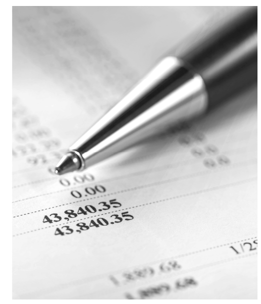
STUDY TEXT





CA SRI LANKA CURRICULUM 2020

Corporate Level

CL1 – Advanced Audit and Assurance

THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

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THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

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Introduction

CL1 Advanced Audit and Assurance

At the Corporate Level knowledge on documenting and evaluating an organisation's internal control system is further looked at. The concept of assurance introduced at the first level is also explored in detail with a deep emphasis on auditing. A discussion on ethical issues is done in a broader manner incorporating regulatory aspects as well.

Syllabus structure

Main syllabus areas	Weightings
A. Governance and internal control frameworks	10%
B. Audit planning and risk assessment	15%
C. Gathering audit evidence	20%
D. Auditing in a digital environment	10%
E. Evaluating evidence and audit reporting	15%
F. Assurance and related services	10%
G. Audit quality and ethics	15%
H. Professional practice of internal audit	5%

One of the key elements in examination success is practice. It is important that not only you fully understand the topics by reading carefully the information contained in this Study Text, but it is also vital that you practise the techniques and apply the principles that you have learned.

In order to do this, you should:

- Work through all the examples provided within the chapters and review the solutions, ensuring that you understand them;
- Complete the progress test for each chapter.

In addition, you should use the Practice and Revision Kit. These questions will provide you with excellent examination practice when you are in the revision phase of your studies.

Pillar structure

The Chartered Accountant of Sri Lanka Curriculum 2019 is structured around four progressively ascending levels of competency, namely, Business I, Business II, Corporate and Strategic Levels

The Corporate Level builds technical abilities whilst enhancing interpersonal and communication skills and problem resolution skills as required of a Certified Senior Business Accountant.

The Curriculum is also subdivided into specific subject areas or knowledge pillars and learning material is delivered to meet the knowledge requirements. These **Knowledge Pillars** focus on imparting the technical knowledge required of a competent CA and comprise of five pillars that focus on the following subject areas:

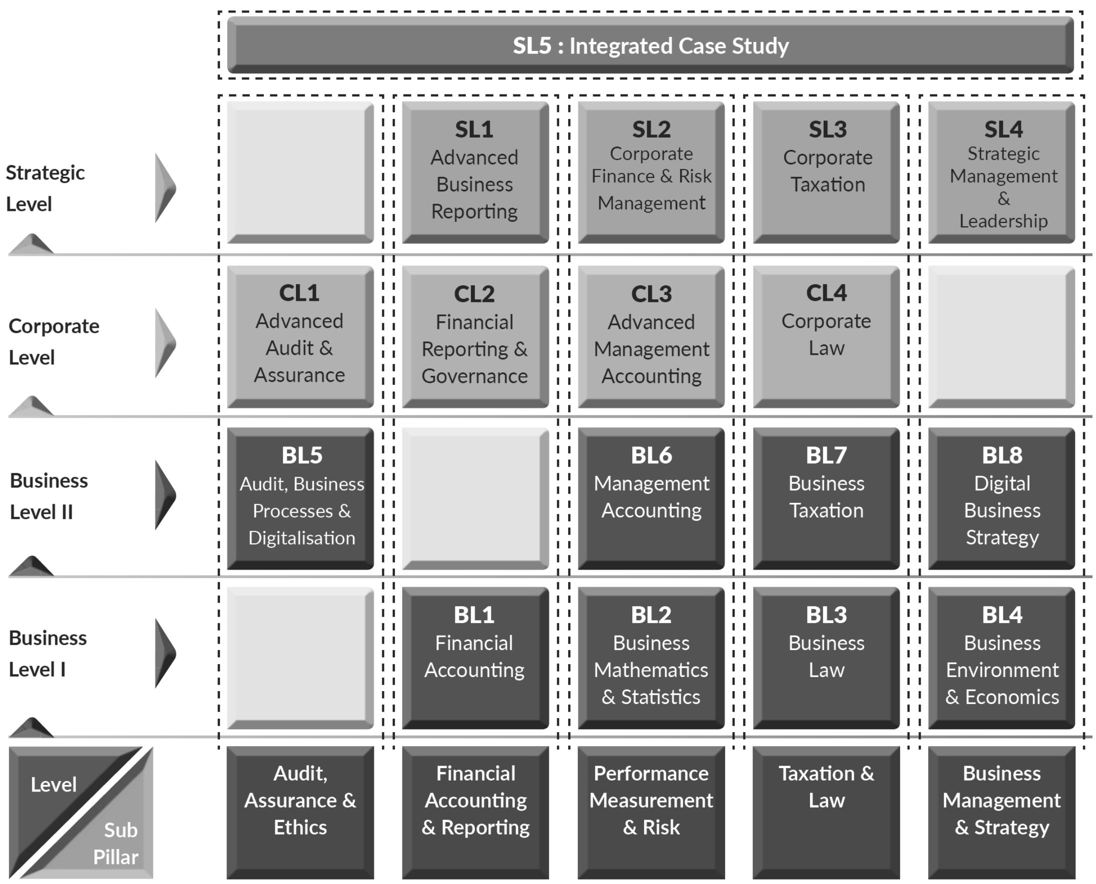
Knowledge Pillar 1: Audit, Assurance and Ethics (AA&E)

Knowledge Pillar 2: Financial Accounting and Reporting (FA&R)

Knowledge Pillar 3: Performance Measurement and Risk (PM&R)

Knowledge Pillar 4: Taxation and Law (T&L)

Knowledge Pillar 5: Business Management and Strategy (BM&S)



Chapter features

Each chapter contains a number of helpful features to guide you through each topic.

Topic list	This tells you what you will be studying in the chapter. The topic items form the numbered headings within the chapter.
Chapter introduction	The introduction puts the chapter topic into perspective and explains why it is important, both within your studies and within your practical working life.
Learning outcomes	The learning outcomes issued for the module by CA Sri Lanka are listed at the beginning of the chapter, with reference to the chapter section within which coverage will be found.
Key terms	These are definitions of important concepts that you really need to know and understand before the exam.
Examples	These are illustrations of particular techniques or concepts with a worked solution or explanation provided immediately afterwards.
Case study	Often based on real world scenarios and contemporary issues, these examples or illustrations are designed to enrich your understanding of a topic and add practical emphasis.
Questions	These are questions that enable you to practise a technique or test your understanding. You will find the answer underneath the question.
Formula to learn	These are the formula that you are required to learn for the exam.
Section introduction	This summarises the key points to remember from each section.
Chapter roundup	This provides a recap of the key areas covered in the chapter.
Progress test	Progress tests at the end of each chapter are designed to test your memory.
Bold text	Throughout the Study Text you will see that some of the text is in bold type. This is to add emphasis and to help you to grasp the key elements within a sentence or paragraph.

Learning outcomes

CA Sri Lanka's Learning outcomes for the module are set out on the following pages. They are cross-referenced to the chapter in the Study Text where they are covered.

A. Governance Internal Control Frameworks (Syllabus Weighting: 10%)			
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Chapter**
1.1 Corporate governance and audit	1.1.1 Discuss the need for an audit of financial statements using agency theory.	Ability to connect stewardship, accountability and agency conflict with a need to conduct an independent audit	1
1.2 Internal control framework	1.2.1 Evaluate components of an integrated internal control system.	COSO-2014 Internal controls five components and 17 principles	2, 3
	1.2.2 Analyse design, implementation and operating effectiveness of identified controls.	SLAuS 315	2
	1.2.3 Outline deficiencies in control activities to be communicated to those charged with governance.	SLAuS 265	2
1.3 IT risk and controls	1.3.1 Demonstrate the importance of IT general controls and application controls in an audit of financial statements.	IT general controls and application controls	2

B. Audit Planning and Risk Assessment (Syllabus Weighting: 15%)			
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Chapter**
2.1 Terms of engagement	2.1.1 Explain precondition required to perform an audit of financial statements.	SLAuS 210	4
2.2 Overall audit strategy	2.2.1 Demonstrate the importance of overall audit strategy as part of audit planning.	Including non-complex group and SME audit scenarios covering the requirements of SLAuS 300, 315, 240 and 600	5
2.3 Risk of material misstatement	2.3.1 Assess risk of material misstatements including risk of frauds to be focused during the audit using risk assessment procedures.		4, 5
2.4 Materiality	2.4.1 Apply the concept of materiality in planning and performing the audit.		4
2.5 Responding to risk of material misstatements	2.5.1 Outline suitable overall response and further audit procedures for identified risk at financial statement level and assertion level.	Including non-complex group and SME audit scenarios covering the requirements of SLAuS 330	5

B. Audit Planning and Risk Assessment (Syllabus Weighting: 15%)			
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Chapter**
2.6 Complex issues	2.6.1 Apply risk assessment procedures to identify risks relating to related party transactions , going concern and accounting estimates including fair value and measurement.	Requirements of SLAuS 540, 550 and 570 in relation to risk assessment	14
2.7 Using the work of others	2.7.1 Demonstrate the use of experts (both management and auditors experts), internal auditors and service organisation auditors in an audit of financial statements.	Requirements under SLAuS 610,SLAuS 620 & SLAuS 402	6
2.8 Laws and regulations	2.8.1 Explain auditors requirements consider compliance with laws and regulations during an audit of financial statement.	Understanding the legal and regulatory framework, procedures when non-compliance is identified or suspected and reporting of identified or suspected non-compliance	6

C. Gathering Audit Evidence (Syllabus Weighting: 20%)			
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Chapter**
3.1 Test of details	3.1.1 Outline audit procedures to address assertion level risk for non-complex key account balances and classes of transactions.	This should cover audit evidence over key account balances and classes of transactions	7, 8, 9, 10, 11, 12
	3.1.2 Apply specific considerations in obtaining sufficient appropriate audit evidence with respect to inventory, litigation and claims involving the entity, and segment information.	SLAuS 501	9, 12
3.2 External confirmation	3.2.1 Apply procedures to design and perform external confirmation to obtain relevant and reliable audit evidence.	SLAuS 505	10, 11
3.3 Opening balances and corresponding figures	3.3.1 Discuss the requirements to be considered by an auditor in an initial engagement and in relation to corresponding figures.	SLAuS 510 and 710	13
3.4 Selecting items for testing and the use of audit sampling	3.4.1 Apply different methods of selecting items for audit testing including audit sampling.	SLAuS 530	13
3.5 Analytical procedures	3.5.1 Apply analytical procedures as substantive procedures and in the overall review of financial statements.	Recognise the importance of analytical software which has the ability to analyse 100% data to identify outliers	7, 15
3.6 Complex account balances	3.6.1 Design audit procedures to address complex items including accounting estimates, fair valuation, related party transactions and going concern.	SLAuS 540, 550, 570	14
3.7 Subsequent events	3.7.1 Outline procedures required to deal with events occurring between the date of the financial statements and the date of the auditor's report and facts that become known to the auditor after the date of the auditor's report.	SLAuS 560	14

D. Auditing in a Digital Environment (Syllabus Weighting: 10%)			
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Chapter**
4.1 Digital business environment	4.1.1 Recognise trends in a digital business environments including Artificial Intelligence (AI), Robotic Process Automation (RPA), Block chain, digital currencies and their impacts on internal controls and audit.	Artificial intelligence (AI), robotic process automation (RPA), blockchain, digital currencies	15
	4.1.2 Recognise the use of big data and analytics as business intelligence tools and potential risk associated with big data.	Big data and analytics	15
4.2 Audit automation	4.2.1 Demonstrates the use of cloud based audit working papers, audit automation tools and their limitations.	Audit automation	15
4.3 Data analytics	4.3.1 Discuss the use of data analytics software including CAATs in planning and gathering audit evidence.	Data analytics	15
4.4 Cyber security	4.4.1 Outline controls required to mitigate cyber security risk.	Cyber security risk	15

E. Evaluating Audit Evidence and Audit Reporting (Syllabus Weighting: 15%)			
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Chapter**
5.1 Audit report	5.1.1 Evaluate the effects of material misstatements on audit the audit opinion.	SLAuS 450	16
	5.1.2 Evaluate the effect of misstatements in opening balances and corresponding figures on current year audit opinion.	SLAuS 510 and SLAuS 710	13

E. Evaluating Audit Evidence and Audit Reporting (Syllabus Weighting: 15%)			
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Chapter**
5.2 Key audit matters	5.2.1 Explain matters to be communicated with those charged with governance.	SLAUS 250	16
	5.2.2 Apply Key Audit Matters (KAM) for a given scenario.	SLAuS 701	16
5.3 Modified audit report	5.3.1 Apply modified audit opinions and going concern reporting requirements for a given scenario.	Reporting considerations relating to SLAuS 705, 701 and SLAuS 570	16
5.4 Emphasis of matters and other matters (SLAuS 706)	5.4.1 Apply emphasis of matter and other matter for a given scenario of audit reporting.	SLAuS 706	16
5.5 Special purpose audit	5.5.1 Apply special purpose audits including audit of single financial statements/elements to a given scenario.	Includes both SLAuS 800 and 805	16
5.6 Other information	5.6.1 Explain auditor's responsibility towards other information included in documents containing audited financial statements.	Fair understanding of the auditor's responsibilities relating to other information contained in an annual report (SLAuS 720)	16
5.7 Review engagements	5.7.1 Explain procedures required in conducting review engagements.	Fair understanding of application of review engagement and that the procedures used in a review engagement is limited compared to an audit of financial statements (SLSRE 2400,SLSRE 2410)	17

F. Assurance and Related Services (Syllabus Weighting: 10%)			
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Chapter**
6.1 Assurance framework	6.1.1 Apply framework for assurance engagements in identifying and accepting assurance engagements.	Understanding of the definition, elements, scope of and preconditions for an assurance engagement	17
6.2 Assurance engagements	6.2.1 Apply Sri Lanka Standard on Assurance Engagement together with subject matter specific assurance standards to provide reasonable or limited assurance as required in the engagement circumstances.	Fair knowledge about application of SLSAE 3000 for general subject matters and subject matter specific assurance standards including prospective financial statements	17
6.3 Related services	6.3.1 Apply Sri Lanka Standard on Related Services relating to agreed up on procedures and compilation as required by engagement circumstances.	Fair understanding of the SLSRE 4400 & SLSRE 4410	17
6.4 Reporting	6.4.1 Outline key elements of reports used in assurance and related services.		17

G. Audit Quality and Ethics (Syllabus Weighting: 15%)			
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Chapter**
7.1 Framework for audit quality	7.1.1 Demonstrate the elements of the framework for audit quality.	Understanding of the definition and elements of the quality framework	18
7.2 System of quality controls	7.2.1 Demonstrate the elements of a system of quality controls of the firm.	Fair understanding of the importance of elements of quality controls of the firm based on SLQC 1	18

G. Audit Quality and Ethics (Syllabus Weighting: 15%)			
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Chapter**
7.3 Audit quality	7.3.1 Explain the requirements to implement quality control procedures at the audit engagement level including the engagement quality control review.	Fair understanding of the importance of elements of quality controls of the firm based on SLAuS 220	18
7.4 Threats to compliance with fundamental and ethical principles	7.4.1 Analyse threats applicable to professional accountants in public practice in complying with fundamental and ethical principle.	Part B of Code of Ethics (Section200 to 270)	19
7.5 Auditors independence	7.5.1 Apply conceptual framework approach to analyse threats relating to auditors independence.	Fair understanding of the importance of auditors independence including the scope of applicability and specific issues dealt in Section 290-100 to 148)	19
	7.5.2 Evaluate threats associated with provision of non-assurance service and methods of mitigating such threats.	Threats associated with provision of non-assurance service and methods of mitigating such threats	19
	7.5.3 Apply conceptual framework approach to evaluate specific non-assurance services.	(Section 290-164- to 219)	19

H. Professional Practice of Internal Audit (Syllabus Weighting: 5%)			
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Chapter**
8.1 International professional practice framework	8.1.1 Recognise the importance of professional practice in internal audit using the elements of the International Professional Practice Framework (IPPF) of the Institute of Internal Auditors.	Core principles for the professional practice of internal auditing Definition of internal auditing Code of ethics International standards for the professional practice of internal auditing	20
8.2 Internal audit charter	8.2.1 Propose an internal audit charter to govern an internal audit function for a given entity considering entity specific circumstances.	Key elements and mandatory nature of the Charter based on IIA standard	20
8.3 Audit universe and plan	8.3.1 Develop an audit universe and a plan aligned to organisations strategies, objectives and risks.		20
8.4 Risk role of internal auditor	8.4.1 Advise the extent to which internal auditor can support risk management initiatives of an entity using assurance and advisory services.	IIA position paper-role of internal auditor in risk management (ERM FAN)	20
8.5 Managing an internal audit	8.5.1 Outline key considerations in setting engagement objectives, engagement planning and conducting an internal audit engagement for a given business scenario.	Ability to apply IIA performance standards applicable to engagement objectives, planning and performance of an internal audit taking into account engagement specific issues eg fraud risk, IT controls, possibility of using data analytics etc	20

H. Professional Practice of Internal Audit (Syllabus Weighting: 5%)			
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Chapter**
8.6 Governance and culture audit	8.6.1 Advise on the process of structuring a governance audit and a culture audit.	Understanding key elements of a governance and culture audit and approach to be followed in the audit	20
8.7 Audit committee and internal audit	8.7.1 Advise on the oversight role to be played by the audit committee in ensuring the independence and effectiveness of internal audit function.	Application of SLAuS 610	20
	8.7.2 Advice on the extent to which external auditor can rely on the work of internal audit.		

Action verbs checklist

Knowledge Process	Verb List	Verb Definitions
Tier - 1 Remember Recall important information	**Define**	Describe exactly the nature, scope or meaning
	Draw	Produce (a picture or diagram)
	Identify	Recognise, establish or select after consideration
	List	Write the connected items one below the other
	Relate	To establish logical or causal connections
	State	Express something definitely or clearly
Tier - 2 Comprehension Explain important information	**Calculate/Compute**	Make a mathematical computation
	Discuss	Examine in detail by argument showing different aspects, for the purpose of arriving at a conclusion
	Explain	Make a clear description in detail revealing relevant facts
	Interpret	Present in understandable terms or to translate
	Recognise	To show validity or otherwise, using knowledge or contextual experience
	Record	Enter relevant entries in detail
	Summarise	Give a brief statement of the main points (in facts or figures)
Tier - 3 Application Use knowledge in a setting other than the one in which it was learned/solve close-ended problems	**Apply**	Put to practical use
	Assess	Determine the value, nature, ability or quality
	Demonstrate	Prove, especially with examples
	Graph	Represent by means of a graph
	Prepare	Make ready for a particular purpose
	Prioritise	Arrange or do in order of importance
	Reconcile	Make consistent with another
	Solve	To find a solution through calculations and/or explanations

Knowledge Process	Verb List	Verb Definitions
Tier - 4 Analysis Draw relations among ideas and to compare and contrast/solve open-ended problems	**Analyse**	Examine in detail in order to determine the solution or outcome
	Compare	Examine for the purpose of discovering similarities
	Contrast	Examine in order to show unlikeness or differences
	Differentiate	Constitute a difference that distinguishes something
	Outline	Make a summary of significant features
Tier - 5 Evaluate Formation of judgments and decisions about the value of methods, ideas, people or products	**Advise**	Offer suggestions about the best course of action in a manner suited to the recipient
	Convince	To persuade others to believe something using evidence and/or argument
	Criticise	Form and express a judgement
	Evaluate	To determine the significance by careful appraisal
	Recommend	A suggestion or proposal as to the best course of action
	Resolve	Settle or find a solution to a problem or contentious matter
	Validate	Check or prove the accuracy
Tier - 6 Synthesis Solve unfamiliar problems by combining different aspects to form a unique or novel solution	**Compile**	Produce by assembling information collected from various sources
	Design	Devise the form or structure according to a plan
	Develop	To disclose, discover, perfect or unfold a plan or idea
	Propose	To form or declare a plan or intention for consideration or adoption

Part A - Governance Internal Control Frameworks

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CHAPTER 01

Introduction to External Audit

INTRODUCTION

In this introductory chapter we look first at what an assurance engagement is and the main elements of an assurance engagement.

An audit is an assurance engagement in which an independent auditor expresses an opinion over the truth and fairness of a company's financial statements. We look at the objectives of the statutory audit and its benefits and limitations.

We also cover in this chapter the regulation of auditors in Sri Lanka and introduce Sri Lanka Auditing Standards (SLAuS). Auditors must follow SLAuSs when carrying out an audit.

Knowledge Component			
A	**Governance internal control frameworks**		
1.1	**Corporate Governance and Audit**	1.1.1	Discuss the need for an audit of financial statements using agency theory

CHAPTER CONTENTS		LEARNING OUTCOME
1	Assurance engagements	1.1.1
2	Objective of statutory audits and the audit opinion	1.1.1
3	Regulation of auditors	1.1.1
4	Sri Lanka Auditing Standards (SLAuSs)	1.1.1

1 Assurance engagements

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

1.1 Introduction to assurance engagements

In this chapter we revise the basic principles of audit engagements, and look at the regulation of auditors.

Assurance engagements play an important role in giving users of financial information, such as company shareholders, confidence that the information is reasonably accurate and has been properly prepared and presented.

This is because during an assurance engagement a review of that information is carried out by a practitioner who was not involved in its preparation. Therefore their conclusions are seen as independent and impartial.

1.2 Accountability, stewardship and agency

The key reason for having a review as part of an assurance engagement can be seen by working through the following case study.

CASE STUDY

Amanthi decides to set up a business selling flowers. She gets up early in the morning, visits the market and then sets up a stall by the side of the road. For the first year, all goes well. She sells all the flowers she is able to buy and she derives some income from the business.

However, Amanthi feels that she could sell more flowers if she was able to transport more to the place where she sells them, and she also knows that there are several other roads nearby where she could sell flowers, if she could be in two places at once. She could achieve these two things by buying a van and by employing people to sell flowers in other locations.

Amanthi needs more money to achieve this expansion of her business. She decides to ask her wealthy friend Thilak to invest in the business.

Thilak can see the potential of Amanthi's business and wants to invest, but he doesn't want to be involved in the management of the business. He also does not want to have ultimate liability for the debts of the business if it fails. He therefore suggests that they set up a company. He will own the majority of the shares and be entitled to dividends. Amanthi will be managing director and be paid a salary for her work.

At the end of the first year of trading as a limited company, Thilak receives a copy of the financial statements. Profits are lower than expected, so his dividend will not be as large as he had hoped. He knows that Amanthi is paid a salary so she does not care as much as him that profits are low.

Thilak is concerned by the level of profits and feels that he wants further assurance on the accounts. He doesn't know whether they give a true reflection on the last year's trading, particularly as the profits do not seem as high as those Amanthi had predicted when he agreed to invest.

The solution is that the **assurance** Thilak is seeking can be given by an independent **audit** of the financial statements.

The practitioner performing the review can provide the two things that Thilak requires:

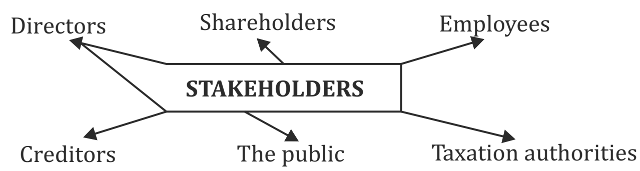
- A **knowledgeable review** of the company's business and of the accounts
- An **impartial view**, since Amanthi's view might be biased

Other people will also view the company's accounts with interest, for example:

- Creditors (payables) of the company
- Taxation authorities

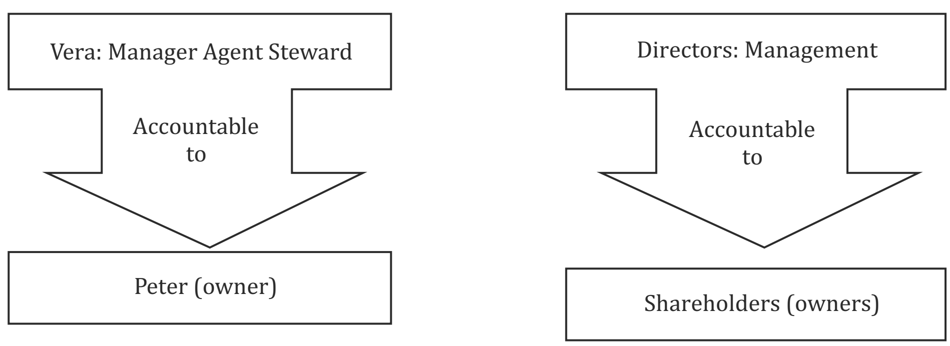
The various parties interested in the accounts of a company are sometimes referred to as **stakeholders**. Although they will each judge the accounts by different criteria, they will all **gain assurance** from learning that the accounts they are reading have been subject to an independent report.

Figure 1.1: Typical stakeholders of an organisation



The example above is a simple one. In practice, companies may have thousands of shareholders and may not know the management personally. It is therefore important that directors are **accountable** to shareholders. Directors act as **stewards** of the shareholders' investments. They are **agents** of the shareholders.

Figure 1.2: Accountabilities



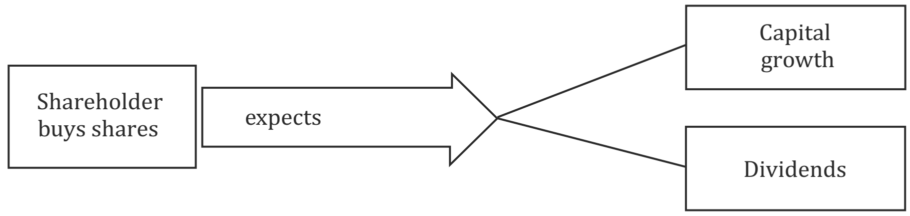
Accountability is the quality or state of being accountable, that is, being required or expected to justify actions and decisions. It suggests an obligation or willingness to accept responsibility for one's actions.

Stewardship refers to the duties and obligations of a person who manages another person's property.

Agents are people employed or used to provide a particular service. In the case of a company, the people being used to provide the service of managing the business also have the second role of trying to maximise their personal wealth in their own right.

You may ask, 'what are the directors accountable for?' It is important to understand the answer to this question. The directors are accountable for the **shareholders' investment**. The shareholders have bought shares in that company (they have invested). They **expect a return** from their investment. As the **directors** manage the company, they are **in a position to affect that return.**

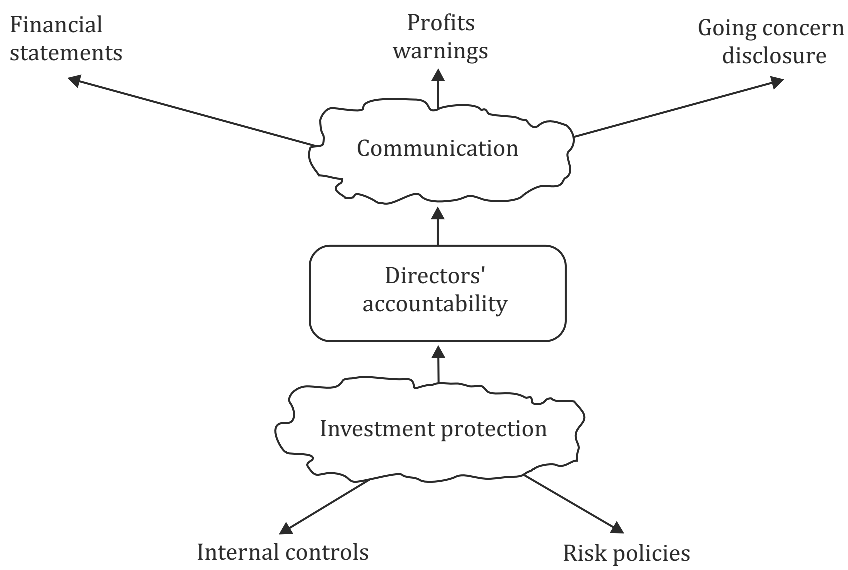
Figure 1.3: Shareholders' expectations



The exact nature of the return expected by the shareholder will depend on the type of company he or she has chosen to invest in: that is part of his or her investment risk analysis. Certain issues are true of any such investment, however. For example, if the directors **mismanage** the company, and it goes **bankrupt**, it will neither provide a source of future dividends nor create capital growth in the investment – indeed, the opposite is true and the original investment may even be lost.

Accountability therefore covers a range of issues, as shown in Figure 1.4.

Figure 1.4: Aspects of accountability



These issues are often discussed under the umbrella title '**corporate governance'**, where 'governance' indicates the management (governing) role of the directors, and 'corporate' indicates that the issue relates to companies (bodies corporate). This is illustrated by our scenario, where we saw Amanthi taking up a corporate governance position in relation to Thilak.

1.3 Assurance Provision

Many of the requirements in relation to corporate governance necessitate **communication** between the directors and the shareholders.

Directors of all companies are usually **required to produce financial statements** annually which give a **true and fair view** of the affairs of the company and its profit or loss for the period. They are also **encouraged** to **communicate with shareholders** on matters relating to **directors' pay** and **benefits**, **going concern** and **management of risks**.

But how will the shareholders know whether the directors' communications are **accurate**, or present a **fair picture?** We are back to the problem that Thilak had in the scenario we presented earlier in this section. He knew that Amanthi's view might be **biased** in a different way to his own, and he sought **assurance** on the information he was presented with.

The *Sri Lanka Framework for Assurance Engagements* provides a frame of reference for professional accountants when performing assurance engagements. It provides the following definition of an assurance engagement.

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

1.4 The objective of an assurance engagement

The objective of an assurance engagement will depend on the **level** of assurance given. First we will consider a **reasonable assurance** engagement, where a **high, but not absolute**, level of assurance is given.

Sri Lanka Framework for Assurance Engagements states that the objective of a **reasonable assurance engagement** is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a **positive form of expression** of the practitioner's conclusion.

In order to give reasonable assurance, a significant amount of testing and evaluation is required to support the positive conclusion, such as the opinion given in the auditor's report on the financial statements. We look at reasonable assurance in the context of an audit in section 2.

Limited assurance is a lower level of assurance. It allows for a lesser amount of testing and evaluation and results in a negative conclusion.

Sri Lanka Framework for Assurance Engagements also states that the objective of a **limited assurance engagement** is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a **negative form of expression** of the practitioner's conclusion.

1.5 The elements of an assurance engagement

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

(a) **A three-party relationship.** The three parties are the intended user, the responsible party and the practitioner (each party is described in the key terms that follow).

(b) **A subject matter**. This is the data to be evaluated that has been prepared by the responsible party. It can take many forms including financial performance (eg historical financial information), non-financial performance (eg key performance indicators), processes (eg internal control) and behaviour (eg compliance with laws and regulations).

(c) **Suitable criteria**. The subject matter is evaluated or measured against criteria in order to reach an opinion.

(d) **Evidence**. Sufficient appropriate evidence needs to be gathered to support the required level of assurance.

(e) **A written assurance report**. A report containing the practitioner's opinion is issued to the intended user.

Intended users are the person, persons or class of persons for whom the practitioner prepares the assurance report.

The **responsible person** is the person (or persons) responsible for the subject matter (in a direct reporting engagement) or subject matter information of the assurance engagement.

The **practitioner** is the individual providing professional services that will review the subject matter and provide the assurance.

One way to remember these five elements of an assurance engagement is using the mnemonic **CREST**.

- **C**riteria
- **R**eport
- **E**vidence
- **S**ubject matter
- **T**hree-party relationship

1.6 Types of assurance services

Assurance services include a wide range of activities such as **external audits**, **internal audits**, **internal control**, **sustainability reviews**, **review engagements** and **forecasting**.

The degree of assurance given by the impartial professional will depend on the nature of the exercise being carried out.

Directors prepare financial statements for the benefit of members. They **declare** that the financial statements give a true and fair view. As we will see in section 2, the auditors provide **assurance** on this declaration.

To provide such assurance, the auditors must:

- Assess risk
- Plan audit procedures
- Conduct audit procedures
- Assess results
- Express an opinion

The degree of satisfaction achieved and, therefore, **the level of assurance which may be provided**, is **determined by** the **nature** of **procedures performed** and their results.

Another type of assurance engagement, where a lower level of assurance is given, is a **review engagement**.

A review engagement can be distinguished from an external audit engagement as follows.

(a) **External audit engagement:** the auditor provides a high, but not absolute, level of assurance that the information audited is free of material misstatement. This is expressed **positively** in the audit report as **reasonable assurance** (see section 2)**.**

(b) **Review engagement:** the auditor provides a limited level of assurance that the information subject to review is free of material misstatement. The assurance report will contain a **negative** form of expression of the practitioner's conclusion.

The following table summarises the different types of assurance engagements that can be carried out by practitioners.

Table 1.1: Different types of assurance engagements

Engagement	Type of assurance	Example	Expression of conclusion
External audit	Reasonable	Statutory external audit	Positive
Review	Limited	Review of interim financial statements	Negative

In a limited assurance engagement, the practitioner expresses the conclusion in the negative form. An example might be:

'Based on our work as set out in this report, nothing has come to our attention that indicates the financial statements have ***not*** *been prepared according to the financial reporting framework'*

2 Objective of statutory audits and the audit opinion

An **external audit** is a type of **assurance engagement** that is carried out by an auditor to give an independent opinion on a set of financial statements.

2.1 The objective of an external audit

The **objectives** of an audit of financial statements are:

1. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
2. To report on the financial statements, and communicate as required by the SLAuSs, in accordance with the auditor's findings.

The purpose of an external audit is to enable auditors to enhance the degree of confidence of intended users (shareholders) in the financial statements by **expressing an opinion** on them. While an audit might produce by-products such as advice to the directors on how to run the business, its objective is **solely to report to the shareholders.**

2.2 The audit opinion in the auditor's report

Within an auditor's report on the financial statements, the auditor will give an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

Following the audit of a company's financial statements, if the auditor finds no reason to modify the audit opinion (that is, a 'clean' report is issued), then the audit opinion in the auditor's report may state:

'In our opinion the financial statements present fairly, in all material respects, the financial position of the company...'

An equivalent wording for 'present fairly in all material respects' is 'give a true and fair view of'. Therefore, under Sri Lanka Auditing Standards (SLAuSs) an alternative wording for an unmodified audit opinion is:

'In our opinion the financial statements give a true and fair view of the financial position of the company...'

If the auditor concludes the financial statements are true and fair, this is generally taken to mean the financial statements:

- Are factual
- Are free from bias
- Reflect the commercial substance of the business's transactions

Below is an example of an auditor's report on an entity's financial statements. This is a report with an **unmodified** opinion (which means the financial statements are true and fair and properly prepared). It has been taken from SLAuS 700 *Forming an opinion and reporting on financial statements.*

Figure 1.5: Example audit report, unmodified

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

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

Basis for Opinion

We conducted our audit in accordance with Sri Lankan Standards on Auditing (SLAuSs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the with the Code of Ethics issued by CA Sri Lanka (Code of Ethics) and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with SLAuS 701, which applies to audits of the financial statements of listed entities.]

Other Information

Management is responsible for the other information. The other information comprises the information included in the X report, but does not include the financial statements and our auditor's report thereon.

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with Sri Lanka Accounting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SLAuSs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with SLAuSs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation, or national auditing standards. The matters addressed by other law, regulation or national auditing standards (referred to as 'other reporting responsibilities') shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the SLAuSs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the SLAuSs may be combined (ie, included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the SLAuSs where such a difference exists.*]

The engagement partner on the audit resulting in this independent auditor's report is [name].

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

Auditor's reports with **modified** opinions may arise because of a number of different reasons and are discussed in depth in Chapter 16.

External auditors give an opinion on the **truth and fairness** of financial statements. This is not an opinion of absolute correctness. 'True' and 'fair' are not defined in law or audit guidance, but the following definitions are generally accepted.

True information is factual and conforms with reality. In addition the information conforms with required standards and law. The financial statements have been correctly extracted from the books and records.

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

The auditor's report refers to the fact that the audit is planned and performed to obtain 'reasonable assurance' whether the financial statements are free from material misstatement. This is because the auditor cannot check everything and therefore can only provide 'reasonable', not 'absolute', assurance.

Reasonable assurance is a high, but not absolute, level of assurance. The auditor's report does not guarantee that the financial statements are correct, but that they are true and fair within a reasonable margin of error.

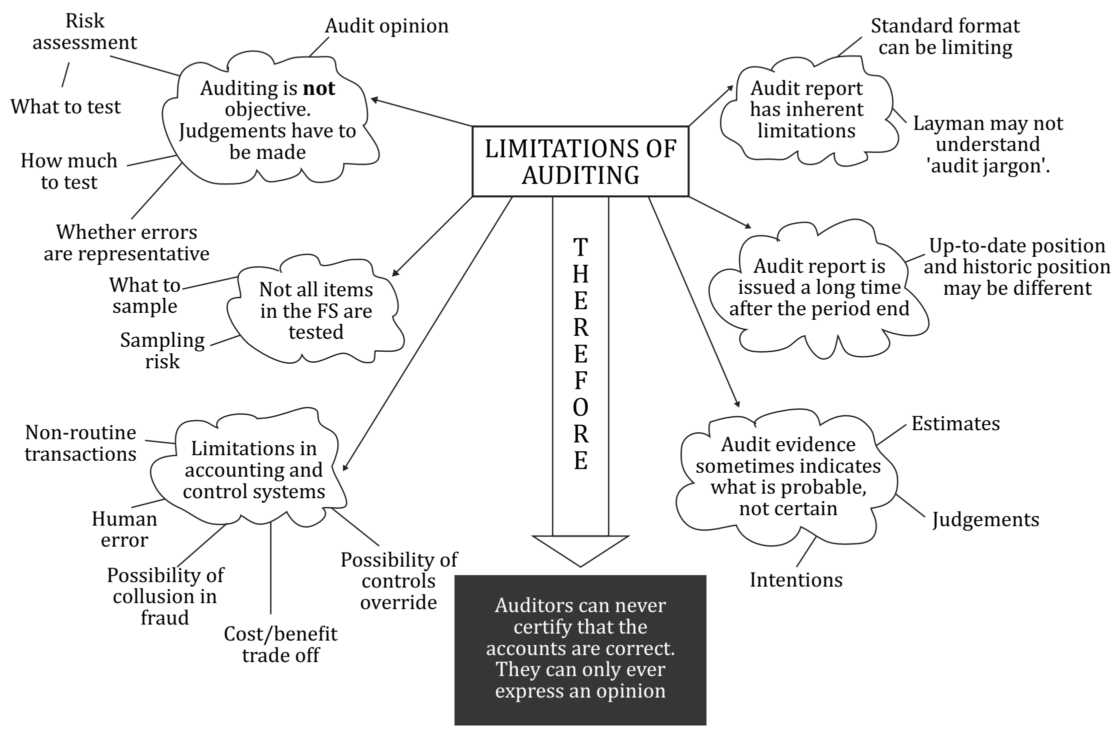
One of the reasons that an auditor does not give absolute assurance is because of the **inherent limitations** of audit. We discuss these limitations below.

2.3 Limitations of audit and materiality

External audits give **reasonable assurance** that the financial statements are free from material misstatement.

The assurance given by auditors is governed by the fact that auditors use **judgement** in deciding what audit procedures to use and what conclusions to draw, and also by the **limitations** of every audit. These are illustrated in the following diagram.

Figure 1.6: Audit limitations



Misstatements which are significant to readers may exist in financial statements and auditors will plan their work on this basis, that is, with **professional scepticism**. The concept of '**significance to readers**' is the concept of **materiality** (which will be discussed in more detail later in this Text).

Materiality is an expression of the relative significance or importance of a particular matter in the context of the financial statements as a whole. A matter is material if its omission or misstatement would reasonably influence the economic decisions of users, taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement.

The auditor's task is to decide whether the financial statements show a **true and fair view**. The auditors are not responsible for establishing whether the financial statements are correct in every particular. This is because it can take a great deal of time and trouble to check the accuracy of even a very small transaction and the resulting benefit may not justify the effort. Also, financial accounting inevitably involves a degree of estimation which means that financial statements can never be completely precise.

Although the definition of materiality refers to the decisions of the addressees of the audit report (the company's members), their decisions may well be influenced by other entities that use the financial statements, for example, the bank.

3 Regulation of auditors

Auditors in Sri Lanka must follow **Sri Lanka Auditing Standards (SLAuSs)**.

SLAuSs are published by the **Institute of Chartered Accountants of Sri Lanka** (CA Sri Lanka).

Auditors are monitored by the **Sri Lanka Accounting & Auditing Standards Monitoring Board** (SLAASMB).

3.1 Regulation of auditors in Sri Lanka

Under the Sri Lanka Accounting and Auditing Standards Act, No 15 of 1995, the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) is the formulating body for Sri Lanka Accounting Standards (SLFRS/LKAS) and Sri Lanka Auditing Standards (SLAuSs). Auditors in Sri Lanka must follow SLAuSs.

Regulation of the auditing profession and monitoring of compliance with SLASs and SLAuSs by Specified Business Enterprises is carried out by the Sri Lanka Accounting & Auditing Standards Monitoring Board (SLAASMB).

Auditors carrying out an audit in accordance with the Accounting and Auditing Standards Act, No 15 of 1995 are required to certify in their auditor's report that the audit has been conducted in accordance with Sri Lanka Auditing Standards and that the financial statements have been prepared and presented in accordance with Sri Lanka Accounting Standards.

3.2 Entities subject to audit

Specified Business Enterprises (SBEs) must have their financial statements audited by members of the Institute of Chartered Accountants of Sri Lanka, holding a certificate to practice issued by the Institute.

SBEs are:

- Companies licensed under the Banking Act, No. 30 of 1988
- Companies authorised, under the Control of Insurance Act, No. 25 of 1962, to carry on insurance business
- Companies carrying on leasing business
- Factoring companies
- Companies registered under the Finance Companies Act, No. 78 of 1988
- Companies licensed under the Securities and Exchange Commission Act, No. 36 of 1987, to operate unit trust
- Fund Management Companies

- Companies licensed under the Securities and Exchange Commission Act, No.36 of 1987, to carry on business as stockbrokers or stock dealers
- Companies licensed under the Securities and Exchange Commission Act, No. 36 of 1987, to operate a Stock Exchange
- Companies listed in a Stock Exchange licensed under the Securities and Exchange Commission Act, No.36 of 1987
- Other companies which:
  - Have a turnover in excess of s 500 million Rupees;
  - At the end of the previous financial year, had shareholder equity in excess of 100 million Rupees;
  - At the end of the previous financial year, had gross assets in excess of 300 million Rupees;
  - At the end of the previous year had liabilities to banks and other financial institutions in excess of 100 million Rupees;
  - Have a staff in excess of 1,000 employees.

4 Sri Lanka Auditing Standards (SLAuSs)

Sri Lanka Auditing Standards (SLAuSs) are based on the Sri Lanka Standards on Auditing published by the Sri Lanka Auditing and Assurance Standards Board (IAASB).

The Sri Lanka Auditing Standards are based on the Sri Lanka Standards on Auditing (SLAuS) published by the Sri Lanka Auditing and Assurance Standards Board (IAASB) of the Sri Lanka Federation of Accountants (IFAC).

The Sri Lanka Standards have been adapted where necessary to comply with Sri Lanka legislation. However, compliance with the SLAuSs ensures compliance in all material respects with the Sri Lanka Standards on Auditing.

The most recently published set of SLAuSs are applicable for audits of financial statements for periods beginning on or after 31 March 2018.

A list of these standards and the SLAuSs themselves can be found on the CA Sri Lanka website at www.casrilanka.com.

CHAPTER ROUNDUP

- An assurance engagement is one in which a practitioner gives an opinion or expresses a conclusion on financial (or other) information, to give people confidence in using the information.
- Assurance services include **external audits** and **review engagements.**
- An **external audit** is a type of **assurance engagement** that is carried out by an auditor to give an independent opinion on a set of financial statements.
- Within an auditor's report on the financial statements, the auditor will give an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.
- External audits give **reasonable assurance** that the financial statements are free from material misstatement.
- Auditors in Sri Lanka must follow **Sri Lanka Auditing Standards (SLAuSs)**.
- SLAuSs are published by the **Institute of Chartered Accountants of Sri Lanka** (CA Sri Lanka).
- Auditors are monitored by the **Sri Lanka Accounting & Auditing Standards Monitoring Board** (SLAASMB).
- Sri Lanka Auditing Standards are based on the Sri Lanka Standards on Auditing published by the Sri Lanka Auditing and Assurance Standards Board (IAASB).

PROGRESS TEST

1 Complete the sentence.

The objective of an audit of .... is to enable the auditor to express an .... on whether the financial statements are prepared, in all .... respects, in accordance with an applicable financial reporting framework.

2 What are the five elements of an assurance engagement?

3 Delete as appropriate:

In a limited assurance engagement, the practitioner expresses the conclusion in the positive/negative form.

4 The SLAASMB publishes Auditing Standards. True or false?

5 Complete the following sentence by selecting the correct option.

Sri Lanka Auditing Standards (SLAuSs) are based on .... ?

Select from:

(a) Sri Lanka Standards on Auditing
(b) UK Auditing Standards
(c) US Auditing Standards

ANSWERS TO PROGRESS TEST

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

2 (a) Suitable criteria

(b) An assurance report

(c) Evidence

(d) Subject matter

(e) Three-party relationship

3 In a limited assurance engagement, the practitioner expresses the conclusion in the negative form.

4 False. Sri Lanka Auditing Standards (SLAuSs) are published by the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka).

5 Sri Lanka Auditing Standards (SLAuSs) are based on **Sri Lanka Standards on Auditing**.

CHAPTER 02

Introduction to Internal Control

INTRODUCTION

The auditor generally seeks to rely on the internal controls within the entity in order to reduce the amount of testing of final balances.

The initial evaluation of a client's system is essential as the auditor gains an understanding of the entity. In this chapter, we shall look at some of the detailed requirements of SLAuS 315 with regard to internal controls, and shall also set out control issues the auditor may come across.

The auditor will assess the risks of material misstatement arising and may respond to those risks by carrying out tests of controls. If he concludes that he can rely on the controls in place, the level of substantive audit testing required can be reduced.

In this chapter we also look at the ways in which auditors can document the internal control systems using narrative notes, flowcharts, questionnaires and checklists.

We shall examine the detailed controls that businesses operate in Chapter 3 and the tests that the auditors may carry out in specific areas. You should bear in mind the principles discussed in this chapter when considering the controls needed over specific accounting areas.

Knowledge Component			
A	**Governance internal control frameworks**		
1.2	**Internal Control Framework**	1.2.1	Evaluate components of an integrated internal control system
		1.2.2	Analyse design, implementation and operating effectiveness of identified controls
		1.2.3	Outline deficiencies in control activities to be communicated to those charged with governance
1.3	**IT Risk and Controls**	1.3.1	Demonstrate the importance of IT general controls and application controls in an audit of financial statements

CHAPTER CONTENTS

		LEARNING OUTCOME
1	Internal control systems	1.2.1
2	Internal control and the statutory audit	1.2.2
3	Evaluation of internal control components	1.2.1, 1.2.2
4	Internal controls in a computerised environment	1.3.1
5	Reporting deficiencies in internal control	1.2.3

1 Internal control systems

The auditor must **understand** the **accounting system** and **control environment** in order to determine their audit approach.

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

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

An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the **nature, timing and extent** of further audit procedures.

