Ordering**: Risks (What can go wrong?) (if there are no controls)

- Unauthorised purchases of goods/services may be made for personal use.
- Cash extracted by employees setting up a fictitious supplier and paying themselves by raising false documentation.
- Goods and services might not be obtained on the most advantageous terms.

What are the control objectives arising from the risks above?



Control Objectives

- All orders for goods and services are properly **authorised** and duly processed.
- All orders for goods and services **are required** by the company
- Orders are only made with **authorised suppliers**
- Orders are made at **competitive prices**

Reminder:

Types of Control Activity



- Authorisation
- Performance Reviews
- Information Processing
- Physical Controls
- Segregation of Duties



Key controls in purchasing system

- Authorisation
- Matching
- Pre numbered sequence

Controls over Ordering (Examples)



- Segregation of duties; ie requisition and ordering separate
- Central policy for choosing on suppliers (e.g. a list of approved suppliers / three quotes must be obtained before ordering)
- Authorisation of order forms
- Evidence required of need for purchase before ordering (eg inventory shortage)

Controls over Ordering (Examples) cont



- Monitoring of supplier terms and taking favourable offers (e.g. bulk purchase discounts)
- Pre-numbered order forms and safeguarding blank forms



Tests of control

- Authorisation of order forms
 - Review a sample of order forms and inspect for evidence of authorisation (eg a signature)
- Sequence check order forms
- Evidence required of need for purchase before ordering
 - Test computer controls to ensure orders can only be raised when pre-set thresholds are met
 - Inspect order forms / purchase requisition for evidence of need for purchase



Other Tests of Controls

- Observation of segregation of duties
- Check orders are supported by a purchase requisition
- Review security arrangements over blank orders
- Review a sample of orders made and compare to authorised supplier list



Lyton - Question

The directors of Lyton Limited (LL) have just uncovered a fraud being perpetrated by the stores manager. He was in charge of ordering, had raised a number of false orders to fictitious suppliers, raised goods received notes (GRNs) in respect of non-existent deliveries and forwarded an invoice to the accounts department, which was then paid.

Which **two** of the following controls could have **prevented** this fraud?



Lyton - Question

- A. Approved list of suppliers
- B. Check of goods inward by person other than person responsible for ordering goods
- c. Pre-numbered order forms
- D. Blank order forms locked in a safe

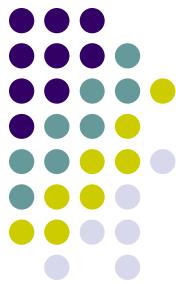


Lyton - Answer

- A. *Approved list of suppliers
- B. *Check of goods inward by person other than person responsible for ordering goods
- c. Pre-numbered order forms
- D. Blank order forms locked in a safe

Before listening to Podcast 2

- Go through the **Sheridan video** on the purchases system using the supporting notes

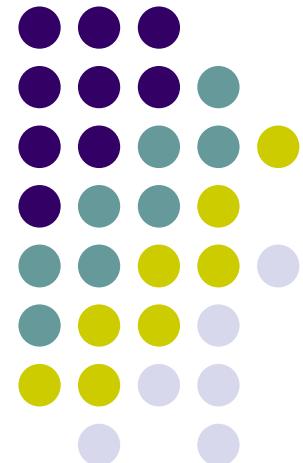


Audit & Assurance

Topic 7

Purchase systems

Podcast 2



3. Goods inward and recording of invoices: What Can Go Wrong?



Goods inward

- Goods may be misappropriated (ie stolen)
- Goods may be accepted that haven't been ordered (or are damaged)

Invoices

- Invoices may not be recorded resulting in non-payment
- The company may not take advantage of the full period of credit extended
- The company may not record credit notes



Control Objectives

- All goods and services received are used for the **company's purposes**, and not private purposes
- Goods and services are **only accepted** if they have been **ordered**, and the **order** has been **authorised**
- All **goods and services received** are accurately **recorded** (to avoid disputes with suppliers)



Control Objectives (cont)

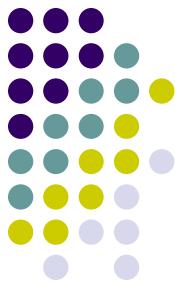
- **Liabilities are recognised** for all goods and services that have been received
- All entries in the payables ledger are made to the **correct payables ledger accounts**
- All **credit notes** that are received are recorded in the nominal and payables ledgers
- All **credits** to which the company is entitled are **claimed and received**



Control activities - examples

- Goods and services are **only accepted** if they have been **ordered**, and the **order** has been **authorised**
 - Only accepting goods that have a corresponding purchase order (**match GRN and order form**)
- **Segregation of duties:** ordering, accounting and checking functions are separate
- Pre numbered GRNs and invoices

Control activities – examples (cont)



- All goods and services received are accurately **recorded**
 - Prompt **recording of purchases** and **purchase returns** in day books and ledgers
- **Payables ledger**
 - Regular maintenance
 - **Reconciliation** to payables control account
 - **Reconciliation** to supplier statements



Tests of controls – examples

- Perform sequence check of pre numbered GRNs and invoices.
- Inspect matching of GRN with purchase orders (for signature)
- Observe segregation of duties
- Inspect reconciliation of payables ledger to payables control account (for signature)
- Inspect reconciliation of payables ledger to supplier statements (for signature)

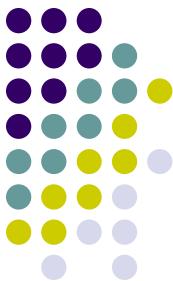


Question

Weezy plc is a company that has a large number of deliveries daily.

Which **one** of the following internal controls is **most likely** to prevent Weezy plc paying for goods that have not been received?

- A. Locked stores
- B. Matching of purchase invoices with goods received notes
- C. Authorisation of order forms
- D. Safeguarding of blank order documents



Question

Weezy plc is a company that has a large number of deliveries daily.

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- A. Locked stores
- B. ***Matching of purchase invoices with goods received notes**
- C. Authorisation of order forms
- D. Safeguarding of blank order documents



Question

As part of your work on trade payables during the year-end audit of Moonlight Ltd, you discovered that the company does not keep a list of approved suppliers from which to purchase raw materials.

Outline the **implications of this internal control deficiency and provide **recommendations** to resolve this deficiency.**



Moonlight Answer - Implications

Implications of deficiency:

- The quality of raw materials may be inappropriate
- Moonlight Ltd may not benefit from the most favourable prices
- Increases the risk of fraudulent acts by staff ordering goods from false or related suppliers



Moonlight answer - recommendations

- Compile and maintain an approved supplier list based on value, prices, quality of goods, reliability of service and discounts available
- Supplier list to be approved by senior management
- Communicate approved supplier list to all staff responsible for ordering
- Require orders to be made with approved suppliers only
- Take disciplinary action where incidences of non-compliance identified

4. Payment: What Could Go Wrong?



- False invoices are paid in error
- Invoices are paid too late or too soon
- Payment is not correctly recorded
- Payments are not recorded in the right period



Control Objectives

- All expenditure is for goods that are received
- All expenditure is authorised
- Invoices are paid on time
- All payments are correctly recorded in the nominal and payables ledgers in the correct period



Control Activities

- All payments are **authorised**
 - Approval limits for large balances
- All payments are **correctly recorded**
 - Payments are matched against the outstanding invoice
 - Regular reconciliation to supplier statements



Control Activities

- Segregation of duties
- GRN (goods received note) signed by warehouse, payment then authorised
- IT system flags payment due dates
- Payments are matched against the outstanding invoice.
- Regular payable ledger reconciliation



Tests of Controls

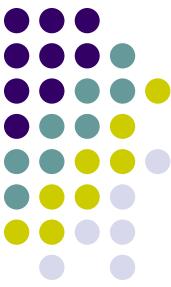
- **Observe** segregation of duties
- **Check** that GRN is being agreed to invoice before payment
- **Review** cheque signatures (**more than one**)
- **Perform** dummy transactions
- **Observe** matching procedure
- **Inspect** reconciliations



Question

Which **two** of the following control activities are most likely to reduce the risk of payments being made twice for the same liability?