Initially, gaining an understanding of internal control helps auditors to determine which ones are **relevant to the audit**. SLAuS 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* points out that there is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. Many of these controls will relate to financial reporting, operations and compliance, but not all of the entity's objectives and controls will be relevant to the auditor's risk assessment.

Having determined which controls are relevant, and are adequately designed to aid in the prevention of material misstatements in the financial statements, the auditor can then decide whether it is more efficient to seek reliance on those controls and perform tests of controls in that area, or more efficient to perform substantive testing over that area.

If the controls are not adequately designed, the auditor needs to perform sufficient substantive testing over that financial statement area in light of the apparent lack of control and increased risk. Any deficiencies are noted and, where appropriate, these will be communicated to management (see Section 5).

1.1 COSO Components of Internal Control

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) in its Integrated Framework Principles, breaks internal controls into five components and 17 principles as shown below. We will look at each of the components in more detail through the rest of this section.

Component	Principles
Component 1: Control Environment (See section 1.3 below)	1. Demonstrates commitment to integrity and ethical values 2. Exercises oversight responsibility 3. Establishes structure, authority, and responsibility 4. Demonstrates commitment to competence 5. Enforces accountability
Component 2: Risk Assessment (See section 1.4 below)	6. Specifies suitable objectives 7. Identifies and analyses risk 8. Assesses fraud risk 9. Identifies and analyses significant change
Component 3: Control Activities (See section 1.5 below)	10. Selects and develops control activities 11. Selects and develops general controls over technology 12. Deploys through policies and procedures
Component 4: Information & Communication (See section 1.6 below)	13. Uses relevant information 14. Communicates internally 15. Communicates externally
Component 5: Monitoring Activities (See section 1.5 below)	16. Conducts ongoing and/or separate evaluations 17. Evaluates and communicates deficiencies

1.2 Audit requirements and internal controls

SLAuS 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* deals with the area of controls.

In obtaining an understanding of internal control, the auditor must understand the **design** of the internal control and the **implementation** of that control. In the following sub-sections, we look at each of the elements of internal control identified above in turn.

1.3 Control environment

The control environment is the framework within which controls operate. The control environment is very much determined by the management of a business.

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 is a component of internal control.

A strong control environment does not, by itself, ensure the effectiveness of the overall internal control system, but can be a positive factor when assessing the risks of material misstatement. A weak control environment can undermine the effectiveness of controls.

Aspects of the control environment (such as management attitudes towards control) will nevertheless be a significant factor in determining how controls operate. Controls are more likely to operate well in an environment where they are treated as being important. In addition, consideration of the control environment will mean determining whether certain controls (internal auditors, budgets) actually exist.

SLAuS 315 states that auditors shall have an understanding of the control environment. As part of this understanding, the auditor shall evaluate whether:

- Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behaviour
- The strengths in the control environment collectively provide an appropriate foundation for the other components of internal control and whether those components are not undermined by deficiencies in the control environment

The following table illustrates the elements of the control environment that may be relevant when obtaining an understanding of the control environment.

Table 2.1: Elements of the control environment

CONTROL ENVIRONMENT	
Communication and enforcement of integrity and ethical values	Essential elements which influence the effectiveness of the design, administration and monitoring of controls
Commitment to competence	Management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge
Participation by those charged with governance	• Independence from management • Experience and stature • Extent of involvement and scrutiny of activities • Appropriateness of actions and interaction with internal and external auditors
Management's philosophy and operating style	• Approach to taking and managing business risks • Attitudes and actions towards financial reporting • Attitudes towards information processing and accounting functions and personnel
Organisational structure	The framework within which an entity's activities for achieving its objectives are planned, executed, controlled and reviewed
Assignment of authority and responsibility	How authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established
Human resource policies and practices	Recruitment, orientation, training, evaluating, counselling, promoting, compensation and remedial actions

The auditor shall assess whether these elements of the control environment have been implemented using a combination of **inquiries of management** and **observation** and **inspection**.

QUESTION — Control Environment

Bastro Plc specialises in the provision of cloud computing to organisations that need to store large amounts of data and run software solutions. The company has grown rapidly since its inception six years ago by the founder, Michael Zeemo, to become one of the largest in the industry and was listed one year ago. The company is heavily reliant on the technology invented by Michael before he established the company.

The rapid growth has been funded through several rounds of investment by private investors and then through the capital raised when listing, but the company is still loss making and is expected to be so for several more years. Michael Zeemo has been criticised recently after accusations of bullying behaviour by several members of staff. Michael currently holds the role of both CEO and Chairman of the board and there have been reports that virtually all decisions in the organisation must go through him.

The board of directors consists of 4 executive directors, two of whom have been with the company from inception and are rarely in attendance at board meetings and the third being Michael's brother Tony. Early investors have been happy not to question this structure as the value of the company has grown exponentially over the last few years, but since listing there has been disquiet by those who purchased shares publicly.

The company has a flat structure beneath the board with major decisions primarily made by Michael and implemented by whichever manager he decides is best placed to undertake the work. The senior managers are hand-picked by Michael, a strategy he justifies by saying "I only choose managers that can execute what I want in exactly the way I want it."

Recently the company has experienced a severe security breach where the data of customers was hacked into and stolen. One manager had suggested to Michael that this was a particular risk due to some new software that required patching, however Michael deemed the cost of doing this prohibitive. This was raised at a senior management meeting to discuss the cause of the breach and the manager who did not complete the patch ultimately left the company that day at Michael's request.

Required

Discuss the deficiencies in the control environment at Bastro Plc.

ANSWER

The first and most obvious problem with the control environment at Bastro Plc is with **management's philosophy and operating style**. Michael Zeemo manages with an autocratic style that seems to bring with it success and large elements of risk. This is evidenced by the acceptance of the risk of data loss, even though there was a fix available, on the basis of cost. This would seem to be an illogical decision given the nature of the business that Bastro Plc operates. Providing cloud-based solutions relies on the trust placed in the company by its customers that their data is safe.

The fact that this decision was allowed to be implemented shows that there is little **participation with those charged with governance.** Looking at the board structure and attitude it is clear that there is a lack of oversight, evidenced by the fact that there are no non-executive directors, and that the executive directors have little involvement or interest in the day-to-day activities of the organisation. There would also seem to be a distinct lack of **experience and stature** present on the board and no scrutiny being provided over the decisions that are being made.

Another key area of the control environment that could be questioned at Bastro plc is the **competence of management** as they are chosen directly by Michael on the basis of whether they will do what they are told by him, rather than their competence in their job. It is likely in the cloud computing industry that an ability to think independently and come up with solutions would be better character traits for managers. This may be exacerbated by the **organisational structure** which may too flat for managers to pass decisions down (or up) the chain of command. The fact that Michael picks the managers and then makes decisions for them reveals a lack of **human resources policies and procedures** and this is another key failing in the control environment of Bastro Plc.

The manager that pointed out that the software problem could be fixed was forced to leave the company even though Michael had made the decision. This shows a disconnect between **authority and responsibility** as they were forced to take responsibility for a decision they did not make.

The failings we have mentioned point to a weak control environment, with the attitude and awareness of the directors unlikely to be sufficient to ensure that any control framework that does exist within the organisation is implemented effectively.

1.4 Entity's risk assessment process

SLAuS 315 says the auditor shall obtain an understanding of whether the entity has a process for:

- Identifying business risks relevant to financial reporting objectives
- Estimating the significance of the risks
- Assessing the likelihood of their occurrence
- Deciding upon actions to address those risks

If the entity has established such a process, the auditor shall obtain an understanding of it. If there is not a process, the auditor shall discuss with management whether relevant business risks have been identified and how they have been addressed.

1.5 Information system relevant to financial reporting

The **information system relevant to financial reporting** is a component of internal control that includes the financial reporting system, and consists of the procedures and records established to initiate, record, process and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities and equity.

The auditor shall obtain an understanding of the information system relevant to financial reporting objectives, including the following areas:

- The classes of transactions in the entity's operations that are significant to the financial statements
- The procedures, within both IT and manual systems, by which those transactions are initiated, recorded, processed, corrected, transferred to the general ledger and reported in the financial statements
- The related accounting records, supporting information and specific accounts in the financial statements, in respect of initiating, recording, processing and reporting transactions
- How the information system captures events and conditions, other than transactions, that are significant to the financial statements
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures
- Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments

The auditor shall obtain an understanding of how the entity **communicates** financial reporting roles and responsibilities and significant matters relating to financial reporting.

1.6 Control activities

Control activities are those policies and procedures that help ensure that management directives are carried out. Control activities are a component of internal control.

SLAuS 315 states that the auditor shall obtain an understanding of control activities relevant to the audit and how the entity has responded to risks arising from IT.

Control activities include those activities designed to **prevent** or to **detect** and **correct errors**. SLAuS 315 provides guidance on the control activities that may be relevant to the auditor, specifying that they will be policies and procedures in the following categories:

Performance reviews, for example the review of what was expected during the budgeting or forecasting process to the actual performance, comparing internal and external data or analysing trends and relationships between data sets.

Information processing, which relates to the control activities that are present in the information system that is used to produce the financial statements. These can be categorised into general IT controls and application IT controls (we look at each of these in detail in section 4 below).

Physical controls, which SLAuS 315 (Appendix 1.9) states encompass:

- *The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.*
- *The authorization for access to computer programs and data files.*
- *The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records).*

Controls in this area are therefore generally related to the prevention of the misappropriation of assets and their importance will therefore be determined by other factors such as the susceptibility of the assets in that entity to misappropriation.

Segregation of duties, which is described in SLAuS 315 (Appendix 1.9) as "*Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.*" This is a very important aspect of internal control and we look at it in more detail in section 1.6.1 below.

Within these categories, control activities will exist in order to prevent or detect errors or fraud.

Table 2.2: Examples of control activities

Examples of control activities	
Approval and control of documents	Transactions should be approved by an appropriate person. For example, overtime should be approved by departmental managers.
Controls over computerised applications	We shall look at computer controls later in this chapter.
Checking the arithmetical accuracy of records	For example, checking to see if individual invoices have been added up correctly.
Maintaining and reviewing control accounts and trial balances	Control accounts bring together transactions in individual ledgers. Trial balances bring together transactions for the organisation as a whole. Preparing these can highlight unusual transactions or accounts.
Reconciliations	Reconciliations involve comparison of a specific balance in the accounting records with what another source says the balance should be, for example, a bank reconciliation. Differences between the two figures should only be reconciling items.
Comparing the results of cash, security and inventory counts with accounting records	For example, in a physical count of petty cash, the balance shown in the cash book should be the same as the amount held.
Comparing internal data with external sources of information	For example, comparing records of goods despatched to customers with customers' acknowledgement of goods that have been received.

Examples of control activities	
Limiting physical access to assets and records	Only authorised personnel should have access to certain assets (particularly valuable or portable ones) eg ensuring that the inventory stores are locked unless store personnel are there.

1.6.1 Segregation of duties

Segregation implies a **number of people** being involved in the accounting process. This makes it more difficult for fraudulent transactions to be processed (since a number of people would have to collude in the fraud), and it is also more difficult for accidental errors to be processed (since the more people are involved, the more checking there can be). Segregation should take place in various ways:

(a) **Segregation of function.** The key functions that should be segregated are the **carrying out** of a transaction, **recording** that transaction in the accounting records and **maintaining custody** of assets that arise from the transaction.

(b) The various **steps** in carrying out the transaction should also be segregated. We shall see how this works in practice when we look at the major transaction cycles in Chapter 3.

(c) The **carrying out** of various **accounting operations** should be segregated. For example, the same staff should not record transactions and carry out the reconciliations at the period-end.

1.7 Monitoring of controls

Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It includes assessing the design and operation of controls on a timely basis and taking necessary corrective actions modified for changes in conditions. Monitoring of controls is a component of internal control.

The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates corrective actions to deficiencies in its controls.

If the entity has an **internal audit function**, the auditor shall obtain an understanding of the **nature of its responsibilities,** its organisational status and the **activities** performed/to be performed.

The auditor shall also obtain an understanding of the **sources of the information** used in the monitoring activities and the **basis** on which management considers it reliable.

There are many ways in which the monitoring of controls may take place either from within the entity, or potentially from external parties. Some ways in which this may occur are:

Management may conduct reviews of the policies and procedures in place over a particular area to assess their effectiveness, for example, there may be a policy of reconciling the receivables ledger on a timely basis every month. Management may review the performance of this procedure to ensure that it is carried out in the manner set down in the policy and on time. If this were not done, there is a risk that the staff member responsible may not carry out the procedure correctly, on time, or at all.

It may be that over time, with changes in the business processes, that internal control procedures that were carried out in the past are no longer relevant. **Staff responsible for the** implementation of internal controls could be asked periodically to assess whether the controls being implemented are still fit for purpose with a review of those that staff felt were outdated or ineffective.

If there is an **internal audit department** within the organisation it is likely that they will be responsible for ongoing review of the implementation and effectiveness of the internal controls that are in place. This will be planned in the most efficient way in the organisation so that every critical area is monitored periodically.

External parties may also have input into the monitoring of internal controls, for example, recommendations made by the **external auditor** in their assessment of internal controls. **Customers and suppliers** may also have a role to play in their corroboration, or not, of the balances due from or to them an indication of control adequacy in these areas.

1.8 Small companies – the problem of control

Many of the controls which would be relevant to a large entity are neither practical nor appropriate for a small company, which often has simple internal control systems. For a small company the most important form of internal control is generally the **close involvement** of the **directors or proprietors**.

However it is also important to note that close involvement by management will enable them to **override controls** and, if they wish, to **exclude transactions** from the records.

Auditors can also have difficulties, not because there is a general lack of controls but because the **evidence** available as to their operation and the completeness of the records is **insufficient**. For example, an owner-manager may well perform an independent review of payroll records, but will not sign and date to indicate the review has taken place, and may not document the investigation of anomalies or how problems were resolved. Therefore it is very difficult for the auditor to obtain evidence that a control is operating effectively, even if it is.

Segregation of duties will often appear inadequate in enterprises having a small number of staff. Similarly, because of the scale of the operation, organisation and management controls are likely to be rudimentary at best.

As discussed above, the onus is on the proprietor, by virtue of his day-to-day involvement, to compensate for this lack. This involvement should encompass physical, authorisation, arithmetical and accounting controls as well as supervision.

Where the manager of a small business is not the owner, the manager may not possess the same degree of commitment to the running of it as an owner-manager would. In such cases, the auditors will have to consider the adequacy of controls exercised by the shareholders over the manager in assessing internal control.

1.8.1 Evidence available in relation to internal control in small companies

We discussed above the fact that audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal but effective. However, although not documented, small companies may develop a culture that emphasises the importance of integrity and ethical behaviour through verbal communication and where management sets a good example. As a result the attitudes, awareness and actions of management are very important to the auditor's understanding of a smaller entity's control environment.

Although size and economic considerations in smaller entities often reduce the opportunity for formal control activities, there is still likely to be some evidence available in relation to internal controls. Some basic control activities are likely to exist for the main transaction cycles, such as revenues, purchases and payroll costs.

In a small company, often management's sole authority for approval of, for example, purchases and payments, can provide strong control over important account balances; the auditor can seek to test and rely on these controls. These key controls lessen or remove the need for more detailed control activities and, if the auditor can gain enough evidence that these key controls are operating effectively, substantive testing can be reduced.

However, because of the factors discussed in the preceding section, the auditor will often choose or be forced to turn to substantive procedures to gain sufficient appropriate audit evidence when auditing a smaller entity. This can often mean use of:

- Confirmations
- Agreeing samples related to different financial statement areas to source documents
- Analytical procedures where these are considered suitable.

1.9 Limitations of accounting and control systems

Any internal control system can only provide the directors with **reasonable assurance** that their objectives are reached, because of **inherent limitations**. These include:

- The **costs** of control **not outweighing** their **benefits**
- The potential for **human error**
- **Collusion** between employees
- The possibility of **controls** being **by-passed** or **overridden** by management
- Controls being **designed to cope** with **routine** and **not non-routine transactions**

These factors demonstrate why auditors cannot obtain all their evidence from tests of the systems of internal control. The key factors in the limitations of controls system are **human error** and **potential for fraud**.

The safeguard of segregation of duties can help deter fraud. However, if employees decide to perpetrate frauds by collusion, or management commit fraud by overriding systems, the accounting system will not be able to prevent such frauds.

This is one of the reasons that auditors always need to be alert to the possibility of fraud, the subject of SLAuS 240 *The auditor's responsibilities relating to fraud in an audit of financial statements*, which we will discuss in more detail in Chapter 6.

QUESTION — Internal control systems

An internal control system has been described as comprising 'the control environment and control activities. It includes all the policies and procedures (internal controls) adopted by the directors and management of an entity to assist in achieving their objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to internal policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information'.

Required

Explain the meaning and relevance to the auditors giving an opinion on financial statements of each of the management objectives above.

ANSWER

The auditors' objective in evaluating and testing internal controls is to determine the degree of reliance which they may place on the information contained in the accounting records. If they obtain reasonable assurance by means of tests of controls that the internal control system is effective in ensuring the completeness and accuracy of the accounting records, they may limit their substantive procedures.

(a) *'The orderly and efficient conduct of its business'*

An organisation which is efficient and conducts its affairs in an orderly manner is much more likely to be able to supply the auditors with sufficient appropriate audit evidence on which to base their audit opinion. More importantly, the level of inherent and control risk will be lower, giving extra assurance that the financial statements do not contain material errors.

(b) *'Adherence to internal policies'*

Management is responsible for setting up an effective system of internal control and management policy provides the broad framework within which internal controls have to operate. Unless management does have a pre-determined set of policies, then it is very difficult to imagine how the company could be expected to operate efficiently. Management policy will cover all aspects of the company's activities, ranging from broad corporate objectives to specific areas such as wage rates.

Given that the auditors must have a sound understanding of the company's affairs generally, and of specific areas of control in particular, then the fact that management policies are followed will make the task of the auditors easier in that they will be able to rely more readily on the information produced by the systems established by management.

(c) '*Safeguarding of assets*'

This objective may relate to the physical protection of assets (for example, locking cash in a safe at night) or to less direct safeguarding (for example, ensuring that there is adequate insurance cover for all assets). It can also be seen as relating to the maintenance of proper records in respect of all assets.

The auditors will be concerned with ensuring that the company has properly safeguarded its assets so that they can form an opinion on the existence of specific assets and whether the company's records can be taken as a reliable basis for the preparation of financial statements. Reliance on the underlying records will be particularly significant where the figures in the financial statements are derived from such records, rather than as the result of physical inspection.

(d) *'Prevention and detection of fraud and error'*

The directors are responsible for taking reasonable steps to prevent and detect fraud. They are also responsible for preparing financial statements which give a true and fair view of the entity's affairs. However, the auditors must plan and perform their audit procedures and evaluate and report the results of these, recognising that fraud or error may materially affect the financial statements. A strong system of internal control will give the auditors some assurance that frauds and errors are not occurring, unless management are colluding to overcome that system.

(e) *'Accuracy and completeness of the accounting records'/'timely preparation of reliable financial information'*

This objective is most clearly related to statutory requirements relating to both management and auditors. The company generally has legal obligations to maintain proper accounting records. The auditors must form an opinion on whether the company has fulfilled these obligations and also conclude whether the financial statements agree with the underlying records.

2 Internal control and the statutory audit

The auditors shall assess the **adequacy** of the systems as a basis for the financial statements and shall identify **risks** of material misstatements to provide a basis for designing and performing further audit procedures.

Auditors are only concerned with assessing policies and procedures which are relevant to the financial statements. Auditors shall:

- **Assess the adequacy** of the accounting system as a basis for preparing the accounts
- **Identify** the types of **potential misstatements** that could occur in the accounts
- **Consider factors** that affect the **risk of misstatements**
- **Design appropriate audit procedures**

We will discuss in detail the process of assessing the risks of material misstatement in Chapter 4. The assessment of the controls of an entity will have an impact on that risk assessment.

Risks arising from **poor control environments** are unlikely to be confined to particular assertions in the financial statements, and, if severe, may even raise questions about whether the financial statements are capable of being audited; that is, if control risk is so high that audit risk cannot be reduced to an acceptable level.

On the other hand, some **control procedures** may be closely connected to an assertion in financial statements; for example, controls over the inventory count are closely connected with the existence and completeness of inventory in the financial statements.

There may be occasions where substantive procedures alone are not sufficient to address the risks arising. Where such risks exist, auditors shall **evaluate the design** and **determine the implementation** of the controls, that is by **controls testing.** This is most likely to be the case in a system which is highly computerised and which does not require much manual intervention.

2.1 Recording accounting and control systems

The auditors must keep a record of the client's systems which must be updated each year. This can be done through the use of narrative notes, flowcharts, questionnaires or checklists.

There are several techniques for recording the assessment of control risk, that is, the system. One or more of the following may be used, depending on the complexity of the system.

- Narrative notes
- Questionnaires
- Flowcharts
- Checklists

We look at each of these methods throughout the rest of Section 2, including the benefits and limitations of each.

In respect of questionnaires, you should note that there are two types, each with a different purpose.

- **Internal Control Questionnaires (ICQs)** are used to ask whether controls exist which meet specific control objectives.
- **Internal Control Evaluation Questionnaires (ICEQs)** are used to determine whether there are controls which prevent or detect specified errors or omissions.

The specific controls for each major transaction system are examined in detail in Chapter 3. However some are also included in the examples included in 2.1.3 and 2.1.4 for the purposes of illustrating how IQCs and ICEQs are used to record internal control systems. Whatever method of recording is used, the record will usually be retained on the permanent file and updated each year.

2.1.1 Narrative notes

The purpose of narrative notes is to **describe** and **explain** the **system**, at the same time as making any comments or criticisms which will help to demonstrate an intelligent understanding of the system.

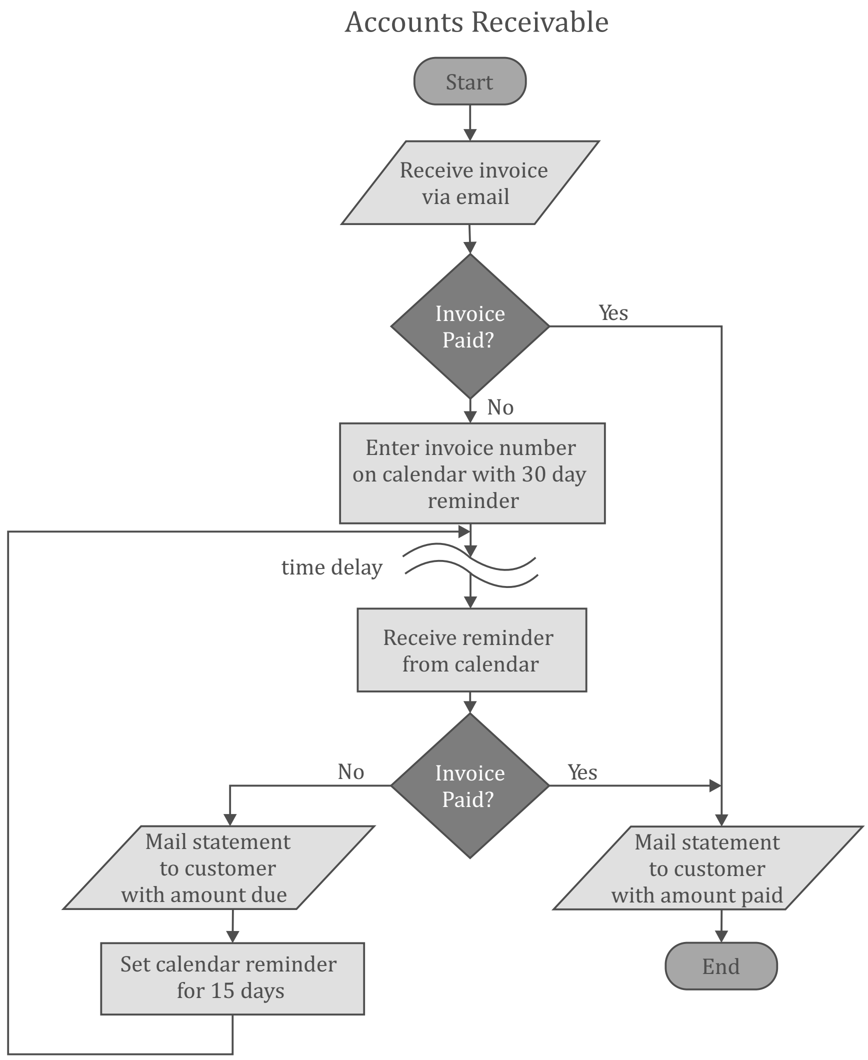
Table 2.3: Narrative notes

Narrative notes	
Advantages	**Disadvantages**
They are relatively simple to record and can facilitate understanding by all audit team members.	Describing something in narrative notes can be a lot more time consuming than, say, representing it as a simple flowchart, particularly where the system follows a logical flow.
They can be used for any system due to the method's flexibility.	They are awkward to update if written manually.
Editing in future years can be relatively easy if they are computerised.	It can be difficult to identify missing internal controls because notes record the detail of systems but may not identify control exceptions clearly.

2.1.2 Flowcharts

Flowcharts can take many forms, but in general are graphical illustrations of the physical flow of information through the accounting system. Flowlines represent the sequences of processes, and other symbols represent the inputs and outputs to a process. An example of an accounts receivable flowchart follows.

Figure 5.1: Flowcharts



Source: http://www.rff.com/flowchart_samples.htm

Flowcharts have certain advantages and disadvantages.

Table 2.4: Advantages and disadvantages of flowcharts

Advantages
After a little experience they can be prepared quickly.
As the information is presented in a standard form, they are fairly easy to follow and to review.

Advantages
They generally ensure that the system is recorded in its entirety, as all document flows have to be traced from beginning to end. Any 'loose ends' will be apparent from a cursory examination.
They eliminate the need for extensive narrative and can be of considerable help in highlighting the salient points of control and any deficiencies in the system.

Disadvantages
They are most suitable for describing standard systems. Procedures for dealing with unusual transactions will normally have to be recorded using narrative notes.
Major amendment is difficult without redrawing.
Time can sometimes be wasted by charting areas that are of no audit significance.

2.1.3 Internal Control Questionnaires (ICQs)

The major question which internal control questionnaires are designed to answer is 'how good is the system of controls?'

Although there are many different forms of ICQ in practice, they all conform to the following basic principles:

(a) They **comprise a list of questions** designed to determine whether desirable controls are present (possible desirable controls are considered for each major transaction cycle in Chapter 3).

(b) They are formulated so that there is one list of questions to **cover each of the major transaction cycles**.

One of the most effective ways of designing the questionnaire is to phrase the questions so that all the answers can be given as 'YES' or 'NO' and that a 'NO' answer indicates a deficiency in the system. An example would be:

Are purchase invoices checked to goods received notes before being passed for payment? YES/NO/Comments

The ICQ questions below dealing with goods inward provide additional illustrations of the ICQ approach.

Goods inward

(a) Are supplies examined on arrival as to quantity and quality?

(b) Is such an examination evidenced in some way?

(c) Is the receipt of supplies recorded, perhaps by means of goods inwards notes?

(d) Are receipt records prepared by a person independent of those responsible for:

(i) Ordering functions?
(ii) The processing and recording of invoices?

(e) Are goods inwards records controlled to ensure that invoices are obtained for all goods received and to enable the liability for unbilled goods to be determined (by pre-numbering the records and accounting for all serial numbers)?

(f) (i) Are goods inward records regularly reviewed for items for which no invoices have been received?

(ii) Are any such items investigated?

(g) Are these records reviewed by a person independent of those responsible for the receipt and control of goods?

2.1.4 Internal Control Evaluation Questionnaires (ICEQs)

In recent years, many auditing firms have developed and implemented an evaluation technique more concerned with assessing whether specific errors (or frauds) are possible, rather than establishing whether certain desirable controls are present. This is achieved by reducing the control criteria for each transaction stream down to a handful of **key questions** (or control questions). The characteristic of these questions is that they concentrate on the significant errors or omissions that could occur at each phase of the appropriate cycle if controls are weak.

The nature of the key questions may best be understood by reference to the example below relating to the purchases (expenditure) cycle.

Internal control evaluation questionnaire: control questions

The purchases (expenditure) cycle

Is there reasonable assurance that:

(a) Goods or services could not be received without a liability being recorded?

(b) Receipt of goods or services is required in order to establish a liability?

(c) A liability will be recorded:

(i) Only for authorised items
(ii) At the proper amount?

(d) All payments are properly authorised?

(e) All credits due from suppliers are received?

(f) All transactions are properly accounted for?

(g) At the period end liabilities are neither overstated nor understated by the system?

(h) The balance at the bank is properly recorded at all times?

(i) Unauthorised cash payments could not be made and that the balance of petty cash is correctly stated at all times?

Each key control question is supported by detailed control points to be considered. For example, the detailed control points to be considered in relation to key control question (b) for the expenditure cycle (Is there reasonable assurance that receipt of goods or services is required to establish a liability?) are as follows.

(1) Is segregation of duties satisfactory?

(2) Are controls over relevant master files satisfactory?

(3) Is there a record that all goods received have been checked, for:

- Weight or number?
- Quality and damage?

(4) Are all goods received taken on charge in the detailed inventory ledgers:

- By means of the goods received note?
- Or by means of purchase invoices?
- Are there, in a computerised system, sensible control totals (hash totals, money values and so on) to reconcile the inventory system input with the payables system?

(5) Are all invoices initialled to show that:

- Receipt of goods has been checked against the goods received records?
- Receipt of services has been verified by the person using it?
- Quality of goods has been checked against the inspection?

(6) In a computerised invoice approval system are there printouts (examined by a responsible person) of:

- Cases where order, GRN and invoice are present but they are not equal ('equal' within predetermined tolerances of minor discrepancies)?
- Cases where invoices have been input but there is no corresponding GRN?

(7) Is there adequate control over direct purchases?

(8) Are receiving documents effectively cancelled (for example, cross-referenced) to prevent their supporting two invoices?

Alternatively, ICEQ questions can be phrased so that the deficiency which should be prevented by a key control is highlighted, such as the following.

Table 2.5: Suggested ICEQ wording

Question	Answer	Comments or explanation of 'yes' answer
Can goods be sent to unauthorised suppliers?		

In these cases a 'yes' answer would require an explanation, rather than a 'no' answer.

2.1.5 Advantages and disadvantages of ICQs and ICEQs

Table 2.6: ICQs & ICEQs

ICQs and ICEQs	
Advantages	**Disadvantages**
If drafted thoroughly, they can ensure **all controls** are **considered**	The principal disadvantage is that they can be **drafted vaguely**, hence **misunderstood** and important controls not identified.
They are **quick** to **prepare**	They may contain a large number of **irrelevant controls.**
They are **easy** to **use** and **control**	They may not include **unusual controls**, which are nevertheless effective in particular circumstances.
Because they are drafted in terms of **objectives** rather than specific controls, **ICEQs** are easier to apply to a variety of systems than **ICQs**	They can give the impression that all controls are of **equal** weight. In many systems one NO answer (for example, lack of segregation of duties) will cancel out a string of YES answers.

ICQs and ICEQs	
Advantages	**Disadvantages**
Answering ICEQs should enable auditors to **identify the key controls** which they are most likely to test during control testing	The client may be able to **overstate controls.**
ICEQs can **highlight deficiencies** where extensive substantive testing will be required	

2.1.6 Checklists

Checklists may be used instead of questionnaires to document and evaluate the internal control system. The subtle difference with these is that, instead of asking questions, statements are made to 'mark off' and tick boxes are used to indicate where the statement holds true. For example a checklist may state that "supplies are examined on arrival as to quantity and quality", which would be ticked if this does actually occur, or crossed if not. Checklists share many of the same advantages and disadvantages of ICQs and ICEQs.

3 Evaluation of internal control components

If the auditors believe the system of controls is strong, they may choose to test controls to assess whether they can rely on the controls having operated effectively.

3.1 Confirming understanding

SLAuS 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* states:

(a) The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgement whether a control, individually or in combination with others, is relevant to the audit.

(b) When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to enquiry of the entity's personnel.

In order to confirm their understanding of the control systems, in addition to enquiry, auditors will often carry out **walk-through tests**. These procedures involve picking up a transaction and following it through the system to see whether all the controls they anticipate should be in existence were actually in operation with regard to that transaction.

3.2 Evaluating controls

In order to evaluate internal controls the auditor should be aware of three aspects for evaluation.

(1) The **design of the control** (design effectiveness)

Evaluating the design of a control involves considering whether it is capable of effectively preventing, or detecting and correcting material misstatements.

A control may be in place with the intention of preventing a misstatement or mitigating a risk but it may be badly designed. In such a situation, there is little point in the auditor assessing the implementation or operating effectiveness as the flawed design will prevent the auditor from relying on it.

(2) **Implementation** of the control

Having ascertained that a control has been adequately designed, an auditor will need to obtain evidence that it has been implemented (ie the control exists and the client is using it). This may be done by a combination of enquiry, observing the control or inspecting related documents.

(3) **Operating effectiveness**

Evidence may be obtained that a control was in place at a point in time during the period under review (eg by observing that control on a given day). However, this does not give reasonable evidence that the control was operating effectively throughout the period. The auditor will have to use **tests of controls** to assess operating effectiveness.

For example, the auditor may be evaluating the controls around bank and cash, particularly assessing the controls around the reconciliation of the bank statement. They will start that assessment by looking at the design of the controls and looking for any obvious flaws.

For example, someone may be required to review bank reconciliations and sign to say they have performed the check – but if design of the control is such that the review is always carried out by the same person preparing the reconciliation, the control is badly designed. This is because an individual is less likely to review their own work as scrupulously as someone else's.

Assuming there are no such obvious flaws, the auditor will look to see that there are key **elements to the design** such as performance of the reconciliations on a timely basis by someone with adequate experience and training, review of the reconciliation by a more senior member of staff and immediate follow up/verification of all reconciling items.

If the design of the controls are adequate, the auditor will then seek to verify that the **implementation of the controls matches the design**. It may be the case that what is written or understood by the policy or procedure is not what actually happens on the ground.

In order to assess whether the controls mentioned above in relation to the bank reconciliation are being **implemented**, the auditor could first of all consult the personnel involved to ask them how the process is undertaken. They could **inquire** about review processes with both the preparer and reviewer to ensure consistency and they could inquire as to the knowledge and experience of both parties. The auditor could **observe** the reconciliation being carried out and ensure that the review takes place and the reconciling items are seen to be followed up (although this will only give evidence for that particular instance). Previous instances of reconciliations could be **inspected** for evidence of date of preparation, sign off by reviewer and follow up of reconciling items.

Once the auditor is satisfied that the design of the controls is adequate and that they are being implemented in line with expectations, they will be in a position to test the operating effectiveness using **tests of control**. SLAuS 330 makes it clear that this is a different and more detailed process than considering the design and implementation of the controls but that some of the information gathered when making this assessment may provide evidence for the **effectiveness of controls**.

3.3 Tests of controls

Tests of controls are tests performed to obtain audit evidence about the effectiveness of the:

– Design of the accounting and internal control systems, ie whether they are suitably designed to prevent, or detect and correct, material misstatement at the assertion level; and

– Operation of the internal controls throughout the period.

Tests of controls are distinguished from substantive tests, which are designed to detect material misstatements in the financial statements.

Tests of controls may include the following.

(a) **Inspection of documents** supporting controls or events to gain audit evidence that internal controls have operated properly, eg verifying that a transaction has been authorised

(b) **Enquiries about internal controls** which leave no audit trail, eg determining who actually performs each function, not merely who is supposed to perform it

(c) **Re-performance of control procedures**, to ensure they were correctly performed by the entity

(d) **Examination of evidence of management views**, eg minutes of management meetings

(e) Testing of internal controls operating on **computerised systems** or over the overall IT function, eg access controls

(f) **Observation of controls** to consider the manner in which the control is being operated

Auditors should consider:

- **How** controls were applied
- The **consistency** with which they were applied during the period
- **By whom** they were applied

Deviations in the operation of controls (caused by change of staff, etc) may increase control risk; tests of control may need to be modified to confirm effective operation during and after any change.

If we consider the example of the **controls over bank reconciliations** that we mentioned above when thinking about the design and implementation of controls, some of this information will have been gathered already when doing this work. The auditor will however have more detailed tests of control to undertake to evaluate the effectiveness of the controls in place. Additional tests of control that may be undertaken will be:

- **Reperformance** of a sample of the bank reconciliations by the auditor.
- **Testing the access** controls over the system used to prepare the bank reconciliations.
- **Inspect documentation** to verify the follow up of reconciling items by management for a sample of reconciliations.

The use of **computer-assisted audit techniques** (CAATs) may be appropriate and these are discussed in detail in Chapter 15.

In a continuing engagement, the auditor will be aware of the accounting and internal control systems through work carried out previously, but will need to update the knowledge gained and consider the need to obtain further audit evidence of any changes in control.

3.4 Revision of risk assessment, audit strategy and audit plan

The auditors may find that the evidence they obtain from controls testing indicates that controls did not operate as well as they expected. If the evidence contradicts the original risk assessment, the auditors will have to amend the further procedures they have planned to carry out.

In particular, if controls testing reveals that controls have not operated effectively throughout the year, the auditor may have to extend substantive testing.

Revising the risk assessment and audit procedures will necessitate an update of the audit strategy, which sets out the scope, timing and direction of the audit. For example, if tests of controls highlight that many controls are not operating as expected, this may lead to an increase in the strategy's emphasis on substantive procedures.

The new or changed procedures will need to be reflected on the audit plan which details the nature, timing and extent of audit procedures to be performed. The audit plan is discussed in detail in Chapter 5.

4 Internal controls in a computerised environment

There are special considerations for auditors when a system is computerised. IT controls comprise **general** and **application** controls.

The internal controls in a computerised environment include both manual procedures and procedures designed into computer programs. Such control procedures comprise two types of control: **general controls** and **application controls**.

General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. They commonly include controls over data centre and network operations, system software acquisition, change and maintenance, access security, and application system acquisition, development and maintenance.

Application controls are manual or automated procedures that typically operate at a business process level. They can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, they relate to procedures used to initiate, record, process and report transactions or other financial data.

4.1 General controls

Table 2.7: Examples of general controls

GENERAL CONTROLS	EXAMPLES
Development of computer applications	**Standards** over systems design, programming and documentation Full **testing procedures** using test data **Approval** by computer users and management **Segregation of duties** so that those responsible for design are not responsible for testing **Installation procedures** so that data is not corrupted in transition **Training** of staff in new procedures and availability of adequate **documentation**
Prevention or detection of unauthorised changes to programs	**Segregation of duties** **Full records** of program changes **Password protection** of programs so that access is limited to computer operations staff **Restricted access** to central computer by locked doors, keypads Maintenance of **programs logs** **Virus checks** on software: use of anti-virus software and policy prohibiting use of non-authorised programs or files **Back-up copies** of programs being taken and stored in other locations **Control copies** of programs being preserved and regularly compared with actual programs **Stricter controls** over certain programs (utility programs) by use of **read-only memory**
Testing and documentation of program changes	Complete **testing procedures** **Documentation standards** **Approval** of changes by computer users and management **Training** of staff using programs
Controls to prevent wrong programs or files being used	**Operation controls** over programs **Libraries** of programs **Proper job scheduling**

GENERAL CONTROLS	EXAMPLES
Controls to prevent unauthorised amendments to data files	**Password protection** **Restricted access** to authorised users only
Controls to ensure continuity of operation	Storing **extra copies** of programs and data files offsite **Protection of equipment** against fire and other hazards **Back-up power sources** **Disaster recovery procedures** eg availability of back-up computer facilities. **Maintenance agreements** and insurance

The auditors will wish to test some or all of the above IT general controls, having considered how they affect the computer applications significant to the audit.

IT general controls that relate to some or all applications are usually interdependent controls, ie their operation is often essential to the effectiveness of application controls. As application controls may be useless when general controls are ineffective, it will be more efficient to review the design of IT general controls first, before reviewing the application controls.

4.2 Application controls

The purpose of application controls is to establish **specific control procedures** over the accounting applications in order to provide reasonable assurance that all transactions are authorised and recorded, and are processed completely, accurately and on a timely basis.

Application controls include the following.

Table 2.8: Examples of application controls

APPLICATION CONTROLS	EXAMPLES
Controls over **input**: **completeness**	Manual or programmed agreement of **control totals** **Document counts** **One-for-one checking** of processed output to source documents **Programmed matching** of input to an expected input control file **Procedures** over resubmission of rejected controls

APPLICATION CONTROLS	EXAMPLES
Controls over **input**: **accuracy**	**Programs to check data** fields (for example value, reference number, date) on input transactions for plausibility: • Digit verification (eg reference numbers are as expected) • Reasonableness test (eg sales tax to total value) • Existence checks (eg customer name) • Character checks (no unexpected characters used in reference) • Necessary information (no transaction passed with gaps) • Permitted range (no transaction processed over a certain value) **Manual scrutiny** of output and reconciliation to source Agreement of **control totals** (manual/programmed)
Controls over **input: authorisation**	**Manual checks** to ensure information input was: • Authorised • Input by authorised personnel
Controls over **processing**	Similar controls to input must be in place when input is completed, for example, **batch reconciliations**. **Screen warnings** can prevent people logging out before processing is complete
Controls over **master files and standing data**	**One-to-one checking** **Cyclical reviews** of all master files and standing data **Record counts** (number of documents processed) and **hash totals** (for example, the total of all the payroll numbers) used when master files are used to ensure no deletions **Controls** over the deletion of accounts that have no current balance

Controls over input, processing, data files and output may be carried out by IT personnel, users of the system or a separate control group and may be programmed into application software. The auditors may wish to test the following application controls.

Table 2.9: Testing of application controls

TESTING OF APPLICATION CONTROLS	
Manual controls exercised by the user	If manual controls exercised by the user of the application system are capable of providing reasonable assurance that the system's output is complete, accurate and authorised, the auditors may decide to limit tests of control to these manual controls.
Controls over system output	If, in addition to manual controls exercised by the user, the controls to be tested use information produced by the computer, or are contained within computer programs, such controls may be tested by examining the system's output using either manual procedures or computers. Such output may be in the form of magnetic media, microfilm or printouts. Alternatively, the auditor may test the control by performing it with the use of computers.
Programmed control procedures	In the case of certain computer systems, the auditor may find that it is not possible or, in some cases, not practical to test controls by examining only user controls or the system's output. The auditor may consider performing tests of control by using computers, reprocessing transaction data or, in unusual situations, examining the coding of the application program.

As we have already noted, IT general controls may have a pervasive effect on the processing of transactions in application systems. If these general controls are not effective, there may be a risk that misstatements occur and go undetected in the application systems. Although weaknesses in IT general controls may preclude testing certain IT application controls, it is possible that manual procedures exercised by users may provide effective control at the **application level**.

4.3 Outsourced IT functions

A client may outsource a significant part of its IT processes to a **service organisation.** The IT systems managed by the service organisation may be part of that client's information systems relevant to financial reporting and, as a result, the auditor will need to evaluate the controls in place at that service organisation.

There is an SLAuS that specifically deals with audit considerations where a company uses a service organisation: SLAuS 402 *Audit considerations relating to an entity using a service organisation.*

Note that service organisations may supply a range of services (not just IT) and may manage other areas relevant to the financial statements (payroll, for example).

Under SLAuS 402, the auditor must obtain an understanding of the nature and significance of services provided by the service organisation and their effect on the audit client's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement. The auditor must then design and perform audit procedures in response to those risks identified.

We look at this SLAuS in more detail in Chapter 6 and discuss how the auditor gains an understanding of controls in place at the service organisation.

5 Reporting deficiencies in internal control

The auditor is required to communicate significant deficiencies in internal control to those charged with governance.

5.1 Communicating deficiencies

Significant deficiencies in internal control shall be communicated in writing to those charged with governance in a **report to management** in accordance with SLAuS 265 *Communicating deficiencies in internal control to those charged with governance and management*, which states that the objective of the auditor is to communicate appropriately, to those charged with governance and management, any deficiencies in internal control identified during the audit which the auditor considers are of sufficient importance to warrant their attention.

A **deficiency in internal control** exists when a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

A **significant deficiency in internal control** is a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgement, is of sufficient importance to merit the attention of those charged with governance.

SLAuS 265 requires the auditor to determine whether one or more deficiencies in internal control have been identified and, if so, whether these constitute significant deficiencies in internal control. The significance of a deficiency depends both on whether a misstatement has occurred, and on the likelihood of a misstatement occurring and its potential magnitude. SLAuS 265 includes examples of matters to consider when determining whether a deficiency in internal control is a significant deficiency:

- The **likelihood** of the deficiencies resulting in material misstatements in the financial statements in the future
- The **susceptibility to loss or fraud** of the related asset or liability
- The **subjectivity and complexity** of determining estimated amounts
- The **amounts** exposed to the deficiencies
- The **volume of activity** that has occurred or could occur
- The **importance of the controls** to the financial reporting process
- The **cause and frequency** of the exceptions identified as a result of the deficiencies
- The **interaction** of the deficiency with other deficiencies in internal control

The SLAuS also lists examples of indicators of significant deficiencies in internal control, which include the following:

- Evidence of **ineffective aspects** of the control environment
- Absence of a **risk assessment process**
- Evidence of an **ineffective entity risk assessment process**
- Evidence of an **ineffective response to identified significant risks**
- **Misstatements** detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control
- **Restatement** of previously issued financial statements that were corrected for a material misstatement due to fraud or error
- Evidence of **management's inability to oversee** the preparation of the financial statements.

In accordance with SLAuS 265 the auditor shall communicate any significant deficiencies in internal control to **those charged with governance** on a timely basis. The auditor must also communicate in writing to **management**, on a timely basis, significant deficiencies in internal control that the auditor has communicated, or intends to communicate, to those charged with governance; and other deficiencies in internal control that have not been communicated to management by other parties and that the auditor considers are of sufficient importance to warrant management's attention. The communication to management of other deficiencies in internal control can be done orally.

The auditor must include the following in the written communication:

- A **description** of the deficiencies and an explanation of their **potential effects** (but there is no need to quantify the effects).
- **Sufficient information** to enable those charged with governance and management to understand the context of the communication, in particular that:
  - The purpose of the audit was for the auditor to express an opinion on the financial statements.
  - The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures appropriate in the circumstances, but not to express an opinion on the effectiveness of internal control.
  - The matters being reported are limited to those deficiencies identified during the audit and which the auditor has concluded are sufficiently important to merit being reported to those charged with governance.

The auditor may also include suggestions for remedial action on the deficiencies, management's actual or proposed responses, and a statement as to whether or not the auditor has undertaken any steps to verify whether management's responses have been implemented. In addition, the auditor may also include the following additional information:

- A statement that, if the auditor had undertaken more extensive procedures on internal control, more deficiencies might have been identified or some of the reported deficiencies need not have been reported.
- The written communication is for the purpose of those charged with governance and may not be suitable for other purposes.

5.2 Impact of deficiencies on the auditor's reliance on internal control

As we discussed in Section 1, if the controls are not adequately designed or not operating effectively, the auditor needs to re-visit the risk assessment and design sufficient substantive testing over that financial statement area. Therefore, where significant deficiencies are identified, unless there are robust compensating controls, the auditor will have no choice but to use purely substantive procedures to obtain sufficient appropriate audit evidence. The auditor will not seek to place reliance on internal controls.