- A. Stamping ‘Paid’ on invoices that have been paid
- B. Prompt dispatch of cheques
- C. Authorisation of payments
- D. Checking supplier statements before payments are made



Question

Which **two** of the following control activities are most likely to reduce the risk of payments being made twice for the same liability?

- A. ***Stamping 'Paid' on invoices that have been paid**
- B. Prompt dispatch of cheques
- C. ***Authorisation of payments**
- D. Checking supplier statements before payments are made



5. Deficiencies Question:

The auditor of Sunny plc has identified that there is no procedure to track purchase invoice due dates. Which **one** of the following is the most likely consequence which might arise as a result of that deficiency?

- A. Prompt payment discounts may not be obtained
- B. Goods not actually received may be paid for
- C. Inferior goods may be purchased
- D. Payments may be made to fictitious suppliers



5. Deficiencies - Question:

The auditor of Sunny plc has identified that there is no procedure to track purchase invoice due dates. Which **one** of the following is the most likely consequence which might arise as a result of that deficiency?

- A. ***Prompt payment discounts may not be obtained**
- B. Goods not actually received may be paid for
- C. Inferior goods may be purchased
- D. Payments may be made to fictitious suppliers



Cut-off Question:

In which month would the following transaction be recognised as a purchase in the financial statements?

- A. **January** – Order placed
- B. **February** – Goods received
- c. **March** – Invoice received from supplier
- D. **April** – Payment made to supplier



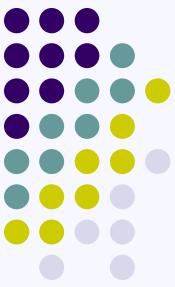
Purchases – substantive tests

See answer to **Comet** question



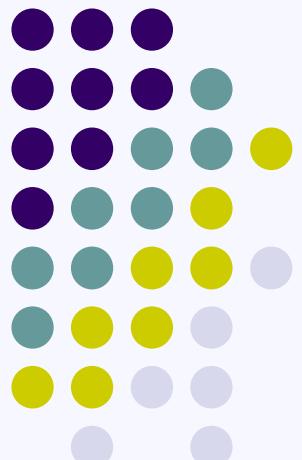
Homework – **slide revised from video**

- Read chapter 7 of ICAEW Assurance Study Manual.
- Go through the **Sheridan video** on the purchases system using the supporting notes
- Go through purchase system **supplementary lecture notes** on Canvas.
- **Fox** – synchronous lecture next week
- **Comet** - synchronous lecture next week
- Practice MCQs on chapter 7 from ICAEW Question Bank



Audit & Assurance

**Topic 6:
The Revenue System
Podcast 1**



Required Reading:



Main reading

Chapter 6, ICAEW 'Assurance' textbook

The Revenue System



By the end of studying this topic, you should be able to:

- Show how specific internal controls in a revenue system **mitigate risk** and state limitations
- **Identify internal controls for revenue** in a given scenario
- Identify internal control **strengths and deficiencies** for revenue, in a given scenario
- Determine the extent to which **tests of controls** should be used for revenue, in a given scenario
- Determine **substantive tests** for revenue and receivables in a given scenario.

Lecture plan



Podcast 1

- Revenue – key issues
- The revenue system
 - 1. Ordering

Podcast 2

- 2. Despatch and invoicing
- 3. Recording
- 4. Cash collection
- Internal control deficiencies
- Substantive testing of revenue & receivables

The Audit Process



Revenue



Revenue is normally the largest item in the financial statements. It is therefore normally **material** by its nature.

Revenue is income generated through the **ordinary activities** of the business.

Revenue can be for selling: (i) **goods** (ii) services

Revenue can be generated by sales to:

- Another business (**B2B**) – on credit
- Individual consumers (**B2C**) – credit or cash



Revenue - Questions

Why might revenue be **overstated**?

ie figure stated in accounts > true amount

Why might revenue be **understated**?

ie figure stated in accounts < true amount



Revenue - examples

Overstated

- Company wants to achieve profit targets (eg to raise share price or achieve budget)
- Invalid sales transactions included
- Cut-off (eg sales of early 2021 recognised in 2020 financial statements). **Thus, 2020 revenue overstated**
- Long term contracts – timing of recognition



Revenue - examples

Understated

- Company wants to reduce profit (eg to avoid/evade tax)
- Fraud – understate sales and steal cash (eg Kingsgate Car Park question)
- Cut-off (eg sales of late 2020 recognised in 2021 financial statements) **Thus, 2020 revenue understated**
- Long term contracts – timing of recognition

Revenue cycle



- **Process** of:
 - Receiving a customer's order (**email, phone, online**)
 - Approving credit for a sale (**B2B**)
 - Determining whether goods are available in inventory
 - Delivering the goods
 - Invoicing the customers
 - Collecting cash
 - Recognising effects of revenue process on other related accounts (eg receivables)



Classes of Revenue Transactions

The classes of transactions in the revenue cycle include:

- Credit sales (B2B)
- Cash receipts (from receivables and cash sales)
- Sales adjustments (discounts, sales returns and allowances).

Revenue System



Ordering



Despatch / Delivery



Invoicing



Sales Day Book



Dr/Cr:

Receivables



Cr: Revenue



Dr: Cash

What can go wrong?



The Revenue System

1. Ordering
2. Despatch and Invoicing (*really 2 processes*)
3. Recording
4. Cash collection



Revenue system

- **Risks** (what can go wrong?) **deficiencies**
- **Control objectives** (to prevent risks occurring)
- **Controls** (put in place by the company to achieve control objectives)
- **Tests of controls** (carried out by the auditor to ensure controls are operating effectively)



Matrix – approach to controls

	CLIENT		AUDITOR	
	Risks	Control Objectives	Controls	Tests of Controls
1. Order				
2. Despatch and Invoicing				
3. Recording				
4. Cash collection				

Supplementary lecture notes – a different approach (See VITAL)



1. Ordering

Risks <u>(ie what can go wrong)</u>	Control Objectives	Controls	Test of controls
Orders may be taken from customers who are not able to pay	Goods and services are only supplied to customers with good credit ratings	Authorisation of credit terms to customers Credit checks on new customers Set credit limits for each <u>customers</u>	Inspect evidence for authorisation Check references are obtained for all new customers Review credit limit procedures. Use dummy transactions

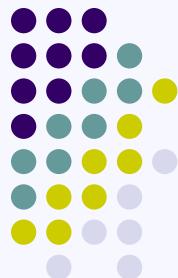


Control deficiencies - what can go wrong?

- Poor controls
- Good controls – but badly implemented
- No controls

Key controls (IMPORTANT)

- Authorisation
- Matching
- Sequence checking
- Segregation of duties



Revenue system - documents

Process	Document
Ordering	Sales order form
Delivery	Goods delivery note (GDN)
Invoicing	Sales invoice
Allowances/returns	Sales credit note



1. Ordering: Risks

What can go wrong? (if no controls)

- Orders may be taken from customers who are not able to pay
- Orders may be taken from customers who are unlikely to pay for a long time
- Orders may not be recorded properly and therefore not fulfilled and customers might be lost
- Orders may be made for inventory not held

What are the control objectives arising from the risks above?