It may be that the deficiencies were not identified during planning and risk assessment, but only become apparent later in the audit process. If this is the case, and the original audit plan was based on a reliance on internal controls, that audit plan will need to be amended, with the likely result that further audit procedures will need to be performed.

5.3 Reports to management

Reports to management can be sent by external auditors after both the interim and final audits. They set out deficiencies in internal control, the implications of those deficiencies on the business and suggested recommendations to mitigate them.

As we saw in Section 5.1, significant deficiencies in internal controls must be communicated in writing to those charged with governance in a **report to management** in accordance with SLAuS 265

In practical terms a **report to management** is a by-product of an external audit, listing any deficiencies found in the accounting systems and making recommendations for improvements. The report to management may also be referred to as the 'management letter', 'letter of weakness' or 'letter on internal control'.

Recommendations regarding internal control are a by-product of the audit of the financial statements, not a primary objective, but nonetheless are frequently of great value to a client.

When auditors prepare a written communication on internal control matters, the following points should be considered:

(a) It should not **include language** that **conflicts** with the **opinion** expressed in the auditor's report.

(b) It should state that the **accounting and internal control** system were **considered only** to the **extent necessary** to **determine** the **auditing procedures** to report on the financial statements and not to determine the adequacy of internal control for management purposes or to provide assurances on the accounting and internal control systems.

(c) It will state that it **discusses only deficiencies** in internal control which have **come to the auditors' attention** as a result of the **audit** and that other deficiencies in internal control may exist.

(d) It should also include a statement that the **communication is provided for use only by management** (or another specific named party).

After the above items and the auditors' suggestions for corrective action are communicated to management, the auditors will usually ascertain the actions taken, including the reasons for those suggestions rejected. The auditors may encourage management to respond to the auditors' comments, in which case any response can be included in the report.

The significance of findings relating to the accounting and internal control systems may change with the passage of time. Suggestions from previous years' audits which have not been adopted, if any, should normally be repeated or referred to.

e.g.

5.3.1 Example report to management

This is an example of a report to management with a covering letter which demonstrates how the principles described above might be put into practice.

Figure 5.2: Example report to management

ABC & Co
Chartered Accountants
181/20 Polhengoda Road
Colombo
Sri Lanka

The Board of Directors
Manufacturing Ltd
15 South Street

1 July 20X8

Members of the board,

Financial statements for the year ended 31 May 20X8

Please find below the report to management which sets out deficiencies in internal control we identified as a result of our review of the accounting systems and procedures operated by your company during our recent audit. The matters dealt with in the report came to our notice during the conduct of our normal audit procedures, which are designed primarily for the purpose of expressing our opinion on the financial statements.

Purchases: ordering procedures

Deficiency

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

Implication

There is therefore the possibility of liabilities being set up for unauthorised items and at a non-competitive price.

Recommendation

We recommend that the buying department should be responsible for such orders and, if they are placed orally, an official order should be raised as confirmation.

Payables ledger reconciliation

Deficiency

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

Implication

The balance on the payables ledger was short by some Rs. 2,120 of the general ledger control account at 31 January 20X8, for which no explanation could be offered. This implies a serious breakdown in the purchase invoice and/or cash payment batching and posting procedures.

Recommendation

It is important in future that this reconciliation is performed regularly by a responsible official independent of the day-to-day payables ledger, cashier and general ledger functions.

Receivables ledger: credit control

Deficiency

As at 28 February 20X8 trade receivables accounted for approximately 12 weeks of sales, although your standard credit terms are cash within 30 days of statement, equivalent to an average of about 40 days (6 weeks) of sales.

Implication

This has resulted in increased overdraft usage and difficulty in settling some key suppliers' accounts on time.

Recommendation

We recommend that a more structured system of debt collection be considered using standard letters and that statements should be sent out a week earlier if possible.

Preparation of payroll and maintenance of personnel records

Deficiency

Under your present system, just two members of staff are entirely and equally responsible for the maintenance of personnel records and preparation of the payroll. Furthermore, the only independent check of any nature on the payroll is that the chief accountant confirms that the amount of the wages cheque presented to him for signature agrees with the total of the net wages column in the payroll. This latter check does not involve any consideration of the reasonableness of the amount of the total net wages cheque or the monies being shown as due to individual employees.

Implication

It is a serious weakness of your present system that so much responsibility is vested in the hands of just two people. This situation is made worse by the fact that there is no clearly defined division of duties between the two of them. In our opinion, it would be far too easy for fraud to take place in this area (eg by inserting the names of 'dummy workmen' into the personnel records and hence on to the payroll) and/or for clerical errors to go undetected.

Recommendations

(i) Some person other than the two wages clerks be made responsible for maintaining the personnel records and for periodically (but on a surprise basis) checking them against the details on the payroll.

(ii) The two wages clerks be allocated specific duties in relation to the preparation of the payroll, with each clerk independently reviewing the work of the other.

(iii) When the payroll is presented in support of the cheque for signature to the chief accountant, he should be responsible for assessing the reasonableness of the overall charge for wages that week.

Please note that this report only sets out those significant deficiencies identified during our audit. If more extensive procedures on internal control had been carried out, we may have identified and reported more deficiencies.

This letter has been produced for the sole use of your company. It must not be disclosed to a third party, or quoted or referred to, without our written consent. No responsibility is assumed by us to any other person.

We should like to take this opportunity of thanking your staff for their co-operation and assistance during the course of our audit.

Yours faithfully

ABC & Co

CHAPTER ROUNDUP

- The auditor must **understand** the **accounting system** and **control environment** in order to determine their audit approach.
- The auditors shall assess the **adequacy** of the systems as a basis for the financial statements and shall identify **risks** of material misstatements to provide a basis for designing and performing further audit procedures.
- The auditors must keep a record of the client's systems, which must be updated each year. This can be done through the use of narrative notes, flowcharts, questionnaires or checklists.
- If the auditors believe the system of controls is strong, they may choose to test controls to assess whether they can rely on the controls having operated effectively.
- There are special considerations for auditors when a system is computerised. IT controls comprise **general** and **application** controls.
- The auditor is required to communicate significant deficiencies in internal control to those charged with governance.
- **Reports to management** can be sent by external auditors after both the interim and final audits. They set out deficiencies in internal control, the implications of those deficiencies on the business and suggested recommendations to mitigate them.

PROGRESS TEST

1 Complete the sentence using the words given below.

The ………… ………………… includes the governance and management functions and the……………., ………………… and ………… of those charged with …………… and management concerning the entity's internal ……… and its ……………… in the entity.

attitudes	importance	control	environment	awareness
governance	actions	control		

2 Name two **key** inherent limitations of an internal control system

1 ………………………………………………

2 ………………………………………………

3 Put the controls below in the correct category

Application controls	General controls

One-to-one checking	Virus checks	Hash totals
Segregation of duties	Passwords	Program libraries
Review of master files	Training	Controls over account deletions
Back-up copies	Record counts	Back-up power source

4 Which of the following is not a test of control?

A Inspection of documents

B Re-performance of control procedures

C Observation of controls

D Verification of value to invoice

5 After the controls have been assessed, the audit plan may be modified. True or false?

ANSWERS TO PROGRESS TEST

1 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.

2 Human error

Possibility of staff colluding in fraud

3

Application controls	General controls
One-to-one checking	Virus checks
Hash totals	Program libraries
Review of master files	Segregation of duties
Record counts	Passwords
	Controls over account deletion
	Training
	Back-up power source
	Back-up copies

4 The correct answer is **D**.

5 True

CHAPTER 03

Internal Controls over Specific Business Areas

INTRODUCTION

We discussed tests of controls in the last chapter. In this chapter we will look at how tests of controls might be applied in practice. We will examine each major component of a typical accounting system.

We have already stated that the auditors must establish what the accounting system and the system of internal control consist of. The auditors will then decide which controls, if any, they wish to rely on and plan tests of controls to obtain the audit evidence as to whether such reliance can be warranted, or not. For each of the major transaction systems we will look at the system objectives the auditors will bear in mind while assessing the internal controls and give examples of common controls. We shall then go on to look at a 'standard' programme of tests of controls.

Knowledge Component			
2	**Governance internal control frameworks**		
1.2	**Internal Control Framework**	1.2.2	Analyse design, implementation and operating effectiveness of identified controls

CHAPTER CONTENTS		LEARNING OUTCOME
1	Order-to-receipt cycle	1.2.2
2	Procurement-to-pay cycle	1.2.2
3	Payroll cycle	1.2.2
4	Control over cash management	1.2.2
5	Inventory controls	1.2.2
6	Property, plant and equipment	1.2.2

1 Order-to-receipt cycle

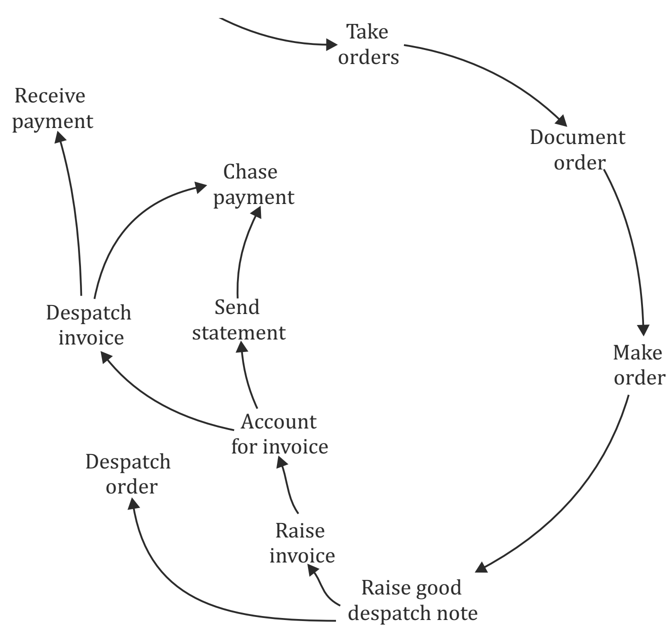
The tests of controls in the **order-to-receipt cycle** will be based around:

- **Selling** (authorisation)
- **Goods outwards** (custody)
- **Accounting** (recording)

The following diagram illustrates the order-to-receipt cycle (also known as the sales system).

Figure 3.1: Order-to-receipt cycle

The order-to-receipt cycle (sales system)



1.1 Control objectives, controls and tests of controls

Table 3.1: Controls, objectives and tests (order-to-receipt)

Assertion	Control objectives	Controls	Tests of controls
Occurrence and existence	• To ensure that one person is not responsible for taking orders, recording sales and receiving payment.	• Segregation of duties.	• Observe and evaluate whether proper segregation of duties is operating.
	• To ensure that recorded sales transactions represent goods or services provided.	• Sales are only recorded if there is an approved sales order form and shipping/despatch documentation.	• For a sample of sales invoices ensure there is a related sales order form that has been authorised, and shipping documentation. • Examine application controls for authorisation.
		• Accounting for numerical sequences of invoices.	• Review and test entity's procedures for accounting for numerical sequences of invoices.

Assertion	Control objectives	Controls	Tests of controls
		• Monthly customer statements sent out and customer queries and complaints handled independently.	• Review entity's procedures for sending out monthly statements and dealing with customer queries and complaints.
	• To ensure that goods and services are only supplied to customers with good credit ratings.	• Authorisation of credit terms to customers (senior staff authorisation, references/credit checks for new customers, regular review of credit limits).	• Review entity's procedures for granting credit to customers.
		• Authorisation by senior staff required for changes in other customer data such as address etc.	• Examine a sample of sales orders for evidence of proper credit approval by the appropriate senior staff member.
		• Orders not accepted unless credit limits reviewed first.	• Examine application controls for credit limits. • Review all new customer files to ensure satisfactory credit references have been obtained.

Assertion	Control objectives	Controls	Tests of controls
	• To ensure that goods and services are provided at authorised prices and on authorised terms. • To ensure that customers are encouraged to pay promptly.	• Authorised price lists and specified terms of trade in place.	• Verify that price lists and terms of trade are properly documented, authorised and communicated. • Examine application controls for authorised prices and terms.
Completeness	• To ensure that all revenue relating to goods dispatched is recorded.	• Accounting for numerical sequences of invoices.	• Review and test entity's procedures for accounting for numerical sequences of invoices.
	• To ensure that all goods and services sold are correctly invoiced.	• Shipping/despatch documentation is matched to sales invoices. • Sales invoices are reconciled to the daily sales report. • An open-order file is maintained and reviewed regularly.	• For a sample of shipping/ despatch documents, ensure each has been matched to a related sales invoice that was subsequently recorded. • Review a sample of reconciliations performed. • Inspect the open-order file for unfilled orders.

Assertion	Control objectives	Controls	Tests of controls
Accuracy	• To ensure that all sales and adjustments are correctly journalised, summarised and posted to the correct accounts.	• Sales invoices and matching documents required for all entries and the date and reference of the entry are written on each document.	• Review supporting documents for a sample of sales entries to ensure they contain the written details that indicate they were referred to when entered.
Cut-off	• To ensure that transactions have been recorded in the correct period.	• All shipping documentation is forwarded to the invoicing section on a daily basis. • Daily invoicing of goods shipped.	• Compare dates on sales invoices with dates of corresponding shipping documentation. • Compare dates on sales invoices with dates recorded in the sales ledger.
Classification	• To ensure that all transactions are properly classified in accounts.	• Chart of accounts (COA) in place and is regularly reviewed for appropriateness and updated where necessary. • Codes in place for different types of products or services.	• Inspect any documentary evidence of review (such as emails requesting update to COA as a result of review) • Test application controls for proper codes.

QUESTION — Sales system

You are the auditor of AB Stationery Ltd, and you have been asked to suggest how audit work should be carried out on the sales system.

AB Stationery Ltd sells stationery to shops. Most sales are to small customers who do not have a sales ledger account. They can collect their purchases and pay by cash. For cash sales:

(a) The customer orders the stationery from the sales department, which raises a pre-numbered multi-copy order form.

(b) The despatch department make up the order and give it to the customer with a copy of the order form.

(c) The customer gives the order form to the cashier who prepares a hand-written sales invoice.

(d) The customer pays the cashier for the goods by cheque or in cash.

(e) The cashier records and banks the cash.

Required

(a) **Analyse** the deficiencies in the cash sales system.

(b) **Design** the systems-based tests you would carry out to audit the controls over the system.

ANSWER

(a) **Deficiencies in the cash sales system**

(i) The physical location of the despatch department and the cashier are not mentioned here, but there is a risk of the customer taking the goods without paying. The customer should pay the cashier on the advice note and return for the goods, which should only be released on sight of the paid invoice.

(ii) There is a failure in segregation of duties in allowing the cashier to both complete the sales invoice and receive the cash as he could perpetrate a fraud by replacing the original invoice with one of lower value and keeping the difference.

(iii) No-one checks the invoices to make sure that the cashier has completed them correctly, for example by using the correct prices and performing calculations correctly.

(iv) The completeness of the sequence of sales invoices cannot be checked unless they are pre-numbered sequentially and the presence of all the invoices is checked by another person. The order forms should also be pre-numbered sequentially.

(v) There is no check that the cashier banks all cash received, and this is a further failure of segregation of duties.

If the sales department prepared and posted the invoices and also posted the cash for cash sales to a sundry sales account, this would solve some of the internal control problems mentioned above. In addition, the sales department could run a weekly check on the account to look for invoices for which no cash had been received. These could then be investigated. Another alternative is to segregate the posting and the checking of this process between departments, for example the sales department posted the invoices and cash, but the accounts department ran the weekly check on the account.

All of these deficiencies, and possible remedies, should be reported to management.

(b) **Tests**

(i) Select a sample of order forms issued to customers during the year. Trace the related sales invoice and check that the details correlate (date, unit amounts etc). The customer should have signed for the goods and this copy should be retained by the despatch department.

(ii) For the sales invoices discovered in the above test, check that the correct order form number is recorded on the invoice, that the prices used are correct (by reference to the prevailing price list).

(iii) Trace the value of the sales invoices to the cash book and from the cash book that the total receipts for the day have been banked and appear promptly on the bank statement.

(iv) Check that the sales invoices have been correctly posted to a cash or sundry sales account. For any sales invoices missing from this account (assuming they are sequentially numbered), trace the cancelled invoice and check that the cancelled invoice was initialled by the customer and replaced by the next invoice in sequence.

(v) Because of the weaknesses in the system, carry out the following sequence checks on large blocks of order forms/invoices, eg four blocks of 100 order forms/invoices.

(1) Inspect all order forms to ensure all present; investigate those missing
(2) Match sales invoices to order forms
(3) Check all sales invoices in a sequence have been used; investigate any missing
(4) Cash for each sales invoice has been entered into the cash book

Using the results of the above tests, decide whether the system for cash sales has operated without material fraud or error. If not satisfied that it has, then this may impact on the audit report.

1.1.1 Failure of controls and business risks

Failure to meet control objectives can lead to increased business risk. Using the example of the sales cycle, some examples include the following:

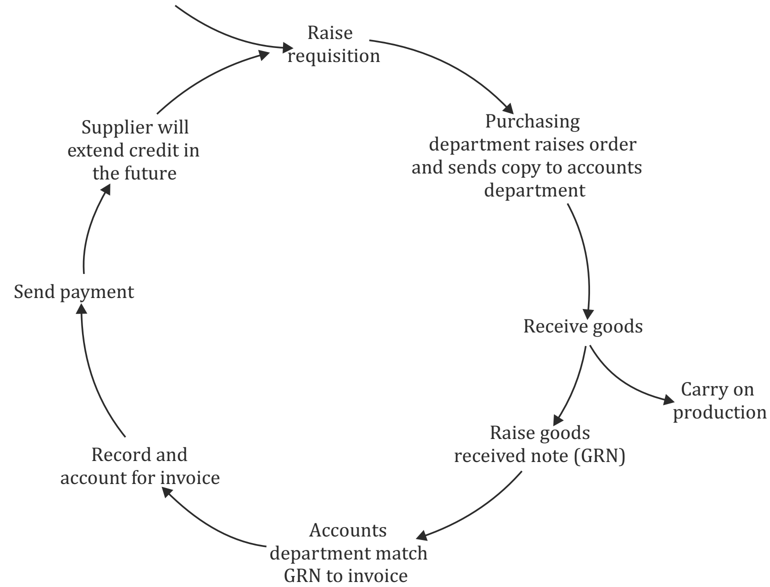
To ensure that recorded sales transactions represent goods or services provided.	If sales are recorded, and therefore customers invoiced when valid sales have not been made, customer goodwill may be lost – resulting in a loss of business.
To ensure that goods and services are only supplied to customers with good credit ratings.	If goods are sold to customers who cannot pay, the business will suffer losses and may not be able to recover the cash or goods.
To ensure that goods and services are provided at authorised prices and on authorised terms.	If sales are not made on the basis of authorised prices, goods may be sold at levels of discount which are not commercially viable, resulting in goods being sold at very low margins or, possibly, at a loss.

2 Procurement-to-pay cycle

The tests of controls in the **procurement-to-pay cycle (purchases system)** will be based around:

- **Buying** (authorisation)
- **Goods inwards** (custody)
- **Accounting** (recording)

Figure 3.2: Procurement-to-pay cycle



2.1 Control objectives, controls and tests of controls

Table 3.2: Controls, objectives and tests (procurement-to-pay)

Assertion	Control objectives	Controls	Tests of controls
Occurrence and existence	• To ensure that recorded purchases represent goods and services received.	• Authorisation procedures and policies in place for ordering goods and services.	• Inspect policies and procedures and enquire about them.
		• Segregation of duties.	• Observe and evaluate segregation of duties.
		• Purchase orders raised for each purchase and authorised by appropriate senior personnel.	• Examine a sample of purchase orders to ensure they have been appropriately authorised. • Review the delegated list of authority for purchases.

Assertion	Control objectives	Controls	Tests of controls
		• Approved purchase order for each receipt of goods.	• For a sample of GRNs, ensure there is a related purchase order and that it has been properly approved.
		• Staff receiving goods check them to the purchase order. • Stores clerks sign for goods received.	• Observe receipt of goods by staff to confirm whether the check is done. • Inspect a sample to confirm whether stores staff undertake this check.
		• Purchase orders and GRNs are matched with the suppliers' invoices.	• Examine supporting documentation to ensure it has been matched for a sample of invoices.
Completeness	• To ensure that all purchase transactions that occurred have been recorded.	• Reconciliation of supplier balances with supplier statements. • Reconciliation of creditor's control account with the sub-ledger. • Regular review of pending purchase orders.	• For a sample of purchase orders in the year ensure each has been matched to a related invoice that was subsequently recorded.

Assertion	Control objectives	Controls	Tests of controls
		• Periodic accounting for pre-numbered GRNs and purchase orders. • Independent check of amount recorded in the purchase journal.	• Review entity's procedures for accounting for pre-numbered documents. • Examine application controls. • Examine documentation for evidence of this check.
Rights and obligations	• To ensure that recorded purchases represent the liabilities of the entity.	• Purchase orders and GRNs are matched with the suppliers' invoices.	• Examine supporting documentation to ensure it has been matched for a sample of invoices.
Accuracy, valuation and allocation, and classification	• To ensure that purchase transactions are correctly recorded in the accounting system.	• Purchase orders and GRNs are matched with the suppliers' invoices. • Mathematical accuracy of the suppliers' invoices is verified • Amount posted to general ledger is reconciled to the purchases ledger. • Chart of accounts in place.	• Examine supporting documentation for a sample of invoices. • Review a sample of invoices for evidence the accuracy has been verified (eg signature or initials) and re-perform the check • Review reconciliations for evidence of this check. • Review purchases journal and general ledger for reasonableness.

Assertion	Control objectives	Controls	Tests of controls
Cut-off	• To ensure that purchase transactions are recorded in the correct accounting period.	• All goods received reports forwarded to accounts payable department daily. • Procedures in place that require recording of purchases as soon as possible after goods/services received.	• Compare dates on reports to dates on relevant vouchers. • Compare dates on vouchers with dates they were recorded in the purchases journal.

QUESTION — Purchase controls

JKL Plc operates a computerised purchase system. Invoices and credit notes are posted to the purchases ledger by the purchases ledger department. The computer subsequently raises a cheque when the invoice has to be paid.

Required

List the controls that should be in operation:

(a) Over the addition, amendment and deletion of suppliers, ensuring that the standing data only includes suppliers from the company's list of authorised suppliers

(b) Over purchase invoices and credit notes, to ensure only authorised purchase invoices and credit notes are posted to the purchase ledger

ANSWER

(a) Controls over the standing data file containing suppliers' details will include the following.

(i) All amendments/additions/deletions to the data should be authorised by a responsible official. A standard form should be used for such changes.

(ii) The amendment forms should be input in batches (with different types of change in different batches), sequentially numbered and recorded in a batch control book so that any gaps in the batch numbers can be investigated. The output produced by the computer should be checked to the input.

(iii) A listing of all such adjustments should automatically be produced by the computer and reviewed by a responsible official, who should also check authorisation.

(iv) A listing of suppliers' accounts on which there has been no movement for a specified period should be produced to allow decisions to be made about possible deletions, thus ensuring that the standing data is current. The buying department manager might also recommend account closures on a periodic basis.

(v) Users should be controlled by use of passwords. This can also be used as a method of controlling those who can amend data.

(vi) Periodic listings of standing data should be produced in order to verify details (for example, addresses) with suppliers' documents (invoices/ statements).

(b) The input of authorised purchase invoices and credit notes should be controlled in the following ways.

(i) Authorisation should be evidenced by the signature of the responsible official such as the Chief Accountant. In addition, the invoice or credit note should show initials to demonstrate that the details have been agreed: to a signed GRN; to a purchase order; to a price list; for additions and extensions.

(ii) There should be adequate segregation of responsibilities between the posting function, inventory custody and receipt, payment of suppliers and changes to standing data.

(iii) Input should be restricted by use of passwords linked to the relevant site number.

(iv) A batch control book should be maintained, recording batches in number sequence. Invoices should be input in batches using pre-numbered batch control sheets. The manually produced invoice total on the batch control sheet should be agreed to the computer-generated total. Credit notes and invoices should be input in separate batches to avoid one being posted as the other.

(v) A program should check calculation of sales tax at standard rate and total of invoice. Non-standard sales tax rates should be highlighted.

(vi) The input of the supplier code should bring up the supplier name for checking by the operator against the invoice.

(vii) Invoices for suppliers which do not have an account should be prevented from being input. Any sundry supplier's account should be very tightly controlled and all entries reviewed in full each month.

(viii) An exception report showing unusual expense allocation (by size or account) should be produced and reviewed by a responsible official. Expenses should be compared to budget and previous years.

(ix) There should be monthly reconciliations of purchase ledger balances to suppliers' statements by someone outside the purchasing (accounting) function.

3 Payroll cycle

Key controls over **payroll** cover:

- **Documentation** and **authorisation** of staff changes
- **Calculation** of wages and salaries
- **Payment** of wages
- **Authorisation** of **deductions**

3.1 Control objectives, controls and tests of controls

Table 3.3: Controls, objectives and tests (payroll cycle)

Assertion	Control objectives	Controls	Tests of controls
Occurrence and existence	• To ensure that payment is made only to bona fide employees of the entity.	• Segregation of duties between HR and payroll functions. • Personnel files held for all employees. • Authorisation procedures for hiring, terminating, time worked, wage rates, overtime, benefits etc. • Any changes in employment status of employees (eg maternity, special leave etc) informed to Human Resources department. • Use of time clocks to record time worked. • Clock cards approved by supervisor.	• Observe and evaluate proper segregation of duties. • Review a sample of starters and leavers in the year to ensure correct documentation is in place. • Review and test authorisation procedures in place. • Review policies and procedures in place for changing status and consider whether adequate. • Review personnel files for a sample of employees whose status changed in the year. • Review of the system generated audit trail against the personnel file.

Assertion	Control objectives	Controls	Tests of controls
		• Adjustments to time clocks, for example an invalid system where only "in" time is automatically recorded, and out time can be varied with employee and employer consent.	• Observe employees' use of time clocks. • Inspect a sample of clock cards for evidence of approval by appropriate level of management. • Review and test procedures for entering and removing employee numbers from the payroll master file.
		• Only employees with valid employee numbers are paid. • Reconciliation of previous month's basic salary and number of employees with those of current month. • Payroll budgets in place and reviewed by management.	• Review budgeting procedures

Assertion	Control objectives	Controls	Tests of controls
Completeness	• To ensure that all payroll costs are recorded for work done by employees.	• Pre-numbered clock cards in use.	• Review numerical sequence of clock cards.
		• Segregation of duties.	• Observe and evaluate proper segregation of duties.
		• Regular reconciliations carried out of payroll records and employee costs recorded in the general ledger.	• Review a sample of reconciliations to ensure they are properly carried out.
		• Comparison of cheques and bank transfer list with payroll to ensure all employees paid have been recorded via payroll.	• Inquire whether comparisons are being made between payment records and payroll and inspect any documentary evidence of the review.
		• Preparation and authorisation of cheques and bank transfer lists	• Examine paid cheques or a certified copy of the bank list for employees paid by cheque or bank transfer to ensure proper authorisation.

Assertion	Control objectives	Controls	Tests of controls
Accuracy, valuation and allocation and classification	• To ensure that all benefits and deductions (tax, pension etc) are computed correctly.	• Re-performance of a sample of payroll benefit and deduction calculations.	• Review documentary evidence that recalculation occurred (eg spreadsheet print out).
		• Payroll budgets in place and reviewed by management.	• Review budgeting procedures.
		• Agreement of gross earnings and total tax deducted with taxation returns.	• Inspect documentation for evidence of management's review.
	• To ensure that payroll transactions are correctly recorded in the accounting system.	• Changes to master payroll file verified through 'before and after' reports.	• Review reconciliation of 'before and after' reports to payroll master file.
		• Payroll master file reconciled to general ledger.	• Review reconciliation of payroll master file to general ledger. Confirm whether discrepancies are followed-up promptly and resolved.

Assertion	Control objectives	Controls	Tests of controls
Cut-off	• To ensure that payroll transactions are recorded in the correct accounting period.	• All starters, leavers, changes to salaries and deductions are reported promptly to payroll department and changes are updated to the payroll master file promptly.	• Review entity's procedures for reporting changes to the payroll department. • Verify sample of starters and leavers.
Presentation	• To ensure that payroll transactions are properly classified in the financial statements.	• Chart of accounts • Independent approval and review of accounts charged to payroll. • Payroll budgets in place and reviewed by management.	• Review chart of accounts. • Review procedures for classifying payroll costs. • Review budgeting procedures.

The following question aims to link the aspects we looked at in Chapter 2 with the control objectives and tests of control we have just looked at.

QUESTION **Payroll controls**

A good understanding of internal controls is essential to auditors. This helps them to understand the business and allows the auditor to effectively plan and execute tests of controls together with an appropriate level of substantive procedures.

A small manufacturing company, Westfield, pays its staff in cash and by bank transfer, and the payroll department consists of a payroll clerk who maintains its payroll on a standalone laptop computer. The payroll clerk is supervised by the chief accountant, who in turn reports to the managing director. You are Westfield's auditor.

Required

(a) For the *payroll department* at Westfield, **outline** the internal control *objectives* that should be in place.

(b) **Evaluate** the internal control *environment* and internal control *activities* that should be in place to achieve the internal control objectives in (a).

(c) Using your answer above, **develop** a control the auditor may seek to rely on when obtaining evidence over 'occurrence and existence' in relation to payroll, and explain why. **Propose** ONE test of control the auditor might carry out to test the operating effectiveness of that control.

ANSWER

(a) **Internal control objectives**

To ensure that:

- Only genuine staff are paid for work performed
- Gross pay has been calculated correctly
- Deductions from gross pay are calculated and recorded accurately
- The correct employees are paid what they are entitled to
- Wages and salaries paid are accurately recorded in the bank and cash records
- The right amounts due in respect of tax and national insurance are paid to the relevant authority on a timely basis

(b) **Internal control environment and control activities**

Internal control environment

The control environment includes the governance and management functions and the attitudes, awareness and actions of management and those charged with governance in terms of the importance of internal control within the business. More specifically it would include the following:

- The way in which management **communicates** to staff the need for integrity and enforces it.
- The consideration which management gives to ensure that the payroll staff have the **requisite skills** and **knowledge** through proper recruitment and training.

- Management's **philosophy** and **operating style,** including the way in which the importance of internal control in the processing of payroll is translated into positive action, for example providing sufficient resources to address security risks regarding access to the computer.
- The way that **authority** and **responsibility** is assigned. For example, the chief accountant might act in a supervisory role whilst the payroll clerk is responsible for the detailed calculations and processing.

Internal control activities

- Responsibility for the preparation of the payroll should be delegated to a responsible, adequately trained member of staff.
- For hourly paid employees, the payroll should be prepared on the basis of timesheets/clockcards authorised by a factory supervisor.
- Standing data used by the computerised payroll system should be checked on a regular basis, eg gross pay to personnel records.
- Any changes should be authorised by the chief accountant, eg change in pay rates, overtime, joiners and leavers.
- For a sample of employees, calculations for gross pay, net pay and deductions should be re-performed by the chief accountant.
- The payroll software should include computerised controls, eg hierarchical password access and range checks. Exception reports should be produced and investigated.
- The managing director should review the payroll by comparing the total monthly cost with the budget and previous month's actual figures.
- The bank transfer list and wage cheque should be authorised by the managing director.
- Cash should be kept securely in the company safe until it is distributed.
- There should be segregation of duties between the member of staff responsible for processing the payroll and the individual handling the cash.
- The chief accountant should maintain and reconcile a wages and salaries control account.
- All changes to any payroll data should be signed off by the human resources manager.

(c) **Occurrence and existence**

The segregation of duties between the member of staff responsible for processing the payroll, and the individual making the bank transfers or cash payments, is a key control in preventing the setting up of bogus employees and diverting funds to a private bank account. The payroll system should be set up so that each person only has access to their own segregated duties. Testing this control will mean that the system and its security will need to be reviewed, and if necessary, amended.

This, therefore, helps fulfil the control objective that only genuine employees are paid and is one control the auditor may seek to test and rely on, to gain evidence in relation to 'occurrence and existence'.

The test of control would simply be to observe and evaluate proper segregation of duties.

4 Control over cash management

Controls over cash receipts and payments should prevent fraud or theft.

4.1 Control objectives, controls and tests of controls

The following table sets out the control objectives, controls and possible tests of controls over **cash payments**. Cash payments in this context covers bank and cash payments, including cheque payments and electronic payments.

Table 3.4: Controls, objectives and tests (cash management)

Assertion	Control objectives	Controls	Tests of controls
Occurrence	• To ensure that only valid payments are made.	• Segregation of duties.	• Observe and evaluate proper segregation of duties.
		• Supplier statements independently reviewed and reconciled to trade payable records.	• Review procedures for reconciling supplier statements.

Assertion	Control objectives	Controls	Tests of controls
		• Monthly bank reconciliations prepared and reviewed. • Only authorised staff can make electronic payments and issue cheques. • Electronic cash payments and cheques prepared only after all source documents have been independently approved. • IOUs are authorised and settled within a stipulated time and monitoring mechanism on settlement in place.	• Review reconciliations to confirm whether undertaken and reviewed. • Review delegated list of authority for cash payments. • Inspect relevant documentation for evidence of approval by senior personnel.
Completeness	• To ensure that all payments that occurred are recorded.	• Segregation of duties. • Supplier statements independently reviewed and reconciled to trade payable records.	• Observe and evaluate proper segregation of duties. • Review procedures for reconciling supplier statements.

Assertion	Control objectives	Controls	Tests of controls
		• Monthly bank reconciliations prepared and reviewed. • Daily reconciliation of petty cash balance with records which is to be approved by the accountant. • Avoid duplicate payments.	• Review authorisation levels and access for payroll vouchers and implement a system where all payroll vouchers are approved. • Review reconciliations to confirm whether undertaken and independently reviewed. • Paid invoices are marked as "paid" to avoid duplicate payments and system controls designed to reject duplicate invoice numbers
		• Review of payments by manager before release. • Daily payments reconciled to posting to payable accounts. • Use of pre-numbered cheques.	• Inspect sample of listings for evidence of senior review. • Review a sample of reconciliations for evidence that they have been done. • Examine evidence of use of pre-numbered cheques.

Assertion	Control objectives	Controls	Tests of controls
Accuracy, valuation and allocation and classification	• To ensure that payments are recorded correctly in the ledger.	• Reconciliation of daily payments report to electronic payment transfers and cheques issued. • Supplier statements reconciled to payable accounts regularly. • Monthly bank reconciliations of bank statements to ledger account.	• Review reconciliation, to ensure performed, reviewed and any discrepancies followed up on a timely basis. • Review authorisation levels and access for payroll vouchers and implement a system where all payroll vouchers are approved. • Review reconciliations for a sample of accounts. • Review bank reconciliation for evidence it was done and independently reviewed.
	• To ensure that payments are posted to the correct payable accounts and to the general ledger.	• Supplier statements reconciled to payable accounts regularly. • Agreement of monthly cash payments journal to general ledger posting.	• Review reconciliations for a sample of accounts. • Review postings from journal to general ledger.

Assertion	Control objectives	Controls	Tests of controls
		• Payable accounts reconciled to general ledger control account.	• Review reconciliation, to ensure performed, reviewed and any discrepancies followed up on a timely basis.
Cut-off	• To ensure that payments are recorded in the correct accounting period.	• Reconciliation of electronic funds transfers and cheques issued with postings to cash payments journal and payable accounts.	• Review reconciliation and check it is carried out regularly.
Presentation	• To ensure that payments are charged to the correct accounts.	• Chart of accounts • Independent approval and review of general ledger account assignment.	• Review cash payments journal to assess reasonableness of charging of accounts. • Review assignment of general ledger account.

The following table sets out the control objectives, controls and possible tests of controls over **cash (bank) receipts**.

Table 3.5: Controls, objectives and tests (cash receipts)

Assertion	Control objectives	Controls	Tests of controls
Occurrence	• To ensure that all valid cash receipts are received and deposited.	• Segregation of duties.	• Observe and evaluate proper segregation of duties.
		• Use of electronic receipts transfer not received or deposited.	• Examine application controls for electronic cash receipts transfer.
		• Monthly bank reconciliations performed and independently reviewed.	• Review monthly bank reconciliations to confirm performed and reviewed.
		• Use of cash registers or point-of-sale devices.	• Observe cash sales procedures.
		• Periodic inspections of cash sales procedures.	• Enquire of managers about results of inspections.
		• Restrictive endorsement of cheques immediately on receipt.	• Observe mail opening, including endorsement of cheques.
		• Mail opened by two staff members.	• Observe mail opening procedures.
		• Immediate preparation of cash book or list of mail receipts.	• Observe preparation of cash receipts' records.

Assertion	Control objectives	Controls	Tests of controls
		• Independent check of agreement of cash/cheques to be deposited at bank with register totals and receipts listing. • Independent check of agreement of bank deposit slip with daily cash summary.	• Review documentation for evidence of independent check. • Review documentation for evidence of independent check.
Completeness	• To ensure that all cash receipts are recorded.	• Segregation of duties. • Use of electronic cash receipts transfer not received or deposited. • Monthly bank reconciliations performed and independently reviewed. • Daily cash receipts listing reconciled with posting to customer accounts.	• Observe and evaluate proper segregation of duties. • Examine application controls for electronic cash receipts transfer. • Review monthly bank reconciliations to confirm performed and reviewed. • Review reconciliation.

Assertion	Control objectives	Controls	Tests of controls
		• Customer statements prepared and sent out on a regular basis.	• Enquire of management about handling of customer statements. • Examine a sample of customers and note frequency of statements.
Accuracy, valuation and allocation and classification	• To ensure that cash receipts are recorded at correct amounts.	• Daily remittance report reconciled to control listing of remittance advices. • Monthly bank statement performed and reviewed independently.	• Review reconciliations. • Review reconciliations for evidence they were performed and independently reviewed.
	• To ensure that cash receipts are posted to correct receivables accounts and to the general ledger.	• Daily remittance report reconciled daily with postings to cash receipts journal and customer accounts. • Monthly customer statements sent out. • Monthly cash receipts journal agreed to general ledger posting. • Receivables' ledger reconciled to control account.	• Review reconciliations. • Review entity's procedures for sending out statements. • Review journal and posting to general ledger. • Review reconciliations.

Assertion	Control objectives	Controls	Tests of controls
Cut-off	• To ensure that cash receipts are recorded in the correct accounting period.	• Bank reconciliation at period-end.	• Review and test reconciliation.
Presentation	• To ensure that cash receipts are charged to the correct accounts.	• Chart of accounts (COA) in place and is regularly reviewed for appropriateness and updated where necessary. • Codes in place for different types of receipts	• Inspect any documentary evidence of review (such as emails requesting update to COA as a result of review) • Test application controls for proper codes.

5 Inventory controls

Inventory controls are designed to ensure safe custody. Such controls include restriction of access, documentation and authorisation of movements, regular **independent inventory counting** and **review of inventory condition**.

5.1 Introduction

The inventory system can be very important in an audit because of the high value of inventory or the complexity of its audit. It is closely connected with the sales and purchases systems covered in the previous sections.

There are three possible approaches to the audit of inventory; the approach chosen depends on the control system in place over inventory.

(a) If the entity has a perpetual inventory system in place where inventory is counted continuously throughout the year, and therefore a year-end count is not undertaken, a controls-based approach can be taken if control risk has been assessed as low.

(b) If an inventory count is to be undertaken near the year-end and adjusted by perpetual inventory records for the year-end value, this approach also requires control risk to be assessed as low.

(c) If inventory quantities will be determined by an inventory count at the year-end date, a largely substantive approach is taken. This approach is covered in Chapter 9.

5.2 Control objectives, controls and tests of controls

Most of the controls testing relating to inventory has been covered in the purchase and sales testing outlined in Sections 1 and 2. Auditors will primarily be concerned at this stage with ensuring that the business keeps track of inventory. To confirm this, tests must be undertaken on how inventory **movements** are **recorded** and how **inventory** is **secured.** Auditors will carry out extensive tests on the **valuation** of inventory at the substantive testing stage (see Chapter 9).

Table 3.6: Controls, objectives and tests (inventory)

Assertion	Control objectives	Controls	Tests of controls
Occurrence and existence	• To ensure that all inventory movements are authorised and recorded.	• Pre-numbered documentation such as GDNs and GRNs in use.	• Review documentation in use.
		• Reconciliations of inventory records with general ledger.	• Review a sample of reconciliations to confirm they are performed and then reviewed by an independent person.
		• Segregation of duties.	• Observe and evaluate proper segregation of duties.
	• To ensure that inventory included on the statement of financial position physically exists.	• Physical safeguards in place to ensure inventory is not stolen. • Separate responsibilities for maintenance of records and custodianship.	• Review security systems in place (eg locked warehouses, CCTV etc). • Review policies and procedures in place; discuss procedures with relevant staff.

Assertion	Control objectives	Controls	Tests of controls
		• Inventory counted regularly.	• Review procedures for counting inventory. • Attend inventory count.
Completeness	• To ensure that all purchases and sales of inventory have been recorded in the accounting system.	• Procedures in place to include inventory held at third parties and exclude inventory held on consignment for third parties. • Reconciliations of accounting records with physical inventory.	• Review entity's procedures relating to consignment inventory. • Review reconciliations performed and whether reviewed by independent person.
Rights and obligations	• To ensure that inventory records only include items that belong to the entity.	• Procedures in place to include inventory held at third parties and exclude inventory held on consignment for third parties.	• Review entity's procedures relating to consignment inventory.
Accuracy, valuation and allocation and classification	• To ensure that inventory quantities have been accurately determined.	• Periodic or annual comparison of inventory with amounts shown in continuous (perpetual) inventory records.	• Review and test entity's procedures for taking physical inventory.

Assertion	Control objectives	Controls	Tests of controls
	• To ensure that inventory is properly stated at the lower of cost and net realisable value.	• Standard costs reviewed by management. • Review of cost accumulation and variance reports. • Inventory managers review inventory regularly to identify slow-moving, obsolete and excess inventory.	• Review and test entity's procedures for developing standard costs. • Inspect variance reports produced. • Discuss with inventory managers how this is done. • Observe the procedure being performed.
Cut-off	• To ensure that all purchases and sales of inventory are recorded in the correct accounting period.	• All despatch documents processed daily to record the despatch of finished goods. • All goods inwards reports processed daily to record the receipt of inventory. • Reconciliations of inventory records with general ledger.	• Inspect documentation to confirm daily processing. • Inspect documentation to confirm daily processing. • Review reconciliations performed.

Assertion	Control objectives	Controls	Tests of controls
Presentation	• To ensure that inventory transactions and balances are properly identified and classified in the financial statements.	• Orders for materials and production data forms used to process goods through manufacturing.	• Review entity's procedures and documentation used to classify inventory.
	• To ensure that disclosures relating to classification and valuation are sufficient.	• Approval by Finance Director	• Review entity's working papers for evidence of review.

6 Property, plant and equipment

When considering property, plant and equipment (PPE) (non-current assets) and subsequent expenditure on the related assets, it is important to assess whether controls are in place to correctly identify and record capital and revenue expenditure. Most of the key controls over capital and revenue expenditure are the general purchase controls.

The nature of a statement of financial position and statement of profit or loss means that it is important to classify capital and revenue expenditure correctly, or profit will be over or understated. You should know the distinction between them from your financial reporting studies.

The controls and tests outlined below are often considered and performed during the audit of non-current assets (see Chapter 8) as this is where the main issue of capitalisation occurs.

6.1 Controls and tests of controls

Table 3.7: Controls, objectives and tests (PPE)

Assertion	Control objectives	Controls	Tests of control
Completeness, accuracy	• To ensure that expenditure is valid.	• Orders for capital items should be authorised by appropriate levels of management. • Order should be requisitioned on appropriate (different to revenue) documentation. • Invoices should be approved by the person who authorised the order. • Invoices should be marked with the appropriate general ledger code.	• Review policies and procedures in place. • Examine a sample of orders for appropriate authorisation. • Inspect invoices to verify the invoice has been appropriately approved. • Inspect invoices to verify the invoice has the correct general ledger code marked on it.
Classification	• To ensure that expenditure is classified correctly in the financial statements as capital or revenue expenditure.	• All the standard controls over purchases are relevant here (see Section 2).	• See Section 2

Assertion	Control objectives	Controls	Tests of control
Completeness, accuracy, valuation	• To ensure that all non-current assets are correctly recorded in the accounting system.	• Capital items should be written up in the non-current asset register. • The non-current asset register should be reconciled regularly to the general ledger and any differences investigated and resolved promptly. • The accounts receivable sub ledger should be reconciled to the general ledger debtors control account. • Process in place to ensure that assets which are ready for use are included in the fixed asset register and depreciated.	• Review reconciliation to ensure it is regularly carried out, reviewed by a more senior person, and that all discrepancies are followed up and resolved on a timely basis. • Account for the numerical sequence of invoices.
		• Proper capitalisation policy in place to judge capital expenditure and evaluate whether subsequent expenditure can be capitalised.	• Check for separate identification of significant components, accounting for major spare parts and overhaul cost.

6.2 Tests of controls and substantive testing

If the ordering documentation is different for capital purchases, all the standard purchase control tests should be carried out. If the documentation is not different, the auditor should also enquire as to the client's system for recording and filing capital invoices.

It is likely that the number of capital purchases in the year will be less than the number of standard purchases in the year; if the invoices are not segregated it may not be cost-efficient to test the controls over this area in which case substantive testing would have to be undertaken.

These substantive tests are often carried out as part of the substantive audit of non-current assets, which is covered in Chapter 8.

The auditor should be aware of the risks attaching to the audit of this area. As tests of controls might not be cost-effective, control risk in this area is higher than it would have been if they were tested.

Inherent risk can also be high in this area. Capital and revenue expenditure is treated differently for the purposes of tax, and if the client is sensitive to the tax bill, there may be an incentive to account creatively.

QUESTION **System control deficiencies**

Jegan is the sole shareholder of LMN Stores, a company which owns five stores. The stores sell mainly food and groceries.

Each store is run by a full-time manager and three or four part-time assistants. Jegan spends on average half a day a week at each store, and spends the rest of his time at home, dealing with his other business interests.

All sales are for cash and are recorded on cash registers, the records of which the manager retains. Shop managers' wages are paid monthly by cheque by Jegan. Wages of shop assistants are paid in cash out of the takings.

Most purchases are made from local wholesalers and are paid for in cash out of the takings. Large purchases (over Rs. 2,500,000) must be made by cheques signed by the shop manager and countersigned by Jegan.

Shop managers bank surplus cash once a week, apart from a float in the till.

All accounting records including the cash book, wages and sales tax records are maintained by the manager. Jegan reviews the weekly bank statements when he visits the shops. He also has a look at inventory to see if inventory levels appear to be about right. All invoices are also kept in a drawer by a manager and marked with a cash book reference, and where appropriate a cheque number when paid.

Required

Evaluate the deficiencies in the control systems of LMN Stores, and how the deficiencies can be remedied.

ANSWER

Deficiencies in the system, and their remedies, are as follows.

Inventory

The shops do not appear to have any inventory movement records. Jegan has also only a very approximate indication of inventory levels. Hence it will be difficult to detect whether inventory levels are too high, or too low with a risk of running out of inventory. Theft of inventory would also be difficult to detect. The company should therefore introduce inventory movement records, detailing values and volumes.

In addition, regular inventory counts should be made either by Jegan or by staff from another shop. Discrepancies between the inventory records and the actual inventory counted should be investigated.

Cash controls

Too much cash appears to be held on site. In addition, the fact that most payments appear to be for cash may mean inadequate documentation is kept. The level of cash on site can be decreased by daily, rather than weekly, banking. In addition, the need for cash on site can be decreased by paying wages by cheque, and by paying all but the smallest payments by cheque.

The cash book should obviously still be maintained but cheque stubs should also show details of amounts paid. The cash book should be supported by invoices and other supporting documentation, and should be cross-referenced to the general ledger (see below).

Cash reconciliations

There is no indication of the till rolls that are kept being reconciled to cash takings.

There should be a daily reconciliation of cash takings and till rolls; this should be reviewed, if not performed by the shop manager.

Bank reconciliations

There is no mention of bank reconciliations taking place.

Bank reconciliations should be carried out at least monthly by the shop manager, and reviewed by the owner.

Purchases

There is no formal system for recording purchases. Invoices do not appear to be filed in any particular way. It would be difficult to see whether accounting records were complete, and hence it would be difficult to prepare a set of accounts from the accounting records available.

In addition, the way records are maintained means that accounts would have to be prepared on a cash basis, and not on an accruals basis.

A purchase day book should be introduced. Invoices should be recorded in the purchase day book, and filed in a logical order: either by date received or by supplier.

General ledger

There is no general ledger, and again this means that annual accounts cannot easily be prepared (and also management accounts).

A general ledger should be maintained with entries made from the cash book, wages records and purchase day book. This will enable accounts to be prepared on an accruals basis.

Supervision

Jegan does not take a very active part in the business, only signing cheques over Rs. 2,500,000, and visiting the shops only half a day each week. This may mean that assets can easily go missing, and Jegan cannot readily see whether the business is performing as he would wish.

Jegan should review wage/sales tax/cash book reconciliations. Management accounts should also be prepared by shop managers for Jegan.

Tutorial note. This question deals with controls that are possible given the circumstances of the business. Greater segregation of duties does not appear to be possible as the shops are small, and Jegan cannot spend more time at the shops (although he can use his time more productively by reviewing reconciliations).

CHAPTER ROUNDUP

- The tests of controls in the **order-to-receipt cycle** (sales system) will be based around:
  - **Selling** (authorisation)
  - **Goods outwards** (custody)
  - **Accounting** (recording)
- The tests of controls in the **procurement-to-pay cycle (purchases system)** will be based around:
  - **Buying** (authorisation)
  - **Goods inwards** (custody)
  - **Accounting** (recording)
- Key controls over **payroll** cover:
  - **Documentation** and **authorisation** of staff changes
  - **Calculation** of wages and salaries
  - **Payment** of wages
  - **Authorisation** of **deductions**
- Controls over cash receipts and payments should prevent fraud or theft.
- **Inventory controls** are designed to ensure safe custody. Such controls include restriction of access, documentation and authorisation of movements, regular **independent inventory counting** and **review of inventory condition**.
- When considering property, plant and equipment (PPE) (non-current assets) and subsequent expenditure on the related assets, it is important to assess whether controls are in place to correctly identify and record capital and revenue expenditure. Most of the key controls over capital and revenue expenditure are the general purchase controls.

PROGRESS TEST

1 Complete the table, putting the order-to-receipt cycle (sales system) control considerations under the correct headings.

Ordering/credit approval	Dispatch/invoicing	Recording/accounting

(a) All sales that have been invoiced have been put in the general ledger
(b) Orders are fulfilled
(c) Cut-off is correct
(d) Goods are only supplied to good credit risks
(e) Goods are correctly invoiced
(f) Customers are encouraged to pay promptly

2 State five controls relating to the ordering and granting of credit process.

1 …………………………………………………..
2 …………………………………………………..
3 …………………………………………………..
4 …………………………………………………..
5 …………………………………………………..

3 Complete the table, putting the procurement-to-pay (purchase system) control considerations under the correct headings.

Ordering	Receipts/invoices	Accounting

(a) Orders are only made to authorised suppliers
(b) Liabilities are recognised for all goods and services received
(c) Orders are made at competitive prices
(d) All expenditure is authorised
(e) Cut-off is correctly applied
(f) Goods and services are only accepted if there is an authorised order

4 (a) State four examples of purchase documentation on which numerical sequence should be checked.

1 ……………………………………………..
2 ……………………………………………..
3 ……………………………………………..
4 ……………………………………………..

(b) Why is numerical sequence checked?

5 State five control objectives relating to inventory.

1 ……………………………………………..
2 ……………………………………………..
3 ……………………………………………..
4 ……………………………………………..
5 ……………………………………………..

6 List five key aims of controls over cash payments and receipts.

1 ………………………………………………………..
2 ………………………………………………………..
3 ………………………………………………………..
4 ………………………………………………………..
5 ………………………………………………………..

7 Give an example of a control which helps to ensure the completeness of non-current assets. Suggest how the auditor can test that the control is operating effectively.

ANSWERS TO PROGRESS TEST

1

Ordering/credit approval	Dispatch/invoicing	Recording/accounting
(b) (d) (f)	(e)	(a) (c)

2
- Segregation of duties; credit control, invoicing and inventory dispatch
- Authorisation of credit terms to customers
  - References/credit checks obtained
  - Authorisation by senior staff
  - Regular review
- Authorisation for changes in other customer data
  - Change of address supported by letterhead
  - Deletion requests supported by evidence balances cleared/customer in liquidation
- Orders only accepted from customers who have no credit problems
- Sequential numbering of blank pre-printed order documents
- Correct prices quoted to customers
- Matching of customer orders with production orders and dispatch notes and querying of orders not matched
- Dealing with customer queries

3

Ordering	Receipts/invoices	Accounting
(a) (c)	(b) (f)	(d) (e)

4 (a) (1) purchase requisitions, (2) purchase orders, (3) goods received notes, (4) goods returned notes, (5) suppliers' invoices

(b) Sequence provides a control that sales are complete. Missing documents should be explained, or cancelled copies available.

5
- To ensure that all inventory movements are authorised and recorded
- To ensure that inventory records only include items that belong to the client
- To ensure that inventory records include inventory that exists and is held by the client
- To ensure that inventory quantities have been recorded correctly

- To ensure that cut-off procedures are properly applied to inventory
- To ensure that inventory is safeguarded against loss, pilferage or damage
- To ensure that the costing system values inventory correctly
- To ensure that allowance is made for slow-moving, obsolete or damaged inventory
- To ensure that levels of inventory held are reasonable

6

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

7 You could have come up with a number of controls that help ensure completeness of non-current assets, but a common one is the regular reconciliation of the non-current asset register with the general ledger, to ensure all items on the register have been recorded. The test of this control would be to obtain a copy of the reconciliation and ensure all discrepancies are followed up and resolved on a timely basis.

Part B -
Audit Planning and Risk Assessment

THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

CHAPTER 04

Agreeing Terms and Risk Assessment

INTRODUCTION

This chapter covers the aspects of the external audit which will be considered at the earliest stages, prior to the start of the audit and during planning.

Firstly we look at agreeing the terms of the engagement and examine the engagement letter before we introduce the concept of risk and look in detail at audit risk and its components (control risk, inherent risk and detection risk) and at how audit risk is managed by the auditor. The distinction between audit risk and business risk is also made.

We discuss the concept of materiality for the financial statements as a whole and performance materiality and the methods used for calculating them. It is important to understand that the calculation of materiality is a matter of judgement and that materiality must be reviewed during the course of the audit and revised if necessary.

The importance of understanding the entity being audited and its environment is a key aspect of audit planning and helps the auditor to identify potential risk areas to focus on. Various techniques can be used here, such as enquiry, analytical procedures, observation and inspection. The risk assessment stage allows the auditor to respond with a proposed audit approach which may be controls-based or totally substantive.

Knowledge Component			
B	**Audit Planning Risk Assessment**		
2.1	**Terms of Engagement**	2.1.1	Explain precondition required to perform an audit of financial statements
2.2	**Overall Audit Strategy**	2.2.1	Demonstrate the importance of overall audit strategy as part of audit planning
2.3	**Risk of Material Misstatement**	2.3.1	Assess risk of material misstatements including risk of frauds to be focused during the audit using risk assessment procedures
2.4	**Materiality**	2.4.1	Apply the concept of materiality in planning and performing the audit
2.5	**Responding to Risk of Material Misstatements**	2.5.1	Outline suitable overall response and further audit procedures for identified risk at financial statement level and assertion level

CHAPTER CONTENTS	LEARNING OUTCOME
1 Agreeing the terms of the audit engagement	2.1.1
2 Introduction to risk	2.3.1
3 Professional scepticism, professional judgement and ethical requirements	2.3.1
4 Audit risk	2.3.1
5 Materiality	2.4.1
6 Understanding the entity and its environment	2.3.1
7 Use of analytical procedures during risk assessment	2.3.1
8 Assessing the risks of material misstatement	2.3.1
9 Responding to the risk assessment and documentation	2.5.1

1 Agreeing the terms of the audit engagement

The **terms** of the audit engagement shall be **agreed** with management and **recorded** in an audit engagement letter.

1.1 Preconditions for an audit

SLAuS 210 *Agreeing the terms of audit engagements* states that the objective of the auditor is to accept or continue an audit engagement only when the basis on which it is to be carried out has been agreed, by establishing whether the **preconditions for an audit** are present and confirming that there is a common understanding between the auditor and management of the terms of the engagement.

The **preconditions for an audit** are the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

To determine whether the preconditions for an audit are present, the auditor shall do the following:

- Determine whether the **financial reporting framework is acceptable**. Factors to consider include the nature of the entity, the purpose of the financial statements, the nature of the financial statements, and whether law or regulation prescribes the applicable financial reporting framework. The financial reporting framework is governed through the Sri Lanka Accounting Standards (SLRFS and LKAS) which are International Financial Reporting Standards (IFRS/IAS) with some modifications.
- Obtain management's agreement that it **acknowledges and understands** its **responsibilities** for the following.
  - **Preparing the financial statements** in accordance with the applicable financial reporting framework
  - **Internal control** that is necessary to enable the preparation of financial statements which are free from material misstatement
  - **Providing the auditor with access to all information** of which management is aware that is relevant to the preparation of the financial statements, with **additional information** that the auditor may request, and with **unrestricted access** to entity staff from whom the auditor determines it necessary to obtain audit evidence

If these preconditions are not present, the auditor shall **discuss** the matter with management. The auditor **shall not accept** the audit engagement if:

- The auditor has determined that the **financial reporting framework** to be applied is **not acceptable**.
- **Management's agreement** referred to above has **not been obtained**.

1.2 The audit engagement letter

The **engagement letter** is the written terms of an engagement in the form of a letter.

The auditor shall agree the terms of the engagement with management or those charged with governance and these shall be recorded in an **audit engagement letter** or other suitable form of written agreement. This has to be done before the audit engagement begins, so as to **avoid misunderstandings** regarding the audit.

1.2.1 Form and content of the audit engagement letter

The audit engagement letter shall include the following:

- The **objective and scope** of the audit
- The **auditor's responsibilities**
- **Management's responsibilities**
- Identification of the **applicable financial reporting framework** for the preparation of the financial statements
- Reference to the **expected form and content of any reports** to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content

1.2.2 Additional matters that may be included

The audit engagement letter may also make reference to the following:

- **Elaboration of scope of audit**, including reference to legislation, regulations, SLAuSs, ethical and other pronouncements
- Form of **any other communication** of results of the engagement
- The fact that due to the inherent limitations of an audit and those of internal control, there is an **unavoidable risk that some material misstatements may not be detected**, even though the audit is properly planned and performed in accordance with SLAuSs
- **Arrangements regarding planning and performance**, including audit team composition
- Expectation that management will provide **written representations**
- **Agreement** of management to provide **draft financial statements** and other information in time to allow auditor to complete the audit in accordance with proposed timetable
- **Agreement** of management to inform auditor of **facts** that may affect the financial statements, of which management may become aware from the date of the auditor's report to the date of issue of the financial statements
- **Fees and billing arrangements**
- Request for management to **acknowledge receipt** of the letter and agree to the terms outlined in it
- Involvement of **other auditors and experts**
- Involvement of **internal auditors and other staff**
- Arrangements to be made with **predecessor auditor**
- Any **restriction of auditor's liability**
- Reference to **any further agreements** between auditor and entity
- Any **obligations to provide audit working papers** to other parties

Appendix 1 of SLAuS 210 includes an example of an audit engagement letter.

1.2.3 Recurring audits

On recurring audits, the auditor shall assess whether the terms of the engagement need to be revised and whether there is a need to remind the entity of the existing terms. The following factors may indicate that it would be appropriate to revise the terms of the engagement or remind the entity of the existing terms.

- Any indication that the entity **misunderstands** the objective and scope of the audit
- Any **revised or special terms** of the audit engagement
- A recent change of **senior management**
- A significant change in **ownership**
- A significant change in **nature or size** of the entity's business
- A change in **legal or regulatory requirements**
- A change in the **financial reporting framework**
- A change in **other reporting requirements**

1.2.4 Acceptance of a change in terms

A change in the terms of audit engagement prior to completion may result from:

(a) A **change in circumstances** affecting the need for the service

(b) A **misunderstanding** as to the nature of an audit or of the related service originally requested

(c) A **restriction on the scope** of the audit engagement, whether imposed by management or caused by circumstances

The auditor shall not agree to a change in the terms of the audit engagement where there is no **reasonable justification** for doing so. In the case of (a) and (b) above, these might be acceptable reasons for requesting a change in the engagement. A change may not be considered reasonable, however, if it seems to relate to information that is incorrect, incomplete or otherwise unsatisfactory. An example would be if the auditor could not obtain sufficient appropriate audit evidence for receivables and is then asked to change the engagement from an audit to a review so as to avoid a modification of the auditor's opinion.

If the auditor is asked to **change** the audit engagement before it is completed, to an engagement providing a **lower level of assurance** such as a review or a related service, the auditor shall determine whether there is **reasonable justification** for doing so because there may be legal or contractual implications.

If the terms are **changed**, the auditor and management shall **agree and record** the new terms in an engagement letter. However, to avoid confusing users, the report on the related service will not include reference to the original audit engagement or any procedures performed in the original audit engagement (unless the engagement is changed to an agreed-upon procedures engagement, where reference to procedures performed is included in the report).

However, if the auditor **cannot agree** to a change of terms, and management does not allow the auditor to carry on with the original audit engagement, the auditor shall **withdraw** from the engagement and determine whether there is an **obligation to report** this to other parties (for example, those charged with governance, owners, regulators).

QUESTION — New auditors

You are a partner in ABC & Co, Chartered Accountants. You are approached by Mr Basnayake, the managing director of N Enterprises Ltd, who asks your firm to become auditors of his company. In return for giving you this appointment Mr Basnayake says that he will expect your firm to waive 50 per cent of your normal fee for the first year's audit. The existing auditors, XYZ & Co, have not resigned but Mr Basnayake informs you that they will not be re-appointed in the future.

Required

(a) **Assess** what action ABC & Co should take in response to the request from Mr Basnayake to reduce their first year's fee by 50 per cent.

(b) **Identify** whether XYZ & Co are within their rights in not resigning when they know Mr Basnayake wishes to replace them. Give reasons for your answer.

ANSWER

(a) The request by Mr Basnayake, that half of the first year's audit fee should be waived, is quite improper. If this proposal were to be accepted it could be held that ABC & Co had sought to procure work through the quoting of lower fees. This would be unethical and could result in disciplinary proceedings being taken against the firm.

Mr Basnayake should be informed that the audit fee will be determined by reference to the work involved in completion of a satisfactory audit, taking into account the nature of the audit tasks involved and the resources required to carry out those tasks in an efficient manner. He should also be told that if he is not prepared to accept an audit fee arrived at in this way and insists on there being a reduction then, regrettably, the nomination to act as auditor will have to be declined.

(b) XYZ & Co have every right not to resign even though they may be aware that Mr Basnayake wishes to replace them. The auditors of a company are appointed by, and report to, the members of a company and the directors are not empowered to remove the auditors. If the reason for the proposed change arises out of a dispute between management and the auditors then the auditors have a right to put forward their views (as seen above) and to insist that any decision should be made by the members, but only once they have been made aware of all pertinent facts concerning the directors' wishes to have them removed from office.

2 Introduction to risk

A **risk assessment** carried out under the SLAuSs helps the auditor to identify the financial statement areas most susceptible to material misstatement and provides a basis for designing and performing further audit procedures.

2.1 The overall objectives of the auditor

At all stages of the audit, including during risk assessment, the auditor must bear in mind what the **overall objectives** are. The full description of the auditor's objectives are given in SLAuS 200 *Overall objectives of the independent auditor and the conduct of an audit in accordance with Sri Lanka Auditing Standards*. This SLAuS states that, in conducting an audit of financial statements, the overall objectives are:

> 'To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SLAuSs, in accordance with the auditor's findings.'

In order to obtain assurance about whether the financial statements are free from material misstatement, the auditor needs to consider how and where misstatements are most likely to arise. A **risk assessment** under the SLAuSs helps the auditor to ensure the key areas more susceptible to material misstatement are adequately investigated and tested during the audit. It also helps the auditor identify low-risk areas where reduced testing may be appropriate, ensuring time is not wasted by over-testing these areas. Risk assessment procedures are considered in more detail in Section 5.

As we discussed in Chapter 2, each SLAuS has its own individual objective followed by requirements and explanatory material.

2.1.1 Conducting the audit in accordance with SLAuSs

Conducting the audit in accordance with SLAuSs and achieving each **individual objective** will allow the auditor to achieve the **overall objective** stated above. Consequently, SLAuS 200 requires that the auditor must **fully understand and comply** with **all** of the SLAuSs relevant to the audit. Furthermore, the auditor must go beyond the requirements in the SLAuS if he or she considers it is necessary to achieve an SLAuS's objective.

In order to achieve the overall objective, auditors also need to plan and perform the audit with **professional scepticism** and apply **professional judgement**, which we look at in detail in the following section.

The SLAuSs also deal with the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific topics. If the auditor does not conduct an audit in accordance with a recognised set of auditing standards (such as the SLAuSs), important responsibilities may not be fulfilled.

Furthermore, the auditor needs to be able to refer to globally recognised standards in the audit report. If all audits are conducted in accordance with standards setting out what is expected of auditors, this means that users of the financial statements should be able to be as confident in one auditor's opinion as another's.

The fact that audits are conducted in accordance with SLAuSs also gives regulators of the audit profession a framework against which to judge auditors. Auditors will be prohibited from undertaking future audit assignments if they are found by the regulators to be conducting audits which do not comply with SLAuSs. The overall effect is that the quality of audit assignments is maintained at a high standard.

3 Professional scepticism, professional judgement and ethical requirements

Auditors are required to carry out the audit with an attitude of **professional scepticism,** exercise **professional judgement** and comply with **ethical requirements**.

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

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

3.1 Professional scepticism

SLAuS 200 states that auditors must plan and perform an audit with an attitude of **professional scepticism**, recognising that circumstances may exist that cause the financial statements to be materially misstated.

Professional scepticism requires the auditor to be alert to:

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

Professional scepticism needs to be maintained throughout the audit to reduce the risks of overlooking unusual transactions, over-generalising when drawing conclusions, and using inappropriate assumptions in determining the nature, timing and extent of audit procedures and evaluating the results of them.

Professional scepticism is also necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses from management and those charged with governance.

3.2 Professional judgement

SLAuS 200 also requires the auditor to exercise **professional judgement** in planning and performing an audit of financial statements. Professional judgement is required in order to audit the following areas:

- Materiality and audit risk
- Nature, timing and extent of audit procedures
- Evaluation of whether sufficient appropriate audit evidence has been obtained

- Evaluating management's judgements in applying the applicable financial reporting framework
- Drawing conclusions based on the audit evidence obtained

2.3 Ethical requirements

SLAuS 200 states that the auditor must comply with the relevant ethical requirements, including those relating to independence, that are relevant to financial statement audit engagements. We discuss professional ethics in Chapter 19 of this Study Text.

CASE STUDY

Amal is auditing the business of Smart Screening, a medium-sized screen-printing and corporate gift company. He notices that the cost of supplying the collateral for screen printing on all office supplies (such as pens and mouse pads) has increased substantially between Year 3 and Year 6.

Amal is busy, and there has only been three days allocated to this audit. However, he is interested in this variance and decides to interrogate the issue further. He discovers a variety of issues including:

- In Year 3 there were three suppliers of office collateral, by Year 6 there was one
- There is no record of a supplier tendering process in the company
- The invoices for the office collateral in the last year are not on file
- All invoices prior to that have been signed off directly by the General Manager. There is no co-signatory.

He decides to commence a formal investigation.

4 Audit risk

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. It is a function of the risk of material misstatement (**inherent risk** and **control risk**) and the risk that the auditor will not detect such misstatement (**detection risk**).

Auditors usually follow a **risk-based approach** to auditing as required by SLAuSs. In this approach, auditors analyse the risks associated with the client's business, transactions and systems which could lead to misstatements in the financial statements, and direct their testing to risky areas.

4.1 How to identify audit risks

A competent auditor needs to be able to identify those risks that may lead to a misstatement in the financial statements. One of the most important things to realise is what makes a risk an **audit** risk (as opposed to a general operational or business risk) is the **link to the financial statements**. If an auditor does not maintain a focus on those risks that may lead to a misstatement in the financial statements, the audit will be a very long process and not at all efficient.

Imagine you are auditing a manufacturing company (XYZ Co with a profit before tax of Rs. 60 million) and the following information comes to light about your client.

"XYZ Co has significant plant and machinery which it uses to make its products. During the year the efficiency of the company's machinery was improved significantly. This was because a comprehensive review of each piece of machinery was undertaken and an assessment was made as to whether a minor repair, extensive refurbishment or a complete replacement was needed. XYZ then took the appropriate action in each case and spent a total of Rs. 15 million in doing so."

From the above you can see management had identified a general (business) risk from their point of view – that the plant and machinery was not efficient enough for the needs of the business. Management has taken what they consider to be the appropriate action by replacing, overhauling or repairing the machinery. There may also be further operational risks arising as a result, such as staff not being used to the new machinery and taking some time to get up to speed.

However an auditor needs to look past these and ask him or herself how the issues above could ultimately lead to a misstatement in the financial statements. This will bring out the **audit risks**. Where will the repairs, refurbishment and new machinery end up in the financial statements and what could go wrong? Where should it end up?

LKAS 16 tells you that the expenditure must generate future economic benefit in order to be included in non-current assets. Other costs that do not meet this criterion should be included as repairs in the statement of profit or loss. In our scenario we appear to have some expenditure on replacement assets, some on extensive refurbishment and some on general repairs.

There is judgement involved here as to whether some of the expenditure is capital or revenue expenditure and the situation is unlikely to be clear cut. Therefore there is a risk that the Rs. 15 million has not been correctly accounted for, and:

- Amounts included in non-current assets might not actually **exist**, as they are really repairs (related assertion is existence of non-current assets).
- The repairs expense may be **incomplete** (or indeed the non-current assets may be incomplete if expenditure of a capital nature has also been included in repairs).

So, if the scenario above came up in the exam one of the audit risks arising is 'Expenditure on repairs is incorrectly recorded as non-current assets, resulting in assets that do not exist being included in the statement of financial position'.

Once the auditor has identified the audit risks, procedures can be put in place in response to that risk. We look again at identifying and assessing risks in the context of the guidance in the relevant SLAuSs in Section 7 of this chapter. We also look in detail at responding to risks in Section 8.

4.2 The procedural approach

The procedural approach is when the auditor performs a set of established and routine tests on the business. These tests are standardised across organisation and industry, and the tests applied are not customised to the client or their business. This means that individual organisational risks are not considered outside of those identified through the standardised procedures. The procedural approach is in direct contrast to the risk-based approach and it is **not in accordance with SLAuSs**. In a procedural approach, the auditor would perform a set of standard tests regardless of the client and its business. The risk of the auditor providing an incorrect opinion on the truth and fairness of the financial statements might be higher if a procedural approach was adopted.

4.3 Overall audit risk

In the previous section we looked at identifying individual risks that could lead to misstatements in the financial statements and we referred to these risks as audit risks. The SLAuSs refer to the individual risks as the risks of material misstatement.

Each of these individual risks can contribute to the **overall audit risk** that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

Now we will consider the concept of the overall audit risk and, in particular, the **audit risk model**. Understanding this model helps the auditor to take action to reduce overall audit risk to an acceptable level. Where we refer to audit risk below we are referring to the overall risk that an inappropriate audit opinion is expressed.

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

Risk of Material Misstatement is the risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

(a) **Inherent Risk** – The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

(b) **Control Risk** – The risk that a misstatement that could occur in an assertion about a class of transaction, any account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Audit risk has **two** major components. One is dependent on the entity, and is the **risk of material misstatement** arising in the financial statements (**inherent risk** and **control risk**). The other is dependent on the auditor, and is the risk that the auditor will not detect material misstatements in the financial statements (**detection risk**). We shall look in detail at the concept of materiality in later in this chapter. Audit risk can be represented by the **audit risk model**:

FORMULA TO LEARN

Audit risk = Inherent risk × control risk × detection risk

4.4 Inherent risk

Inherent risk is the risk that items will be misstated due to the characteristics of those items, such as the fact they are estimates or that they are important items in the accounts. The auditors must use their professional judgement and all available knowledge to assess inherent risk. If no such information or knowledge is available then the inherent risk is **high**.

Inherent risk is affected by the nature of the entity; for example, the industry it is in and the regulations it falls under, and also the nature of the strategies it adopts. We shall look at more examples of inherent risks later in this chapter.

4.5 Control risk

The other element of the risk of material misstatements in the financial statements is control risk.

4.6 Detection risk

Detection risk is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, individually or when aggregated with other misstatements.

The third element of audit risk is detection risk. This is the component of audit risk that the auditors have a degree of control over, because, if risk is too high to be tolerated, the auditors can carry out more work to reduce this aspect of audit risk and, therefore, audit risk as a whole.

One way to decrease detection risk is to increase sample sizes. **Sampling risk** and **non-sampling risk** are components of detection risk, and will be examined further in Chapter 13.

However, increasing sample sizes and carrying out more work is not the only way to manage detection risk. This is because **detection risk is a function of the effectiveness of an audit procedure and of its application** by the auditor.

Although increasing sample sizes or doing more work can help to reduce detection risk, the following actions can also improve the effectiveness and application of procedures and therefore help to reduce detection risk:

- Adequate planning
- Assignment of more experienced personnel to the engagement team
- The application of professional scepticism
- Increased supervision and review of the audit work performed

All of the above reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

4.7 Management of audit risk

SLAuS 200 states that "to obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion."

Auditors will want their overall audit risk to be at an acceptable level, or it will not be worth them carrying out the audit. In other words, if the chance of them giving an inappropriate opinion and being sued is high, it might be better not to do the audit at all.

The auditors will obviously consider how risky a new audit client is during the acceptance process and may decide not to go ahead with the relationship.

However, they will also consider audit risk for each individual audit and will seek to manage the risk.

As we have seen above, it is not in the auditors' power to affect inherent or control risk. These are risks integral to the client, and the auditor cannot change the level of these risks. The auditors, therefore, manage overall audit risk by manipulating detection risk, the only element of audit risk they have control over. This is because the more audit work the auditors carry out, the lower detection risk becomes, although it can never be entirely eliminated due to the inherent limitations of audit. The auditors will decide what level of overall risk is acceptable and then determine a level of audit work so that detection risk is as low as possible.

It is important to understand that there is not a standard level of audit risk which is generally considered by auditors to be acceptable. This is a matter of **audit judgement** and so will vary from firm to firm and audit to audit. Audit firms are likely to charge higher fees for higher-risk clients. Regardless of the risk level of the audit, however, it is vital that audit firms always carry out an audit of **sufficient quality**.

QUESTION — Audit risk

Hippo Ltd is a long-established client of your firm. It manufactures bathroom fittings and fixtures, which it sells to a range of wholesalers, on credit. You are the audit senior and have recently been sent the following extract from the draft statement of financial position by the finance director.

	Budget		*Actual*	
	Rs.'000s	Rs.'000s	Rs.'000s	Rs.'000s
Non-current assets		45,300		36,700
Current assets				
Trade accounts receivable	113,400		97,600	
Bank	–		5,400	
Current liabilities				
Trade accounts payable	96,700		94,400	
Bank overdraft	900		–	

During the course of your conversation with the finance director, you establish that a major new customer the company had included in its budget went bankrupt during the year.

Required

Outline any potential risks for the audit of Hippo and explain why you believe they are risks.

ANSWER

Potential risks relevant to the audit of Hippo

(1) **Credit sales**. Hippo makes sales on credit. This increases the risk that Hippo's sales will not be converted into cash. Trade receivables is likely to be a risky area and the auditors will have to consider what the best evidence that customers are going to pay is likely to be.

(2) **Related industry**. Hippo manufactures bathroom fixtures and fittings. These are sold to wholesalers, but it is possible that Hippo's ultimate market is the building industry. This is a notoriously volatile industry, and Hippo may find that its results fluctuate too, as demand rises and falls. This suspicion is added to by the bankruptcy of the wholesaler in the year. The auditors must be sure that accounts which present Hippo as a viable company are, in fact, correct.

(3) **Controls**. The fact that a major new customer went bankrupt suggests that Hippo did not undertake a very thorough credit check on that customer before agreeing to supply them. This implies that the controls at Hippo may not be very strong.

(4) **Variance**. The actual results are different from budget. This may be explained by the fact that the major customer went bankrupt, or it may reveal that there are other errors and problems in the reported results, or in the original budget.

(5) **Bankrupt wholesaler**. There is a risk that the result reported contains balances due from the bankrupt wholesaler, which are likely to be irrecoverable.

4.8 Business risk approach

The other major category of risk which the auditor should be aware of is **business risk** and this came up earlier when we talked about focusing on risks that impact on the financial statements.

Business risk is the risk inherent to the company in its operations and, as we discussed, the auditor is concerned with those business risks which are, or can lead to, risks of material misstatement in the financial statements.

This 'business risk' approach was developed because it is often the case that the risk of the financial statements being misstated arises predominantly from the business risks of the company.

The table below highlights some of the factors that may exist.

Table 4.1: Implications of principal risks

Principal risk	Immediate financial statement implications
Economic pressures causing reduced unit sales and eroding margins	Inventory values (LKAS 2) Going concern
Economic pressures resulting in demands for extended credit	Receivables recoverability
Product quality issues related to inadequate control over supply chain and transportation damage	Inventory values – net realisable value and inventory returns
Customer dissatisfaction related to inability to meet order requirements	Going concern
Customer dissatisfaction related to invoicing errors and transportation damage	Receivables valuation
Unacceptable service response call rate related to poor product quality	Going concern Litigation – provisions and contingencies Inventory – net realisable value
Out-of-date IT systems affecting management's ability to make informed decisions	Anywhere

The business risk audit approach tries to mirror the risk management steps that have been taken by the directors. In this way, the auditor will **seek to establish that the financial statement objectives have been met**, through an investigation into whether all the other business objectives have been met by the directors.

This approach to the audit has been called a **'top-down' approach**, because it starts at the business and its objectives, and works back down to the financial statements – rather than working up from the financial statements, which has historically been the approach to audit.

The other key element of a business risk approach is that as it is focused on the business more fully, rather than the financial statements, there is greater opportunity for the auditor to add value to the client's business and to assist in managing the risks that the business faces.

4.8.1 Advantages of business risk approach

There are a number of reasons why firms may adopt the business risk approach prefer it to historic approaches:

- Added value is given to clients, as the approach focuses on the business as a whole
- Audit attention focused on high-level controls, with extensive use of analytical procedures, increases audit efficiency and therefore reduces cost
- Does not focus on merely routine processes, which technological developments have rendered less prone to error than has historically been the case
- Responds to the importance placed by regulators and the government on corporate governance
- Lower engagement risk (risk of auditor being sued) as a result of broader understanding of the client's business and practices.

QUESTION **Business risks**

As audit senior, you have recently attended a meeting with the managing director of BigMall Ltd (audit client) and the new audit partner assigned to the audit, Nipun Rajapakse, who has recently joined your firm. The audit partner is familiarising himself with the client.

BigMall Ltd is a large limited liability building company set up by Kasun Corea, who has been managing director since incorporation. It purchases land in and around major towns and builds retail parks and shopping malls, which the company then manages. You are familiar with the client, as you have taken part in the audit for the last three years. The other key member of the board is Clarice Singhe, who set up the business with Kasun Corea and is finance director. Clarice is a qualified accountant, and the accounting systems and procedures at BigMall Ltd have always appeared sound.

You took minutes of the meeting, which are given below.

Minutes of a meeting between Nipun Rajapakse and Kasun Corea, 30 March 20X2

NR introduced himself to KC and asked for a brief history of the business, which was given. Currently, the majority of income is from the property management side, as the building market is becoming saturated. With interest rates set to rise, KC is less keen to borrow and build in the current climate.

NR asked KC whether a recent spate of terrorist bomb attacks in malls in tourist areas had had any effect on business. KC commented that he had been given the impression that retail was down and that customers were staying away from the retail centres – but he felt that some of that could be attributed to a rise in interest rates and was likely to be temporary. First months of the year are always poor for retail …

NR asked whether there had been a rise in empty units in the retail centres and malls. KC said there had been a small rise.

NR asked KC about his views in relation to the current proposed legislation before the government concerning quality standards in the building trade. KC commented that it seemed like a 'load of nonsense' to him, and expressed some dissatisfaction with the current political situation… NR pressed the matter, enquiring as to KC's opinion on the likely effects on his business if more stringent standards were to be required in the future. KC is of the firm belief that it would not be passed. NR expressed his fear that the legislation was more than likely to be passed, and would have far-reaching and expensive effects on most builders in the country. KC repeated some of his previous comments about politicians.

NR enquired as to whether there were any anticipated developments in the business, which he should know about. KC made reference to CS's plans to retire from full-time work in the business. NR asked how KC was going to replace her. KC commented that he was hoping to persuade her to stay on as she deals with all the financial side, and he'd be lost without her. NR tried to enquire how firm her retirement plans were, but KC was not forthcoming.

After the meeting, Nipun Rajapakse asked you to ring Clarice and discuss her plans. She confirmed that she does plan to retire. She informed you that she plans to emigrate to Australia, and is not keen to put back her plans. She asked about the possibility of your firm assisting in the recruitment process for her replacement, as she does not feel that Kasun Corea has the technical ability to recruit someone without her, and has not accepted her plans enough to recruit before her retirement. She said that she has even wondered about the possibility of someone being seconded to the company from your firm to cover her position after she has left and before her replacement is found.

Nipun is keen to reappraise the audit strategy taken towards the audit of BigMall, as he feels the audit could be conducted more efficiently than it has in the past. Historically the audit has been highly substantive.

Required

(a) **Discuss** the key business risks that exist at BigMall

(b) **Outline** what is meant by the 'business risk approach' to an audit

(c) **Propose** and justify a strategy for the audit of BigMall

(d) **Analyse** the ethical implications for the audit of the two suggestions made by Clarice.

ANSWER

(a) **Key business risks at BigMall**

Operational – industry

The building industry is generally considered to be a volatile industry and sensitive to changes in economic climate. The managing director has identified that the particular market that the company operates in, retail parks and shopping malls, has become saturated. BigMall's business is therefore likely to be volatile generally and the market for the services BigMall provides is saturated. This is an operational risk – what will BigMall do if it does not do what it has done historically?

The company is not only strongly connected with the building industry, but also the retail industry. This is another industry that is volatile. It has recently been affected by higher interest rates and reduced consumer spending. It has also suffered due to the bomb threats made against retail parks, which have discouraged consumers from shopping.

Operational – personnel

The business is about to lose a key member of personnel on the financial side, and there appear to be no current plans to replace her. This could severely affect systems in the finance department, which could have a knock-on effect on crucial supplier and customer relations and, hence, the operations of the wider business.

Finance

It is likely that BigMall has a **high level of borrowings secured** on the buildings that they have built and now manage. If this is the case, the **increase in interest rates** will adversely affect their business directly in the form of **interest** on these loans. This may be particularly severe if they have over-borrowed when interest rates were low.

Compliance

There is currently legislation before the government that is likely to have far-reaching effects on the operations of BigMall's building arm. The law relates to quality standards in the building industry and is likely to be costly to implement. It is possible that BigMall will struggle to **afford to implement such standards**. An even more significant concern is that it appears that the director has taken **no steps to mitigate this risk** and has put **no action plans into place** to ensure that the law would be complied with, if passed. This could mean that the company could be liable to legal action and fines.

(b) **Business risk approach**

The business risk approach is an extension of the audit risk approach. When using an audit risk approach, the auditors focus their attention on matters that they feel are the most significantly risky to the financial statements so that they can provide a cost-effective audit.

The audit risk approach concentrates on three areas of risk: inherent risk, control risk and detection risk.

In a business risk approach, the auditors determine that the risks that are most likely to adversely affect the financial statements are the business risks of the company, hence they direct their testing to the business risks apparent in the business.

This can be illustrated in the given scenario by looking at the significant links between the business risks identified and the financial statements.

Table 4.2: Links between business risks and financial statements

Operational – industry	
Volatile industry	Significant issues relating to **going concern** arising, auditors should direct their audit work in this area.
Retail units affected by bomb threats	Potential issues relating to **receivables' recoverability**. Retail units/shops may not be able to pay rent/honour leases if they are not receiving sufficient income from sales. The potential fall in income related to the retail units could affect the valuation **of tangible non-current assets** – is there a need for an impairment review?

Operational – personnel	
Loss of FD	This could have a significant impact on the **calculation and presentation of the financial statements** if they are now drafted by an inexperienced person. There is also a significant impact on the **control environment**, which will affect assessment of control risk.
Finance	
Interest rates	The issues relating to high interest rates will affect the **interest figure** in the statement of profit or loss. It may also affect the **going concern** assumption.
Compliance	
New law	Depending on the timing of the new legislation and the outcomes discussed above, this could affect **events after the reporting period**, contingencies or **provisions**. It could also potentially affect going concern.

(c) **Audit strategy**

The audit strategy will depend on certain matters such as the date when Clarice Singhe leaves the business. Assuming that she leaves after the audit, a **business risk approach** would be appropriate.

This is because business risks have already been identified, and, as outlined above, there are **significant links between the business risks and the financial statements.**

The **control environment has historically been strong**, so making use of controls testing would appear to be appropriate. This in particular is highly dependent on the presence of Clarice Singhe at the audit date.

The **audit senior** has **experience** of the client and significant **knowledge** of the business therefore it seems appropriate given this, that a high use be made of **analytical procedures**. It also appears that strong explanations will be available for movements on accounts over the period. Again, this is dependent on the presence of Clarice Singhe.

Lastly, the business risk approach is considered an **efficient approach** as it uses 'top-down' procedures, so as strong evidence appears to be available, it is sensible to take the most efficient approach possible, while ensuring that a quality audit is conducted.

(d) **Ethical implications**

(i) *Recruitment*

It is very important that the audit firm does not take management decisions on behalf of the entity. Hence it would be appropriate for it to take an advisory role in the recruitment process, perhaps reviewing CVs and advising as to qualifications and factors to look for. However, it should not get heavily involved in the interviewing process, as this could lead it to, in effect, making management decisions on behalf of the directors.

(ii) *Secondment*

If a staff member of the audit firm is to be seconded to the audit client to work in this significant role, the firm would have to be very clear that there were boundaries in place between that staff member and the audit team. This may, in practice, be impossible.

However, provided that objectivity can be retained for the audit team and that there is not a problem of familiarity, a secondment might be appropriate.

A problem of familiarity could arise if:

- The person seconded had previously worked on the audit and the strategy and approach were not changed; or
- The audit team were familiar with the person seconded and had a personal relationship with him that presented a significant risk to objectivity.

5 Materiality

Materiality for the financial statements as a whole and **performance materiality** must be calculated at the planning stages of all audits. The calculation or estimation of materiality should be based on experience and judgement. Materiality for the financial statements as a whole must be **reviewed throughout** the audit and **revised if necessary**.

SLAuS 320 *Materiality in planning and performing an audit* provides guidance to auditors in this area and states the objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

SLAuS 320 does not define materiality (in relation to the financial statements as a whole) but notes that, whilst it may be discussed in different terms by different financial reporting frameworks, the following are generally the case:

(a) Misstatements are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users

(b) Judgements about materiality are made in the light of surrounding circumstances, and are affected by the size and nature of a misstatement or a combination of both

(c) Judgements about matters that are material to users of financial statements are based on a consideration of the common financial information needs of users as a group

The practical implication of this is that the auditor must be concerned with identifying 'material' errors, omissions and misstatements. Both the amount (quantity) and nature (quality) of misstatements need to be considered; for example, a lack of disclosure regarding ongoing litigation is likely to be considered material.

Some misstatements may fall under specified benchmarks, but are still considered material overall due to their qualitative effects.

Magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, may not be a sufficient basis for a materiality judgment. As a result, qualitative factors may cause misstatements of quantitatively small amounts to be material.

Examples of this are given SLAuS 320:

- Law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related-party transactions, and the remuneration of management and those charged with governance).
- Some disclosures are key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company)
- Attention is sometimes focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).

Materiality will always be a matter of judgement and will depend on the level of audit risk. The higher the anticipated risk, the lower the value of materiality will be.

The materiality level will impact on the auditors' decisions relating to:

- How many items to examine
- Which items to examine
- Whether to use sampling techniques
- What level of misstatement is likely to result in a modified audit opinion

5.1 Determining and calculating materiality and performance materiality when planning the audit

During planning, the auditor must establish materiality for the **financial statements as a whole,** but must also set **performance materiality** levels.

5.1.1 Materiality for the financial statements as a whole

Determining **materiality for the financial statements as a whole** involves the exercise of professional judgement (which we covered in Section 5 of this chapter). Generally, a percentage is applied to a chosen benchmark as a starting point for determining materiality for the financial statements as a whole. The following factors may affect the identification of an appropriate benchmark:

- **Elements** of the financial statements (eg assets, liabilities, equity, revenue, expenses)
- Whether there are items on which **users tend to focus**
- **Nature of the entity**, **industry** and **economic environment**
- Entity's **ownership structure and financing**
- Relative **volatility** of the benchmark

The following **benchmarks and percentages** may be appropriate in the calculation of materiality for the financial statements as a whole.

Value	%
Profit before tax	5
Gross profit	½ – 1
Revenue	½ – 1
Total assets	1 – 2
Net assets	2 – 5
Profit after tax	5 – 10

Which benchmark or benchmarks are appropriate will depend on the nature of the business being audited.

The percentage guidelines of assets and profits that are commonly used for materiality must be handled with care. The auditor must bear in mind the **focus** of the company being audited.

In some companies, **post-tax profit** is the key figure in the financial statements, as the level of dividend is the most important factor in the accounts.

In **owner-managed businesses**, if owners are paid a salary and are indifferent to dividends, the key profit figure stands higher in the statement of profit or loss, say at **gross profit** level. Alternatively, in this situation, the auditor should consider a figure that does not appear in the statement of profit or loss: **profit before directors' salaries and benefits**.

Some companies are **driven by assets** rather than the need for profits. In such examples, higher materiality might need to be applied to assets. In some companies, say charities, **costs** are the driving factor, and materiality might be considered in relation to these.

While rules or guidelines are helpful to auditors when assessing materiality, they must always keep in mind the **nature** of the business they are dealing with. Materiality must be **tailored to the business and the anticipated user** of financial statements, or it is not truly materiality. Refer back to the definition of materiality and consider **all the elements** of it.

5.1.2 Performance materiality

Consider what would happen if this materiality for the financial statements as a whole was applied directly to, for example, different account balances (such as receivables, inventory etc). It could be that a number of balances (or elements making up those balances) are untested or dismissed on the grounds they are immaterial. However, a number of errors or misstatements could exist in those untested balances, and these could aggregate to a material misstatement.

For this reason the auditor is required to set **performance materiality** levels, which are lower than the materiality for the financial statements as a whole and this means a lower threshold is applied during testing. The risk of misstatements which could add up to a material misstatement is therefore reduced.

As we can see below, performance materiality really has two definitions (taken from SLAuS 320).

Performance materiality is the amount or amounts 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 financial statements as a whole. statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

This indicates that the auditor sets a level or levels of materiality lower than overall materiality for the purposes of performing procedures in general (for example on a low-risk area) and this is just to account for aggregation. However, an even lower level is set for certain balances, transactions or disclosures where there is an increased risk or if qualitative considerations (discussed below) necessitate it.

As you can see, determining performance materiality is very much dependent on the auditor's professional judgement. In summary is affected by

- The nature and extent of misstatements identified in prior audits.
- The auditor's understanding of the entity
- Result of risk assessment procedures.

5.2 Revision of materiality

The level of materiality must be revised for the financial statements as a whole if the auditor becomes aware of information during the audit that would have caused the auditor to have determined a different amount during planning.

If the auditor concludes that a lower amount of materiality for the financial statements as a whole is appropriate, the auditor must determine whether performance materiality also needs to be revised, and whether the nature, timing and extent of further audit procedures are still appropriate. A revision to materiality might be required, for example, if during the audit it appears that actual results are going to be significantly different from the expected results, which were used to calculate materiality for the financial statements as a whole during planning.

5.3 Documentation of materiality

SLAuS 320 requires the following to be documented:

- Materiality for the financial statements as a whole
- Materiality level or levels for particular classes of transactions, account balances or disclosures if applicable
- Performance materiality
- Any revision of the above as the audit progresses

6 Understanding the entity and its environment

The auditor is required to obtain an **understanding** of the entity and its environment in order to be able to assess the risks of material misstatements.

6.1 Why do we need an understanding?

SLAuS 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* states that the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

The following table summarises this simply.