Control Objectives

- Goods and services are only supplied to customers with **good credit ratings**
- Customers are encouraged to **pay promptly**
- Orders are **recorded correctly**
- Orders are **fulfilled**
- Orders should only be taken where **there is availability of inventory**

Control objectives prevent things going wrong

Reminder:

Types of Control Activity



- Authorisation
- Performance Reviews
- Information Processing
- Physical Controls
- Segregation of Duties



Controls over Ordering (**Examples**)

– to achieve control objectives)

- **Segregation of duties:** credit control, invoicing and inventory despatch
- **Authorisation of credit terms** to customers
 - References/credit checks obtained
 - Authorisation by senior staff (**who?**)
 - Regular review
- **Authorisation** for changes in **customer data**
 - Change of address supported by letterhead
 - Deletion requests supported by evidence of balances cleared/customer in liquidation



Controls over Ordering (**Examples** – to achieve control objectives) **cont**

- Orders only accepted from customers who have no credit problems
- Sequential numbering of blank pre-printed order documents and subsequent checking of sequence for completeness (**understatement**)
- Correct prices quoted to customers
- Matching of customer orders with production orders and despatch notes (and querying if not matched) **Deliver what's ordered**
- Dealing with customer queries



Tests of control - examples

- Check that **references** are being obtained for all new customers
- Check that all **new accounts** on the receivables ledger have been **authorised** by senior staff
- Check that **orders** are only **accepted** from customers who are **within** their **credit terms** and **credit limits**
- Check that **customer orders** are being **matched** with production orders and despatch notes

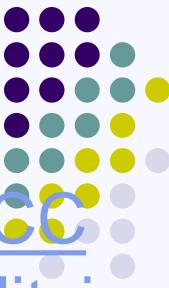


Audit simulation

The following slide has a link to four audit simulation videos relating to revenue systems.

You should watch these before listening to the second podcast.

Audit simulation



https://blackboard.uwe.ac.uk/bbcswebdav/orgs/ACC/simulations/auditsim_0919_xg/auditsim_web/auditsim_files/intro.html

Go to:

“Virtual Desk and Filing System” (top right)

“Interim Visit – Sales Systems – documents and resources”

Play and watch the following videos:

- (1) Sheridan AV’s Sales Process
- (2) Cash receipts at Sheridan AV
- (3) Sheridan AV’s Credit Process
- (4) Sheridan AV: Aged Debtor Analysis

Sales Order

64412 

Prenumbered Sales Order. Controlled
numerically

To:

Okra Development Corp.
8924 Bailey Road
Salem, OR 97317

Copy

Faragut Sales, Inc.
Ship to Okra Development
8924 Bailey Road, OR

Ship by September 12, 20XX
Terms: 2/10, n/30
FOB Shipping Point

Credit Approval C.H. 
Goods Counted M.K.
Customer Order Number 6-3378

10

Model 317

Roller Bearing

480.00

Date shipped: 8/20/20XX Freight Bill #229-237441

Okra Development Corp.

Copy



8924 Bailey Road
Salem, OR 92117

Purchase Order **6-3378**

Date: August 5, 201X
Ship By: September 12, 201X
Terms: 2/10, n/30
FOB Shipping Point

To:

Faragut Sales, Inc.
3812 Briar Drive
Salem, OR 92115

Ship to:

Okra Development Corp.
8924 Bailey Road,
Salem, OR 92117

Quantity	Number	Description	Price	Amount
10	Model 317	Roller Bearing for Model 3118 Ripper	48.00	480.00

**Purchase order number must appear
on all shipments and invoices**

Ordered By

Margaret Spangler



Question – MCQ

Which TWO of the following controls best mitigate the risk that customers might not be able to pay for a delivery?

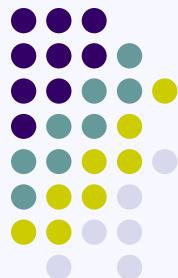
- A Authorisation of credit terms to customers
- B Obtaining customers' signatures on delivery documentation
- C Regular preparation of trade receivables statements
- D Checking the ageing analysis of the current receivables ledger balance prior to accepting order

Question – MCQ (answer)



Which TWO of the following controls best mitigate the risk that customers might not be able to pay for a delivery?

- *A Authorisation of credit terms to customers
- B Obtaining customers' signatures on delivery documentation (too late)
- C Regular preparation of trade receivables statements (too late)
- *D Checking the ageing analysis of the current receivables ledger balance prior to accepting order



Question - Selina

You are the audit senior for the external audit of Selina Ltd for the year ended 30 September 2020. When evaluating the controls over sales made over the telephone, you have noted that sales staff do not check availability of inventory or customer credit limits before accepting the order.

Required

Identify the possible consequences of this control deficiency and provide recommendations to the directors of Selina of how they could resolve this deficiency.

Tasks to do - Important



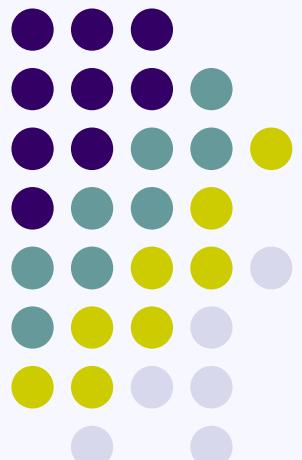
Before listening to the second podcast:

- (1) Answer the Salina question.
- (2) Watch the four audit simulation videos for Sheridan AV (*link on audit simulation slide above*):
 - Sales process (*7-8 minutes*)
 - Cash receipts process (*7 minutes*)
 - Credit process (*4-5 minutes*)
 - Aged debtor analysis (*2 minutes*)
- **Action point:** identify internal control deficiencies for Sheridan AV in each of the four videos above.



Audit & Assurance

**Topic 6:
The Revenue System
Podcast 2**



Lecture plan

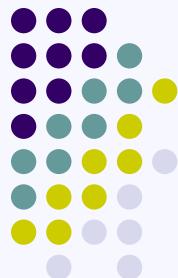


Podcast 1

- Revenue – key issues
- The revenue system
 - 1. Ordering

Podcast 2

- 2. Despatch and invoicing
- 3. Recording
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- Internal control deficiencies
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Required

Identify the possible consequences of this control deficiency and provide recommendations to the directors of Selina of how they could resolve this deficiency.



Selina - Answer

Consequences

- May lose customers / bad reputation / customers go elsewhere because they make an order than cannot be fulfilled as no inventory
- May not get paid for sales made because may make sales to non-creditworthy customers



Selina – Answer

Recommendations

- Check inventory levels before accepting an order
- Check credit limits before accepting an order
- Either:
 - document manual checks
 - automated checks

Revenue System



Ordering



Despatch / Delivery



Invoicing



Sales Day Book



Dr/Cr:
Receivables



Cr: Revenue



Dr: Cash

What can
go wrong?



Matrix – approach to controls

	CLIENT		AUDITOR	
	Risks	Control Objectives	Controls	Tests of Controls
1. Order				
2. Despatch and Invoicing				
3. Recording				
4. Cash collection				



2. Despatch and invoicing: Risks - What can go wrong?

- Goods may be despatched but delivery not recorded so they are lost to the business
- Goods may be despatched but not invoiced for
- Goods despatched are of a poor quality
- Invoices may be raised in error with resulting customer dissatisfaction
- Invoices may be wrongly cancelled by credit notes (**negative invoice**) resulting in loss to the business

What are the control objectives arising from the risks above?



Control Objectives

- All **despatches** of goods are **recorded**
- All **goods and services** sold are correctly **invoiced**
- **Goods** sold are **fit for purpose**
- All **invoices** raised relate to goods and services **supplied by the business**
- **Credit notes** are only given for valid reasons

Controls (Examples)



- All goods dispatched are recorded on a GDN (**Goods delivery note**)
- GDN are matched to the order form and sent to the accounts dept promptly
- Pre-numbering of GDN and regular checks on sequence
- Regular review of unmatched GDNs (**Understatement**)
- Inspection of goods prior to delivery
- Customer to sign GDN as evidence of correct quality & quantity
- Invoice only raised on receipt of matched order and signed GDN
- Credit notes require management authorisation



Tests of Control (Examples)

- Sequence check GDNs
- Sequence check order forms.
- Check matching process is carried out
- Sequence check invoices
- Check matching process is carried out
- Verify checks taken place (sample sign off)
- Check sample for customer sign off
- Inspect invoices for sign off of checks carried out.
- Check for authorisation
- Check that details have been verified

Faragut Sales, Inc.

3812 Briar Drive, Salem, OR 92115

D8-9912

Copy

Prenumbered Sales Invoice. Controlled numerically

Sales Invoice

Sold
Okra Development Corp.
8924 Bailey Road
Salem, OR 92117

Shipped to
8924 Bailey Road
Salem, OR 92117

Freight Bill No.
229-237441

FOB Shipping Point

Invoice Date	Date Shipped	Terms	Your Order No.
August 25, 20XX	August 25, 20XX	2/10, n/30	6-3378
Quantity	We are pleased to serve you	Price	Amount
10	Model 317	48.00	480.00
<i>Key controls. Initials are evidence of control being performed. In total or sample.</i>			
		Pricing and Math	J.D.
		Account Coding	S.A.L.

MCQ



Boot Ltd operates a number of control procedures in its sales system.

Which of the following control procedures is MOST likely to ensure that customers are invoiced for goods they received?

- A Use of pre-printed sequentially numbered sales order documentation
- B Matching of sales orders with despatch notes
- C Matching of despatch notes with sales invoices
- D Requiring customers to sign for goods received

MCQ - answer



Boot Ltd operates a number of control procedures in its sales system.

Which of the following control procedures is **MOST** likely to ensure that customers are invoiced for goods they received?

- A Use of pre-printed sequentially numbered sales order documentation (**completeness of orders**)
- B Matching of sales orders with despatch notes
- *C** Matching of despatch notes with sales invoices
- D Requiring customers to sign for goods received (**only confirms delivery**)

3. Recording

Risks - What can go wrong?



- **Invoiced** sales might not be properly recorded
- **Credit notes** might not be properly recorded
- Sales might be recorded in the **wrong** customer accounts
- Debts might be included on the **receivables** ledger that are **not collectable**



Recording

Control objectives

- All sales **invoiced** are **recorded** in the nominal and receivables ledgers
- All **credit notes issued** are **recorded** in the nominal and receivables ledgers
- All **entries** in receivables ledger are **made** to the **correct** receivables ledger **accounts**
- **Cut-off** applied correctly to receivables ledger
- Potential **bad debts** are **identified**



Recording Controls (examples)

- **Segregation of duties**: recording sales, customer accounts and preparing statements
- **Recording of sales invoices** sequence and **control over spoilt invoices**
- **Matching** of cash receipts with **invoices**
- **Retention of customer remittance advices**
- Separate recording of **sales returns, price adjustments** etc
- **Cut-off procedures** to ensure goods despatched and not invoiced (or *vice versa*) are properly dealt with in the correct period



Recording Controls (examples) cont.

- Regular preparation of trade receivables statements
- Checking of trade receivables statements
- Safeguarding of trade receivables statements so that they cannot be altered before despatch
- Review and **follow-up** of overdue accounts
- Authorisation of writing off for bad debts
- Reconciliation of receivables ledger control account (arithmetic control)
- Analytical procedures for receivables ledger and profit margins

Recording

Tests of controls (examples)



Sales day book (checks on client procedures)

- Check entries with invoices and credit notes respectively
- Check additions and cross casts
- Check postings to receivables ledger control account
- Check postings to receivables ledger

Recording

Tests of controls (examples) cont



Receivables ledger (checks on client procedures)

- Check entries in a **sample of accounts** to sales day book
- Check that **control accounts reconciled** to total of receivables ledger balances
- **Scrutinise accounts** to see if **credit limits** have been observed
- Check that **trade receivables statements** are prepared and **sent out regularly**
- Check **overdue accounts** are followed up
- Check that all bad debts written off have been **authorised** by management

Question - Green Ltd



During the external audit of Green Ltd for the year ended 30 September 2020, it was found that a sales credit note for a large amount, which related to a sale on 22 September 2020, was issued to a customer on 21 October 2020. This credit note has not been recorded in the draft financial statements for the year ended 30 September 2020.

Requirements:

- Explain the possible consequences of this control deficiency
- Explain why this matter impacts the audit plan

Answer - Green Ltd



Consequences

- Revenue and receivables may be **overstated**.
- Inventory may be **understated** and, as a consequence, cost of sales will be **overstated**.
- Inventory may be overstated if goods are found to be **faulty**; the net realisable value of goods may be lower than cost. Green may not identify faulty goods promptly and therefore may deliver faulty goods to other customers adversely impacting customer goodwill.

Answer - Green Ltd



Impact on Audit Plan

- May be further returns not recorded
- Ensure goods are included in inventory and excluded from sales and receivables
- Goods may be faulty – may require a provision and may indicate further provisions required if similar goods are also faulty
- May impact the audit opinion if the directors don't make adjustments



4. Cash collection

Risks - What can go wrong?

Cash received at the business premises may not be recorded or banked:

This could be due to:

- Fraud (eg Kingsgate Car Park question)
- Error
- Simply losing cash or cheques received.

Cash collection

Control objectives



- All monies received are recorded
- All monies received are banked

Cash collection Controls (Examples)



- **Segregation of duties** between cash handlers and bankers (eg post is opened in pairs)
- **Daily banking**
- **Comparison** of cash received to amounts banked
- **Bank Reconciliations** (**arithmetic control**)
- Independent surprise **cash counts**
- Cash stored in a **safe**

Cash collection

Tests of Controls (Examples)



- Observe segregation of duties in operation
- Examine evidence of payment for dates
- Inspect for sign off
- Inspect bank reconciliation
- Examine documentary evidence that they have taken place
- Observation of procedures

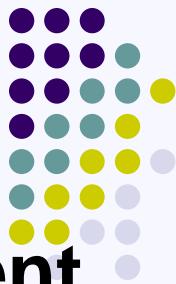
MCQ



Which of the following controls will **not prevent** misappropriation (**ie stealing**) of customers' remittances?

- A Segregation of duties between cash handling and recording
- B Post opening by two people
- C Investigation of differences between till records and cash collected
- D Regular banking

MCQ answer



Which of the following controls will **not prevent** misappropriation (**ie stealing**) of customers' remittances?

- A Segregation of duties between cash handling and recording
- B Post opening by two people
- *C Investigation of differences between till records and cash collected (**detects but does not prevent**)**
- D Regular banking

5. Deficiencies



Once you can identify control risks in a scenario and are aware of the types of control that will mitigate those risks, you should also be able to identify weaknesses in the revenue system.