Table 4.3: Understanding of the entity

Obtaining an understanding of the entity and its environment	
Why?	– To identify and assess the risks of material misstatement in the financial statements – To enable the auditor to design and perform further audit procedures – To provide a frame of reference for exercising audit judgement, for example, when setting audit materiality
What?	– Industry, regulatory and other external factors, including the applicable financial reporting framework – Nature of the entity, including operations, ownership and governance, investments, structure and financing – Entity's selection and application of accounting policies – Objectives and strategies and related business risks that might cause material misstatement in the financial statements – Measurement and review of the entity's financial performance – Internal control (which we looked at in Chapter 2)

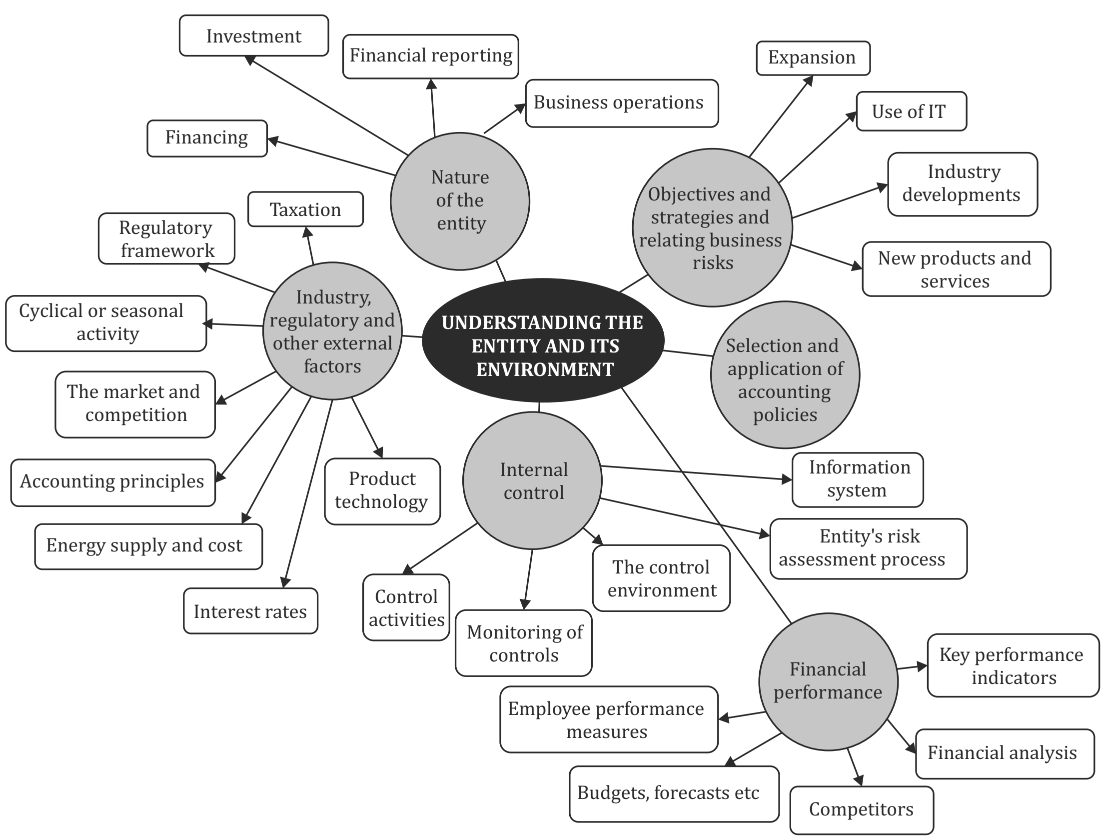
Obtaining an understanding of the entity and its environment	
How?	– Enquiries of management, appropriate individuals within the internal audit function and others within the entity – Analytical procedures – Observation and inspection – Prior period knowledge – Client acceptance or continuance process – Discussion by the audit team of the susceptibility of the financial statements to material misstatement – Information from other engagements undertaken for the entity

As can be seen in the table, the reasons the auditor has to obtain an understanding of the entity and its environment are very much bound up with assessing risks and exercising audit judgement.

6.2 What do we need an understanding of?

The SLAuS sets out a number of requirements about what the auditors shall consider in relation to obtaining an understanding of the business. The general areas are shown in the following diagram.

Figure 4.1: Understanding the entity



6.3 How do we gain an understanding?

SLAuS 315 sets out the methods that the auditor shall use to obtain the understanding and they were shown in the table in Section 6.1. In addition to the sources shown in the diagram above, the auditor will refer to the following to help in obtaining an understanding of the entity and its environment:

- The **permanent audit file** where information of continuing importance to the audit is kept
- Audit working papers from the **previous year's audit file**
- Information from the **client's website**
- **Publications or websites related to the industry** the client operates in

6.4 Risk assessment procedures

A combination of the following procedures should be used as risk assessment procedures:

- **Enquiries** of management, internal auditors and others within the entity
- **Analytical procedures** (see Section 6)
- **Observation** and **inspection**

SLAuS 315 also states the auditor shall consider whether information obtained from client acceptance or continuance processes is relevant.

If the engagement partner has performed other engagements for the entity, they shall consider whether information from these is relevant to identifying risks of material misstatement.

SLAuS 315 states that if the auditor is going to use information from prior year audits, the auditor shall determine whether changes have occurred that could affect the relevance to the current year's audit.

SLAuS 315 also requires the engagement partner and other key team members to discuss the susceptibility of the financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine what matters are to be communicated to team members not involved in the discussion.

6.4.1 Enquiry

The auditors will usually obtain most of the information they require from staff in the accounts department, but may also need to make enquiries of other personnel, for example production staff or those charged with governance.

Those charged with governance may give insight into the environment in which the financial statements are prepared. In-house legal counsel may help with understanding matters such as outstanding litigation, or compliance with laws and regulations. Sales and marketing personnel may give information about marketing strategies and sales trends.

If the client has an internal audit function, enquiries should be made of internal auditors as appropriate as part of risk assessment procedures.

6.4.2 Observation and inspection

These techniques are likely to confirm the answers made to enquiries made of management. They will include observing the normal operations of a company, reading documents or manuals relating to the client's operations or visiting premises and meeting staff.

7 Use of analytical procedures during risk assessment

Analytical procedures must be used as risk assessment procedures.

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

Analytical procedures can be used at all stages of the audit. SLAuS 315 requires their use during the risk assessment stage of the audit. Their use during other stages of the audit is considered in Chapters 7 and 15.

Analytical procedures include:

(a) The consideration of comparisons with:

- **Similar information** for prior periods
- **Anticipated results** of the entity, from budgets or forecasts
- **Predictions** prepared by the auditors
- **Industry information**

(b) Those between elements of financial information that are expected to conform to a predicted pattern based on the entity's experience, such as the relationship of gross profit to sales.

(c) Those between financial information and relevant non-financial information, such as the relationship of payroll costs to number of employees.

A variety of methods can be used to perform the procedures discussed above, ranging from **simple comparisons** to **complex analysis** using statistics, on a company level, branch level or individual account level. **Ratio analysis** can be a useful technique when carrying out analytical procedures. We consider ratio analysis in Chapter 7 which considers analytical procedures as a form of substantive procedures when collecting audit evidence. Ratio analysis can also be used when applying analytical procedures at the risk assessment stage.

The choice of procedures is a matter for the auditors' professional judgement. The use of information technology may be extensive when carrying out analytical procedures during risk assessment.

Auditors may also use specific industry information or general knowledge of current industry conditions to assess the client's performance.

As well as helping to determine the nature, timing and extent of other audit procedures, such analytical procedures may also indicate aspects of the business of which the auditors were previously unaware. Auditors are looking to see if developments in the client's business have had the expected effects. They will be particularly interested in changes in audit areas where problems have occurred in the past.

Analytical procedures at the risk assessment stage of the audit are usually based on interim financial information, budgets or management accounts.

QUESTION **Analytical procedure**

You are auditing the financial statements of PQR Ltd for the year ended 31 March 20X9. PQR Ltd is a chain of bakeries operating in five locations. The bakeries sell a range of cakes, pastries, bread, sandwiches, pasties and drinks which customers purchase in cash. The company has had a 'challenging' year, according to its directors, and is renegotiating its bank overdraft facility with its bank. The statement of profit or loss for the year ended 31 March 20X8 is shown below together with the draft statement of profit or loss for the year ended 31 March 20X9.

PQR Ltd: Statements of profit or loss

	31 March 20X9	**31 March 20X8**
	Rs.000	**Rs.000**
Revenue	4,205	3,764
Cost of sales	(1,376)	(1,555)
Gross profit	2,829	2,209
Operating expenses		
Administration	(667)	(798)
Selling and distribution	(423)	(460)
Interest payable	(50)	(49)
Profit/(loss) before tax	1,689	902

Required

As part of your risk assessment procedures for the audit of PQR Ltd, **perform** analytical procedures on the draft statement of profit or loss to identify possible risk areas requiring further audit work.

ANSWER

In total, PQR's profit for the year has increased by 87% which appears at odds with the revenue figure, which has only increased by 12% in comparison to the previous year. This may indicate that revenue has been inflated or incorrect cut-off applied, especially given the fact that the directors of PQR have described the year as 'challenging'.

Revenue has increased overall by 12% but cost of sales has fallen by 12% – we would expect an increase in revenue to be matched by a corresponding increase in cost of sales. Again this may indicate incorrect allocation of revenue in order for the bank to look favourably on the company and increase its overdraft facility. It could also indicate an error in the valuation of closing inventory.

The gross profit has increased by 28% compared to the previous period. The audit will need to focus on this change which is significant, focusing on the revenue and costs of sales figures to establish the reasons for the increase.

Administration expenses have fallen in comparison to the previous year (decrease of 16%) which is unusual given that revenue has increased by 12%. We would expect an increase in costs to be in line with the increase in the revenue figure. This could indicate that expenses may be understated through incorrect cut-off or incorrectly capitalising expenditure which should be written off to the statement of profit or loss for the year.

A similar issue applies to selling and distribution costs which have fallen by 8% – they have not increased as expected in line with revenue. There could be legitimate reasons for the change but this area needs to be investigated further during the audit fieldwork stage.

Interest payable has stayed in line with the previous year (increase of 2%). This figure can be verified easily during the audit fieldwork by inspecting bank statements and other relevant documentation from the bank.

8 Assessing the risks of material misstatement

When the auditor has obtained an understanding of the entity, he shall assess the risks of material misstatement in the financial statements, also identifying significant risks.

8.1 Identifying and assessing the risks of material misstatement

SLAuS 315 requires the auditor to identify and assess the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances and disclosures.

It requires the auditor to take the following steps:

- Identify risks throughout the process of obtaining an understanding of the entity and its environment
- Assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole
- Relate the risks to what can go wrong at the assertion level
- Consider the likelihood of misstatement

Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. For example, risks at the financial statement level may derive from a deficient control environment, including management override of internal control or management's lack of competence. These do not increase the risk associated with a particular balance but potentially affect many or all the balances in the financial statement. SLAuS 315 also states that financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

The overall response to risk of material misstatement at the financial statement level will be dependent on the reason for the risk arising. In general these types of risk will arise due to risk of **fraud, control weakness or going concern** uncertainty. The overall response therefore will be slightly different depending on which of these has been identified as a risk.

When the auditor has identified an increased risk of material misstatement due to **fraud** the overall response will include:

- Increasing the level of **professional scepticism**, corroboration and reliability of evidence.
- Making the selection of procedures more **unpredictable** to reduce the likelihood of client personnel predicting those performed.

- Consider whether there is any **bias** in management selection of accounting policies.
- Ensure that the audit team have the requisite level of knowledge and skill to undertake the tasks assigned given the new level of risk.

If the risk of material misstatement at the financial statement level relates to **control weakness**, then there will be a slightly different response with the requirement for an emphasis on **professional scepticism**, adequate **supervision** of **experienced** staff and **modification of procedures** to ensure reliable evidence is generated. It is also important to increase the **unpredictability** of testing in this situation.

In the case of **going concern** the auditor will be more focused on **assessment of management's assumptions** and the **reliability** of data used, any events that occurred since those assumptions were made as well as **specific procedures** related to the circumstances.

e.g.

Example: Risk of Fraud

You have been part of the audit team that has audited Favis Co for the last 3 years and the current audit is in the planning stage for the year ended 31 December 20X0. A junior auditor that joined the team this year discovered, when discussing the controls over cash handling with the audit client staff, that there are many times when the required controls are not actually implemented leading to the potential misappropriation of cash during the counting and banking process. This discovery has also led to other staff members voicing concerns over the process for paying suppliers and for paying staff expenses where some suspect there may have been fraudulent payments made.

Required

What should the overall response of the audit team be to the discoveries outlined above?

Solution

The discovery of the potential for fraud in the cash handling procedures combined with the further information provided by staff relating to other areas of the financial reporting system means that there is a pervasive risk of fraud in the financial statements as a whole relating to many assertions.

The overall response of the auditor will be to firstly ensure that audit staff with the requisite level of knowledge and experience are put in charge of auditing the high-risk areas such as cash handling. This is currently being undertaken by a junior auditor with little experience who should be supervised closely by a more senior member of staff or assigned to a lower risk area with a more senior auditor put in charge of this area.

The audit team will also need to incorporate unpredictability into their selection procedures across the audit from this point. The team have audited the client for the last 3 years so it may be that the same procedures are being used now as in previous years. There is potential here for client staff who are aware of what these procedures are to be able to conduct fraudulent activity in a way that avoids detection by the usual tests carried out. It is important, therefore, that this element of predictability is removed.

There will also be a need for increase professional scepticism across the audit team, requiring evidence to be corroborated by multiple sources where possible and endeavouring to obtain the most reliable evidence possible throughout the audit.

Assertions are representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditors to consider the different types of potential misstatements that may occur. We look at these and risk at the assertion level in detail in Chapter 7.

8.2 Significant risks

Significant risks are complex or unusual transactions that may indicate fraud, or other special risks.

Significant risks are those that require special audit consideration.

As part of the risk assessment described above, the auditor shall determine whether any of the risks are **significant risks**.

The auditor is required to exercise professional scepticism and professional judgement to decide whether a risk is significant. When using professional judgement to determine the severity of a risk, the auditor needs to examine the likelihood of the risk occurring, and the seriousness of the risk event on business operations. The following factors need to be considered:

- Whether the risk is related to recent significant economic, accounting or other developments, and therefore requires special audit consideration.
- The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty.
- If the risk involves a significant transaction with a related party in the normal course of business.

- The complexity of the transaction.
- If the risk involves a significant transaction which is outside the normal course of business for the entity, or which otherwise appear to be unusual.

Routine, non-complex transactions are less likely to give rise to significant risk than unusual transactions or matters of management judgement. This is because unusual transactions are likely to have more:

- Management intervention
- Complex accounting principles or calculations
- Manual intervention
- Opportunity for control procedures not to be followed

When the auditor identifies a significant risk, if he has not done so already, he shall obtain an understanding of the entity's controls relevant to that risk.

CASE STUDY

Amal is still conducting his audit of Smart Screening, the medium-sized screen-printing and corporate gift company. He has commenced an investigation into the substantial increase in cost for office collateral from Year 3 through to Year 6. He discovers that the General Manager personally signs for these invoices and they are filed in his office. The standard procedure is for two signatories on each invoice, and for all invoices to be filed in the accounting filing system. These are both indicators of potential fraud.

QUESTION **Assessing the risks of material misstatement**

You are involved with the audit of TUV Ltd, a small company. You have been carrying out procedures to gain an understanding of the entity. The following matters have come to your attention:

The company offers standard credit terms to its customers of 60 days from the date of invoice. Statements are sent to customers on a monthly basis. However, TUV does not employ a credit controller and, other than sending the statements on a monthly basis, it does not otherwise communicate with its customers on a systematic basis. On occasion, the sales ledger clerk may telephone a customer if the company has not received a payment for some time. Some customers pay regularly according to the credit terms offered to them, but others pay on a very haphazard basis and do not provide a remittance advice. Sales ledger receipts are entered onto the sales ledger but not matched to invoices remitted. The company does not produce an aged list of balances.

Required

From the above information, **assess** the risks of material misstatement arising in the financial statements. **Outline** the potential materiality of the risks and **evaluate** factors in the likelihood of the risks arising.

ANSWER

The key risk arising from the above information is that trade receivables will not be carried at the appropriate **value** in the financial statements, as some may be irrecoverable. Where receipts are not matched against invoices in the ledger, the balance on the ledger may include old invoices that the customer has no intention of paying.

It is difficult to assess at this stage whether this will be material. Trade receivables is likely to be a material balance in the financial statements, but the number of irrecoverable balances may not be material. Analytical procedures, for example, to see if the level of receivables has risen year-on-year, in a manner that is not explained by price rises or levels of production, might help to assess this.

A key factor that affects the likelihood of the material misstatement arising is the poor controls over the sales ledger. The fact that invoices are not matched against receipts increases the chance of old invoices not having been paid and not noticed by TUV. It appears reasonably likely that the trade receivables balance is overstated in this instance.

8.3 Companies that use e-business

When considering the effect on the financial statements of a company using e-commerce, the auditor needs to consider whether the **skills and knowledge** of team members are appropriate to perform the audit, and also whether an **expert** is required.

The auditor also needs to have a good **understanding of the business** to assess the significance of e-commerce and its effect on audit risk. The auditor should consider the following:

- The entity's **business activities and industry**
- The entity's **e-commerce strategy**
- The **extent** of e-commerce activities
- **Outsourcing** arrangements

Specific risks affecting entities that engage in e-commerce include:

- Loss of transaction integrity
- Security risks

- Improper accounting policies (eg capitalisation of expenditure, translation of foreign currency, allowances for warranties and returns, revenue recognition)
- Non-compliance with taxation and other laws and regulations
- Failure to ensure that contracts are binding
- Over-reliance on e-commerce
- Systems and infrastructure failures or crashes

The auditor uses the knowledge of the business gained to identify events, transactions and practices related to business risks arising from e-commerce activities that may result in material misstatements in the financial statements.

The auditor also considers the control environment and control procedures that are relevant to the financial statement assertions, in accordance with SLAuS 315, in particular those relating to **security, transaction integrity** and **process alignment**.

9 Responding to the risk assessment and documentation

The auditor shall **formulate an approach** to the assessed risks of material misstatement.

The main objective of SLAuS 330 *The auditor's responses to assessed risks* is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

9.1 Overall responses

Overall responses include issues such as emphasising to the team the importance of professional scepticism, allocating more staff, using experts or providing more supervision.

Overall responses to address the risks of material misstatement at the financial statement level will be changes to the general audit strategy or re-affirmations to staff of the general audit strategy. For example:

- Emphasising to audit staff the need to maintain professional scepticism
- Assigning additional or more experienced staff to the audit team
- Providing more supervision on the audit
- Incorporating more unpredictability into the audit procedures
- Making general changes to the nature, timing or extent of audit procedures

The evaluation of the control environment, which will have taken place as part of the assessment of the client's internal control systems, will help the auditor determine what type of audit approach to take.

9.2 Responses to the risks of material misstatement at the assertion level

The SLAuS says that the auditor shall design and perform further audit procedures whose **nature**, **timing** and **extent** are based on, and are responsive to, the assessed risks of material misstatement at the assertion level. 'Nature' refers to the purpose and the type of test that is carried out, which include **tests of controls** and **substantive tests**.

9.2.1 Tests of controls

Tests of controls are audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

When the auditor's risk assessment includes an expectation that controls are operating effectively, the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence that the controls were operating. We looked at some examples of tests of controls in Chapter 2.

The auditor shall also undertake tests of control when it will not be possible to obtain sufficient appropriate audit evidence simply from substantive procedures. This might be the case if the entity conducts its business using IT systems which do not produce documentation of transactions.

In carrying out tests of controls, auditors shall use **enquiry**, but shall also use other procedures. **Re-performance** and **inspection** will often be helpful procedures.

When considering timing in relation to tests of controls, the purpose of the test will be important. For example, if the company carries out a year-end inventory count, controls over the inventory count can only be tested at the year-end. Other controls will operate all year round, and the auditor may need to test that those controls have been effective throughout the period.

Some controls may have been tested in prior audits and the auditor may choose to rely on that evidence of their effectiveness. If this is the case, the auditor shall obtain evidence about any changes since the controls were last tested and shall test the controls if they have changed. In any case, controls shall be tested for effectiveness at least once in every three audits.

If the related risk has been designated a significant risk, the auditor shall not rely on testing done in prior years, but shall perform testing in the current year.

9.2.2 Substantive procedures

Substantive procedures are audit procedures designed to detect material misstatements at the assertion level. They consist of tests of details of classes of transactions, account balances and disclosures, and substantive analytical procedures.

The auditor must always carry out substantive procedures on material items. The SLAuS says that, irrespective of the assessed risk of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance and disclosure.

In addition, the auditor shall carry out the following substantive procedures:

- Agreeing or reconciling the financial statements to the underlying accounting records
- Examining material journal entries
- Examining other adjustments made in preparing the financial statements

Substantive procedures fall into two categories: analytical procedures and tests of details. The auditor must determine when it is appropriate to use which type of substantive procedure. We discuss these in more detail in Chapter 7 but they are introduced below.

Analytical procedures as substantive procedures tend to be appropriate for large volumes of predictable transactions (for example, wages and salaries). **Tests of detail** may be appropriate to gain information about account balances, for example, inventory or trade receivables.

In accordance with SLAuS 330, where the auditor has assessed the risk of material misstatement at the assertion level to be a significant risk, substantive procedures must be performed which are specifically responsive to that risk. When the approach adopted consists of substantive procedures only those procedures must include tests of details. Significant risks are likely to be the most difficult to obtain sufficient appropriate audit evidence about.

9.3 Examples of responses to audit risks

The best way to understand how the auditor can respond to the risks identified during audit planning is to consider some examples of audit risks along with an adequate response to each risk. (Note: we look at auditing specific financial statement balances, such as non-current assets, receivables and payables, in later chapters. Therefore you may want to re-visit the responses in this section once you have covered chapters 8 to 12.)

Table 4.4: Example responses to audit risks

Examples of risks	Possible responses
Risk that inventory has a lower net realisable value (NRV) than cost and is therefore overstated (eg NRV falls due to the client being in an industry where tastes/fashions change quickly).	Examine the instructions to identify slow-moving inventory lines when attending the inventory count. Increase the emphasis on reviewing the year-end aged inventory analysis for evidence of slow-moving inventory. Ascertain sales values for items sold post year-end that were in inventory at the year end to ensure their NRV was higher than the cost recorded as part of the inventory value in the financial statements.
Assets are desirable/more susceptible to theft, leading to a risk that recorded assets do not exist (eg inventory/non-current assets).	Focus on testing internal controls over those assets (including physical controls to prevent theft). Increase sample sizes for inspecting recorded assets, ensuring any material assets are verified (in the context of performance materiality).
Increased risk of revenue expenditure being incorrectly classified as capital (or *vice-versa*), leading to misstatement of assets/expenses (eg extensive refurbishment of non-current assets where judgement is needed to establish whether the nature of the work is to enhance the asset or repair/replace it).	Obtain a breakdown of related costs and review accounting entries against invoices/details of work done to ensure expenditure is correctly treated as capital/revenue. Perform a detailed review of repairs accounts for any items which should be included in non-current assets. Review the asset register to ensure only capital items have been included.

Examples of risks	Possible responses
Increased risk of incomplete or unrecorded income due to fraud or theft (eg large amounts of cash collected and held prior to banking).	Perform analytical procedures focusing on comparing revenue with expected seasonal/monthly patterns. If a retail client, perform/re-perform a reconciliation of a sample of till records to actual bankings.
Receipts/invoicing significantly in advance/arrears of the provision of the services or goods, leading to an increased risk of revenue being in the wrong period (eg deposits received in advance, reservation fees, contracts spanning the year-end).	For a sample of revenue entries recorded prior to the year-end, agree the transactions as relating to pre-year-end sales by inspecting the contract/other supporting documentation. Trace post-year-end transactions back to a supporting contract/documentation to test that revenue was recorded in the proper period. For a sample of contracts/GDNs, verify the revenue was recognised according to the provision of services/goods. Perform analytical procedures where monthly revenue is compared to expectations and budgeted revenue. Unexpected deviations should be investigated.
Invoices received (or payments made) in advance/arrears of goods or services delivery date, leading to overstatement or understatement of costs and/or liabilities.	Review post-year-end bank statements/cash book payments for evidence of amounts relating to the financial year but not included in liabilities. For a sample of documents pre- and post-year-end indicating date of delivery of goods/services (eg GRNs), verify the cost and liability were recorded in the appropriate period.

Examples of risks	Possible responses
There is an increased risk of irrecoverable debts (eg due to the nature of the client's industry or customers), resulting in assets being potentially overstated.	Identify year-end receivable balances still outstanding at the date of the audit by reviewing post-year-end receipts from customers. For amounts still outstanding, establish whether these are provided for. Review aged receivables analysis and customer correspondence files for evidence of disputes with receivables and consider the adequacy of any related receivables allowance.
Significant client borrowing and/or overdraft with cash flow problems which may indicate going concern problems.	Review correspondence with the bank/lender for any evidence of withdrawal or extension of facilities. If there are bank covenants linked to performance on which facilities depend, review compliance with these, and increase testing on areas where management could manipulate performance indicators (such as provisions). Review post-year-end results and cash flow forecasts (if prepared) for evidence the company can continue as a going concern.
New client systems/controls/staff impacting on amounts recorded in the financial statements, increasing the risk of errors and the risk of internal controls not operating effectively.	Undertake additional visits (eg interim audit) to assess the effectiveness of controls operating over areas affected. Perform extra work to document and evaluate new systems/controls, performing tests of controls where necessary. Increase sample sizes for substantive testing over financial statement areas impacted.
Management has an incentive to manipulate performance, increasing the risk of profits being overstated (eg remuneration or bank funding is reliant on performance).	Focus on, and increase testing on, judgemental areas in the financial statements (eg provisions, revenue recognition accounting policies).

Above are just **some examples** of risks you may encounter. The best response to each risk will depend on the particular circumstances of the client and the environment in which it operates.

You should not simply learn a list of responses. Instead your focus should be on understanding the link between audit risks and responses, and being able to identify and explain risks and suitable responses when presented with different scenarios.

9.4 Documentation of risk assessment

Auditors must ensure they have **documented** the work done at the risk assessment stage, such as the discussion among the audit team of the susceptibility of the financial statements to material misstatements, significant risks, and overall responses.

In the next chapter we will look in particular at the **audit plan** and the **audit strategy**, two documents for planning. SLAuSs 315 and 330 contain a number of general requirements about documentation, and we shall briefly run through those here.

The following matters shall be documented during planning:

- The discussion among the audit team concerning the susceptibility of the financial statements to material misstatements, including any significant decisions reached
- Key elements of the understanding gained of the entity regarding the elements of the entity and its internal control components specified in SLAuS 315, the sources of the information gained and the risk assessment procedures carried out
- The identified and assessed risks of material misstatement at the financial statement level and at the assertion level
- Risks identified and related controls evaluated
- The overall responses to address the risks of material misstatement at the financial statement level
- Nature, extent and timing of further audit procedures linked to the assessed risks at the assertion level
- Results of audit procedures
- If the auditors have relied on evidence about the effectiveness of controls from previous audits, conclusions about how this is appropriate
- Demonstration that the financial statements agree or reconcile with the underlying accounting records

CHAPTER ROUNDUP

- The **terms** of the audit engagement shall be **agreed** with management and **recorded** in an audit engagement letter
- A **risk assessment** carried out under the SLAuSs helps the auditor to identify the financial statement areas most susceptible to material misstatement and provides a basis for designing and performing further audit procedures.
- Auditors are required to carry out the audit with an attitude of **professional scepticism**, exercise **professional judgement** and comply with **ethical requirements**.
- **Audit risk** is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. It is a function of the risk of material misstatement (**inherent risk** and **control risk**) and the risk that the auditors will not detect such misstatement (**detection risk**).
- **Materiality for the financial statements as a whole** and **performance materiality** must be calculated at the planning stages of all audits. The calculation or estimation of materiality should be based on experience and judgement. Materiality for the financial statements as a whole must be **reviewed throughout** the audit and **revised if necessary**.
- The auditor is required to obtain an **understanding** of the entity and its environment in order to be able to assess the risks of material misstatements.
- Analytical procedures must be used as risk assessment procedures.
- When the auditor has obtained an understanding of the entity, they shall assess the risks of material misstatement in the financial statements, also identifying significant risks.
- **Significant risks** are complex or unusual transactions that may indicate fraud, or other special risks.
- The auditor shall **formulate an approach** to the assessed risks of material misstatement.
- Auditors must ensure they have **documented** the work done at the risk assessment stage, such as the discussion among the audit team of the susceptibility of the financial statements to material misstatements, significant risks, and overall responses.

PROGRESS TEST

1 An engagement letter is only ever sent to a client before the first audit. True or false?

2 Complete the sentences.

………………. risk is the risk that …………….. may give an …………………..opinion on the financial statements.

………………. risk is the …………………… of an assertion to a ………………… that could be material, assuming there were no related …………… ……………

3 If control risk and inherent risk are assessed as sufficiently low, substantive procedures can be abandoned completely. True or false?

4 Which procedures might an auditor use in gaining an understanding of the entity?

5 The audit team is required to discuss the susceptibility of the financial statements to material misstatements. True or false?

6 Auditors have a duty to detect fraud. True or false?

ANSWERS TO PROGRESS TEST

1 False. It should be re-issued if there is a change in circumstances.

2 **Audit** risk is the risk that **auditors** may give an **inappropriate** opinion on the financial statements.

Inherent risk is the **susceptibility** of an assertion to a **misstatement** that could be material, assuming there were no related **internal controls**.

3 False

4 Enquiry, analytical procedures, observation and inspection.

5 True

6 False

CHAPTER 05

Audit Planning

INTRODUCTION

In this chapter we look at the contents of the overall audit strategy and the detailed audit plan.

We also look at how auditors can split their audit into two stages - the interim audit and the final audit. The interim audit will typically take place prior to the client's year end date and involve planning, risk assessment and control related procedures. The final audit will focus on substantive procedures and will take place after the year end.

Lastly we will look at the particular issues around planning and risk assessment in relation to an audit of a Group of companies.

Knowledge Component			
B	**Audit Planning Risk Assessment**		
2.2	**Overall Audit Strategy**	2.2.1	Demonstrate the importance of overall audit strategy as part of audit planning
		2.5.1	Outline suitable overall response and further audit procedures for identified risk at financial statement level and assertion level

CHAPTER CONTENTS	LEARNING OUTCOME
1 The importance of planning	2.2.1
2 The overall audit strategy and the audit plan	2.2.1
3 Interim and final audits	2.2.1
4 Audit of groups	2.2.1, 2.5.1

1 The importance of planning

An effective and efficient audit relies on proper planning procedures.

As with any other process, the better an audit is planned, the more efficient and effective it will be. The planning process is covered in general terms by SLAuS 300 *Planning an audit of financial statements,* which states that the auditor shall plan the audit so that the engagement is performed in an effective manner. Audits are planned, to:

- Help the auditor devote appropriate attention to important areas of the audit.
- Help the auditor identify and resolve potential problems on a timely basis.
- Help the auditor properly organise and manage the audit so it is performed in an effective manner.
- Assist in the selection of appropriate team members and assignment of work to them.
- Facilitate the direction, supervision and review of work.
- Assist in co-ordination of work done by auditors of components and experts.

Audit procedures should be discussed with the client's management, staff and/or audit committee in order to co-ordinate audit work, including that of internal audit. However, all audit procedures remain the responsibility of the external auditors.

A structured approach to planning will include:

Step 1 Ensuring that ethical requirements are met, including independence

Step 2 Ensuring the terms of the engagement are understood

Step 3 Establishing the overall audit strategy that sets the scope, timing and direction of the audit and guides the development of the audit plan

- Identify the characteristics of the engagement that define its scope.
- Ascertain the reporting objectives to plan the timing of the audit and nature of communications required.
- Consider significant factors in directing the team's efforts.
- Consider results of preliminary engagement activities.
- Ascertain nature, timing and extent of resources necessary to perform the engagement.

Step 4 Developing an audit plan that includes the nature, timing and extent of planned risk assessment procedures and further audit procedures.

2 The overall audit strategy and the audit plan

The auditor formulates an **overall audit strategy** which is translated into a **detailed audit plan** for audit staff to follow. The overall audit strategy and audit plan shall be updated and changed as necessary during the course of the audit.

2.1 The audit strategy

The overall **audit strategy** sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

The matters the auditor may consider in establishing an overall audit strategy are set out in the table below.

Table 4.1: Considerations for the overall audit strategy

The overall audit strategy: matters to consider	
Characteristics of the engagement	• Financial reporting framework • Industry-specific reporting requirements • Expected audit coverage • Nature of business segments • Availability of internal audit work • Use of service organisations • Effect of information technology on audit procedures • Availability of client personnel and data

The overall audit strategy: matters to consider	
Reporting objectives, timing of the audit and nature of communications	• Entity's timetable for reporting • Organisation of meetings with management and those charged with governance • Discussions with management and those charged with governance • Expected communications with third parties
Significant factors, preliminary engagement activities, and knowledge gained on other engagements	• Determination of materiality • Areas identified with higher risk of material misstatement • Results of previous audits • Need to maintain professional scepticism • Evidence of management's commitment to design, implementation and maintenance of sound internal control • Volume of transactions • Significant business developments • Significant industry developments • Significant changes in financial reporting framework • Other significant recent developments
Nature, timing and extent of resources	• Selection of engagement team • Assignment of work to team members • Engagement budgeting

Examples of items to include in the overall audit strategy could be:

- Industry-specific financial reporting requirements
- Number of locations to be visited
- Audit client's timetable for reporting to its members
- Communication between the audit team and the client

2.2 The audit plan

The **audit plan** converts the audit strategy into a more detailed plan and includes the nature, timing and extent of audit procedures to be performed by engagement team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

The audit plan shall include the following:

- A description of the nature, timing and extent of planned risk assessment procedures
- A description of the nature, timing and extent of planned further audit procedures at the assertion level
- Other planned audit procedures required to be carried out for the engagement to comply with SLAuSs

The planning for these procedures occurs over the course of the audit as the audit plan develops.

Examples of items included in the audit plan could be:

- Timetable of planned audit work
- Allocation of work to audit team members
- Audit procedures for each major account area (eg inventory, receivables, cash etc)
- Materiality for the financial statements as a whole and performance materiality

Any changes made during the audit engagement to the overall audit strategy or audit plan, and the reasons for such changes, shall be included in the audit documentation.

3 Interim and final audits

Auditors usually carry out their audit work for a financial year in one or more sittings. These are referred to as the **interim audit(s)** and the **final audit**.

It can be beneficial for auditors to perform their audit work in two stages. These are referred to as the **interim audit(s)** and the **final audit**.

The interim audit visit is carried out during the period of review and the final audit visit will take place after the year end.

We look at the different types of procedures later in this text, but because we refer to **substantive procedures** and **tests of control** during our explanation of the interim and final audit, we will define those terms here.

Tests of controls are performed to obtain audit evidence about the operating effectiveness of controls preventing, or detecting and correcting, material misstatements at the assertion level.

Substantive procedures are audit procedures performed to detect material misstatements at the assertion level. They are generally of two types:

- Substantive analytical procedures
- Tests of detail of classes of transactions, account balances and disclosures

3.1 The purpose of the interim audit and procedures likely to be adopted

The purpose of the interim audit is to carry out procedures that would be difficult to perform at the year-end because of time constraints. Work at this visit tends to focus on risk assessment and on documenting and testing internal controls. Some substantive procedures can also be carried out but these are limited because statement of financial position figures will not be the ones to be reported upon.

The final audit will focus on the audit of the financial statements. It concludes with the auditor issuing a report which contains the opinion expressed on the financial statements covering the entire year being audited. The final audit opinion will take account of conclusions reached at both (or all) audit visits.

SLAuS 330 *The auditor's responses to assessed risks* states that the higher the risk of material misstatement, the more likely it is that the auditor will decide that it is more effective to undertake substantive procedures nearer to, or at, the period-end rather than earlier.

The audit responses overall, and the allocation of procedures to the interim and final audit, will depend on the level of risks identified over the various financial statement areas. As alluded to in the previous paragraph, the timing and nature of audit procedures are linked to the assessed level of risk.

Some audit procedures can only be performed at the final audit visit, such as agreeing the financial statements to the accounting records and examining adjustments made during the process of preparing the financial statements.

The following table summarises some of the typical procedures carried out the interim and final audits.

Table 4.2: Typical procedures in interim and final audits

Interim audit procedures may include:	Final audit procedures include:
• Inherent risk assessment and gaining an understanding of the entity. • Recording the entity's system of internal control. • Evaluating the design of internal controls. • Carrying out tests of control on the company's internal controls to ensure they are operating as expected. • Performing substantive testing of transactions/balances to gain evidence that the books and records are a reliable basis for the preparation of financial statements. • Identification of issues that may have an impact on work to take place at the final audit.	• Substantive procedures involving verification of statement of financial position balances and amounts in the statement of profit or loss. • Obtaining third-party confirmations. • Analytical procedures relating to figures in the financial statements. • Subsequent events review. • Agreeing the financial statements to the accounting records. • Examining adjustments made during the process of preparing the financial statements. • Consideration of the going concern status of the entity. • Performing tests to ensure that the conclusions formed at the interim audit are still valid. • Obtaining written representations.

3.2 Impact of interim audit work on the final audit in general

The benefit of spreading audit procedures over an interim and final audit is that it is possible to provide shareholders and other users of the financial statements with the audited accounts sooner than if all audit procedures were carried out at a final audit taking place after the year end.

Performing audit procedures before the period-end can **assist in identifying significant matters at an early stage** of the audit and help resolve them with management's assistance or develop an effective audit approach to address them. This **reduces the time taken at the final audit** to gain the remaining sufficient appropriate audit evidence needed.

3.3 Impact of interim audit work relating to internal controls on the final audit

If the auditors are to place reliance on internal controls they must obtain evidence that **controls** have operated effectively **throughout the period**. If the auditor obtains audit evidence about the operating effectiveness of controls at the interim audit, when it comes to the final audit, instead of having to gain evidence over controls covering the whole year, the auditor can focus on:

- Obtaining audit evidence about **significant changes to those controls** subsequent to the interim period
- Determining the **additional audit evidence** to be obtained for the remaining period

While at the final audit, the amount of work needed to gain additional audit evidence about controls that were operating during the period between the interim audit and the year end will depend on:

- The significance of the assessed risks of material misstatement at the assertion level.
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes and personnel.
- The degree to which audit evidence about the operating effectiveness of those controls was obtained.
- The length of the remaining period.
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls.
- The control environment.

3.4 Impact of substantive procedures performed during the interim audit on the final audit

If substantive procedures are performed at an interim date, the auditor must cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls for the intervening period.

Conclusions will have been reached on the testing carried out at the interim audit; the auditor essentially has to carry out any procedures necessary to provide a reasonable basis for extending the audit conclusions from the interim date to the period end.

One approach an auditor that has carried out an interim audit can take is to compare and reconcile information concerning the balance at the period end with the comparable information at the interim date. Essentially, because the interim balance has been audited, the auditor can focus on auditing the movements in the balance between the interim date and the year end.

A point to note is that when misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor many need to modify the planned nature, timing or extent of substantive procedures covering the remaining period. This may result in repeating the procedures in full that were performed at the interim date. Therefore part of the expected benefit of carrying out the interim audit will have been lost.

QUESTION

Examine the case study from Chapter 4 below in light of planning the audit for this year.

As audit senior, you have recently attended a meeting with the managing director of BigMall Ltd (audit client) and the new audit partner assigned to the audit, Nipun Rajapakse, who has recently joined your firm. The audit partner is familiarising himself with the client.

BigMall Ltd is a large limited liability building company set up by Kasun Corea, who has been managing director since incorporation. It purchases land in and around major towns and builds retail parks and shopping malls, which the company then manages. You are familiar with the client, as you have taken part in the audit for the last three years. The other key member of the board is Clarice Singhe, who set up the business with Kasun Corea and is finance director. Clarice is a qualified accountant, and the accounting systems and procedures at BigMall Ltd have always appeared sound.

You took minutes of the meeting, which are given below.

Minutes of a meeting between Nipun Rajapakse and Kasun Corea, 30 March 20X2

NR introduced himself to KC and asked for a brief history of the business, which was given. Currently, the majority of income is from the property management side, as the building market is becoming saturated. With interest rates set to rise, KC is less keen to borrow and build in the current climate.

NR asked KC whether a recent spate of terrorist bomb attacks in malls in tourist areas had had any effect on business. KC commented that he had been given the impression that retail was down and that customers were staying away from the retail centres – but he felt that some of that could be attributed to a rise in interest rates and was likely to be temporary. First months of the year are always poor for retail …

> NR asked whether there had been a rise in empty units in the retail centres and malls. KC said there had been a small rise.
>
> NR asked KC about his views in relation to the current proposed legislation before the government concerning quality standards in the building trade. KC commented that it seemed like a 'load of nonsense' to him, and expressed some dissatisfaction with the current political situation… NR pressed the matter, enquiring as to KC's opinion on the likely effects on his business if more stringent standards were to be required in the future. KC is of the firm belief that it would not be passed. NR expressed his fear that the legislation was more than likely to be passed, and would have far-reaching and expensive effects on most builders in the country. KC repeated some of his previous comments about politicians.

Nipun is keen to reappraise the audit strategy taken towards the audit of BigMall, as he feels the audit could be conducted more efficiently than it has in the past. It has largely focused on substantive procedures up to now.

Required

Nipun asks you to plan this year's audit as if BigMall was a new client:

(a) **Outline** the steps when approaching the audit plan of BigMall.

(b) You need to **advise** Nipun whether to carry out the audit work in two stages – an interim audit and a final audit. **Explain** the procedure of the interim audit and how it operates in conjunction with the final audit. **Conclude** whether an interim audit is required in the case of BigMall.

ANSWER

(a) **Step 1** Ensure ethical requirements are met. Ensure independence of the audit and the auditor has been established.

Step 2 Clarify and finalise the terms of engagement

Step 3 Establish overall audit strategy. Ensure you set scope, timing and direction of audit.

Step 4 Develop an audit plan which includes the nature, timing and extent of the planned risk assessment procedures to be performed by engagement team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. BigMall has some major risks as outlined in the meeting.

(b) The purpose of the interim audit is to carry out procedures that would be difficult to perform at the year-end because of time constraints. Work at this visit tends to focus on risk assessment and on documenting and testing internal controls. Some substantive procedures can also be carried out but these are limited because statement of financial position figures will not be the ones to be reported upon. This is a strength for BigMall as they want to focus less on substantive procedures in the audit process.

The final audit is the one that focuses on the substantive audit of the financial statements. The audit responses overall, and the allocation of procedures to the interim and final audit, will depend on the level of risks identified over the various financial statement areas.

Performing an interim audit can assist in identifying can **assist in identifying significant matters at an early stage** of the audit and help resolve them with management's assistance or develop an effective audit approach to address them. This **reduces the time taken at the final audit** to gain the remaining sufficient appropriate audit evidence needed.

The number of issues identified at BigMall means that an interim audit will **assist in identifying significant matters at an early stage** of the audit and help resolve them with management's assistance or develop an effective audit approach to address them. This **reduces the time taken at the final audit** to gain the remaining sufficient appropriate audit evidence needed.

The effectiveness of an interim audit lies in the planning of the audit overall. Once the interim audit has been conducted, you will need to revisit the final audit scope and plan to ensure that double work is not being performed, and that risks identified in the interim audit are recorded and further investigation completed if required.

4 Audit of groups

The group engagement partner is responsible for the direction, supervision and performance of the group audit.

The standard here is SLAuS 600 *Special considerations – audits of group financial statements (including the work of component auditors)*.

SLAuS 600 states that the **objectives** of the auditor are:

SLAuS 600.8

The objectives of the auditor are:

(a) To determine whether to act as the auditor of the group financial statements

(b) If acting as the auditor of the group financial statements:

(i) To communicate clearly with component auditors about the scope and timing of their work on financial information related to components and their findings

(ii) To obtain sufficient appropriate audit evidence about the financial information of the components and the consolidation process to express an opinion on whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework

The group auditor should gain an understanding of the group as a whole and assess risks for the group as a whole and for individually significant components. The group auditor has to ensure other auditors are professionally qualified, meet quality control and ethical requirements and will allow the group auditor access to working papers or components themselves.

4.1 Definitions

Component. An entity or business activity for which the group or component management prepares financial information that should be included in the group financial statements.

Component auditor. An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

Component materiality. The materiality level for a component determined by the group engagement team.

Group. All the components whose financial information is included in the group financial statements. A group always has more than one component.

Group audit. The audit of the group financial statements.

4.2 Responsibilities

Group financial statements may include amounts derived from financial statements which have not been audited by the group auditors, but by a different firm altogether: the **component auditor**. Components of group financial statements can include subsidiaries, associates, joint ventures and branches.

4.2.1 Audit opinion

The group auditor takes sole responsibility for the group audit opinion.

SLAuS 600.11

The group engagement partner is responsible for the direction, supervision and performance of the group audit engagement in compliance with professional standards and applicable legal and regulatory requirements, and whether the auditor's report that is issued is appropriate in the circumstances.

Hence the auditor's report on the group financial statements **shall not refer to a component auditor**. If a reference to a component auditor is required (eg by local laws or regulations), the report shall indicate that this reference does not diminish the group auditor's responsibility for the group audit opinion.

If the opinion on a component is qualified, the group audit opinion is only affected if the matter is material to the group. **Only a matter which is material in a group context will affect the group audit opinion**.

QUESTION **Group audit opinion**

Aristotle & Co is the group auditor of the Plato Group. At the planning stage of the audit, group materiality is determined at Rs. 37.5 million.

Plato Co is the parent company of the group, and has a subsidiary called Socrates Co. The group auditor considers Socrates to be a significant component for the purposes of the group audit. Socrates Co is audited by a component auditor.

The component auditor's report on Socrates Co is qualified as a result of a material misstatement. The amount of the misstatement is Rs. 18 million.

Required

What is the effect on the audit report given on the Plato Group?

ANSWER

The group audit report is not modified, as the amount of the misstatement is not material to the group.

4.2.2 Parent company financial statements

Balances contained within only the parent company financial statements (but not the group accounts) will also have an effect on the group financial statements. For example, the parent's statement of financial position (SOFP) will include investments in subsidiaries as non-current assets, and the parent's statement of comprehensive income (SOCI) will include dividend receipts from subsidiaries. The group auditor must obtain sufficient appropriate evidence in respect of these, in order to express an opinion on the financial statements of the parent as well as on the group.

4.3 Objectives

In practical terms in order to achieve the group audit objectives the auditor needs to obtain evidence in relation to the:

(1) **Individual components** of the group – this is covered in the remainder of Section 3.

(2) **Consolidation process** – this is covered in Section 4.

4.4 Acceptance and continuance

The group auditor must consider whether it will be possible to obtain sufficient appropriate audit evidence about components.

SLAuS 600 places special emphasis on the need for the group auditor to determine whether or not to accept the appointment. This is particularly important here because it is possible for it to be straightforward to audit the parent company, but impossible to obtain sufficient appropriate evidence about the rest of the group.

If the group engagement partner concludes that it will **not be possible to obtain sufficient appropriate audit evidence on the group** and that this is serious enough to result in a disclaimer of opinion, then **the engagement should not be accepted** (or withdrawn from, if already accepted – SLAuS 600.13). For this purpose the group engagement partner **must obtain an understanding of the group before acceptance** (SLAuS 600.12).

4.4.1 Obtaining an understanding of the group, its components and their environments

Possible sources of information include:

- Information provided by group management
- Communication with group management
- Communication with the previous group engagement team, component manager, or component auditors

Other matters to consider will include:

- The **group structure**
- **Components' business activities** including the industry and regulatory, economic and political environments in which those activities take place
- The use of **service organisations**
- A description of **group-wide controls**
- The complexity of the consolidation process
- **Whether component auditors** that are not from the group engagement partner's firm **will perform work** on the financial information of any of the components
- **Whether the group engagement team will have unrestricted access** to those charged with governance of the group, those charged with governance of the component, component management, component information and the component auditors (including relevant audit documentation sought by the group engagement team)

In the case of **continuing engagements** the group engagement team's ability to obtain sufficient appropriate audit evidence may be affected by **significant changes**, eg changes in group structure, changes in business activities and concerns regarding the integrity and competence of group or component management.

In addition to these points the group engagement team should also consider the general points relating to acceptance of appointment discussed earlier in this Study Text.

4.5 Planning and risk assessment

The planning and risk assessment process will need to take into account the fact that all elements of the group financial statements are not audited by the group auditor directly. **The group auditor will not be able to simply rely on the**

conclusions of the component auditor. SLAuS 600 requires the group auditor to evaluate the reliability of the component auditor and the work performed. This will then determine the extent of further procedures.

4.5.1 Significant components

The SLAuS distinguishes between **significant components** and other components which are not individually significant to the group financial statements.