Deficiencies can be:

- Wrong controls
- Right controls - but badly operated (eg wrong person or wrong timing)
- No controls (omitted controls)

6. Substantive testing



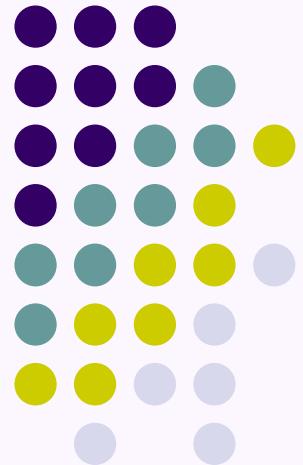
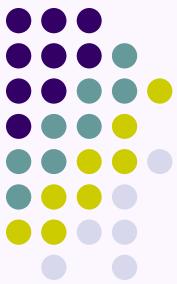
See Question **Twinkle Toys** for substantive tests of:

- Revenue
- Receivables

Audit & Assurance

ACFI210

Week 1 Video 1 Introduction to Assurance

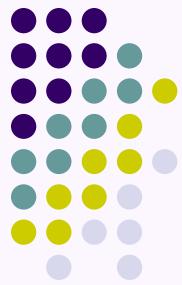




Introduction to Assurance

By the end of week 1, you should be able to:

- Explain the concept of assurance
- Discuss the different levels of assurance provided by different types of engagement
- Explain the need for and benefits of assurance engagements and financial statement audits
- Discuss the limitations of assurance engagements

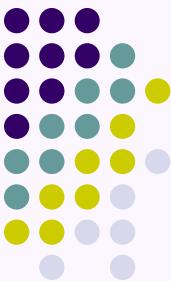


What is Assurance?

You buy a house – What can go wrong?

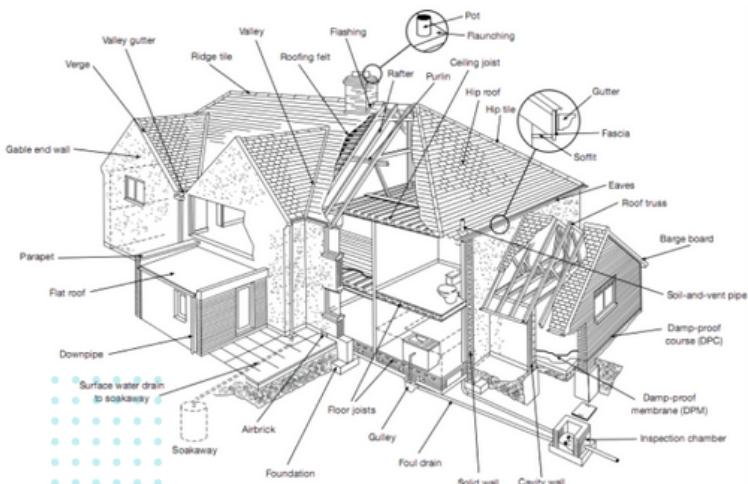


- Plans to build a Casino next door?
- Is the structure secure?
- Does my heating/electric system work?
- Where do boundaries end?
- Any restrictions?
- Has building work been done properly in the past?



Need Assurances - Structure

House Surveyor – what do they do?

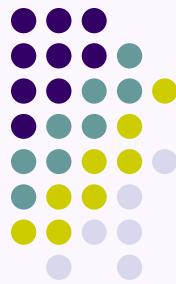


A HomeBuyer report by a qualified RICS surveyor will help you understand what you are really buying.

A HomeBuyer survey is a comprehensive check of your potential property, so that you are well equipped to deal with possible issues. The survey can help you identify any likely deal-breakers that might make you think twice about your investment.

An RICS qualified surveyor would assess the condition of all parts of the property. The surveyor will assess a variety of areas such as cracks, damp, roof etc. Based on the assessment, the surveyor will produce an RICS prescribed HomeBuyer report.

Need Assurances – Legal aspects



- Conveyancing solicitors – what do they do?

For the buyer, a property solicitor will undertake a review of the legal title to assess if there are any issues that could stop you from buying the property, reselling it again in the future to someone else or from registering a charge over the [title](#) (even if you aren't getting a mortgage yourself). There are a number of potential issues that could arise and the buyer's solicitor is tasked with finding these with the information provided including reviewing the deeds and title, inspecting the property searches from the local council and assessing the personal circumstances of the client ([proof of ID](#) and [proof of funds](#)).



All cars on the road must be safe to drive

- Steering
- Brakes
- Tyres
- Suspension
- Emissions
- Horn

Is it roadworthy? How do we know?



Need Assurances

MOT – Important parts on your vehicle are checked by an authorised mechanic to make sure they meet legal standards

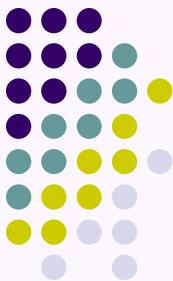
MOT Test Certificate		VOSA	
		Vehicle & Operator Services Agency	
MOT Test Number		Vehicle Registration Mark	
Make		Vehicle Identification Number	
Model		Country of Registration	GB
Colour	RED		
Issuer's name		Test Class	
Signature of Issuer		IV	
Expiry Date	JUNE 28th 2016 (SIXTEEN)	Odometer Reading and History	
		17/06/2015: 85451 18/06/2014: 76401 26/06/2013: 67545 27/06/2012: 57371	
		Issued	17/06/2015 12:20
Additional Information			
To preserve the anniversary of the expiry date the earliest you can present your vehicle for test is 29/05/2016			
Inspection Authority		Test Station	
<i>An executive agency of the Department for Transport</i>			
Advisory Information			
Advisory Items			
001 Nearside front Shock absorber has a light misting of oil [2.7.3]			
002 O/s drive shaft oil seal leaking			
About this document			
1 This document is a receipt style certificate telling you that an MOT Test pass result has been recorded on The Vehicle & Operator Services Agency's (VOSA's) database of MOT Test results; this may be verified at www.direct.gov.uk/yourmotcheck			
2 A test certificate relates only to the condition of the components examined at the time of test. It does not confirm the vehicle will remain roadworthy for the validity of the certificate.			
3 Check carefully that the details are correct.			
4 Whilst advisory items listed above do not constitute MOT failure items they are drawn to your attention for advice only.			
5 For further information about this document please visit www.direct.gov.uk/mot or contact VOSA on 0300 123 9000*.			
*Your call may be monitored or recorded for lawful purposes.			



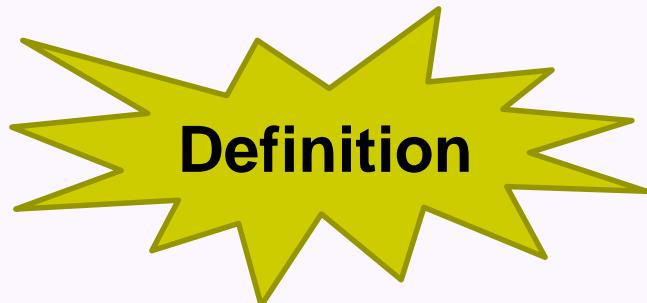
From a business perspective

- Investing in a business
- Giving a loan to a business
- Entering into a partnership
- Already invested and need confidence in reports I'm receiving

I WANT TO KNOW IS MY MONEY SAFE!!



What is Assurance?

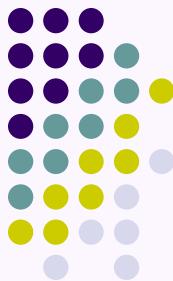


An assurance engagement is one in which a practitioner **expresses a conclusion** designed to **enhance the degree of confidence** of the intended users other than the responsible party **about the outcome of the evaluation or measurement of a subject matter against criteria.**

(IFAC – International Federation of Accountants*)

* Global organisation for the accounting profession

Key Elements of Assurance Engagements – MOT example



- The parties involved
 - Practitioner – Mechanic
 - Intended user – DVLA/Government
 - Responsible party – car owner/driver
- The subject matter - Car
- Suitable criteria to measure information against – Motor safety guidelines
- Sufficient, appropriate evidence to support the conclusion – Testing of car
- A written report – MOT certificate

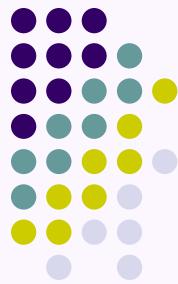
What is Assurance?

VERY Basic Explanation



Auditors (assurance providers) go in to check something – often the financial statements – to make sure they are **alright.**





Key Elements of Assurance Engagements – Financial Application

WHY?

- Subject matter lacks sufficient credibility without independent assurance.

WHO?

- Three people or groups
 - The practitioner (accountant)
 - The intended users
 - The responsible party (the person(s) who prepared the subject matter)

Key Elements of Assurance Engagements



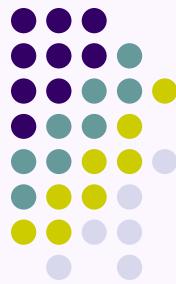
WHAT?

- **A subject matter**

The subject matter of an assurance engagement may vary considerably. However, it is likely to fall into one of three categories:

- Data (for example, financial statements or business projections)
- Systems or processes (for example, internal control systems or computer systems)
- Behaviour (for example, social and environmental performance or corporate governance)

Key Elements of Assurance Engagements



HOW?

Suitable criteria

The person providing the assurance must have something (a benchmark) by which to judge whether the information is reliable and can be trusted. So for example, in an assurance engagement relating to financial statements, the criteria might be accounting standards.

Sufficient appropriate evidence to support the assurance opinion

The practitioner must substantiate the opinion that he/she draws in order that the user can have confidence that it is reliable. The practitioner must obtain evidence as to whether the criteria have been met.

Key Elements of Assurance Engagements



SO WHAT?

A written report in appropriate form

- It is required that assurance reports are provided to the intended users in a written form and contain certain specified information. This adds to the assurance that the user is being given, as it ensures that key information is being given and that the assurance given is clear and unequivocal.

Key Elements of Assurance Engagements



- The parties involved
 - Practitioner – Mechanic
 - Intended user – DVLA/Government
 - Responsible party – car owner/driver
- The subject matter
- Suitable criteria to measure information against
- Sufficient, appropriate evidence to support the conclusion
- A written report



Exercise 1

You are an accountant who has been approached by Reacher Ltd which wishes to borrow money from the Sharklays Bank in order to expand the business.

Reacher have provided you with their cash flow forecasts for the next 2 years.

Identify the key elements of a potential assurance engagement in this situation

Why? Who? What? How? So What?

Examples of assurance engagements*



- UK statutory audit
- Pension scheme audit
- Charity audit

Types of audit – required by law or governed by legal requirements

- Value for money report
- Due diligence
- Report on forecasts
- Internal control report
- Regulatory submission

Other types of assurance where terms are agreed between the relevant parties

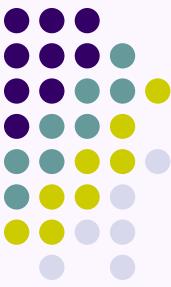


Audit: Important Type of Assurance Engagement

The statutory audit is one type (but the most important type) of assurance engagement.

Definition

An audit is a process of collecting evidence, and exercising judgement upon that evidence, in order to form an opinion on the reliability of the financial statements (or other financial information) by persons independent of the preparer and of other persons likely to be affected by the use of the information. An audit report is issued with the intention of increasing the credibility of the financial information and therefore its usefulness. The audit may also attest as to whether the financial statements have been issued in accordance with relevant Financial Reporting Standards.

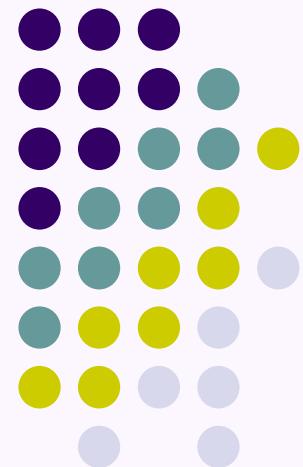
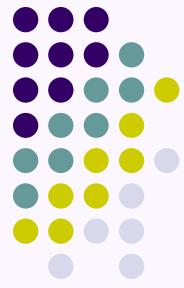


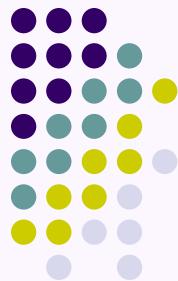
Summary

- Can you define assurance and give some examples of types of assurance engagement?
- Do you know the key elements of an assurance engagement?
- What is a statutory audit?

Audit & Assurance

Levels of Assurance





Levels of Assurance

- International Framework for Assurance Engagements (issued by IFAC) identifies two types of assurance engagement:

1. ***Reasonable*** assurance engagement
 2. ***Limited*** assurance engagement
- High but not absolute level
- Low level

Imagine a survey on a house or MOT on a car and the practitioner isn't given the keys.



Levels of Assurance

Limited assurance	Reasonable assurance
Moderate/low level of assurance	High but not absolute level of assurance
Conclusion expressed negatively	Conclusion expressed positively
Example – a review of interim accounts	Example – the statutory audit of financial statements
'Based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view.'	'In our opinion, the financial statements show a true and fair view.'



Exercise

You are an accountant who has been approached by Reacher Ltd which wishes to borrow money from the Sharklays Bank in order to expand the business. Reacher have provided you with their cash flow forecasts for the next 2 years.

What level of assurance would you expect to be provided by an assurance engagement examining the cash flow forecasts for Reacher Ltd? Explain why.



Exercise - Answer

- A forecast is based on future events and so difficult to obtain evidence
- Limited to assessing reasonableness of assumptions
- Application of assumptions correctly
- Correctly calculated

Limited Assurance

Reasonable Assurance vs Absolute Assurance



ISA 200 explains that absolute assurance is not possible due to inherent limitations of an audit or assurance assignment:

- In financial reporting many items involve judgement
- The use of sample testing
- Inherent limitations of internal control
- The fact that most evidence is persuasive rather than conclusive
- The impracticability of examining all items
- The possibility of fraudulent collusion or misrepresentation



Exercise

For each of the following assurance engagements, select what level of assurance you would expect to be given: absolute, reasonable or limited;

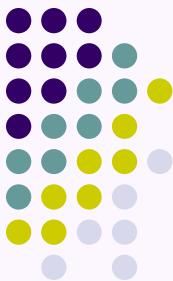
- Statutory audit
- ‘Review’ of year-end financial information – not as extensive as a statutory audit
- Report on a business plan



Exercise - Answer

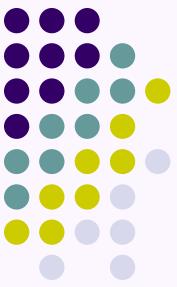
- Statutory audit - REASONABLE
- ‘Review’ of year-end financial information – not as extensive as a statutory audit - LIMITED
- Report on a business plan – LIMITED

NONE ARE EVER ABSOLUTE



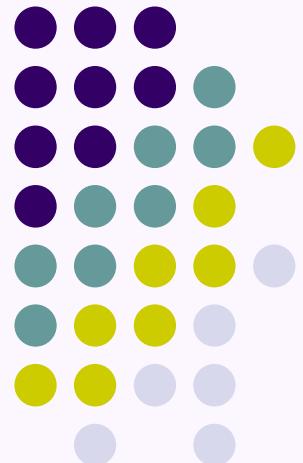
Summary

- Can you identify the two different levels of assurance engagement and **explain why** these two levels are different
- Can you discuss the differences in the work performed, evidence gathered and conclusion reached on these two types of engagement?
- Can you explain why absolute assurance is not possible?



Audit & Assurance

The Need for Assurance





Where are we up to?

- What is Assurance?
- Level of Assurance – Reasonable or Limited?

Types of assurance engagement



The following are examples of assurance engagements:

- Statutory audit
- Fraud investigations
- Due diligence
- Internal controls assessment
- Business plan/projection reviews
- Environmental audits



The Agency Problem

Who owns a company?

Shareholders.

Who runs a company?