Significant component. A component identified by the group engagement team: (a) that is of individual significance to the group, or (b) that due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

SLAuS 600.A5 states that a significant component can be identified by using a **benchmark**. If component assets, liabilities, cash flows, profit or turnover (whichever is the most appropriate benchmark) **exceed 15% of the related group figure**, then the auditor may judge that the component is a **significant component.**

If a component is financially significant to the group financial statements then the group engagement team or a component auditor will perform a full audit based on the component materiality level.

The group auditor should be involved in the assessment of risk in relation to significant components. If the component is otherwise significant due to its nature or circumstances, the group auditors will require one of the following.

- A full audit using component materiality
- An audit of specified account balances related to identified significant risks
- Specified audit procedures relating to identified significant risks

Components that are not 'significant components' will be subject to analytical procedures at a group level – a full audit is not required.

The analytical procedures will be carried out at a 'group level' which means that the financial information for the components will need to be aggregated for the purposes of this analysis. This may be done at various levels to ensure that the analysis minimises the risk of material misstatement.

The analysis conducted will be designed to gain assurance that there are no significant risks within the aggregated financial information of components that are not significant components.

The auditor will look for unusual trends or anomalous figures within the aggregated financial information, and only if there is an indication of potential risk will further investigation be undertaken.

QUESTION — Significant component

Salto Group is a group of companies that has expanded rapidly to become one of the largest furniture retailers in Sri Lanka. Group revenue has grown rapidly in recent years and in the current year was Rs. 540m (last year Rs. 500m).

The majority of the revenue for the group (70%) is generated by Salto Co, with 8% generated by Fixert Co. a 100% owned subsidiary purchased ten years ago operating in the same industry.

Several years ago, the group decided to diversify their operations into the insurance industry and purchased 100% of the shares in Lento Insurance Co, which has grown to the point where it contributes 20% of group revenue. There have been problems in the current year causing Lento to make a loss, including an impairment charge relating to financial assets amounting to 23% of group revenue.

In the current year Salto Co completed the purchase of the entire shareholding in Giro Co, a small competitor offering online sales which Salto hopes to expand in future years. Giro Co accounts for the remaining 2% of revenue in the current year.

Required

What is the classification of each component from the group audit perspective and the scope of work required for each?

ANSWER

Salto Co

Salto Co is a significant component due to it being individually large in terms of the group as it contributes 70% of the revenue. Salto will therefore be required to have a full audit.

Fixert Co

Fixert Co would appear to be non-significant as it contributes only 8% of the total revenue and operates in the same industry which is not highly regulated or particularly risky. The group auditor may well decide that the use of analytical procedures on the financial information would be enough evidence relating to Fixert Co.

Lento Insurance Co

Lento is a significant component due to its individual size and the fact that it is in a highly regulated industry with significant risk of material misstatement particularly related to the impairment of financial assets. As such the group auditor will decide whether or not to conduct a full audit on this significant component or to audit the financial assets specifically as this is where the main source of risk exists.

Giro Co

Giro Co is financially insignificant due to its small contribution of revenue to the group so is not going to be audited in full. However, the group auditor may decide that as it was acquired in the current year it requires more than simple analytical review and may decide to undertake a limited review.

4.5.2 Understanding the component auditor

SLAuS 600 requires the group engagement team to obtain an understanding of the component auditor. This involves an assessment of the following.

(a) Whether the component auditor is **independent** and understands and will comply with the ethical requirements that are relevant to the group audit

(b) The component auditor's **professional competence**

(c) Whether the group engagement team will be **involved in the work of the component auditor** to the extent that it is necessary to obtain sufficient appropriate audit evidence

(d) Whether the component auditor operates in a **regulatory environment** that actively oversees auditors

The group engagement team may obtain this understanding in a number of ways. In the first year, for example, the component auditor may be visited to discuss these issues. Alternatively the component auditor may be asked to confirm these matters in writing or to complete a questionnaire. Confirmations from professional bodies may also be sought and the reputation of the firm will be taken into account.

4.5.3 Materiality

The group auditor is responsible for setting the materiality level for the group financial statements as a whole. Materiality levels should also be set for components which are individually significant. These should be set at a lower level than the materiality level of the group as a whole.

SLAuS 600 21 (c) states that:

"Component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit. To reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole, ***component materiality shall be lower than materiality for the group financial statements as a whole.****"*

This does not mean that component materiality will be a portion of group materiality in an arithmetical sense, ie component materiality may total to more than group materiality when aggregated. Component materiality may also be set at a different level for the different components within the group.

QUESTION — Component materiality

Freno Group is comprised of the parent company and two subsidiaries, Cheves Co and Sans Co. The group auditor has determined that materiality should be calculated on the basis of revenue.

Cheves Co has been part of the group for many years and has had stable growth and profitability in that time. Sans Co was acquired in the current year and this is the first year of profitability since it was established 5 years ago.

The total consolidated revenue for the group is Rs. 300m with the breakdown:

Rs. 150m contributed by Freno Co.

Rs. 90m contributed by Cheves Co.

Rs. 60m contributed by Sans Co.

Required

Discuss how the auditor may set materiality at a group level for the Freno group and at the individual component level.

ANSWER

As materiality is always a judgement made by the group auditor and will involve a number of factors, this suggested approach is for guidance only and other factors may well influence it in practice.

It has been decided by the group auditor that materiality should be set on the basis of revenue, the quantitative benchmark for which may be 0.5% – 1%. If we take the lower of these on the basis of prudence, then group materiality could be set at (Rs. 300 million × 0.5%) Rs. 1,500,000.

Component materiality will then be set at a lover level than group materiality in order to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole. As such we may apply a reduction of say 20% to group materiality.

Component materiality could therefore be set at (1,500,000 × 80%) Rs. 1,200,000 for Cheves Co and Sans Co.

The group engagement team may also feel that due to the acquisition of Sans in the current year and the lack of profitable history, that component materiality should be set at a lower level for this particular subsidiary.

4.5.4 Involvement in the work of a component auditor

The extent of involvement by the group auditor at the planning stage will depend on the:

- Significance of the component
- Risks of material misstatement of the group financial statements
- Extent of the group auditor's understanding of the component auditor

The basic rule is that **where the component is significant, the group auditor must be involved in the component auditor's work**.

The group auditor may perform the following procedures.

(a) **Meeting** with the **component management or the component auditors** to obtain an understanding of the component and its environment

(b) **Reviewing** the component auditor's overall **audit strategy and audit plan**

(c) **Performing risk assessment** procedures to identify and assess risks of material **misstatement at the component level**. These may be performed with the component auditor or by the group auditor.

Where the component is a **significant component**, the nature, timing and extent of the group auditor's involvement is affected by their understanding of the component auditor but at a minimum should include the following procedures.

- Discussion with the component auditor or component management of the component's business activities that are significant to the group

- Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error

- Reviewing the component auditor's documentation of identified significant risks of material misstatements. This may be in the form of a memorandum including the conclusions drawn by the component auditors.

QUESTION **Component audit**

Plato Group has recently established a new subsidiary, Plotinus Co. The group auditor does not consider Plotinus Co to be a significant component in accordance with SLAuS 600. The auditor of Plotinus Co has not communicated any of the findings of its audit to the group auditor. Aristotle & Co, the group auditor, has performed analytical procedures on the final financial statements of Plotinus Co, and is satisfied that there are unlikely to be any misstatements therein that are material to the group.

Required

What is the effect on the audit report given on the Plato Group?

ANSWER

The group auditor's opinion is unmodified, with no additional reporting requirements. SLAuS 600.28 specifies that where a component is not a significant component, then analytical procedures performed at a group level are sufficient.

4.6 Access to information about components

The group auditor may not be able to access all the information it needs about components or component auditors, eg because of laws relating to confidentiality or data privacy. The effect on the group audit opinion depends on the **significance of the component**.

If the **component is not significant**, then it may be sufficient just to have a complete set of financial statements, the component auditor's report, and information kept by group management.

If the **component is significant** then it is possible that there will be an **inability to obtain sufficient appropriate audit evidence** about the component, in which case the audit opinion is either **qualified** or a **disclaimer of opinion** is issued. In this case it would also be impossible to comply with SLAuS 600's requirement to be involved with the work of the component auditor (for significant components), which would also lead to an inability to obtain sufficient appropriate audit evidence.

4.7 Evaluating the work of the component auditor

For all companies in the group the group auditor is required to perform a review of the work done by the component auditor. This is normally achieved by reviewing a report or questionnaire completed by the component auditor which highlights the key issues which have been identified during the course of the audit. The effect of any uncorrected misstatements and any instances where there has been an inability to obtain sufficient appropriate audit evidence should also be evaluated. On the basis of this review the group auditor then needs to determine whether any additional procedures are necessary. These may include:

- Designing and performing further audit procedures. These may be designed and performed with the component auditors, or by the group auditor.
- Participating in the closing and other key meetings between the component auditors and component management
- Reviewing other relevant parts of the component auditors' documentation

In co-operating with the group auditor the component auditor would be expected to provide access to audit documentation unless prohibited from doing so by law.

The consolidation: problems and procedures

Consolidation procedures include checking consolidation adjustments have been correctly made, checking treatment of additions and disposals have been accounted for correctly and arithmetical checks.

4.8 Audit procedures

SLAuS 600 requires the auditor to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment. Part of that process involves **obtaining an understanding of the consolidation process**, including instructions issued by group management to components.

There are several key risks that will need to be addressed by management during the consolidation process including **identification and correct classification of components.**

SLFRS 10 provides the detailed definition of **control:**

"An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee."

This is most commonly demonstrated where an investor owns 50% or more of the voting rights in the investee, but may include an element of judgement where potential shareholdings (eg convertible debt) is owned by the investor or where there is a contractual right to appoint members to the board of an investee. If control exists, then the investee must be fully **consolidated as a subsidiary**. There is a risk of misstatement in a situation where this judgement is not clear cut and management may not include entities as subsidiaries which do in fact meet the definition or vice versa.

Similarly, SLFRS 11 outlines the treatment where **joint control** exists leading to a joint arrangement through contractually agreed sharing of control requiring unanimous consent of the parties. Again, management may fail to recognise that joint control exists or if they do, they may not apply the distinction between a joint operation and a joint venture correctly leading to the incorrect treatment being applied.

If an investment does not meet the definition of control, it may be that the investor has '**significant influence'** over the investee through membership on the board or a 20% plus holding. Once again, however, there is a risk of misstatement as, although significant influence is assumed at a 20% holding, this may not be the case if, for example, one other investor holds the other 80% and is able to make all decisions regardless of input from the holder of 20%. In such a situation, significant influence would not exist, and the entity should not be equity accounted under LKAS 28 but treated as a financial asset under SLFRS 9. This distinction may be **mis-applied or misunderstood** by management leading to an incorrect treatment. Similarly, holding less than 20% but meeting one of the other indicators of significant influence such as providing essential technical information (see Chapter 16) will require treatment as an associate. This may not be considered or understood by management, leading to a misstatement.

There are **detailed disclosure requirements** under SLFRS 12 as to the determination of the components within the group and there is a potential risk of misstatement if the correct information is not disclosed.

Once the components have been identified and to achieve uniformity and comparability of financial information the group management will normally issue instructions to components. The instructions ordinarily cover:

- The accounting policies to be applied
- Statutory and other disclosure requirements including:
  - The identification and reporting of segments
  - Related party relationships and reporting of segments
  - Intra-group transactions and unrealised profits
  - Intra-group account balances
- A reporting timetable

The group engagement team will consider:

- The clarity and practicality of the instructions for completing the reporting package
- Whether the instructions:
  - Adequately describe the applicable financial reporting framework
  - Provide for adequate disclosures
  - Adequately provide for the identification of consolidation adjustments
  - Provide for the approval of the financial information by component management

The group auditor is also responsible for the audit of the consolidation process itself.

After receiving and reviewing all the subsidiaries' (and associates') financial statements, the group auditors will be in a position to audit the consolidated financial statements. An important part of the work on the consolidation will be checking the consolidation adjustments. Consolidation adjustments generally fall into two categories:

- **Permanent consolidation adjustments**
- **Consolidation adjustments** for the **current year**

The audit steps involved in the consolidation process may be summarised as follows.

Step 1 Compare the audited financial statements of each subsidiary/associate with the consolidation schedules to ensure figures have been transposed correctly, and that all components have been included.

Step 2 Review the adjustments made on consolidation to ensure they are appropriate and comparable with the previous year. This will involve:

- **Recording** the **dates** and **costs** of **acquisitions** of subsidiaries and the assets acquired
- **Calculating goodwill** and **pre-acquisition reserves** arising on consolidation
- **Preparing** an overall **reconciliation** of movements on reserves and non-controlling interests
- **Reconciling** any inter-company balances, and eliminating intra-group items from profit or loss
- **Verifying** that where relevant, subsidiary balances have been included in the group accounts at **fair value**, eg properties, which may be carried at depreciated cost in the subsidiary, must be at fair value in the group accounts
- **Verifying** that the **deferred tax** consequences of consolidation and fair value adjustments have been accounted for correctly

Step 3 For business combinations determine:

- Whether the combination has been **appropriately** treated as an acquisition
- The **appropriateness** of the **date** used as the date of combination
- The **treatment** of the **results** of **investments** acquired during the year
- If acquisition accounting has been used, that the **fair value** of acquired **assets** and **liabilities** is reasonable (to ascertainable market value by use of an expert)
- **Goodwill** has been **calculated correctly** and reviewed annually for indicators of impairment

Step 4 For disposals:

- Agree the **date** used as the date for disposal to sales documentation
- Review management accounts to ascertain whether the **results** of the **investment** have been **included** up to the date of disposal, and whether figures used are reasonable

Step 5 **Consider** whether **previous treatment** of **existing subsidiaries** or **associates** is still **correct** (consider level of influence, degree of support), and that there has not been eg a part-disposal during the period.

Step 6 Verify the **arithmetical accuracy** of the consolidation workings by recalculating them.

Step 7 **Review** the **consolidated financial statements** for **compliance** with the legislation, accounting standards and other relevant regulations. Care will need to be taken where:

- Group companies do not have coterminous accounting periods
- Accounting policies of group members differ because foreign subsidiaries operate under different rules

Other important areas include:

- Treatment of participating interests and associates
- Treatment of goodwill and intangible assets
- Taxation
- Foreign currency translation
- Treatment of loss-making subsidiaries
- Treatment of restrictions on distribution of profits of a subsidiary

Step 8 **Review** the **consolidated financial statements** to confirm that they give a true and fair view in the circumstances.

The audit of related party transactions was considered earlier in this Study Text. Remember that when auditing a consolidation, the relevant related parties are those related to the **consolidated group.** Transactions with consolidated subsidiaries need **not** be disclosed, as they are incorporated in the financial statements.

The group auditors are often requested to carry out the consolidation work even where the financial statements of the subsidiaries have been prepared by the client. In these circumstances the auditors are of course acting as accountants **and** auditors, and care must be taken to ensure that the **audit** function is carried out and documented.

SLRFS 3 requires goodwill to be reviewed annually for impairment, in accordance with LKAS 36. This is the responsibility of management, and the auditor's role is to obtain audit evidence regarding the impairment review that management has already conducted.

QUESTION — Intra-group balances/profits

Your firm is the auditor of Beeston Industries, a limited liability company, which has a number of subsidiaries in your country (and no overseas subsidiaries), some of which are audited by other firms of professional accountants. You have been asked to consider the work which should be carried out to ensure that inter-company transactions and balances are correctly treated in the group accounts.

Required

(a) Describe the audit work you would perform to check that intra-group balances agree, state why intra-group balances should agree, and the consequences of them not agreeing.

(b) Describe the audit work you would perform to verify that intra-group profit in inventory has been correctly accounted for in the group accounts.

ANSWER

(a) Intra-group balances should agree because, in the preparation of consolidated financial statements, it is necessary to cancel them out. If they do not cancel out then the group accounts will be displaying an item which has no value outside of the group and profits may be correspondingly under or over-stated. The audit work required to check that intra-group balances agree would be as follows.

(i) Obtain and review a copy of the holding company's instructions to all group members relating to the procedures for reconciliation and agreement of year end intra-group balances. Particular attention should be paid to the treatment of 'in-transit' items to ensure that there is a proper cut-off.

(ii) Obtain a schedule of intra-group balances from all group companies and check the details therein to the summary prepared by the parent company. The details on these schedules should also be independently confirmed in writing by the other auditors involved.

(iii) Nil balances should be confirmed by both the group companies concerned and their respective auditors.

(iv) The details on the schedules in (iii) above should also be agreed to the details in the financial statements of the individual group companies which are submitted to the parent company for consolidation purposes.

(b) Where one company in a group supplies goods to another company at cost plus a percentage, and such goods remain in inventory at the year end, then the group inventory will contain an element of unrealised profit. In the preparation of the group accounts, best accounting practice requires that a provision should be made for this unrealised profit.

In order to verify that intra-group profit in inventory has been correctly accounted for in the group accounts, the audit work required would be as follows.

(i) Confirm the group's procedures for identification of such inventory and their notification to the parent company who will be responsible for making the required provision.

(ii) Obtain and review schedules of intra-group inventory from group companies and confirm that the same categories of inventory have been included as in previous years.

(iii) Select a sample of invoices for goods purchased from group companies and check to see that, where necessary, these have been included in year end intra-group inventory. Obtain confirmation from other auditors that they have satisfactorily completed a similar exercise.

(iv) Check the calculation of the provision for unrealised profit and confirm that this has been arrived at on a consistent basis with that used in earlier years, after making due allowance for any known changes in the profit margins operated by various group companies.

(v) Check the schedules of intra-group inventory against the various inventory sheets and consider whether the level of intra-group inventory appears to be reasonable in comparison with previous years, ensuring that satisfactory explanations are obtained for any material differences.

CHAPTER ROUNDUP

- An effective and efficient audit relies on proper planning procedures.
- The auditor formulates an **overall audit strategy** which is translated into a **detailed audit plan** for audit staff to follow. The overall audit strategy and audit plan shall be updated and changed as necessary during the course of the audit.
- Auditors usually carry out their audit work for a financial year in one or more sittings. These are referred to as the **interim audit(s)** and the **final audit**.
- The group engagement partner is responsible for the direction, supervision and performance of the group audit.
- Group financial statements may include amounts derived from financial statements which have not been audited by the group auditors, but by a different firm altogether: the component auditor**.**
- The group auditor takes sole responsibility for the group audit opinion.

PROGRESS TEST

1 List three benefits of planning an audit.

2 Complete the sentences.

An ……………… ……..…….. ……………… is the formulation of a general strategy for the audit.

An ……………… ………….. is a set of instructions to the audit team that sets out the further audit procedures to be carried out.

3 Changes to the overall audit strategy or audit plan do not need to be documented. True or false?

4 If substantive procedures are carried out at the interim audit before the year end, the auditor need not carry out substantive procedures at the final audit. True or false?

5 Identify at which audit stage each of the following procedures is most likely to be performed, by marking the appropriate box.

	Interim audit	Final audit
Risk assessment procedures		
Substantive testing of year-end balances		
Evaluation of internal controls		
Going concern review		

6 Define the term 'component auditor'.

ANSWERS TO PROGRESS TEST

1 Any three of the following are valid benefits of planning an audit.

Proper planning:

- Helps the auditor devote appropriate attention to important areas of the audit.
- Helps the auditor identify and resolve potential problems on a timely basis.
- Helps the auditor properly organise and manage the audit so it is performed in an effective manner.
- Assists in the selection of appropriate team members and assignment of work to them.
- Facilitates the direction, supervision and review of work.
- Assists in co-ordination of work done by auditors of components and experts.

2 An **overall audit strategy** is the formulation of a general strategy for the audit.

An **audit plan** is a set of instructions to the audit team that sets out the further audit procedures to be carried out.

3 False. Any changes shall be fully documented in accordance with SLAuS 300 *Planning an audit of financial statements*.

4 False. If substantive procedures are performed at an interim date, the auditor must cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls for the intervening period.

5 The audit stage at which each of the following procedures is most likely to be performed is:

	Interim audit	Final audit
Risk assessment procedures	X	
Substantive testing of year-end balances		X
Evaluation of internal controls	X	
Going concern review		X

6 An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

CHAPTER 06

The Auditor's Responsibilities in Relation to Fraud, Laws and Regulations

INTRODUCTION

In this chapter we will consider when it is appropriate for the auditor to place reliance on the work of others, such as the client's internal audit department. The auditor needs to consider the risks of fraud and non-compliance with laws and regulations, which we examine towards the end of this chapter.

Knowledge Component			
B	**Audit Planning Risk Assessment**		
2.3	**Risk of Material misstatement**	2.3.1	Assess risk of material misstatements including risk of frauds to be focused during the audit using risk assessment procedures
2.7	**Using the Work of Others**	2.7.1	Demonstrate the use of experts (both management and auditors experts), internal auditors and service organisation auditors in an audit of financial statements
2.8	**Laws and Regulations**	2.8.1	Explain auditors requirements consider compliance with laws and regulations during an audit of financial statement

CHAPTER CONTENTS	LEARNING OUTCOME
1 Using the work of others	2.7.1
2 Fraud	2.3.1
3 Laws and Regulations	2.8.1

1 Using the work of others

External auditors may make use of the work of an **auditor's expert**, **internal auditors** or **service organisations** and their auditors.

1.1 Using the work of an expert

An **auditor's expert** is an individual or organisation who has expertise in a field other than auditing or accounting, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be an auditor's internal expert (partner or staff, including temporary staff, of the auditor's firm or network firm) or an auditor's external expert.

Management's expert is an individual or organisation having expertise in a field other than auditing or accounting, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

Professional audit staff are highly trained and educated, but their experience and training is limited to accountancy and audit matters. In certain situations it will therefore be necessary to employ an **auditor's expert**.

Examples of areas in which an auditor's expert may be needed to help gain audit evidence include:

- Valuations of land and buildings
- Valuation of inventory or work in progress, including the determination of the physical condition of inventory
- Legal opinions, including expert opinions on the possible outcomes of litigation or disputes.

Guidance on this area is provided by SLAuS 620 *Using the work of an auditor's expert*. An auditor's expert could be employed by the auditor to assist in:

- Obtaining an understanding of the entity and its environment, including its internal control
- Identifying and assessing the risks of material misstatement
- Determining and implementing overall responses to assessed risks at the financial statement level
- Designing and performing further audit procedures to respond to assessed risks at the assertion level
- Evaluating the sufficiency and appropriateness of audit evidence obtained in forming an opinion on the financial statements

1.1.1 Competence, capabilities and objectivity of the auditor's expert

SLAuS 620 requires the auditor to evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity. Where the auditor's expert is external, the evaluation of objectivity will include enquiry of interests and relationships that could create a threat to objectivity.

Information on these areas may come from the following sources:

- **Personal experience** with previous work done by the expert
- **Discussions with the expert**
- **Discussions with other people** who are familiar with the expert's work
- Knowledge of the expert's **qualifications, membership of a professional body or industry association, licence to practise** etc
- **Published papers or books** by the expert
- The auditor's firm's **quality control policies and procedures**

1.1.2 Obtaining an understanding of the field of expertise

The auditor shall obtain a sufficient understanding of the auditor's expert's field of expertise to allow the auditor to determine the nature, scope and objectives of the work and to evaluate the adequacy of the work done.

1.1.3 Agreement

SLAuS 620 requires the auditor to agree in writing the following with the auditor's expert:

- **Nature, scope and objectives** of the work
- Respective **roles and responsibilities** of the auditor and the auditor's expert
- **Nature, timing and extent of communication** between auditor and auditor's expert, including the **form of any report**
- **Confidentiality requirements**

The agreement between the auditor and the auditor's expert is often in the form of an engagement letter. The Appendix to SLAuS 620 lists matters to consider for inclusion in the engagement letter.

1.1.4 Evaluating the work of the auditor's expert

The auditor shall evaluate the adequacy of the auditor's expert's work, which will include the following:

- The **relevance and reasonableness** of the expert's work and **consistency** with other audit evidence
- The relevance and reasonableness of any **assumptions and methods** used
- The relevance, completeness and accuracy of any **source data** used

If the auditor's evaluation results in a conclusion that the expert's work is not adequate, the auditor must agree on the nature and extent of further work to be done by the expert, and perform additional audit procedures that may be necessary in the circumstances.

1.1.5 Reference to the auditor's expert in the auditor's report

The auditor must not refer to the work of an auditor's expert in the auditor's report containing an unmodified opinion (unless required by law or regulation). If the auditor makes reference to the work of an auditor's expert in the auditor's report because it is relevant to understanding a modification to the opinion, the auditor must state in the auditor's report that this reference does not reduce the auditor's responsibility for the opinion.

1.2 Using the work of internal audit

SLAuS 610 *Using the work of internal audit* provides guidance to the external auditor when the external auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor.

The objectives of the auditor (as stated in SLAuS 610) are as follows.

- To determine whether the work of the internal audit function can be used, and if so, in which areas and to what extent; and having made that determination:
- If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit.

For the purposes of the SLAuSs an **internal audit function** is defined as:

"A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes."

The basic issue here is the same as with using the work of any other expert: you cannot just rely on their work, but must decide whether it is actually suitable for the external audit. In the case of work done by the internal audit function, SLAuS 610 states that the external auditor must determine:

- Whether internal audit's work can be used at all
- If the work can be used, in which areas and to what extent? Is the work adequate for the purposes of the external audit?

1.2.1 Assessing the internal audit function

Determining what work can be used involves considering three main things:

(a) Internal audit's **organisational status** and relevant policies and procedures. Are the internal auditors **objective**?

(b) The **level of competence** of the internal audit function

(c) Whether the internal audit function applies a **systematic and disciplined approach**, including **quality control**

In assessing internal audit's **objectivity**, the external auditor should consider:

Assessing the objectivity of the internal audit function	
Organisational status	**High organisational status** may indicate greater objectivity. Does the internal audit function report to those charged with governance, or merely to management?
Conflicting responsibilities	Does internal audit have **other responsibilities** that affect its objectivity?

Assessing the objectivity of the internal audit function	
Employment decisions	Are employment **decisions overseen** by those charged with governance?
Constraints and restrictions	Is the internal audit function **restricted from communicating findings** to the external auditor?
Membership of a professional body	Are the internal auditors members of relevant **professional bodies**? Are they obliged to comply with relevant professional standards, including **CPD requirements**?

In assessing internal audit's **competence**, the following factors should be considered.

Factors affecting the competence of the internal audit function
Level of resources relative to the size and nature of its operations
Established **policies** for hiring, training and assigning internal auditors to engagements
Whether internal auditors have **adequate technical training** and **proficiency** in auditing
Whether the internal auditors possess the required **financial reporting knowledge** and necessary skills
Whether the internal auditors are **members of relevant professional bodies**

The external auditor should also look for evidence of a **systematic and disciplined approach**. The internal audit function should have documented internal audit procedures, including those covering areas such as risk assessment, work programs, documentation and reporting. The external auditor will also consider whether appropriate **quality control** procedures are in place.

If the internal audit function lacks any of the above (ie objectivity, competence, or a systematic and disciplined approach), then **none of its work can be relied upon**.

1.2.2 Determining the nature and extent of work that can be used

The key question is: is the work relevant to the overall audit strategy and audit plan?

The ISA lists the following as examples of internal audit work that can typically be used by the external auditor.

Internal audit work that can typically be used
Testing of the **operating effectiveness of controls**
Substantive procedures involving limited judgment
Observations of **inventory counts**
Tracing transactions through the financial reporting information system
Testing of **compliance with regulatory requirements**
In some circumstances, **audits** or reviews of the financial information **of subsidiaries** that are not significant components to the group

Any work that involves significant judgements cannot be used. Work in the following areas **cannot** be relied upon:

- Assessing the risk of material misstatement
- Evaluating the sufficiency of tests performed
- Evaluating the appropriateness of management's use of the going concern assumption
- Evaluating significant accounting estimates
- Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report

SLAuS 610 requires the external auditor to reperform some of the work carried out by the internal audit function.

1.2.3 Direct assistance

The external auditor cannot use the internal audit function to provide direct assistance if:

- It is prohibited by law
- There are significant threats to the objectivity of the internal audit function
- The internal audit function lacks sufficient competence to perform the proposed work

In addition the internal audit function must not provide direct assistance to perform procedures which:

- Involve making significant judgments
- Relate to areas where the risk of material misstatement is higher and judgment in applying the procedure is higher than limited

- Relate to work which the internal auditors have been involved in and which have been or will be reported to management by them
- Relate to decisions that the external auditor makes about the internal audit function and the use of its work

If the conclusion is that the internal audit function can provide direct assistance the external auditor must obtain written agreement that the internal auditors will be allowed to follow the instructions of the external auditor. The internal audit function must also confirm in writing that they will keep matters confidential as instructed by the external auditor.

The external auditor is then required to direct, supervise and review the work performed in accordance with SLAuS 220.

1.3 Service organisations

A **service organisation** provides services to user entities. There may be special considerations for the auditor of a user entity when that entity makes use of a service organisation.

A **service organisation** is a third-party organisation that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

A **user entity** is an entity that uses a service organisation and whose financial statements are being audited.

A **user auditor** is an auditor who audits and reports on the financial statements of a user entity.

A **service auditor** is an auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation.

SLAuS 402 *Audit considerations relating to an entity using a service organisation* provides guidance to auditors whose clients use such an organisation. It expands on how the user auditor obtains an understanding of the user entity, including internal control sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

A client may use a service organisation such as one that executes transactions and maintains related accountability, or records transactions and processes related data. Many companies outsource aspects of their business activities to external service organisations. Examples relevant to the independent auditors include:

- Payroll processing
- Maintenance of accounting records
- Maintenance of IT systems relevant to financial reporting

1.3.1 Understanding the services provided

User auditors must obtain an understanding of the services provided by the service organisation in accordance with SLAuS 315. This understanding must include the following:

- Nature of services provided and the significance of these to the user entity, including effect on user entity's internal control
- Nature and materiality of transactions processed or financial reporting processes affected
- Degree of interaction
- Nature of relationship, including contractual terms

When obtaining an understanding of the internal control relevant to the audit, the user auditor must evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation.

The user auditor needs to determine whether a sufficient understanding of the nature and significance of the services provided, and their effect on internal control, has been obtained to allow for the identification and assessment of risks of material misstatement in the financial statements.

If the user auditor cannot get this understanding from the user entity, the understanding needs to be obtained from one or more of the following procedures:

- Obtaining a type 1 report (report on description and design of controls at a service organisation) or type 2 report (report on the description, design and operating effectiveness of controls at a service organisation) from a service auditor, if available
- Contacting the service organisation through the user entity
- Visiting the service organisation and performing necessary procedures
- Using another auditor to perform necessary procedures

If the user auditor uses a type 1 or type 2 report to obtain an understanding of the services, the auditor must be satisfied as to the service auditor's professional competence and independence, and the adequacy of standards used.

1.3.2 Responding to the assessed risks of material misstatement

In responding to the assessed risks in accordance with SLAuS 330, the user auditor must:

(a) Determine whether **sufficient appropriate audit evidence** concerning the relevant financial statement assertions is available from records held at the user entity; and if not

(b) Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.

1.3.3 Reporting by the user auditor

The user auditor is always **solely responsible** for the auditor's opinion. He must be assured that he has gained sufficient appropriate audit evidence to form an opinion on the financial statements and he must then express his opinion in the auditor's report. The user auditor must therefore not refer to the work of a service auditor in the user auditor's report if it contains an unmodified opinion (unless required by law or regulation). If the user auditor makes reference to the work of a service auditor in the user auditor's report because it is relevant to understanding a modification to the opinion, the user auditor must state in the user auditor's report that this reference does not reduce the user auditor's responsibility for the opinion.

2 Fraud

An overriding requirement of the SLAuSs is that auditors are aware of the possibility of there being misstatements due to fraud.

2.1 What is fraud?

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

Fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Fraud is a wide legal concept, but the auditor's main concern is with fraud that causes a material misstatement in financial statements. It is distinguished from error, which is when a material misstatement is caused by mistake, for example, in the misapplication of an accounting policy.

Specifically, there are two types of fraud causing material misstatement in financial statements:

- Fraudulent financial reporting
- Misappropriation of assets

2.1.1 Fraudulent financial reporting

Fraudulent financial reporting involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users.

This may include:

- Manipulation, falsification or alteration of accounting records/supporting documents
- Misrepresentation (or omission) of events or transactions in the financial statements
- Intentional misapplication of accounting principles

Such fraud may be carried out by overriding controls that would otherwise appear to be operating effectively; for example, by recording fictitious journal entries or improperly adjusting assumptions or estimates used in financial reporting.

Aggressive earnings management is a topical issue and, at its most aggressive, may constitute fraudulent financial reporting. Auditors should consider issues such as unsuitable revenue recognition, accruals, liabilities, provisions and reserves accounting and large numbers of immaterial breaches of financial reporting requirements to see whether, together, they constitute fraud.

2.1.2 Misappropriation of assets

Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more capable of disguising or concealing misappropriations in ways that are difficult to detect.

This is the theft of the entity's assets (for example, cash or inventory). Employees may be involved in such fraud in small and immaterial amounts, but it can also be carried out on a larger scale by management who may then conceal the misappropriation, for example, by:

- Embezzling receipts (for example, diverting them to private bank accounts)
- Stealing physical assets or intellectual property (inventory, selling data)
- Causing an entity to pay for goods not received (payments to fictitious vendors)
- Using assets for personal use

2.2 Fraud and the auditor

SLAuS 240 *The auditor's responsibilities relating to fraud in an audit of financial statements* provides guidance to auditors in this area.

2.2.1 General

The key responsibility of an auditor is set out early in the SLAuS.

SLAuS 240.5

An auditor conducting an audit in accordance with SLAuSs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement whether caused by fraud or error.

SLAuS 240.10

The objectives of the auditor are:

(a) To identify and assess the risks of material misstatement of the financial statements due to fraud.

(b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses.

(c) To respond appropriately to fraud or suspected fraud identified during the audit.

An overriding requirement of the SLAuS is that auditors are aware of the possibility of there being misstatements due to fraud.

SLAuS 240.12

In accordance with SLAuS 200, the auditor shall maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.

The SLAuS also requires discussion by members of the engagement team of the susceptibility of the entity's financial statements to material misstatement due to fraud, including how fraud might occur.

The engagement partner must consider what matters discussed should be passed on to other members of the team not present at the discussion. The discussion itself usually includes:

- An exchange of ideas between the engagement team about how fraud could be perpetrated
- A consideration of circumstances that might be indicative of aggressive earnings management
- A consideration of known factors that might give incentive to management to commit fraud
- A consideration of management's oversight of employees with access to cash/other assets
- A consideration of any unusual/unexplained changes in lifestyle of management/employees
- An emphasis on maintaining professional scepticism throughout the audit
- A consideration of the types of circumstance that might indicate fraud
- A consideration of how unpredictability will be incorporated into the audit
- A consideration of what audit procedures might be carried out to answer any suspicions of fraud
- A consideration of any allegations of fraud that have come to the auditors' attention
- A consideration of the risk of management override of controls

2.2.2 Risk assessment procedures

The auditor would undertake risk assessment procedures as set out in SLAuS 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* which would include assessing the risk of fraud. These procedures will include:

- Enquiries of management and those charged with governance
- Consideration of when fraud risk factors are present
- Consideration of results of analytical procedures
- Consideration of any other relevant information

In identifying the risks of fraud, the auditor is required by the SLAuS to carry out some specific procedures.

SLAuS 240.17

The auditor shall make enquiries of management regarding:

(a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments

(b) Management's processes for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances or disclosures for which a risk of fraud is likely to exist

(c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity, and

(d) Management's communication, if any, to employees regarding its views on business practices and ethical behaviour

SLAuS 240.18

The auditor shall make enquiries of management and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.

SLAuS 240.19

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

SLAuS 240.20

Unless all of those charged with governance are involved in managing the entity the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.

SLAuS 240.21

Unless all of those charged with governance are involved in managing the entity, the auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

SLAuS 240.24

The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud.

The size, complexity and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity there may be factors that generally constrain improper conduct by management including effective oversight by those charged with governance, an effective internal audit function and a written code of conduct. These considerations are less likely in the case of a small entity.

SLAuS 240 also contains an assumption that revenue recognition is at high risk of material misstatement due to fraud. This risk is 'rebuttable' if the auditor should determine that there is not such a risk in the revenue recognition of the entity.

SLAuS 240.26

When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 specifies the documentation required where the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud.

There should also be a recognition that the possibility of management override of controls may occur. This potential should be considered at the risk assessment stage and the auditor should act with professional scepticism throughout in order to minimise this risk.

SLAuS 240.31

Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

2.2.3 Examples of fraud risk factors

SLAuS 240 does not attempt to provide a definitive list of risk factors but, in an appendix, identifies and gives examples of two types of fraud that are relevant to auditors which we referred to earlier:

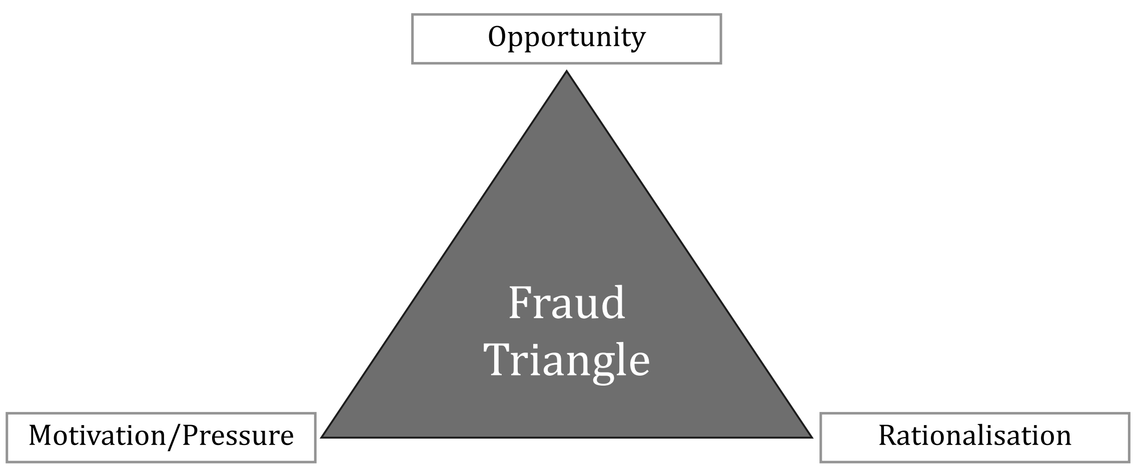
- Fraudulent financial reporting
- Misstatements arising from misappropriation of assets

For each of these, the risk factors are classified according to three conditions that are generally present when misstatements due to fraud occur:

- Incentives/pressures
- Opportunities
- Attitudes/rationalisations

These three factors are based on an idea first expressed by Donald R. Cressey, who described a 'fraud triangle'.

Figure 6.1: Donald R. Cressey's 'fraud triangle'



The three factors at each point of the triangle are considered present in every fraud situation and breaking the fraud triangle is essential to fraud deterrence. Organisations can try to reduce the risk of fraud by removing one of the elements.

Examples of each factor could be:

(a) **Motivation/Pressure**: An employee is poorly paid and struggling financially

(b) **Opportunity**: Segregation of duties is inadequate and the same person that records cash received is responsible for paying it into the bank

(c) **Rationalisation**: The employee feels they are just taking what would be a fair wage as they consider themselves underpaid

Risk factors for fraudulent financial reporting and misappropriation of assets given in SLAuS 240 are as follows. They are categorised according to the three factors in the Fraud Triangle.

Figure 6.2: Risk factors for fraudulent financial reporting

Fraudulent financial reporting

- **Incentives/pressures**
  - Financial stability/profitability is threatened
  - Pressure on management to meet the expectations of third parties
  - Personal financial situation of management threatened by the entity's financial performance
  - Excessive pressure on management or operating personnel to meet financial targets
- **Opportunities**
  - Significant related-party transactions
  - Assets, liabilities, revenues or expenses based on significant estimates
  - Domination of management by a single person or small group
  - Complex or unstable organisational structure
  - Internal control components are deficient
- **Attitudes/rationalisations**
  - Ineffective communication or enforcement of the entity's values or ethical standards by management
  - Known history of violations of securities laws or other laws and regulations
  - A practice by management of committing to achieve aggressive or unrealistic forecasts
  - Low morale among senior management
  - Relationship between management and the current or predecessor auditor is strained

Misappropriation of assets

- **Incentives/pressures**
  - Personal financial obligations
  - Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft
- **Opportunities**
  - Large amounts of cash on hand or processed
  - Inventory items that are small in size, of high value, or in high demand
  - Easily convertible assets, such as bearer bonds, diamonds, or computer chips
  - Inadequate internal control over assets
- **Attitudes/rationalisations**
  - Overriding existing controls
  - Failing to correct known internal control deficiencies
  - Behaviour indicating displeasure or dissatisfaction with the entity
  - Changes in behaviour or lifestyle

2.2.4 Fraud red flags

Red flags are possible actions or omissions in the company that may suggest fraudulent activity is taking place. A red flag could be a symptom of an underlying disease – fraud. At the very least, a red flag means that the area requires further investigation.

Financial reporting red flags

Red flags that may suggest possible financial reporting fraud include:

- Recent or frequent changes in auditors
- Records of frequent disagreements between management and external auditors
- Evasiveness or hesitancy from management about questions relating to the financial statements
- CEO or CFO insist on attending all meetings between audit committee and the external or internal auditors
- Financial reports are significantly stronger than competitors, with little or no difference in operations
- Overly optimistic shareholder communications or new releases
- Large transactions made at the last minute that result in large revenues showing in quarterly or annual reports
- Pattern of shipping the quarterly or months sales in the last day or last week of the period
- Internal audit operates under very restrictive management conditions
- Changes in the statement of financial position which are unusual, for example delayed accounts payable or receivables growing faster than revenues
- Consistently close or exact match to planned versus actual revenues
- Use of reserves to smooth out earnings
- Significant and frequent changes in estimates with no clear reason
- Management reluctance to adopt recommendations from internal and/or external auditors

Another red flag of financial statement fraud is suspected "window dressing" of the financial statements.

Window dressing is a technique used by management to manipulate the financial statements in order to show a more favourable result for the period. It is a short-term strategy designed to present the financial statements as more consistent and more desirable than they really are.

Companies generally window dress the financial statements by selling off assets and using the proceeds to fund operations or to buy new assets. This means that the cash balance on the statement of financial position remains consistent.

Window dressing is not illegal or fraudulent. However, it is generally viewed as dishonest and unethical as its purpose is generally to mislead investors about the company's true performance. It is also a strong indicator that the company may be engaged in fraudulent behaviour.

Asset misappropriation red flags

Red flags that may suggest possible asset misappropriation include:

- Internal controls breakdowns or overrides
- Any process or transaction that is unusual or out of the ordinary, such as invoices signed off by a different person, transaction amounts that are too big (or too small)
- Accounting mistakes or anomalies, such as false documents or mistakes in ledger entries
- Lifestyle changes in employees
- Employees showing behavioural changes or increased stress for no apparent reason
- Tips or complaints from other employees or stakeholders

QUESTION **Fraud risk factors**

You are an audit manager for Elle and Emm, a firm of Chartered Accountants. You are carrying out the planning of the audit of Sellfones Plc, a listed company and a high street retailer of mobile phones, for the year ending 30 September 20X7. The notes from your planning meeting with Prema De Silva, the financial director, include the following:

(1) One of Sellfones Plc's main competitors ceased trading during the year due to the increasing pressure on margins in the industry and competition from online retailers.

(2) A new management structure has been implemented, with 10 new divisional managers appointed during the year. The high street shops have been allocated to these managers, with approximately 20 branch managers reporting to each divisional manager. The divisional managers have been set challenging financial targets for their areas, with substantial bonuses offered to incentivise them to meet the targets. The board of directors has also decided to cut the amount that will be paid to shop staff as a year-end bonus.

(3) In response to recommendations in the prior year's Report to Management, a new inventory system has been implemented. There were some problems in its first months of operation but a report has been submitted to the board by Sanjeev Abekoon, the chief accountant, confirming that the problems have all been resolved and that information produced by the system will be accurate. Prema commented that the chief accountant has had to work very long hours to deal with this new system, often working at weekends and even refusing to take any leave until the system was running properly.

(4) The company is planning to raise new capital through a share issue after the year-end in order to finance expansion of the business into other countries in Europe. As a result, Prema has requested that the auditor's report is signed off by 15 December 20X7 (six weeks earlier than in previous years).

(5) The latest board summary of results includes:

9 months to 30 June 20X7 (unaudited)		*Year to 30 September 20X6 (audited)*	
	Rs Mn		Rs Mn
Revenue	32,000	Revenue	28,000
Cost of sales	21,500	Cost of sales	19,900
Gross profit	10,500	Gross profit	8,100
Operating expenses	(8,900)	Operating expenses	(7,000)
Exceptional profit on sale of properties	3,000		–
Profit before tax	4,600		1,100

(6) Several shop properties owned by the company were sold under sale and leaseback arrangements.

Required

Analyse and **present** any fraud risk factors that the audit team should consider when planning the audit of Sellphones Plc.

ANSWER

In this scenario there are a large number of factors that should alert the auditors to the possibility of misstatements arising from fraudulent financial reporting, and others that could indicate a risk of misstatements arising from misappropriation of assets.

(1) **Operating conditions within the industry**

The failure of a competitor in a highly competitive business sector highlights the threat to the survival of a business such as Sellphones and this could place the directors under pressure to overstate the performance and position of the company in an attempt to maintain investor confidence, particularly given the intention to raise new share capital.

(2) **Management structure and incentives**

It is not clear in the scenario how much involvement the new divisional managers have in the financial reporting process but the auditors would need to examine any reports prepared or reviewed by them very carefully as their personal interest may lead them to overstate results in order to earn their bonuses.

(3) **New inventory system/chief accountant**

The problems with the implementation of the new inventory system suggest that there may have been control deficiencies and errors in the recording of inventory figures. Misstatements, whether deliberate or not, may not have been identified. The amount of time spent by the chief accountant on the implementation of the new inventory system could be seen as merely underlining the severity of the problems, but the fact that he has not taken any leave should also be considered as suspicious and the auditors should be alert to any indication that he may have been involved in any deliberate misstatement of figures.

(4) **Results**

The year-on-year results look better than might be expected given the business environment. The gross profit margin has increased to 32.8% (20X6 25.3%) and the operating profit margin has increased to 5% (20X6 3.9%). This seems to conflict with what is known about the industry and should increase the auditor's professional scepticism in planning the audit.

(5) **Exceptional gain**

The sale and leaseback transaction may involve complex considerations relating to its commercial substance. It may not be appropriate to recognise a gain or the gain may have been miscalculated.

(6) **Time pressure on audit**

The auditors should be alert to the possibility that the tight deadline may have been set to reduce the amount of time the auditors have to gather evidence after the end of the reporting period, perhaps in the hope that certain deliberate misstatements will not be discovered.

(7) **Risk of misappropriation of assets**

The nature of the inventory held in the shops increases the risk that staff may steal goods. This risk is perhaps increased by the fact that the attitude of the staff towards their employer is likely to have been damaged by the cut in their year-end bonus. The problems with the new inventory recording system increase the risk that any such discrepancies in inventory may not have been identified.

2.2.5 Responding to assessed risks

Generally, the auditor:

- Identifies fraud risks
- Relates this to what could go wrong at a financial statement level
- Considers the likely magnitude of potential misstatement

The auditor must then come up with responses to the assessed risks.

SLAuS 240.28

In accordance with SLAuS 330 the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level.

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

(a) Consider the assignment and supervision of personnel

(b) Consider the accounting policies used by the entity, and

(c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures

SLAuS 240.30

In accordance with SLAuS 330, the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.

The auditor may have to **amend** the **nature, timing or extent** of planned audit procedures to address assessed risks. The auditor should also consider the following:

- Audit procedures responsive to management override of controls
- Journal entries and other adjustments
- Accounting estimates
- Business rationale for significant transactions

We mentioned above that the auditor must recognise that there is a risk management override of controls and as such SLAuS 240 outlines specific procedures that the auditor should put in place to address these risks:

SLAuS 240.32

(a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:

(i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;

(ii) Select journal entries and other adjustments made at the end of a reporting period; and

(iii) Consider the need to test journal entries and other adjustments throughout the period.

(b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall:

(i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall re-evaluate the accounting estimates taken as a whole; and

(ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year

2.2.6 Examples: specific audit procedures

The auditor might choose to attend previously unvisited branches to carry out inventory or cash checks.

The auditor might perform detailed analytical procedures using disaggregated data, for example, comparing sales and costs of sales by location.

The auditor might use an expert to assess management estimates in a subjective area.

QUESTION **Response to fraud risk factors**

You are an audit manager for Jethas, a firm of Chartered Accountants. You are carrying out the audit of Lanthos Plc, a listed company in the retail industry. Lanthos has had a difficult trading year and the directors are worried about the share price which has decreased by 10% in the year. If it were to fall further, they would not be eligible for a significant bonus based on share price growth over a three-year period.

When conducting the audit of the revenue figure it was discovered that there was a large journal entry releasing a significant amount of deferred income relating to goods that had yet to be delivered at the year end. This journal entry amounted to 2% of total revenue and was posted two days prior to the year-end date. The finance manager has been unable to find the detailed paperwork to back-up the figure.

Lanthos has also recognised a gain amounting to 25% of profit on a land-mark city centre property that was previously used as their head office but for several years has been let to a large insurance company as an investment property, treating it under the fair value model. Property prices in the area have not increased significantly in the last 12 months. The finance director was responsible for estimating the current value of the property.

Required

Suggest audit procedures that should now be carried out in order to respond to the discovery of the journal entry and the gain on the investment property.

ANSWER

The auditor should carry out specific procedures where fraud risk factors such as those in Lanthos Plc are apparent.

There is a clear potential for fraud in this case as we can see that the directors are under pressure to maintain the share price leading to the incentive to manipulate revenue and profit.

The journal entry relating to deferred income is potentially fraudulent and may be an attempt to bolster the share price by posting higher revenue. In order to test it the auditor should:

- Inquire of management as to the basis of the journal entry and request that the back-up be provided.
- Assuming that the back-up is provided, re-calculate the amount based on the correct accounting treatment and release of deferred income to see if it matches management's calculation.
- Consider taking a large sample of other journal entries made around the year-end and evaluate the basis for their inclusion.
- Consider the need to sample other journal entries across the period, particularly those related to revenue recognition.

The revaluation of the building would also seem to be high risk. It is an investment property and as such will be revalued on an annual basis with the gain or loss recognised in profit or loss, yet in the current year property prices have not increased and the value of the investment property has been assessed as having increased by 25%. Again, there is an incentive for management to recognise a large gain in profit or loss to maintain the share price. Possible audit procedures include:

- Evaluate the assumptions made by the finance director in the estimate of the fair value of the property for reasonableness.
- Consider the use of an auditor's expert to evaluate the fair value of the building.

- If within the expertise and experience of the auditor, make an estimate of the fair value to compare to management's estimate.
- Consider whether there are other subjective estimates that management have made that should now be re-considered.

2.3 Evaluation of audit evidence

The auditor evaluates the audit evidence obtained to ensure it is consistent and that it achieves its aim of answering the risks of fraud. This will include a consideration of results of analytical procedures and any misstatements found. The auditor must also consider the reliability of written representations.

The auditor must obtain written representation that management accepts its responsibility for the prevention and detection of fraud and has made all relevant disclosures to the auditors.

2.4 Documentation

The auditor must document:

- The significant decisions reached as a result of the team's discussion of fraud
- The identified and assessed risks of material misstatement due to fraud
- The overall responses to assessed risks
- Results of specific audit tests
- Any communications with management
- Reasons for concluding that the presumption that there is a risk of fraud related to revenue recognition is not applicable.

2.5 Reporting

There are various reporting requirements in SLAuS 240.

SLAuS 240.40

If the auditor has identified a fraud or has obtained information that indicates a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

SLAuS 240.41

Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:

(a) Management

(b) Employees who have significant roles in internal control, or

(c) Others, where the fraud results in a material misstatement in the financial statements

the auditor shall communicate these matters to **those charged with governance** on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit.

The auditor should also make relevant parties within the entity aware of significant deficiencies in the design or implementation of controls to prevent and detect fraud which have come to the auditor's attention, and consider whether there are any other relevant matters to bring to the attention of those charged with governance with regard to fraud.

The auditor may have a **statutory duty** to report fraudulent behaviour to **regulators** outside the entity. If no such legal duty arises, the auditor must consider whether to do so would breach their **professional duty of confidence**. In either event, the auditor should take **legal advice**.

2.6 Auditor unable to continue

The auditor should consider the need to withdraw from the engagement if he uncovers exceptional circumstances with regard to fraud.

2.7 Fraud in a global economic downturn

The global economic downturn resulted in the uncovering of a number of frauds. Sustaining fraud often relies on incoming cash from investors. As the world economy deteriorates, less cash is available for investment and the fraudulent scheme collapses. This partly explains why more fraud is discovered in a global economic downturn.

Additionally, a tougher economic climate can increase the pressure to carry out fraud. This can be for personal reasons where an employee desires to maintain a higher standard of living than they can now afford. Worries over job security or decreased compensation due to lower bonuses and share values can all add to an employee being able to rationalise and justify fraud. Alternatively, fraud may be perpetrated as management feel pressure to maintain earnings or meet company debt covenants rather than for personal gain.

In the wake of the financial crisis of 2007-8, there was a lot of discussion in the profession about extending the auditor's responsibilities with regard to fraud. In a global economic downturn the auditor needs to be increasingly aware of the risk of fraud. The audit must be planned and carried out with this in mind.

QUESTION — Detection of fraud

Required

(a) **Discuss** what responsibility auditors have to detect fraud.

(b) **Explain** how the auditors might conduct their audit in response to an assessed risk of:

(i) Misappropriation

(ii) Fraudulent financial reporting

ANSWER

(a) The primary responsibility for the prevention and detection of fraud and irregularities rests with management and those charged with governance. This responsibility may be partly discharged by the institution of an adequate system of internal control including, for example, authorisation controls and controls covering segregation of duties.

The auditors should recognise the possibility of material irregularities or frauds which could, unless adequately disclosed, distort the results or state of affairs shown by the financial statements. SLAuS 240 states that the auditor is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Auditors are required to carry out their audit with professional scepticism.

Auditors are required to carry out risk assessment procedures in respect of fraud. This will involve making enquiries of management, considering if any risk factors (such as the existence of pressure for management to meet certain targets) are present and to consider the results of analytical procedures if any method or unexpected relationships have been identified.

If there is an assessed risk of fraud, the auditor must make suitable responses. Overall responses include considering the personnel for the assignment (for example, using more experienced personnel), considering the accounting policies used by the entity (have they changed? are they reasonable?) and incorporating an element of unpredictability into the audit.

Specific responses to the risk of misstatement at the assertion level due to fraud will vary depending on the circumstances, but could include:

(i) Changing the nature of audit tests (for example, introducing CAATs if more detail is required about a computerised system)

(ii) Changing the timing of audit tests (for example, testing throughout an audit period, instead of extending audit conclusions from an interim audit)

(iii) Changing the extent of audit tests (for example, increasing sample sizes)

(b) (i) **Misappropriation**

Employee frauds such as misappropriation are likely to take place when controls are weak. If controls are weak, auditors may not test controls and hence evidence of employee fraud might go undetected. However, if auditors have identified a risk of employee fraud, they might, as a response, test controls in the relevant area (such as purchases or sales) in order to identify any unexplained patterns in the company's procedures. For example, if a purchase fraud is suspected, auditors might scrutinise authorisation controls to see if a particular member of staff always authorises certain items/for certain people, where the system does not require that.

Many substantive procedures normally performed by the auditors may assist in isolating employee frauds, if they are occurring. For example, tests performed on the receivables ledger may be aimed at revealing overstatement or irrecoverable receivables, but the design of such tests also assists with cash understatement objectives and may reveal irregularities such as 'teeming and lading' (see table 10.3 in Chapter 10 for details).

(ii) **Fraudulent financial reporting**

If the auditors conclude that there is a high risk of fraudulent financial reporting by management they will concentrate on techniques such as analytical procedures, scrutiny of unusual transactions and all journal entries, review of events after the reporting period (including going concern evaluation), and review of the financial statements and accounting policies for any changes or material distortions.

3 Law and regulations

The auditor must consider the risk of non-compliance with law and regulations causing a misstatement in the financial statements.

The auditor is also required to consider the issue of law and regulations in the audit. Auditors are given guidance in SLAuS 250 *Consideration of laws and regulations in an audit of financial statements*. The objectives of the auditor are:

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

3.1 Responsibilities of management compared with auditors

It is management's responsibility to ensure that the entity complies with the relevant laws and regulations. It is not the auditor's responsibility to prevent or detect non-compliance with laws and regulations.

The auditor's responsibility is to obtain reasonable assurance that the financial statements are free from material misstatement and, in this respect, the auditor must take into account the legal and regulatory framework within which the entity operates.

SLAuS 250 distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations:

- Those that have a **direct effect** on the determination of **material amounts** and disclosures in the financial statements
- Those that **do not have a direct effect** on the determination of material amounts and disclosures in the financial statements but where compliance may be fundamental to the **operating aspects**, ability to **continue in business**, or to avoid **material penalties**

For the first category, the auditor's responsibility is to obtain sufficient appropriate audit evidence about **compliance** with those laws and regulations.

For the second category, the auditor's responsibility is to undertake specified audit procedures to help **identify non-compliance** with laws and regulations that may have a **material effect** on the financial statements. These include enquiries of management and inspecting correspondence with the relevant licensing or regulatory authorities.

3.2 Audit procedures

In accordance with SLAuS 315, the auditor shall obtain a general understanding of:

- The applicable legal and regulatory framework
- How the entity complies with that framework

The auditor can achieve this understanding by using his/her **existing understanding** and updating it, and making **enquiries of management** about other laws and regulations that may affect the entity, about its policies and procedures for ensuring compliance, and about its policies and procedures for identifying, evaluating and accounting for litigation claims.

The auditor shall remain alert throughout the audit to the possibility that **other audit procedures** may bring instances of non-compliance or suspected non-compliance to the auditor's attention. These audit procedures could include:

- Reading minutes
- Making enquiries of management and in-house/external legal advisors regarding litigation, claims and assessments
- Performing substantive tests of details of classes of transactions, account balances or disclosures

The auditor shall request **written representations** from management that all known instances of non-compliance or suspected non-compliance with laws and regulations, whose effects should be considered when preparing the financial statements, have been disclosed to the auditor.

3.3 Audit procedures when non-compliance is identified or suspected

The following factors may indicate non-compliance with laws and regulations: Non compliance red flags

- Investigations by regulatory authorities and government departments
- Payment of fines or penalties
- Payments for unspecified services or loans to consultants, related parties, employees or government employees
- Sales commissions or agents' fees that appear excessive
- Purchasing at prices significantly above/below market price
- Unusual payments in cash
- Unusual transactions with companies registered in tax havens

- Payment for goods and services made to a country different to the one in which the goods and services originated
- Payments without proper exchange control documentation
- Existence of an information system that fails to provide an adequate audit trail or sufficient evidence
- Unauthorised transactions or improperly recorded transactions
- Adverse media comment

The following table summarises audit procedures to be performed when non-compliance is identified or suspected.

Table 6.2: Non-compliance audit procedures

Non-compliance: audit procedures
Obtain understanding of nature of act and circumstances.
Obtain further information to evaluate possible effect on financial statements.
Discuss with management and those charged with governance.
Consider need to obtain legal advice if sufficient information not provided and matter is material.
Evaluate effect on auditor's opinion if sufficient information not obtained.
Evaluate implications on risk assessment and reliability of written representations.

3.4 Reporting identified or suspected non-compliance

The auditor shall communicate with **those charged with governance**, but if the auditor suspects that those charged with governance are involved, the auditor shall communicate with the next higher level of authority such as the **audit committee or supervisory board**. If this does not exist, the auditor shall consider the need to obtain **legal advice.**

The auditor shall consider the effect on the **auditor's report** if they conclude that the non-compliance has a material effect on the financial statements and has not been adequately reflected, or if the auditor is prevented by management and those charged with governance from obtaining **sufficient appropriate audit evidence** to evaluate whether the effect of the non-compliance is material to the financial statements.

The auditor shall determine whether identified or suspected non-compliance has to be reported to the **regulatory and enforcement authorities**. Although the auditor must maintain the fundamental principle of **confidentiality**, in some jurisdictions the duty of confidentiality may be **overridden** by law or statute.

The auditor must balance their duty of confidentiality to their client with their duty to act in the **public interest**. This duty towards the public includes making disclosures about a client's non-compliance with laws and regulations, so the auditor cannot simply hide behind the principle of confidentiality, but must instead make a judgment about whether to disclose in the public interest.

CHAPTER ROUNDUP

- External auditors may make use of the work of an **auditor's expert**, **internal auditors** or **service organisations** and their auditors.
- A **service organisation** provides services to user entities. There may be special considerations for the auditor of a user entity when that entity makes use of a service organisation.
- An overriding requirement of the SLAuSs is that auditors are aware of the possibility of there being misstatements due to fraud.
- The auditor must consider the risk of non-compliance with law and regulations causing a misstatement in the financial statements.

PROGRESS TEST

1 There are four criteria for evaluating whether the work of the internal audit function can be used. State these criteria.

(1) ………………………………………….

(2) ………………………………………….

(3) ………………………………………….

(4) ………………………………………….

2 If the auditor relies on the work of an auditor's expert or service organisation, he may refer to that individual or organisation in the auditor's report and share responsibility with them. True or false?

3 Define fraud.

4 Auditors have a duty to detect fraud. True or false?

3 Draw a table showing the reporting requirements of SLAuS 240 *The auditor's responsibilities relating to fraud in an audit of financial statements*.

4 Complete the following sentence:

The primary responsibility for the prevention and detection of fraud and irregularities rests with ……………………………………………………… .

5 Delete the correct words from within the box to complete the sentence below.

It $\boxed{\text{is / is not}}$ the auditor's responsibility to prevent or detect non-compliance with laws and regulations.

ANSWERS TO PROGRESS TEST

1 (1) Objectivity of the function
(2) Technical competence
(3) Due professional care
(4) Effective communication

2 False.

3 Fraud is the use of deception to obtain unjust or illegal financial advantage and intentional misrepresentation by management, employees or third parties

4 False. Auditor's may detect fraud as a result of their procedures but do not have a specific duty to detect fraud.

5

Management	If the auditors suspect or detect any fraud (even if immaterial) as soon as they can they should tell management.
Those charged with governance	If the auditor has identified fraud involving management, employees with significant roles in internal control, or others, if it results in a material misstatement, they must report it to those charged with governance.
Third parties	Auditors may have a statutory duty to report to a regulator. Auditors are advised to take legal advice if reporting externally to the company.

6 The primary responsibility for the prevention and detection of fraud and irregularities rests with **management and those charged with governance.**

7 It **is not** the auditor's responsibility to prevent or detect non-compliance with laws and regulations.

Part C - Gathering Audit Evidence

THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

CHAPTER 07

Audit Evidence

INTRODUCTION

In this chapter, we discuss the fundamental auditing concept of audit evidence. Audit evidence is required to enable the auditor to form an opinion on the financial statements. Therefore, such evidence has to be sufficient and appropriate.

We also explain the financial statement assertions for which audit evidence is required. These will be particularly important when we consider detailed testing later in this Study Text, since audit tests are designed to obtain sufficient appropriate evidence about the assertions for each balance or series of transactions in the financial statements.

We end by looking at the various types of audit procedures used to obtain audit evidence.

Knowledge Component			
C	**Gathering Audit Evidence**		
3.1	**Test of Details**	3.1.1	Outline audit procedures to address assertion level risk for non-complex key account balances and classes of transactions
3.5	**Analytical Procedures**	3.5.1	Apply analytical procedures as substantive procedures and in the overall review of financial statements.

CHAPTER CONTENTS	LEARNING OUTCOME
1 Sufficient appropriate audit evidence	3.1.1
2 Sources of audit evidence	3.1.1
3 Financial statement assertions	3.1.1
4 Audit procedures to obtain audit evidence	3.5.1

1 Sufficient appropriate audit evidence

Auditors must design and perform audit procedures to obtain **sufficient appropriate** audit evidence.

Remember that the objective of an audit of financial statements is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. In this section, we shall look at the **audit evidence** gathered, which enables the auditor to express his opinion.

Audit evidence is all of the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based.

Audit evidence includes the information contained in the accounting records underlying the financial statements and other information gathered by the auditors, such as confirmations from third parties. Auditors are **not expected to look at all the information** that might exist. They will often select **samples** to test.

SLAuS 500 *Audit evidence* requires auditors to 'design and perform audit procedures that are appropriate in the circumstances for the purposes of obtaining **sufficient appropriate** audit evidence'.

The **appropriateness** of audit evidence is the measure of the quality of it, that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

The **sufficiency** of audit evidence is the measure of the quantity of audit evidence.

'Sufficiency' and 'appropriateness' are interrelated and apply to both tests of controls and substantive procedures.

- **Sufficiency** is the measure of the **quantity** of audit evidence.
- **Appropriateness** is the measure of the **quality or reliability** of the audit evidence.

The **quantity** of audit evidence required is affected by the **level of risk** in the area being audited. It is also affected by the **quality** of evidence obtained. If the evidence is high quality, the auditor may need less than if it were poor quality. However, obtaining a high quantity of poor quality evidence will not cancel out its poor quality. The SLAuS requires auditors to consider the **relevance and reliability** of the information to be used as audit evidence when designing and performing audit procedures.

Relevance deals with the logical connection between the purpose of the audit procedure and the assertion under consideration (we look at assertions in the next section). The relevance of information may be affected by the direction of testing.

Reliability is influenced by the source and nature of the information, including the controls over its preparation and maintenance. The following generalisations may help in assessing the **reliability** of audit evidence.

Table 7.1: Quality and reliability of audit evidence

Quality of evidence	
External	Audit evidence from **external sources** is more reliable than that obtained from the entity's records, because it is from an independent source.
Auditor	Evidence obtained **directly by auditors** is more reliable than that obtained indirectly or by inference
Entity	Evidence obtained from the entity's records is more reliable when the related **control system operates effectively**
Written	Evidence in the form of **documents (paper or electronic)** or **written representations** is more reliable than oral representations, since oral representations can be retracted.
Originals	**Original documents** are more reliable than photocopies or facsimiles, which can easily be altered by the client.

1.1 Management's expert

A **management's expert** is an individual or organisation possessing expertise in a field other than auditing or accounting, whose work is used by the entity to assist in the preparation of the financial statements.

SLAuS 500 considers the use of a management's expert by management and states that if information to be used as audit evidence has been prepared by a management's expert, the auditor must evaluate the competence, capabilities and objectivity of the expert, obtain an understanding of the work done, and evaluate the appropriateness of the work done as audit evidence.

1.2 Information produced by the entity

If information produced by the entity is to be used by the auditor, the auditor needs to evaluate whether it is sufficiently reliable for the auditor's purposes, including obtaining audit evidence regarding its accuracy and completeness, and evaluating whether it is sufficiently precise and detailed.

1.3 Selecting items to test

SLAuS 500 states that the auditor must determine the means of selecting items for testing that are effective in meeting the purpose of the audit procedure. The auditor could either select **all items**, select **specific items** or use **audit sampling**.

1.4 Inconsistencies and doubts over reliability

If audit evidence from one source is inconsistent with that from another, or the auditor has doubts over the reliability of information, the auditor must determine what modifications or additions to audit procedures are necessary to resolve the issues and must consider the effect on other aspects of the audit.

2 Sources of audit evidence

The auditor obtains evidence from both internal and external sources. If standard audit evidence is not available or does not apply, then they use alternative procedures to gather evidence.

As we will see in Section 4, audit evidence is gained through performance of audit procedures to test accounting records.

The auditor can increase the level of assurance obtained, when they obtain evidence from different sources that are **consistent.** Often the auditor will obtain evidence from a source internal to the organisation being audited and corroborate it with evidence obtained from a source external to the organisation. For example, management at the entity may provide a list of amounts owed by customers making up a trade receivables balance. The auditor will then confirm those individual balances with the external customers, using a receivables confirmation.

As we discussed in Section 1, information from sources independent of the entity is considered more reliable than information from internal sources.

Information from independent sources that may be used by the auditor include:

- Analysts reports
- Confirmations from third parties
- Competitor data
- Valuations from independent valuers
- Expert opinions from independent lawyers

We cover possible sources of evidence in relation to specific audit areas in detail in Chapters 8 to 12.

If standard audit evidence is not available or is unclear, then the auditor can employ alternative procedures to establish the truth of the financial statements. Examples of alternative audit procedures are:

- Inspection of documentation about the specific sale of inventory items
- Comparing accounts data to input/ sales data
- Attendance at an actual inventory count

The type of alternative audit procedures used to collect evidence need to be recorded in the final audit report.

3 Financial statement assertions

Audit tests are designed to obtain evidence about the **financial statement assertions**. Assertions relate to **classes of transactions and events**, **account balances** at the period-end, and **presentation and disclosure**.

Financial statement assertions are the 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.

SLAuS 315 (Revised), states that the auditor must use assertions for **classes of transactions and events and related disclosures** (ie statement of profit or loss) and **account balances and related disclosures** (ie statement of financial position) in sufficient detail to form the basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. It gives examples of assertions in these areas which are set out in the table that follows.

Table 7.2: Assertions used by auditors

Assertions used by the auditor	
Assertions about **classes of transactions and events and related disclosures** for the period under audit	**Occurrence**: Transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity. **Completeness**: All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included. **Accuracy**: Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described. **Cut-off**: Transactions and events have been recorded in the correct reporting period. **Classification**: Transactions and events have been recorded in the proper accounts. **Presentation**: Transactions and events are appropriately aggregated or disaggregated and are clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.
Assertions about **account balances and related disclosures** at the period end	**Existence**: Assets, liabilities and equity interests exist. **Rights and obligations**: The entity holds or controls the rights to assets, and liabilities are the obligations of the entity. **Completeness**: All assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.

Assertions used by the auditor	
	Accuracy, valuation and allocation: Assets, liabilities and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described. **Classification**: Assets, liabilities and equity interests have been recorded in the proper accounts. **Presentation**: Assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

You **must** be very comfortable with the assertions that relate to each of the three areas, as the same assertions do not always apply to each of these areas. Exam questions may test this area in the context of audit procedures to test particular assertions so it's vital that you take the time to learn, understand and test your knowledge.

4 Audit procedures to obtain audit evidence

Audit evidence can be obtained by inspection, observation, enquiry and confirmation, recalculation, re-performance and analytical procedures.

4.1 Audit procedures

The auditor obtains audit evidence by undertaking audit procedures to do the following:

- Obtain an understanding of the entity and its environment to assess the risks of material misstatement at the financial statement and assertion levels (**risk assessment procedures**)
- Test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level (**tests of controls**)
- Detect material misstatements at the assertion level (**substantive procedures**)

The auditor must **always** perform **risk assessment procedures** to provide a satisfactory assessment of risks.

Tests of controls are necessary to test the controls to support the risk assessment, and also when substantive procedures alone do not provide sufficient appropriate audit evidence. **Substantive procedures** must **always** be carried out for **material** classes of transactions, account balances and disclosures.

The audit procedures described in Table 7.3 can be used as risk assessment procedures, tests of controls and substantive procedures. We introduced tests of controls and substantive procedures in Chapter 4. Make sure you understand the difference between them.

Tests of controls are performed to obtain audit evidence about the operating effectiveness of controls preventing, or detecting and correcting, material misstatements at the assertion level.

Substantive procedures are audit procedures performed to detect material misstatements at the assertion level. They are generally of two types:

- Substantive analytical procedures
- Tests of detail of classes of transactions, account balances and disclosures

Auditors obtain evidence by one or more of the following procedures.

Table 7.3: Procedures to obtain audit evidence

Procedures	
Inspection of tangible assets	Inspection of tangible assets that are recorded in the accounting records confirms existence, but does not necessarily confirm rights and obligations or valuation. Confirmation that assets seen are recorded in accounting records gives evidence of completeness.
Inspection of documentation or records	This is the examination of documents and records, both internal and external, in paper, electronic or other forms. This procedure provides evidence of varying reliability, depending on the nature, source and effectiveness of controls over production (if internal). Inspection can provide evidence of existence (eg a document constituting a financial instrument), but not necessarily about ownership or value.
Observation	This involves watching a procedure or process being performed (for example, post opening). It is of limited use, as it only confirms the procedure took place when the auditor was watching, and because the act of being observed could affect how the procedure or process was performed.

Procedures	
Enquiry	This involves seeking information from client staff or external sources. Strength of evidence depends on the knowledge and integrity of source of information. Enquiry alone does not provide sufficient audit evidence to detect a material misstatement at assertion level nor is it sufficient to test the operating effectiveness of controls.
Confirmation	This is the process of obtaining a representation of information or of an existing condition directly from a third party eg confirmation from bank of bank balances.
Recalculation	This consists of checking the mathematical accuracy of documents or records and can be performed through the use of IT.
Re-performance	This is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.
Analytical procedures	Evaluating and comparing financial and/or non-financial data for plausible relationships. Also include the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

QUESTION — Audit evidence

(a) **Analyse** the quality of the following types of audit evidence, giving two examples of each form of evidence.

(i) Evidence originated by the auditors

(ii) Evidence created by third parties

(iii) Evidence created by the management of the client

(b) **Describe** the general considerations which auditors must bear in mind when evaluating audit evidence.

ANSWER

(a) **Quality of audit evidence**

(i) *Evidence originated by the auditors*

This is in general the most reliable type of audit evidence because there is little risk that it can be manipulated by management.

Examples

(1) Analytical procedures, such as the calculation of ratios and trends in order to examine unusual variations

(2) Physical inspection or observation, such as attendance at inventory counts

(3) Re-performance of calculations making up figures in the accounts, such as the computation of total inventory values

(ii) *Evidence created by third parties*

Third-party evidence is more reliable than client-produced evidence to the extent that it is obtained from independent sources. Its reliability will be reduced if it is obtained from sources which are not independent, or if there is a risk that client personnel may be able to, and have reason to, suppress or manipulate it.

Examples

(1) Circularisation of trade receivables or payables, confirmation of bank balances.

(2) Reports produced by experts, such as property valuations, actuarial valuations, legal opinions. In evaluating such evidence, the auditors need to take into account the expert's qualifications, independence and the terms of reference for the work.

(3) Documents held by the client which were issued by third parties, such as invoices, price lists and statements. These may sometimes be manipulated by the client and so are less reliable than confirmations received directly.

(iii) *Evidence created by management*

The auditors cannot place the same degree of reliance on evidence produced by client management as on that produced outside the company. However, it will often be necessary to place some reliance on such evidence. The auditors will need to obtain audit evidence that the information supplied is complete and accurate, and apply judgement in doing so, taking into account previous experience of the client's reliability and the extent to which the client's representations appear compatible with other audit findings, as well as the materiality of the item under discussion.

Examples

(1) The company's accounting records and supporting schedules. Although these are prepared by management, the auditors have a statutory right to examine such records in full: this right enhances the quality of this information.

(2) The client's explanations of, for instance, apparently unusual fluctuations in results. Such evidence requires interpretation by the auditors and, being oral evidence, only limited reliance can be placed upon it.

(3) Information provided to the auditors about the internal control system. The auditors need to confirm that this information is accurate and up-to-date, and that it does not simply describe an idealised system which is not adhered to in practice.

(b) **General considerations in evaluating audit evidence**

Audit evidence will often not be wholly conclusive. The auditors must obtain evidence which is **sufficient and appropriate** to form the basis for their audit conclusions. The evidence gathered should also be **relevant** to those conclusions, and sufficiently **reliable** to form the basis for the audit opinion. The auditors must exercise skill and judgement to ensure that evidence is correctly interpreted and that only valid inferences are drawn from it.

Certain general principles can be stated. **Written evidence** is preferable to oral evidence; **independent evidence** obtained from outside the organisation is more reliable than that obtained internally; and **evidence generated by the auditors** is more reliable than that obtained from others.

4.2 Substantive procedures

Substantive procedures aim to obtain appropriate audit evidence to support the financial statement assertions.

Substantive procedures are tests to obtain audit evidence to detect material misstatements in the financial statements. They are generally of two types:

- Analytical procedures
- Tests of detail of transactions, account balances and disclosures

The types of substantive tests carried out to obtain evidence about various financial statement assertions are outlined in the table below.

Table 7.4: Typical audit tests, by assertion type

Audit assertion	Type of assertion	Typical audit tests
Occurrence	Classes of transactions and events and related disclosures	(a) Inspection of supporting documentation (b) Confirmation from directors that transactions relate to business (c) Inspection of items purchased
Completeness	Classes of transactions and events, account balances and related disclosures	(a) Review of post-year-end items (b) Cut-off testing (c) Analytical procedures (d) Confirmations (e) Reconciliations to control accounts
Accuracy	Classes of transactions and events and related disclosures	(a) Recalculation of correct amounts (b) Analytical procedures
Accuracy, valuation and allocation	Account balances and related disclosures	(a) Third-party confirmation (b) Matching amounts to invoices (c) Recalculation (d) Confirming accounting policy is consistent and reasonable (e) Review of post-year-end payments and invoices (f) Expert valuation
Cut-off	Classes of transactions and events and related disclosures	(a) Cut-off testing (b) Analytical procedures
Classification	Classes of transactions and events, account balances and related disclosure	(a) Confirming compliance with law and accounting standards (b) Reviewing notes for understandability

Audit assertion	Type of assertion	Typical audit tests
Presentation	Classes of transactions and events, account balances and related disclosure	(a) Review of financial statement disclosures (b) Review of disaggregated amounts in disclosures
Existence	Account balances and related disclosures	(a) Physical verification (b) Third-party confirmations (c) Cut-off testing
Rights and obligations	Account balances and related disclosures	(a) Reviewing invoices for proof that item belongs to the company (b) Confirmations with third parties

Use the following model for drawing up an audit plan:

- **Agree opening balances** with **previous year's working papers**
- **Review general ledger** for unusual records
- **Agree client schedules to/from accounting records** to ensure completeness
- Carry out **analytical review**
- **Test transactions in detail**
- **Test balances in detail**
- **Review presentation** and **disclosure** in accounts

4.2.1 Categories of testing

Substantive procedures are designed to discover errors or omissions.

Broadly speaking, substantive procedures can be said to fall into two categories:

- Tests to discover **errors** (resulting in over or understatement)
- Tests to discover **omissions** (resulting in understatement)

Tests designed to discover errors will start with the **accounting records** in which the transactions are recorded to supporting documents or other evidence. Such tests should detect any overstatement and also any understatement through causes other than omission. For example, if a test is designed to ensure that sales are priced correctly, it would begin with a sales invoice selected from the receivables ledger. Prices would then be checked to the official price list.

Tests designed to discover omissions must start from **outside the accounting records** and then be matched back to those records. Understatements through omission will never be revealed by starting with the account itself as there is clearly no chance of selecting items that have been omitted from the account. For example, if a test is designed to discover whether all raw material purchases have been properly processed, it would start with goods received notes to be agreed to the inventory records or purchase ledger.

4.2.2 Directional testing

For most systems, auditors would include tests designed to discover both errors and omissions. The type of test, and direction of the test, should be recognised before selecting the test sample. If the sample which tested the accuracy and validity of the sales ledger were chosen from a file of sales invoices then it would not substantiate the fact that there were no errors in the receivables ledger.

Directional testing is particularly appropriate when testing the financial statement assertions of existence, completeness, rights and obligations, and valuation.

The concept of directional testing derives from the principle of double-entry bookkeeping, in that for every **debit** there should be a **corresponding credit**. Therefore, any **misstatement** of a **debit entry** will result in either a corresponding **misstatement** of a **credit entry** or a **misstatement** in the opposite direction, of **another debit entry**.

By designing audit tests carefully, the auditors are able to use this principle in drawing audit conclusions, not only about the debit or credit entries that they have directly tested, but also about the corresponding credit or debit entries that are necessary to balance the books.

Tests are therefore designed in the following way.

Table 7.5: Test design considerations

Test item	Example
Test **debit items** (expenditure or assets) for overstatement by selecting debit entries recorded in the general ledger and checking value, existence and ownership	If a non-current asset entry in the general ledger of Rs. 10,000,000 is selected, it would be overstated if it should have been recorded at anything less than Rs. 10,000,000 or if the company did not own it, or indeed if it did not exist (eg it had been sold or the amount of Rs. 10,000,000 in fact represented a revenue expense).

Test item	Example
Test **credit items** (income or liabilities) for understatement by selecting items from appropriate sources independent of the general ledger and ensuring that they result in the correct general ledger entry	Select a goods despatched note and agree that the resultant sale has been recorded in the general ledger sales account. Sales would be understated if the general ledger did not reflect the transaction at all (completeness) or reflected it at less than full value (say if goods valued at Rs. 10,000,000 were recorded in the sales account at Rs. 9,000,000, there would be an understatement of Rs. 1,000,000).

A test for the overstatement of an asset simultaneously gives comfort on understatement of other assets, overstatement of liabilities, overstatement of income and understatement of expenses.

So, by performing the primary tests, the auditors obtain audit assurance in other audit areas. Successful completion of the primary tests will therefore result in them having tested all account areas, both for overstatement and understatement.

4.3 Analytical procedures

Analytical procedures are used at all stages of the audit, including as substantive procedures. When using analytical procedures as **substantive procedures**, auditors must consider the information available, assessing **availability**, **relevance** and **comparability**.

We introduced analytical procedures in Chapter 4 where they were used at the planning stage of an audit. They can also be used as substantive procedures to obtain audit evidence directly (and at the finalisation and review stage which we will consider in Chapter 14).

SLAuS 520 *Analytical procedures* provides guidance to auditors on the use of analytical procedures as substantive procedures. Remember from Chapter 4 that analytical procedures include:

(a) The consideration of comparisons with:

- **Comparable information** for prior periods
- **Anticipated results** of the entity, from budgets or forecasts
- **Expectations** prepared by the auditors (eg estimation of depreciation)
- **Industry information**

(b) Those between elements of financial information that are expected to conform to a predicted pattern based on the entity's experience, such as the relationship of gross profit to sales

(c) Those between financial information and relevant non-financial information, such as the relationship of payroll costs to number of employees

SLAuS 520 states that, when using analytical procedures as substantive tests, the auditor must:

- Determine the **suitability** of particular analytical procedures for given assertions.
- Evaluate the **reliability of data** from which the auditor's expectation of recorded amounts or ratios is developed.
- **Develop an expectation** of recorded amounts or ratios and evaluate whether this is **sufficiently precise** to identify a misstatement that may cause the financial statements to be materially misstated.
- Determine the amount of any difference that is **acceptable** without further investigation.

4.3.1 Suitability of analytical procedures

Substantive analytical procedures are usually more applicable to large volumes of transactions that tend to be predictable over time. The suitability of a particular analytical procedure will depend on the auditor's assessment of how effective it will be in detecting material misstatements. Determining the suitability will be influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement.

4.3.2 Reliability of data

The SLAuS sets out factors which influence the reliability of data which are set out in the following table, with examples.

Table 7.6: Factors which affect the reliability of data

Reliability factors	Example
Source of the information	Information may be more reliable when obtained from independent sources outside the entity.
Comparability of information available	Broad industry data may need to be supplemented so it is comparable to that of an entity that produces and sells specialised products.

Reliability factors	Example
Nature and relevance of the information available	Whether budgets have been set up as results to be expected, rather than goals to be achieved.
Controls over the preparation of the information to ensure its **completeness, accuracy and validity**	Controls over the preparation, review and maintenance of budgets.

The auditor will need to consider testing the controls, if any, over the **preparation** of **information** used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and therefore in the results of analytical procedures.

The **controls** over **non-financial information** can often be tested in conjunction with tests of **accounting-related controls**. For example, in establishing controls over the processing of sales invoices, a business may include controls over unit sales recording. The auditor could therefore test the controls over the recording of unit sales in conjunction with tests of controls over the processing of sales invoices.

Alternatively the auditor may consider whether the information was subjected to audit testing. SLAuS 500 contains guidance in determining the audit procedures to be performed on information to be used for substantive analytical procedures.

4.3.3 Evaluation of whether the expectation is sufficiently precise

The factors to consider, when evaluating whether the expectation can be developed sufficiently precisely to identify a misstatement that may cause the financial statements to be materially misstated, are set out in the following table.

Table 7.7: Factors which impact on precision of data

Factors to consider	Example
The **accuracy** with which the expected results of analytical procedures can be predicted	The auditor may expect greater consistency in comparing the relationship of gross profit to sales from one period to another than in comparing discretionary expenses, such as research or advertising.

Factors to consider	Example
The **degree to which information can be disaggregated**	Analytical procedures may be more effective when applied to financial information on individual sections of an operation or to the financial statements of components of a diversified entity than when applied to the financial statements as a whole.
The **availability** of the information	The auditor may consider whether financial information (eg budgets or forecasts) and non-financial information (eg number of units produced or sold) is available.

4.3.4 Acceptable differences

The amount of the difference of recorded amounts from the expected value that is acceptable depends on **materiality** and **consistency with the desired level of assurance**, having taken into account that a misstatement may cause the financial statements to be materially misstated. Therefore, as the **assessed risk increases**, the **amount of the difference that is acceptable** without further investigation **decreases**.

4.3.5 Practical techniques

Analytical procedures can be performed using various techniques, ranging from simple comparisons to complex analyses using advanced statistical techniques. In this section we look at some of the techniques that can be used to carry out analytical procedures.

Ratio analysis can be a useful technique. However, ratios mean very little when used in isolation. They should be calculated for previous periods and for comparable companies. This may involve a certain amount of initial research, but subsequently it is just a matter of adding new statistics to the existing information each year. The permanent file should contain a section with summarised accounts and the chosen ratios for prior years.

In addition to looking at the more usual ratios, the auditors should consider examining other ratios that may be relevant to the particular clients' business. Other analytical techniques include:

(a) **Examining related accounts** in conjunction with each other. Often revenue and expense accounts are related to accounts in the statement of financial position and comparisons should be made to ensure relationships are reasonable.

(b) **Trend analysis**. Sophisticated statistical techniques can be used to compare this period with previous periods.

(c) **Reasonableness test**. This involves calculating the **expected value** of an item and comparing it with its actual value, for example, for straight-line depreciation.

(Cost + Additions – Disposals) × Depreciation % = Charge in statement of profit or loss

Table 7.8: Ratios and areas for consideration

Important accounting ratios	• Gross profit margins, in total and by product, area and months/quarter (if possible) • Operating profit margin • Receivables collection period (average collection period in days) • Payables payment period (average payment period in days) • Inventory holding period (average number of days inventory is held) • Inventory revenue ratio (revenue divided into cost of sales) • Current ratio (current assets to current liabilities) • Quick or acid test ratio (liquid assets to current liabilities) • Gearing ratio (debt capital to equity capital) • Return on capital employed (profit before tax to total assets less current liabilities)
Related items	• Payables and purchases • Inventories and cost of sales • Non-current assets and depreciation, repairs and maintenance expense • Intangible assets and amortisation • Loans and interest expense • Investments and investment income • Receivables and irrecoverable debt expense • Receivables and sales

Other areas for consideration
• **Examine changes** in **products, customers and levels** of **returns**
• **Assess** the effect of **price and mix changes** on the cost of sales
• **Consider** the effect of **inflation, industrial disputes, changes in production methods** and **changes in activity** on the charge for wages
• **Obtain explanations** for all **major variances** analysed using a standard costing system. Particular attention should be paid to those relating to the over or under absorption of overheads since these may, *inter alia*, affect inventory valuations
• **Compare trends in production and sales** and assess the effect on any provisions for obsolete inventory
• **Ensure** that **changes in the percentage labour or overhead content** of production costs are also reflected in the inventory valuation
• **Review other expenditure**, comparing: – Rent with annual rent per rental agreement – Rates with previous year and known rates increases – Interest payable on loans with outstanding balance and interest rate per loan agreement – Hire or leasing charges with annual rate per agreements – Vehicle running expenses with those expected for the company's vehicles – Other items related to activity level with general price increase and change in relevant level of activity (for example telephone expenditure will increase disproportionately if export or import business increases) – Other items not related to activity level with general price increases (or specific increases if known)
• **Review** statement of profit or loss and other comprehensive income for **items** which may have been **omitted** (eg scrap sales, training levy, special contributions to pension fund, provisions for dilapidation etc)
• **Ensure expected variations** arising from the following have occurred: – Industry or local trends – Known disturbances of the trading pattern (for example, strikes, depot closures, failure of suppliers)

Some comparisons and ratios measuring liquidity and longer-term capital structure will assist in evaluating whether the company is a going concern, in addition to contributing to the overall view of the accounts. We shall see in Chapter 14, however, that there are factors other than declining ratios that may indicate going concern problems.

The working papers must contain the completed results of analytical procedures. They should include:

- The outline **programme** of the work
- The summary of **significant figures** and relationships for the period
- A summary of **comparisons** made with budgets and with previous years
- Details of all **significant fluctuations** or **unexpected relationships** considered
- Details of the **results of investigations** into such fluctuations/relationships
- The audit **conclusions** reached
- **Information considered** necessary for assisting in the **planning** of subsequent audits

4.3.6 Investigating the results of analytical procedures

SLAuS 520 states that where analytical procedures identify fluctuations or relationships that are inconsistent with other relevant information, or that differ significantly from the expected results, the auditor shall investigate by:

- **Enquiries of management** and obtaining appropriate audit evidence relevant to **management's responses**
- Performing **other audit procedures** if necessary (eg if management cannot provide an explanation or the explanation is not adequate)

QUESTION **Analytical procedures**

You are part of the audit team auditing the financial statements of Sweep Ltd, a small office supplies business, for the year ended 31 March 20X9. The company employed the following staff at the start of the financial year: 7 office and warehouse managers, 20 warehouse staff and 25 office staff.

The pay ranges for each category of staff is shown below:

Office and warehouse managers:	Rs. 3,500,000 to Rs. 5,000,000 per year
Warehouse and office staff:	Rs. 1,800,000 to Rs. 2,500,000 per year

You have been asked to audit the wages and salaries expense for the year. All staff were given a 4% pay rise in the year, backdated to the start of the year. One of the office managers left the company part-way through the year. There were two new members of warehouse staff and three new members of office staff.

The expense for the year is shown in the draft statement of profit or loss as Rs. 124,945,000.

Required

Using analytical procedures, **perform** a proof in total on the wages and salaries expense for the year.

ANSWER

An expectation of the charge for the year can be developed using the information provided and compared to the charge in the draft statement of profit or loss to assess its reasonableness. All figures are expressed in Rs'000.

Managers

Based on salary range, average annual salary:	4,250
Applying the 4% rise:	4,420
Total average salary for year (ie × 7):	30,940
Assume leaver left half-way through year:	(2,210)
Total for managers:	**28,730**

Office and warehouse staff

Based on salary range, average annual salary:	2,150
Applying the 4% rise:	2,236
Total average salary for year (ie × 45, exclude starters):	100,620
Assume starters started half-way through year:	5,590
Total for office and warehouse staff:	**106,210**
Expected total expense for wages and salaries:	**134,940**
Expense per draft statement of profit or loss:	**124,945**
Difference:	**8%**

The difference between the expected total and the expense in the draft statement of profit or loss is 8%. The auditor needs to consider whether this is acceptable in light of materiality for the financial statements as a whole and performance materiality and the risk of material misstatement and whether further explanations from management may be necessary.

CHAPTER ROUNDUP

- Auditors must design and perform audit procedures to obtain **sufficient appropriate** audit evidence.
- The auditor obtains evidence from both internal and external sources. If standard audit evidence is not available or does not apply, then they use alternative procedures to gather evidence.
- Audit tests are designed to obtain evidence about the **financial statement assertions**. Assertions relate to **classes of transactions and events**, **account balances** at the period-end, and **presentation and disclosure**.
- Audit evidence can be obtained by inspection, observation, enquiry and confirmation, recalculation, re-performance and analytical procedures.
- **Substantive procedures** aim to obtain appropriate audit evidence to support the financial statement assertions.
- Substantive procedures are designed to discover **errors** or **omissions**.
- **Analytical procedures** are used at all stages of the audit, including as substantive procedures. When using analytical procedures as **substantive procedures**, auditors must consider the information available, assessing its **availability, relevance** and **comparability.**

PROGRESS TEST

1 Define sufficiency and appropriateness as they relate to audit evidence.

2 State the financial statement assertions.

3 Fill in the blanks.

Audit evidence from external sources is …………………… ………………….. than that obtained from the entity's records.

4 State five procedures which auditors can use to obtain audit evidence.

5 Explain what 're-performance' is.

6 Link the type of account with the purpose of the primary test in directional testing.

(a)	Assets	(i)	Overstatement
(b)	Liabilities	(ii)	Overstatement
(c)	Income	(iii)	Understatement
(d)	Expense	(iv)	Understatement

7 State four issues auditors should consider when carrying out analytical procedures on wages and salaries.

(1) ……………………………………………………..

(2) ……………………………………………………..

(3) ……………………………………………………..

(4) ……………………………………………………..

8 Identify the significant relationships in the list of items below.

(a)	payables	(b)	interest	(c)	purchases	(d)	sales
(e)	amortisation	(f)	loans	(g)	receivables	(h)	intangibles

ANSWERS TO PROGRESS TEST

1 Sufficiency is the measure of the quantity of audit evidence.

Appropriateness is the measure of the quality/reliability of audit evidence.

2 Assertions:

Occurrence
Completeness
Accuracy
Cut-off
Classification
Presentation
Existence
Rights and Obligations
Accuracy, valuation and allocation.

3 Audit evidence from external sources is **more reliable** than that obtained from the entity's records.

4 Any 5 from:

Inspection
Observation
Enquiry
Confirmation
Recalculation
Re-performance
Analytical procedures

5 'Re-performance' is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

6 (a) (i)
(b) (iii)
(c) (ii)
(d) (iv)

7 (1) Salary rate changes
(2) Average wage by month over the year
(3) Salary/employee
(4) Payroll proof in total

8 (a) (c)
(b) (f)
(d) (g)
(e) (h)

CHAPTER 08

Auditing Non-current Assets

INTRODUCTION

This chapter covers the audit of non-current assets, a key area of the statement of financial position.

It highlights the key objectives for each major component of non-current assets. You must understand what objectives the various audit tests are designed to achieve in relation to the financial statement assertions. Objectives of particular significance for tangible non-current assets are rights and obligations (ownership), existence and valuation.