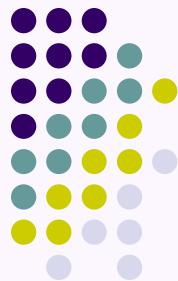
Directors.

How do we know the directors are doing a good job?

Financial statements.

Who is responsible for preparing financial statements?

Directors



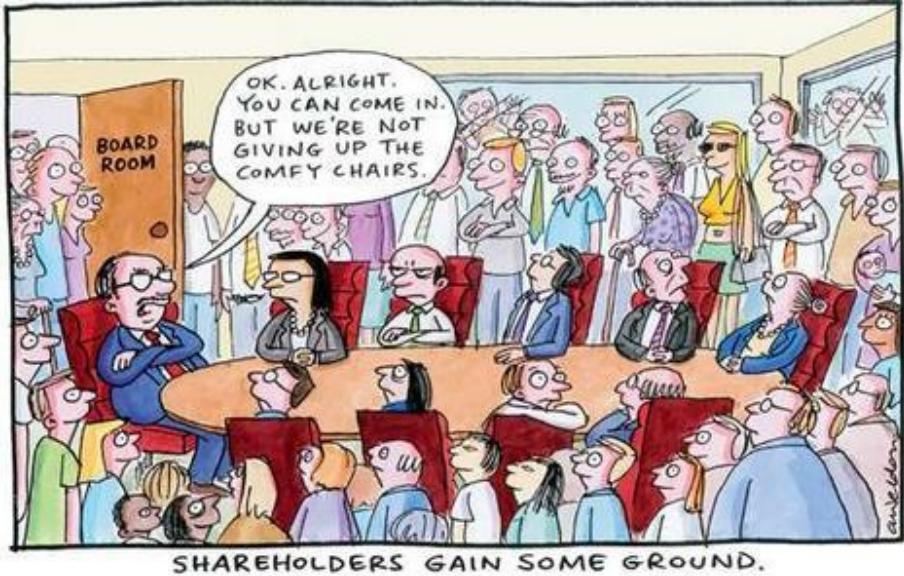
Simple Form of Agency Theory

- Principals (i.e. shareholders) appoint agents (i.e. directors) to run their business for them
- Principals needs to **trust** the agents to act in the principals' best interest
- Situation results in '***information asymmetry***' and agents may act in their own self-interest

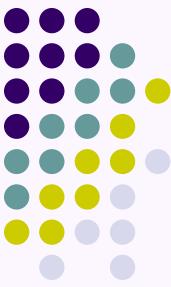


The Need for Assurance

The need for audit has arisen from the separation of ownership and control of businesses



Users of the reports produced (whether financial statements or other types of report) need to know the reports are **reliable**



Benefits of Assurance

Although an assurance report may only be addressed to one set of people, it may give additional confidence to other parties in a way that benefits the business:

- Independent scrutiny of the business by experts (commercial and systems advice)
- Adds credibility (especially in raising finance)
- By-products/subsidiary benefits (e.g. fraud deterrent)
- Draws attention to issues (including ethical issues)
- Reduces risk of management bias
- Improves confidence in information produced.



Limitations of Assurance

We saw earlier that reasonable assurance is a high, but not absolute, level of assurance. We cannot give 100% assurance for reasons including:-

- Sampling we don't review 100% of transactions
- Inherent limitations of systems that produce financial information
- Evidence is generally persuasive not conclusive
- Collusion to defraud
- Financial information includes subjective and judgemental matter
- Use of management representations as evidence may be unavoidable.



Statutory Audit

A common type of assurance engagement is the audit of a company's financial statements.

In the UK, audits are governed by:-

- Companies Act 2006
- International Standards on Auditing (ISAs)

Objectives of an auditor (ISA 200)



- To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.
- To express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework (ACFI201).

Objectives of an auditor (ISA 200) continued...



In order to comply with these requirements, the auditor must:

- Comply with relevant ethical requirements
- Plan and perform the audit with professional scepticism
- Exercise professional judgement
- Obtain audit evidence that is sufficient (enough) and appropriate (good quality) on which to base their opinion



Key Definitions – ISA200

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

Professional judgement – The application of relevant training, knowledge and experience in making informed decisions about the courses of actions that are appropriate in the circumstances of the audit.

Exemptions from a statutory audit – from 1 January 2016



Companies Act 2006 exempts small private limited companies from a mandatory audit if they satisfy 2/3 criteria

- No more than 50 employees
- Turnover doesn't exceed £10.2m
- Total assets don't exceed £5.1m

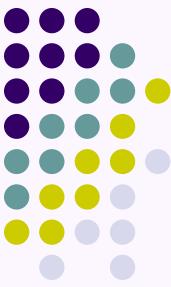


An auditor must

Be a member of a Recognised Supervisory Board (RSB) that have rules to ensure those for appointment of company auditor are

- Individuals holding an appropriate qualification or
- Part of a firm controlled by qualified persons

Examples being ICAEW, ACCA, ICAS



An auditor must

Not be ineligible, the Companies Act 2006 prohibits a person being the auditor of a company if he/she is:

- An officer or employee of the company
- A partner or employee of the above



Exercise

Martyn Jones (former ICAEW president) stated:

“raising statutory audit thresholds higher may seem to some to be an attractive policy but the supposed savings are often illusory. Rather, it can be a recipe for poor financial control, tax evasion and more SMEs going bust”

<http://economia.icaew.com/opinion/january-2014/from-the-top>



Exercise

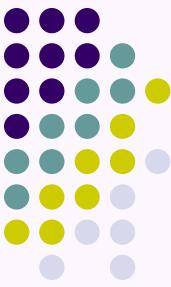
In what ways could small companies not being required to have an audit lead to “poor financial control, tax evasion and more SMEs going bust”?

Make some notes answering this question. This isn't a question with a 'right' answer. Write down some ideas



Exercise – Possible ideas

- Lack of confidence in financial information
- Lack of fraud deterrent
- Lost expert advice on control deficiencies and commercial issues
- Errors in numbers leads to incorrect tax payments
- Lost credibility of financial statements in terms of raising finance
- Reputational impact

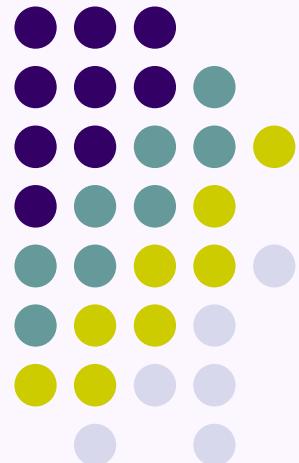
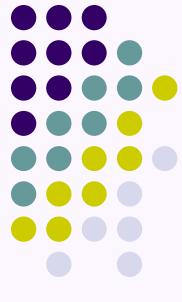


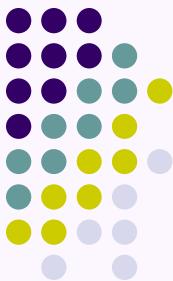
Summary

- Can you discuss the benefits of assurance and identify benefits specific to different stakeholders?
- Can you discuss the limitations of assurance?
- Do you understand the need for a statutory audit?
- Do you know who can and can't be an auditor?

Audit & Assurance

The expectations gap





The expectations gap

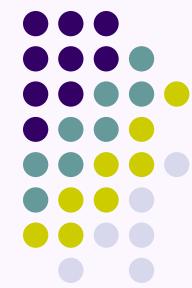
- Many shareholders and members of the public do not understand the nature of a statutory audit.
- Those who may rely on the auditor's report on the financial statements of the companies they own shares in, are employed by, or trade with, these misunderstandings can cause problems for the auditing profession.



The expectations gap

Examples of these misunderstandings include belief that:

- The auditor detects all fraud and error
- The auditor tests 100% of transactions
- The company is guaranteed to continue to trade for the foreseeable future if a true and fair opinion is issued
- The Statement of Financial Position shows the true value of the company.



Auditor doesn't say they're correct, but True and Fair

Auditor gives an opinion as to whether they think the financial statements give **a** 'true and fair' view

True: Information is factual and conforms with reality, not false. In addition the information conforms with required standards and law. The accounts have been correctly extracted from the books and records.

Fair: Information is free from discrimination and bias in compliance with expected standards and rules. The accounts should reflect the commercial substance of the company's underlying transactions.

Professional Judgement In Action: Going Concern

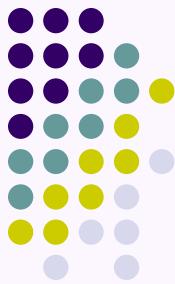


ISA 570 Going Concern

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. Financial statements are prepared on a 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.

Note: it is the **directors' responsibility** to assess whether the business is a going concern

Going Concern: Responsibilities



Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions.

The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern.

Going Concern Concept: Impact on Financial Statements



If entity is not a going concern (i.e. cannot continue for the foreseeable future):

- Accounts need to be prepared on a **break-up basis**
- Concept of '**non-current**' does not apply
- Assets need to be shown at **recoverable amount**

VERY IMPORTANT FOR MANAGEMENT TO GET THIS RIGHT: VERY IMPORTANT THE AUDITOR GATHERS ENOUGH EVIDENCE TO SUPPORT THE CONCLUSION

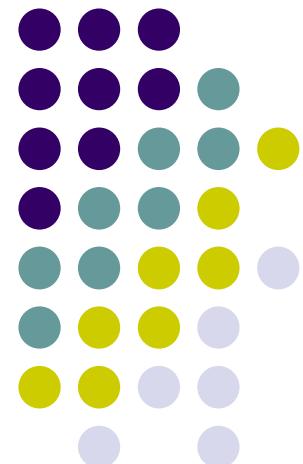


Summary

- Can you discuss the respective roles of the auditor and the directors regarding going concern?
- Can you define ‘true and fair’ and discuss the implications of this concept?
- Do you understand the expectations gap in relation to auditing?

Audit & Assurance

Topic 9B
Substantive Procedures
Podcast





The Audit Process





Substantive Procedures

By the end of studying this topic, you should be able to:

- Identify suitable substantive procedures for **revenue** in a given business scenario
- Understand the nature of substantive procedures for **current liabilities** and **bank balances** and the objectives of those tests.



Lecture plan

- Revenue
- Current liabilities (payables, accruals, provisions)
- Bank balances and cash

1. Revenue - Substantive Procedures



Key substantive analytical procedures

- Compare overall revenue against prior years and budget (consider price and volume changes)
- Obtain an analysis of revenue analysed into major product lines and/or geographical areas
- Calculate the gross margin and compare to the prior years. Investigate any significant fluctuations.

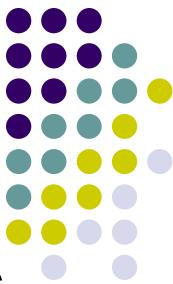
Revenue - Substantive Procedures



Key tests of details

- Select sample of orders and agree to despatch notes and sales invoices; through to inclusion in the sales ledger (understatement/completeness test)
- Select sample from sales account and trace to related invoices, despatch notes and orders. (overstatement test)
- Select sample of despatch notes both pre and post year end, follow through to sales invoices in the correct accounting period (cut-off).
- Select a sample of credit notes issued after the year end and trace back to sales invoice.

Substantive Procedures: example PP



The principal activity of PP is the staging of parties and events as per customer specification. The events range from a basic package to more complex events with marquees, interactive audio-visual equipment and constructed stages. The service includes the planning of the event, catering, an event manager, and the subsequent dismantling of any marquee and staging at the end of the event. The company has national and international customers, most of whom are invoiced in the customer's local currency.



- The directors of PP agree a fixed price with the customer to cover cost of the event. The terms of trading are 50% of contract price to be paid on signing of the contract, with the balance due seven days after the event has taken place. It is the company's policy to recognise revenue once the event has taken place. The accounts department maintains a record of events, which is updated when a new contract is signed.



Requirements - PP

Requirements

In the audit of revenue for PP:

- (a) Set out the key audit risks
- (b) Describe the audit procedures



Audit Risks

- The existence of overseas customers who are paid in their local currency may give rise to foreign currency translation errors.
- There is a risk of incorrect revenue recognition due to customers paying 50% of the contract price before the work commences and the balance after the service is completed.



Audit Risks - Income

Dr Cash £50,000
Cr Deferred income (**liability**) £50,000

Being 50% deposit

Dr Receivables £50,000
Dr Deferred income £50,000
Cr Revenue £100,000

Being recognition of revenue on completion of event.

Audit Risks – Income (cont)



Dr Cash £50,000

Cr Receivables £50,000

Being receipt of remaining 50% cash



Substantive Procedures

- Re-perform foreign currency translations for a sample of invoices, checking the exchange rate to a reliable independent source.
- Evaluate and test the system for recording deferred income and its transfer to revenue.
- Vouch entries in the revenue account to:
 - Invoices
 - Contracts/record of dates to ensure trade fair has taken place
- For a sample of contracts in progress at the year end, ensure initial payments are included in deferred income/payments on account.



2. Current liabilities

Payables - expenses that have been incurred in the current period and an invoice has been received from the supplier, but it has not been paid by the end of the accounting period.

Accrual - expenses that have been incurred in the current period, but an invoice from the supplier has not been received by the end of the accounting period.

Provision – a liability of uncertain timing or amount (IAS 37).



Question: cut-off

Year end 31 December 2019:

How should each of the following purchase transactions be treated?

	Transaction 1	Transaction 2
Goods received	15 December 2019	28 December 2019
Invoiced received	21 December 2019	17 January 2020
Invoice paid	23 January 2020	9 February 2020

Payables – substantive tests



- Obtain a listing of trade payables from the purchase ledger and agree to general ledger.
- Circularise suppliers sample to confirm balances.
- Reconcile supplier statements to purchase ledger
- Reconcile total of purchase ledger accounts with purchase ledger control account.
- Calculate trade payable days, compare to prior years and investigate differences.
- Review payments to suppliers after year end, then follow through to year end balances on purchase ledger (completeness)
- Select sample of GRNs before the year-end, follow through to year-end payables balance.



Provisions - IAS 37

- A present obligation
- Arising from past event
- Probable future outflow of resources

Obligation may be:

- Legal obligation
- Constructive obligation

Examples

- Redundancies
- Legal case

3. Bank and cash



Includes:

- Current accounts
- Deposit accounts
- Overdrafts
- Physical cash (notes and coins)



Bank and cash

Documents and evidence:

- Cash book
- Bank statements
- Direct confirmation from the bank

Procedures:

- Bank reconciliation
- Cash counts

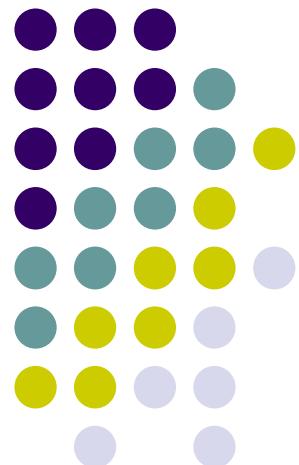
Bank – What can go wrong?



- Bank balances materially overstated
(existence, valuation, rights)
- Bank balances or overdrafts not disclosed
and so not included in financial statements
(completeness)
- Timing of recognition of cash received or
paid incorrect **(cut-off)**

Aero Co

Payables and accruals
Bank balances



Dashing Co

Receivables Provisions