Valuation is an important assertion. The auditors will concentrate on testing any external valuations made during the year, and also whether other values appear reasonable given asset usage and condition. An important aspect of testing valuation is reviewing depreciation rates. A topic we covered previously, using the work of an expert, may well be important in the audit of non-current assets in respect of valuation.

Knowledge Component			
C	**Gathering Audit Evidence**		
3.1	**Test of Details**	3.1.1	Outline audit procedures to address assertion level risk for non-complex key account balances and classes of transactions

CHAPTER CONTENTS	LEARNING OUTCOME
1 Tangible non-current assets	3.1.1
2 Intangible non-current assets	3.1.1

1 Tangible non-current assets

Key areas when testing **tangible non-current assets** are:

- **Confirmation** of ownership
- **Inspection** of non-current assets
- **Valuation** by third parties
- **Adequacy** of **depreciation** rates
- Whether **impairments** have been identified and properly accounted for

1.1 Audit objectives for tangible non-current assets

Table 8.1: Objectives, tangible non-current assets

Financial statement assertion	Audit objective
Existence	– Additions represent assets acquired in the year and disposal represent assets sold or scrapped in the year – Recorded assets represent those in use at the year-end
Completeness	– All additions and disposals that occurred in the year have been recorded – Balances represent assets in use at the year-end
Rights and obligations	– The entity has rights to the assets purchased and those recorded at the year-end
Accuracy, valuation and allocation	– Non-current assets are correctly stated at cost less accumulated depreciation – Additions and disposals are correctly recorded

Financial statement assertion	Audit objective
Classification	– Tangible assets have been recorded in the correct accounts, and expenses which are not of a capital nature are taken to profit or loss
Presentation	– Disclosures relating to cost, additions and disposals, depreciation policies, useful lives and assets held under finance leases are adequate and in accordance with accounting standards

1.2 Internal control considerations

The **non-current asset register** is a very important aspect of the internal control system. It enables assets to be identified; comparisons between the general ledger, non-current asset register and the assets themselves provide **evidence** that the assets are **completely recorded**.

Another significant control is procedures over acquisitions and disposals, that acquisitions are properly **authorised**, **disposals** are **authorised** and **proceeds accounted for**. The controls and tests outlined in Chapter 3 are often considered and performed during the audit of non-current assets, as this is where the main issue of capitalisation occurs.

Other significant aspects are whether:

- **Security arrangements** over non-current assets are **sufficient**.
- **Non-current assets** are **maintained properly**.
- **Depreciation** is **reviewed every year**.
- **All income** is **collected** from **income-yielding assets**.

1.3 Audit procedures for tangible non-current assets

The plan below contains procedures for non-current assets in the statement of financial position and the related statement of profit or loss and other comprehensive income items (such as the depreciation charge and profits or losses on disposals).

Table 8.2: Procedures, tangible non-current assets

Audit procedures: tangible non-current assets	
Completeness	• **Obtain** or **prepare** a **summary** of tangible non-current assets showing how: – **Gross book value** – **Accumulated depreciation** – **Net book value** **reconcile** with the **opening position**. • **Compare non-current assets** in the general ledger with the **non-current assets register** and **obtain explanations** for **differences**. • For a sample of assets which physically exist, agree that they are **recorded** in the **non-current asset register**. • If a non-current asset register is not kept, **obtain** a **schedule** showing the original costs and present depreciated value of major non-current assets. • **Reconcile** the **schedule** of non-current assets with the **general ledger**.
Existence	• **Confirm** that the **company physically inspects** all items in the non-current asset register each year. • **Inspect assets**, concentrating on high-value items and additions in year. Confirm that items inspected: – Exist – Are in use – Are in good condition – Have correct serial numbers • **Review records** of **income-yielding assets**. • **Reconcile** opening and closing **vehicles** by numbers as well as amounts.

Audit procedures: tangible non-current assets	
Accuracy, valuation and allocation	• **Verify valuation** to valuation certificate. • **Consider reasonableness** of **valuation**, reviewing: – Experience of valuer – Scope of work – Methods and assumptions used – Valuation bases are in line with accounting standards • **Re-perform** calculation of revaluation surplus. • Confirm whether valuations of all assets that have been revalued have been **updated regularly** (full valuation every five years and an interim valuation in year three, generally) by asking the Finance Director and inspecting the previous financial statements. • **Inspect** draft accounts to check that client has recognised in the statement of profit or loss revaluation losses, unless there is a credit balance in respect of that asset in equity, in which case it should be debited to equity to cancel the credit. All revaluation gains should be credited to equity. • **Review insurance policies** in force for all categories of tangible non-current assets and consider the adequacy of their insured values and check expiry dates.
Accuracy, valuation and allocation – depreciation	• **Review depreciation** rates applied in relation to: – Asset lives – Residual values – Replacement policy – Past experience of gains and losses on disposal – Consistency with prior years and accounting policy – Possible obsolescence • **Review** non-current assets register to ensure that **depreciation** has been **charged on all assets** with a limited useful life. • For **revalued assets**, ensure that the charge for **depreciation** is based on the revalued amount by recalculating it for a sample of revalued assets. • **Re-perform calculation** of depreciation rates to ensure it is correct.

Audit procedures: tangible non-current assets	
	• Compare ratios of depreciation to non-current assets (by category) with: – Previous years – Depreciation policy rates • **Scrutinise** draft accounts to ensure that **depreciation policies** and rates are **disclosed** in the accounts.
Rights and obligations	• **Verify title** to land and buildings by inspection of: – Title deeds – Land registry certificates – Leases • Obtain a certificate from solicitors/bankers: – **Stating purpose** for which the deeds are being held (custody only) – **Stating deeds** are free from **mortgage** or **lien**. • **Inspect registration documents** for vehicles held, confirming that they are in client's name. • **Confirm** all vehicles are used for the **client's business**. • **Examine documents** of **title** for other assets (including purchase invoices, architects' certificates, contracts, hire purchase or lease agreements). • **Review** for **evidence** of charges in statutory books and by company search. • **Review leases** of leasehold properties to ensure that company has fulfilled covenants therein. • **Examine invoices received after year-end, orders** and **minutes** for evidence of capital commitments.
Additions	These tests are to confirm **rights and obligations**, **accuracy, valuation and allocation** and **completeness**. • Verify additions by inspection of architects' certificates, solicitors' completion statements, suppliers' invoices etc. • **Review** capitalisation of expenditure by examining for non-current assets additions and items in relevant expense categories (repairs, motor expenses, sundry expenses) to ensure that: – Capital/revenue distinction is correctly drawn

Audit procedures: tangible non-current assets	
	– Capitalisation is in line with consistently applied company policy • **Inspect** non-current asset accounts for a sample of purchases to ensure they have been **properly allocated**. • Ensure that appropriate **claims** have been made for **grants**, and grants received and receivable have been received, by **inspecting** claims documentations and bank statements. • Verify that **additions** have been **recorded** by **scrutinising** the non-current asset register and general ledger.
Self-constructed assets	These tests are to confirm **accuracy, valuation and allocation** and **completeness**. • **Verify material** and **labour** costs and **overheads** to invoices, wage records etc. • Ensure expenditure has been **analysed correctly** and **properly charged** to capital. • Expenditure should be capitalised if it: – **Enhances** the **economic benefits** of the asset in excess of its previously assessed standard of performance – **Replaces or restores a component** of the asset that has been treated separately for depreciation purposes, and depreciated over its useful economic life – Relates to a **major inspection** or **overhaul** that restores the economic benefits of the asset that have been consumed by the entity, and have already been reflected in depreciation • **Review** costs to ensure that no profit element has been included. • **Review** accounts to ensure that **finance costs** have been **capitalised** or not capitalised on a consistent basis, and costs capitalised in period do not exceed total finance costs for period.

Audit procedures: tangible non-current assets	
Disposals	These tests are to confirm **rights and obligations**, **completeness**, **occurrence** and **accuracy**. • **Verify disposals** with supporting documentation, checking transfer of title, sales price and dates of completion and payment. • **Recalculate** profit or loss on disposal. • **Consider** whether **proceeds** are **reasonable**. • If the asset was **used as security**, ensure **release from security** has been correctly made.
Classification	• **Review** non-current asset disclosures in the financial statements to ensure they meet LKAS 16 criteria. • For a sample of **fully depreciated assets**, inspect the register to ensure no further depreciation is charged.

QUESTION — Non-current assets

You are the manager in charge of the audit of Puppy, a building and construction company, and you are reviewing the non-current asset section of the current audit file for the year ended 30 September 20X5. You find the following five matters which the audit senior has identified as problem areas. He is reviewing the company's proposed treatment of the five transactions in the accounts and is not sure that he has yet carried out sufficient audit work.

(a) During the year Puppy built a new canteen for its own staff at a cost of Rs. 45 million. This amount has been included in buildings as at 30 September 20X5.

(b) Loose tools, included in the financial statements at a total cost of Rs. 16.6 million, are tools used on two of the construction sites on which Puppy operates. They are classified as non-current assets and depreciated over two years.

(c) A dumper truck, previously written-off in the company's accounting records, has been refurbished at a cost of Rs. 4.6 million and this amount included in plant and machinery as at 30 September 20X5.

(d) The company's main office block has been revalued from Rs. 21.6 million to Rs. 26.6 million and this amount included in the statement of financial position as at 30 September 20X5.

(e) A deposit of Rs. 2 million for new equipment has been included under the heading 'plant and machinery', although the final instalment of Rs. 3.5 million was not paid over until 31 October 20X5, which was the date of delivery of the plant.

Required

(a) **Analyse** the acceptability of the accounting treatment and disclosure as indicated above.

(b) **Outline** the audit work and evidence required to substantiate the assets.

ANSWER

(a) *Acceptability of accounting treatment and disclosure*

(i) *New staff canteen*. The costs of building a new staff canteen can quite properly be capitalised and treated as part of buildings in the statement of financial position as work has produced future economic benefits (LKAS 16). The company's normal depreciation policy should be applied, subject only to the canteen being completed and in use at the year-end.

(ii) *Loose tools*. Loose tools tend to have a very limited life and to be immaterial in value individually. For these reasons any capitalisation policy must be extremely prudent. The acceptability of this accounting treatment would depend on the policy in previous years and normal practice within the industry.

(iii) *Dumper truck*. The refurbishment costs have obviously extended the useful life of this asset and it therefore seems reasonable to capitalise the expenditure. Depreciation should be charged on the refurbishment costs over the estimated remaining useful life.

(iv) *Revaluation of office block.* The revaluation of property is acceptable, but the auditors will need to ensure that the company complies with a number of disclosure requirements. A note to the accounts should give details of the revaluation and the name of the valuer. The surplus on revaluation should be transferred to a separate non-distributable reserve in the statement of financial position as part of shareholders' funds. Furthermore, any other assets of a similar nature to this should also be revalued.

(v) *Deposit for new equipment*. As the equipment was not actually in the company's possession and use at the year-end, the deposit should not have been shown as plant and machinery, but rather as a payment on account. If the amount was considered to be material, a note to the accounts should give details of this prepayment.

(b) The audit work and evidence required to substantiate each of the assets referred to in (a) above would be as follows.

(i) *New staff canteen*

(1) Physically confirm existence of the asset.

(2) Confirm title to building by reference to central registry certificate.

(3) Ascertain and confirm the details of any security granted over the asset, ensuring that this is properly recorded and disclosed.

(4) Review the detailed costings of the building and obtain explanations for any material variances from the original budget. Particular care should be taken in assessing the reasonableness of any overheads included as an element of cost.

(5) Review the depreciation policy for adequacy and consistency.

(ii) *Loose tools*

(1) Visit the two sites where the loose tools are used to confirm the existence and condition of a sample of them.

(2) Vouch the cost and ownership of the loose tools to purchase invoices and the company's asset register.

(3) Confirm the company's estimate of a two-year life for these assets.

(4) Review control procedures for safe custody of the loose tools.

(5) Review the company's policy with regard to scrapping and/or sale of tools no longer required, to ensure that any proceeds are properly recorded and the assets register appropriately updated and tools are completely recorded.

(iii) *Dumper truck*

(1) Inspect the truck to confirm its existence and to gain evidence of its valuation by reviewing its condition and the fact that it is still being used.

(2) If the vehicle is used at all on public roads then the vehicle registration document should be inspected as some evidence of title.

(3) Inspect the insurance policy for the truck as evidence of valuation.

(4) Vouch the expenditure on refurbishment to suppliers' invoices or company's payroll records where any of the work has been done by the client's own staff.

(5) Review the depreciation policy and assess for reasonableness by discussion with management and past experience of similar vehicles.

(iv) *Revaluation of office block*

(1) Inspect the building to confirm its existence and state of repair.

(2) Examine documents of title to confirm ownership.

(3) Enquire about any charges on the building and confirm that these have been properly recorded and disclosed.

(4) Review the valuer's certificate and agree to the amount used in the financial statements, with consideration also being given to his qualifications, experience and reputation.

(5) Assess the reasonableness of the valuation by comparison with any similar properties which may have recently changed hands on the open market.

(v) *Deposit for new equipment*

(1) Agree the payment of the deposit to the contract for purchase of the equipment.

(2) Confirm the existence of the plant following its delivery on 31 October 20X5, as it is unlikely that the audit work will have been completed by that date.

1.4 Impairment of non-current assets

Auditors must assess whether an entity has considered whether tangible assets have been impaired and, if they are, have accounted for those impairments in accordance with Sri Lanka Accounting Standards.

An asset is impaired when its carrying amount (depreciated cost or depreciated valuation) exceeds its recoverable amount.

The **recoverable amount** of an asset or cash-generating unit is the higher of its **fair value** less costs of disposal and its value in use.

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

A **cash-generating unit** is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

Management is required by LKAS 16 *Property, plant and equipment* to determine whether there is any indication that the assets are impaired. To determine whether an asset is impaired the entity will apply LKAS 36 *Impairment of assets*.

LKAS 36 specifies the following indicators of possible impairment, which may be obtained from external or internal sources.

External sources of information regarding possible impairment:

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

Internal sources of information regarding possible impairment:

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

The auditors will consider whether there are any indicators of impairment when carrying out risk assessment procedures. They will use the same impairment criteria laid out in LKAS 36 as management does. If the auditors believe that impairment is indicated, they should request that management shows them the impairment review that has been carried out. If no impairment review has been carried out, then the auditors should discuss the need for one with management, and if management refuses to carry out an impairment review and the auditors conclude that the financial statements are materially misstated, they should qualify their opinion on these grounds.

If an impairment review has been carried out, then the auditors should audit that impairment review. Management will have estimated whether the recoverable amount of the asset/cash generating unit is lower than the carrying amount.

For auditors, the key risk is that recoverable amount requires estimation, which involves management using its judgement. Auditors will need to consider whether the judgement made by management is reasonable in accordance with LKAS 36.

Management has to determine if recoverable amount is higher than carrying amount. It may not have been necessary for them to estimate both fair value and value in use, because if one is higher than carrying amount, then the asset is not impaired. If it is not possible to make a reliable estimate of fair value, then it is necessary to calculate value in use.

1.4.1 Auditing fair value

For auditors, the determination of fair value will generally be more difficult than determining historical cost. It will be more difficult to establish whether fair value is reasonable for complex assets and liabilities than for more straightforward assets or liabilities which have a market and, therefore, a market value.

There is an auditing standard which includes guidance on how to audit fair values: SLAuS 540 *Auditing accounting estimates, including fair value accounting estimates and related disclosures.*

Auditors should also refer to Sri Lanka Accounting Standard SLFRS 13 *Fair Value Measurement* for guidance on the calculation of fair value by the company. This includes the three valuation techniques and the hierarchy of their importance to the measurement, and therefore auditing, of fair value.

To increase the consistency and comparability in fair value measurements and related disclosures, SLFRS 13 establishes a fair value hierarchy as follows:

- The highest priority is quoted prices (unadjusted) in active markets for identical assets or liabilities. This is a Level 1 input.
- The second level is those inputs other than quoted prices included in Level 1 that are observable for the asset or liability (directly or indirectly). Examples include quoted prices for similar assets or liabilities in active markets, and inputs other than quoted prices such as interest rates, yield curves, implied volatilities and credit spreads.
- The third and lowest level is unobservable inputs which must reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

Accounting estimate. An approximation of a monetary amount in the absence of a precise measurement. This term is used for an amount measured at **fair value** where there is estimation uncertainty as well as for other amounts that require estimation.

SLAuS 540's requirements are as follows:

- The auditor shall obtain an understanding of the following as part of the process of understanding the business:
  - The requirements of the applicable financial reporting framework.
  - The means by which the management identifies transactions, events and conditions that may give rise to the accounting estimate.
  - How management makes the accounting estimate.

    This means that the auditor must have a sound knowledge of the accounting requirements relevant to the entity and when fair value is allowed, for example, LKAS 16 allows fair value provided 'it can be measured reliably'.
- The auditor shall evaluate the degree of estimation uncertainty associated with the accounting estimate and assess whether this gives rise to significant risks.
- Based on the assessed risks the auditor will determine whether the financial reporting framework has been properly applied and whether methods for making estimates are appropriate and have been applied consistently.
- The auditor will also:
  - Determine whether events occurring up to the date of the audit report provide evidence regarding the accounting estimate
  - Test how management made the accounting estimate
  - Test the operating effectiveness of controls together with appropriate substantive procedures
  - Develop a point estimate or a range to evaluate the management's point estimate.

Management's point estimate is the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

- For accounting estimates which give rise to significant risks the auditor should also evaluate the following:
  - How management has considered alternative assumptions or outcomes
  - Whether the significant assumptions used are reasonable
  - Management intent to carry out specific courses of action and its ability to do so, where these affect the accounting estimate

   - Management's decision to recognise, or to not recognise, the accounting estimate
   - The selected measurement basis

- The possibility of management bias must be considered by the auditor
- Written representations will be obtained from management as to whether management believes that significant assumptions used in making accounting estimates are reasonable.

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

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

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

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

If there are alternative allowable methods for measuring fair value, or a particular method is not prescribed by the relevant accounting standard such as SLFRS 13, the auditor should consider whether the entity's method is consistent with other fair value measurements in the financial statements and whether it is applied consistently.

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

- The length of time any assumptions cover (the longer, the more subjective the value is)
- The number of assumptions made in relation to the item

- The degree of subjectivity in the process
- The degree of uncertainty associated with the outcome of events
- Any lack of objective data
- The timings of any valuations used
- The reliability of third-party evidence
- The impact of subsequent events on the fair value measurement

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

1.4.2 Auditing value in use

If management has calculated the value in use of an asset or cash-generating unit, then the auditors will have to audit that calculation. The following procedures will be relevant.

Value in use

- Obtain management's calculation of value in use
- Re-perform calculation to ensure that it is mathematically correct
- Compare the cash flow projections to recent budgets and projections approved by the board to ensure that they are realistic
- Calculate/obtain from analysts the long-term average growth rate for the products and ensure that the growth rates assumed in the calculation of value in use do not exceed it
- Refer to competitors' published information to compare how similar assets are valued by companies trading in similar conditions
- Compare to previous calculations of value in use to ensure that all relevant costs of maintaining the asset have been included
- Ensure that the cost/income from disposal of the asset at the end of its life has been included
- Review calculation to ensure cash flows from financing activities and income tax have been excluded
- Compare discount rate used to published market rates to ensure that it correctly reflects the return expected by the market

1.4.3 If the asset is impaired

If the asset is impaired and has been written down to recoverable amount, the auditors should review the financial statements to ensure that the write-down has been carried out correctly and that the LKAS 36 disclosures have been made correctly.

Although this section has been focused on impairment of tangible non-current assets, these considerations apply equally to intangibles (covered in Section 2), which can be impaired too – eg goodwill, which must be tested annually for impairment.

2 Intangible non-current assets

Key assertions for intangible non-current assets are **existence** and **accuracy, valuation and allocation**.

The key assertions relating to intangibles are **existence** (not so much 'do they exist?', but 'are they genuinely assets?') and **accuracy, valuation and allocation**. They will therefore be audited with reference to criteria laid down in Sri Lanka Accounting Standards. As only purchased goodwill or intangibles with a readily ascertainable market value can be capitalised, **audit evidence should be available** (purchase invoices or specialist valuations). The audit of **amortisation** will be similar to the audit of depreciation.

Table 8.3: Procedures, intangible non-current assets

Audit procedures: other non-current assets	
Goodwill	• Agree the consideration to sales agreement by **inspection**. • Consider whether asset valuation is reasonable. • Agree that the calculation is correct by **recalculation**. • **Review** any impairment review and **discuss** with management. • Ensure valuation of goodwill is reasonable/there has been no impairment not adjusted through **discussion** with management.

Audit procedures: other non-current assets	
Research and development costs	• Confirm that capitalised development costs conform to LKAS 38 criteria by **inspecting** details of projects and **discussions** with technical managers. • Confirm feasibility and viability by **inspection** of budgets. • **Recalculate** amortisation calculation, to ensure it commences with production/is reasonable. • **Inspect** invoices to verify expenditure incurred on R&D projects.
Other intangibles	• Agree purchased intangibles to purchase documentation agreement by **inspection**. • **Inspect** specialist valuation of intangibles and ensure it is reasonable. • Review amortisation calculations and ensure they are correct by **recalculation**.

CHAPTER ROUNDUP

- Key areas when testing **tangible non-current assets** are:
  - **Confirmation** of ownership
  - **Inspection** of non-current assets
  - **Valuation** by third parties
  - **Adequacy** of **depreciation** rates
  - Whether i**mpairments** have been identified and properly accounted for
- Key assertions for intangible non-current assets are **existence** and **accuracy, valuation and allocation**.

PROGRESS TEST

1 State the key financial statement assertions for tangible non-current assets.

2 Complete the table, showing which tests are designed to provide evidence over which financial statement assertion.

Completeness	Existence

Accuracy, valuation and allocation	Rights and obligations

(a) Inspect assets

(b) Verify to valuation certificate

(c) Inspect title deeds

(d) Compare assets in ledger to non-current asset register

(e) Review depreciation rates

(f) Verify material on self-constructed asset to invoices

(g) Examine invoices after the year-end

(h) Review repairs in general ledger

3 Which of the following tests would provide audit evidence as to the existence of a tangible non-current asset?

(a) Inspecting board minutes approving authorisation of the asset
(b) Physically inspecting the asset
(c) Reviewing the non-current asset register for inclusion of the asset
(d) Inspecting the invoice and purchase order documentation of the asset

4 Inspecting the title deeds of a building provides audit evidence concerning which one of the following financial statement assertions?

(a) Existence
(b) Accuracy, valuation and allocation
(c) Rights and obligations
(d) Completeness

5 What are the key financial statement assertions for other non-current assets?

ANSWERS TO PROGRESS TEST

1 Rights and obligations, existence, accuracy, valuation and allocation, completeness

2

Completeness	Existence
(d) Compare assets in ledger to register (h) Review repairs in general ledger	(a) Inspect assets

Accuracy, valuation and allocation	Rights and obligations
(b) Verify to valuation certificate (e) Review valuation rates (f) Verify material on self-constructed assets to invoice	(c) Inspect title deeds (g) Examine invoices after the year-end

3 (b) Physically inspecting the asset

4 (c) Rights and obligations

5 Existence, accuracy, valuation and allocation

CHAPTER 09

Auditing Inventory

INTRODUCTION

No area of the statement of financial position creates more potential problems for the auditors than that of inventory.

Closing inventory does not normally form an integrated part of the double entry bookkeeping system and hence a misstatement (under or overstatement) may not be detected from tests in other audit areas.

The key assertions relating to the substantive audit of inventory (completeness, existence, rights and obligations, cut-off and accuracy, valuation and allocation) require careful consideration.

The auditor's attendance at the inventory count is a particularly important part of the audit of inventory. This is because the inventory count gives evidence about the existence and completeness of inventory, and a review of the condition of the inventory is an important part of assessing whether it has been correctly valued.

Knowledge Component			
C	**Gathering Audit Evidence**		
3.1	**Test of Details**	3.1.1	Outline audit procedures to address assertion level risk for non-complex key account balances and classes of transactions
		3.1.2	Apply specific considerations in obtaining sufficient appropriate audit evidence with respect to inventory, litigation and claims involving the entity, and segment information

CHAPTER CONTENTS		LEARNING OUTCOME
1	Introduction to audit of inventory	3.1.1
2	Accounting for inventory	3.1.1
3	Audit procedures in relation to inventory	3.1.1
4	Audit procedures at the inventory count	3.1.2
5	Auditing cut-off of inventory	3.1.1
6	Obtaining evidence over inventory valuation	3.1.1

1 Introduction to audit of inventory

The key assertions relating to inventory are:

- Existence
- Completeness
- Rights and obligations
- Accuracy, valuation and allocation
- Cut-off
- Presentation

The audit of inventory can pose problems for auditors, as a result of its nature and potential material value on the statement of financial position. The audit approach taken depends on the auditor's assessment of the controls in place. In this chapter we focus on the **substantive** audit of inventory.

The following table demonstrates the audit objectives for inventory and the related financial statement assertions. The audit procedures described in the remainder of this chapter are undertaken to provide audit evidence to support these assertions.

Table 9.1: Audit objectives for inventory

Financial statement assertion	Audit objective
Existence and occurrence	– Recorded purchases and sales represent inventories bought and sold. – Inventory on the statement of financial position physically exists.
Completeness	– All purchases and sales are recorded. – All inventory at year-end is included on the statement of financial position.
Rights and obligations	– The entity has rights to inventory recorded in the period and at the year-end.
Accuracy, valuation and allocation	– Costs are accurately determined in accordance with accounting standards. – Inventory is recorded at year-end at the lower of cost and net realisable value.
Classification	– Inventory is recorded in the proper accounts.
Cut-off	– All purchases and sales of inventories are recorded in the correct period.
Presentation (classification, completeness, accuracy and valuation)	– Inventory is properly classified in the accounts. – Disclosures relating to classification and valuation are adequate and in accordance with accounting standards.

1.1 Internal control considerations

The approach taken to the audit of inventory depends on the control system in place over inventory.

If the entity has a perpetual inventory system in place (where inventory is counted continuously throughout the year) and a year-end count is not undertaken, a controls-based approach is feasible as long as the controls over the system are appropriately designed. In fact, a controls-based approach may actually be more efficient.

However, where inventory quantities will be determined by an inventory count at the year-end date, a largely substantive approach is taken. We look at both year-end inventory counts and periodic counts in support of perpetual inventory systems later in this chapter.

2 Accounting for inventory

The **valuation** and **disclosure** rules for inventory are laid down in LKAS 2 *Inventories*. Inventory should be valued at the **lower** of cost and net realisable value.

Cost is defined by LKAS 2 as comprising all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Production costs (costs of conversion) include:

(a) Costs specifically attributable to units of production
(b) Production overheads
(c) Other overheads attributable to bringing the product or service to its present location and condition

Net realisable value is defined by LKAS 2 as the estimated selling price in the ordinary course of business, less the estimated costs of completion and the estimated costs necessary to make the sale.

3 Audit procedures in relation to inventory

Audit procedures must be performed at the inventory count and the results followed up subsequently.

The following table sets out audit procedures to test year-end inventory. The physical inventory count is discussed in detail in Section 4 of this chapter, and cut-off and valuation are expanded upon in Sections 5 and 6.

Table 9.2: Audit procedures – inventory

Audit procedures: inventory	
Completeness	• **Trace** test counts to the detailed inventory listing. • Where inventory is held in **third-party locations**, **physically inspect** this inventory or **review confirmations** received from the third party and match to the general ledger. • **Compare** the gross profit % to the previous year or industry data. • Complete the **disclosure checklist** to ensure that all the disclosures relevant to inventory have been made.
Existence	• Observe the **physical inventory count** (see Section 4 for details of attendance at the inventory count).

Audit procedures: inventory	
Rights and obligations	• Verify that any **inventory held for third parties** is not included in the year-end inventory figure by being appropriately segregated during the inventory count. • For any **'bill-and-hold' inventory** (ie where the inventory has been sold but is being held by the entity until the customer requires it), identify such inventory and ensure that it is segregated during the inventory count so that it is not included in the year-end inventory figure. • Confirm that any inventory held at **third-party locations** is included in the year-end inventory figure.
Accuracy, valuation and allocation	• Obtain a copy of the inventory listing and **agree** the totals to the general ledger. • **Cast** the inventory listing to ensure it is mathematically correct. • Confirm that an appropriate **basis of valuation** (eg FIFO) is being used by discussing with management. • **Vouch** a sample of inventory items to suppliers' invoices to ensure they are correctly valued. • Where **standard costing** is used, test a sample of inventory to ensure it is correctly valued. • For **materials**, agree the valuation of raw materials to invoices and price lists. • For **labour** costs, agree costs to wage records. • **Review** standard labour costs in the light of actual costs and production. • **Reconcile** labour hours to time summaries. • Make **enquiries of management** to ascertain any slow-moving or obsolete inventory that should be written down. • **Examine prices** at which finished goods have been sold after the year-end to ascertain whether any finished goods need to be written down. • If significant levels of finished goods remain unsold for an unusual period of time, **discuss** with management and consider the need to make allowance. • **Compare** the gross profit % to the previous year or industry data. • **Compare** raw material, finished goods and total inventory turnover to the previous year and industry averages.

Audit procedures: inventory	
	• **Compare** inventory days to the previous year and industry average. • **Compare** the current year standard costs to the previous year after considering current conditions. • **Compare** actual manufacturing overhead costs with budgeted or standard manufacturing overhead costs. • Obtain a copy of the inventory listing and **cast** it, and test the mathematical extensions of quantity multiplied by price. • **Trace** test counts back to the inventory listing. • If the entity has adjusted the general ledger to agree with the physical inventory count amounts, **agree** the two amounts. • Where a **continuous (perpetual) inventory system** is maintained, agree the total on the inventory listing to the continuous inventory records, using CAATs.
Cut-off	• Note the numbers of the **last GDNs and GRNs** before the year-end and the **first GDNs and GRNs** after the year-end and check that these have been included in the correct financial year.
Occurrence and rights and obligations	• **Enquire** of management and **review** any loan agreements and board minutes for evidence that inventory has been pledged or assigned. • Enquire of management about warranty obligation issues.
Classification	• **Review** the inventory listing to ensure that inventory has been properly classified between raw materials, work-in-progress and finished goods. • **Read** the notes to the accounts relating to inventory to ensure they are understandable.
Presentation	• **Review** the financial statements to confirm whether the cost method used to value inventory is accurately disclosed. • **Read** the notes to the accounts to ensure that the information is accurate and properly presented at the appropriate amounts.

4 Audit procedures at the inventory count

Physical inventory count procedures are vital as they provide evidence which cannot be obtained elsewhere, or at any other time, about the quantities and conditions of inventories and work-in-progress.

SLAuS 501 *Audit evidence – specific considerations for selected items* provides guidance to auditors on attending the physical inventory count to obtain evidence regarding the existence and condition of inventory.

It states that where inventory is **material**, auditors shall obtain sufficient appropriate audit evidence regarding its **existence** and **condition** by attending the physical inventory count (unless this is impracticable) to do the following:

- Evaluate management's instructions and procedures for recording and controlling the result of the physical inventory count
- Observe the performance of the count procedures
- Inspect the inventory
- Perform test counts

The auditor shall also perform audit procedures over the entity's final inventory records to determine whether they accurately reflect the count results.

Attendance at the inventory count can serve as either substantive procedures or tests of controls, depending on the auditor's risk assessment, planned approach and specific procedures carried out.

Factors to consider when planning attendance at the inventory count include the following:

- The **risks of material misstatement** of inventory
- **Internal controls** related to inventory
- Whether **adequate procedures** are expected to be established and **proper instructions** issued for counting
- The **timing** of the count
- Whether the entity maintains a **perpetual inventory system**
- **Locations** at which inventory is held (including materiality at different locations)
- Whether the assistance of an **auditor's expert** is required

4.1 The inventory count

A business may count inventory by one, or a combination, of the following methods.

(a) **Physical inventory counts** at the **year-end**

From the viewpoint of the auditor this is often the best method.

(b) **Physical inventory counts before** or **after** the **year-end**

This will provide audit evidence of varying reliability, depending on:

(i) The **length of time** between the physical inventory count and the year-end (the greater the time period, the less the value of audit evidence)

(ii) The **business's system** of **internal controls**

(iii) The **quality of records** of **inventory movements** in the period between the physical inventory count and the year-end

(c) **Perpetual** (or **continuous**) **inventory** where management has a programme of inventory-counting throughout the year

If **perpetual** inventory counting is used, auditors will verify that management:

(a) Ensures that all inventory lines are counted at least once a year

(b) Maintains **adequate inventory records** that are kept up-to-date. Auditors may compare sales and purchase transactions with inventory movements and carry out other tests on the inventory records, for example, checking addition and classification of inventory.

(c) Has **satisfactory procedures** for **inventory counts** and **test-counting**. Auditors should confirm the inventory count arrangements and instructions are as rigorous as those for a year-end inventory count by reviewing instructions and observing counts. Auditors will be particularly concerned with **cut-off**, that there are no inventory movements while the count is taking place and inventory records are updated until the time of the inventory count.

(d) **Investigates** and **corrects** all **material differences**. Reasons for differences should be recorded and any necessary corrective action taken. All corrections to inventory movements should be **authorised** by a manager who has not been involved in the detailed work. These procedures are necessary to guard against the possibility that inventory records may be adjusted to conceal shortages. Auditors should check that the procedures are being operated.

Table 9.3: Audit procedures – perpetual inventory count

Audit procedures: perpetual inventory count
• **Attend** one of the inventory counts (to observe and confirm that instructions are being adhered to).
• **Follow up** the **inventory counts attended** to compare quantities counted by the auditors with the inventory records, obtaining and verifying explanations for any differences, and checking that the client has reconciled count records with book inventory records.
• **Review** the **year's inventory counts** to confirm the extent of counting, the treatment of discrepancies and the overall accuracy of records. (If matters are not satisfactory, auditors will only be able to gain sufficient assurance by a full count at the year-end).
• Assuming a full count is not necessary at the year-end, **compare** the **listing of inventory with the detailed inventory records**, and carry out other procedures (**cut-off, analytical procedures**) to gain further comfort.

The audit work when perpetual inventory counting is used focuses on tests of controls rather than substantive audit work. Nevertheless, the auditor will also need to do some further substantive audit work on completeness and existence at the year-end.

Attendance at an inventory count gives evidence of the **existence** and apparent **ownership** of inventory. It also gives evidence of the **completeness** of inventory, as do the follow-up tests to ensure all inventory sheets were included in the final count.

4.2 Planning attendance at inventory count

Before the physical inventory count the auditors should ensure audit **coverage** of the **count** is **appropriate**, and that the client's **count instructions** have been reviewed.

Table 9.4: Audit Procedures – inventory count

Audit procedures: planning inventory count	
Gain knowledge	• **Review** previous year's **arrangements** • **Discuss with management** the inventory count arrangements and significant changes
Assess key factors	• The **nature** and **volume** of the **inventory** • **Risks** relating to inventory • **Identification** of **high-value items**

Audit procedures: planning inventory count	
	• **Method of accounting for inventory** • **Unit of measurement of inventory** • **Location** of inventory and how it affects inventory control and recording • **Internal control** and **accounting systems** to identify potential areas of difficulty
Plan procedures	• **Ensure** a **representative selection** of **locations**, **inventory** and **procedures** are covered • Ensure sufficient attention is given to **high-value items** • **Arrange to obtain,** from any **third parties, confirmation** of inventory they hold • Consider the need for **expert help**
Audit procedures: review of inventory count instructions	
Organisation of count	• **Supervision** by senior staff including senior staff not normally involved with inventory • **Tidying** and **marking** inventory to help counting • **Restriction** and **control** of the production process and inventory movements during the count • **Identification of damaged, obsolete, slow-moving, third-party** and **returnable** inventory
Counting	• **Systematic counting** to ensure all inventory is counted • Teams of **two counters,** with one counting and the other checking or **two independent counts**
Recording	• **Serial numbering, control** and **return** of all inventory sheets • Inventory sheets being **completed** in **ink** and **signed** • **Information** to be recorded on the **count records** (location and identity, count units, quantity counted, conditions of items, stage reached in production process) • Recording of **quantity, conditions** and **stage of production** of **work-in-progress** • Recording of last numbers of **goods inwards** and **outwards** records and of internal transfer records • **Reconciliation** with **inventory records** and **investigation** and correction of any **differences**

4.3 Attendance at inventory count

During the count the auditors should **observe** whether the count is being carried out according to instructions, carry out **test counts**, and watch out for **third-party inventory** and **slow-moving inventory** and **cut-off problems.**

Table 9.5: Audit procedures – attendance at inventory count

Audit procedures: attendance at inventory count
• **Observe** whether the **client's staff** are following instructions as this will help to ensure the count is complete and accurate.
• **Perform test counts** to ensure procedures and internal controls are working properly, and to gain evidence over existence and completeness of inventory.
• **Ensure** that the **procedures** for **identifying damaged, obsolete** and **slow-moving** inventory operate properly; the auditors should obtain information about the inventory's condition, age, usage and, in the case of work-in-progress, its stage of completion, to ensure that it is valued appropriately.
• **Confirm** that **inventory held** on behalf of **third parties** is separately identified and accounted for so that inventory is not overstated.
• **Conclude** whether the **count** has been **properly carried out** and is sufficiently reliable as a basis for determining the existence of inventories.
• **Consider** whether any **amendment** is necessary to subsequent **audit procedures**.
• **Gain** an **overall impression** of the levels and values of inventories held so that the auditors may, in due course, judge whether the figure for inventory appearing in the financial statements is reasonable.

When carrying out test counts the auditors should select items from the count records and from the physical inventory and check one to the other, to confirm the accuracy of the count records. These two-way tests provide evidence for completeness and existence. The auditors should concentrate on high-value inventory. If the results of the test counts are not satisfactory, the auditors may request that inventory be recounted.

The auditor's working papers should include:

- Details of their **observations** and **tests**
- The manner in which **points** that are **relevant** and **material** to the inventory being counted or measured have been dealt with by the client
- Instances where the **client's procedures** have **not been satisfactorily carried out**

- **Items for subsequent testing**, such as photocopies of (or extracts from) rough inventory sheets
- **Details** of the **sequence** of **inventory sheets**
- The **auditors' conclusions**

4.4 After the inventory count

After the count the auditors should check that **final inventory sheets** have been **properly compiled** from count records and that **book inventory** has been **appropriately adjusted**.

After the count, the matters recorded in the auditors' working papers at the time of the count or measurement should be followed up. Key tests include the following.

Table 9.6: Audit procedures – following up inventory count

Audit procedures: following up the inventory count
• **Trace items** that were **test counted** to final inventory sheets.
• **Observe whether all count** records have been **included** in final inventory sheets.
• **Inspect final inventory sheets** to ensure they are **supported by** count records.
• **Ensure** that **continuous inventory records** have been **adjusted** to the amounts physically counted or measured, and that differences have been investigated.
• **Confirm cut-off** by using details of the last serial number of goods inwards and outwards notes and details of movements during the count.
• **Review replies** from **third parties** about inventory held by or for them.
• **Confirm** the client's final **valuation** of inventory has been calculated correctly.
• **Follow up queries** and **notify problems** to management.

4.5 Inventory held by third parties

Where the entity has inventory that is held by third parties and which is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence by performing one or both of the following:

- **Direct confirmation** from the third party regarding quantities and condition (in accordance with SLAuS 505 *External confirmations*)
- **Inspection** or other **appropriate audit procedures** (if third party's integrity and objectivity are doubtful)

The other appropriate audit procedures referred to above could include the following:

- Attending, or arranging for another auditor to attend, the third party's inventory count
- Obtaining another auditor's report on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded
- Inspecting documentation in respect of third-party inventory (eg warehouse receipts)
- Requesting confirmation from other parties when inventory has been pledged as collateral

QUESTION — Inventory count

In connection with your examination of the financial statements of Camry Products Plc for the year ended 31 March 20X9, you are reviewing the plans for a physical inventory count at the company's warehouse on 31 March 20X9. The company assembles domestic appliances; inventory of finished appliances, unassembled parts and sundry inventory are stored in the warehouse which is adjacent to the company's assembly plant. The plant will continue to produce goods during the inventory count until 5pm on 31 March 20X9. On 30 March 20X9, the warehouse staff will deliver the estimated quantities of unassembled parts and sundry inventory which will be required for production for 31 March 20X9; however, emergency requisitions by the factory will be filled on 31 March. During the inventory count, the warehouse staff will continue to receive parts and sundry inventory, and to dispatch finished appliances. Appliances which are completed on 31 March 20X9 will remain in the assembly plant until after the count has been completed.

Required

(a) **Outline** the principal procedures which the auditors should carry out when planning attendance at a company's physical inventory count.

(b) **Recommend** the procedures which Camry Products should establish in order to ensure that all inventory items are counted and that no item is counted twice.

ANSWER

(a) In planning attendance at a physical inventory count the auditors should:

(i) Review previous year's audit working papers and discuss any developments during the year with management.

(ii) Obtain and review a copy of the company's count instructions.

(iii) Arrange attendance at count planning meetings, with the consent of management.

(iv) Gain an understanding of the nature of the inventory and of any special problems this is likely to present, for example liquid in tanks, scrap in piles.

(v) Consider whether expert involvement is likely to be required as a result of any circumstances noted in (iv) above.

(vi) Obtain a full list of all locations at which inventories are held, including an estimate of the amount and value of inventories held at different locations.

(vii) Using the results of the above steps, plan for audit attendance by appropriately experienced audit staff at all locations where material inventories are held, subject to other factors (for example rotational auditing, reliance on internal controls).

(viii) Consider the impact of internal controls upon the nature and timing of attendance at the count.

(ix) Ascertain whether inventories are held by third parties and if so make arrangements to obtain written confirmation of them or, if necessary, to attend the count.

(b) Procedures to ensure a complete count and to prevent double-counting are particularly important in this case because movements will continue throughout the count.

(i) Clear instructions should be given as to procedures, and an official, preferably not someone normally responsible for inventories, should be given responsibility for organising the count and dealing with queries.

(ii) Before the count, all locations should be tidied and inventory should be laid out in an orderly manner.

(iii) All inventory should be clearly identified and should be marked after being counted by a tag or indelible mark, so that it is evident that it has been counted.

(iv) Pre-numbered sheets should be issued to counters and should be accounted for at the end of the count.

(v) Counters should be given responsibility for specific areas of the warehouse. Each area should be subject to a recount.

(vi) A separate record should be kept of all goods received or issued during the day (for example by noting the goods received note or dispatch note numbers involved).

(vii) Goods received on the day should be physically segregated until the count has been completed.

(viii) Similarly, goods due to be despatched on the day should be identified in advance and moved to a special area or clearly marked so that they are not inadvertently counted in inventory as well as being included in sales.

5 Auditing cut-off of inventory

Auditors should test **cut-off** by noting the **serial numbers** of GDNs and GRNs received and despatched just before and after the year-end, and subsequently testing that they have been included in the **correct period**.

5.1 The importance of cut-off

Cut-off is most critical to the accurate recording of transactions in a manufacturing enterprise at particular points in the accounting cycle as follows:

- The **point** of **purchase** and **receipt** of **goods** and **services**
- The **requisitioning** of **raw materials** for production
- The **transfer** of **completed work-in-progress** to finished goods
- The **sale** and **dispatch** of **finished goods**

While cut-off is a transaction assertion, it is important to note that it has a direct impact on the related statement of financial position balances. For example, a cut-off error in the recording of sales will result in misstatements in the inventory and receivables balances. A cut-off error in the recording of purchases of raw materials will have an equal knock-on effect on inventory and payables. Therefore, cut-off testing is often used to confirm the completeness of inventory, as well as the existence of receivables and payables.

5.2 Audit procedures

The auditors should consider whether management has implemented adequate cut-off procedures: procedures intended to ensure that movements into, within and out of inventories are properly identified and reflected in the accounting records.

Purchase invoices should be recorded as liabilities only if the goods were received prior to the count. A schedule of 'goods received not invoiced' should be prepared, and items on the list should be accrued for in the accounts.

Sales cut-off is generally more straightforward to achieve correctly than purchases cut-off. Invoices for goods dispatched after the count should not appear in the statement of profit or loss for the period.

Prior to the physical inventory count, management should make arrangements for cut-off to be properly applied.

(a) Appropriate systems of recording of receipts and despatches of goods are in place, and also a system for documenting materials requisitions. Goods received notes (GRNs) and goods dispatched notes (GDNs) should be sequentially pre-numbered.

(b) Final GRN and GDN and materials requisition numbers are noted. These numbers can then be used to subsequently check that purchases and sales have been recorded in the current period.

(c) Arrangements should be made to ensure that the cut-off arrangement for inventories held by third parties are satisfactory.

There should ideally be no movement of inventory during the count. Preferably, receipts and dispatches should be suspended for the full period of the count. It may not be practicable to suspend all deliveries, in which case any deliveries which are received during the count should be segregated from other inventory and carefully documented.

6 Obtaining evidence over inventory accuracy, valuation and allocation

Auditing the **accuracy, valuation and allocation** of inventory includes:

- Testing the **allocation of overheads** is appropriate
- Confirming inventory is carried at the **lower** of **cost** and **net realisable value**

6.1 Assessment of cost and net realisable value

Auditors must understand how the company determines the cost of an item for inventory valuation purposes.

There are several ways of determining cost. Auditors must ensure that the company is **applying** the method **consistently** and that each year the method used gives a **fair approximation** to cost. They may need to support this by additional procedures:

- **Reviewing price** changes near the year-end
- **Agreeing the inventory** held
- **Checking gross profit** margins to reliable management accounts

6.1.1 Valuation of raw materials and brought-in components

The auditors should perform work to test whether the correct prices have been used to value raw materials and brought-in components valued at actual costs by **referring** to **suppliers' invoices**. The valuation may include unrealised profit if inventory is valued at the latest invoice price. Reference to suppliers' invoice will also provide the auditors with assurance as regards ownership.

If standard costs are used, auditors should **check** the **basis** of the **standards**, **compare standard costs** with **actual costs** and **confirm** that **variances** are being **treated appropriately**.

6.1.2 Valuation of work-in-progress and finished goods

'Cost' comprises the cost of purchase plus the costs of conversion. The cost of conversion comprises:

- Costs specifically attributable to units of production
- Production overheads
- Other overheads attributable to bringing the product or service to its present location and condition

6.2 Audit procedures

The audit procedures will depend on the methods used by the client to value work-in-progress and finished goods, and on the adequacy of the system of internal control.

The auditors should consider what tests they can carry out to check the reasonableness of the valuation of finished goods and work-in-progress. **Analytical procedures** may assist comparisons being made with items and categories from the previous year's summaries. If the client has a computerised accounting system, the auditors may be able to request an exception report listing, for example, all items whose value has changed by more than a specified amount. A reasonableness check will also provide the auditors with assurance regarding completeness.

6.2.1 Cost

The auditors should ensure that the client includes a proportion of overheads **appropriate** to **bringing** the **inventory** to its **present location and condition in accordance with LKAS 2**. The basis of overhead allocation should be:

- Consistent with prior years
- Calculated on the normal level of production activity

Thus, overheads arising from **reduced levels of activity**, **idle time** or **inefficient production** should be written-off to the statement of profit or loss, rather than being included in inventory.

Difficulty may be experienced if the client operates a system of total overhead absorption. It will be necessary for those overheads that are of a general, non-productive nature to be identified and excluded from the valuation.

6.2.2 Cost vs NRV

Auditors should **compare cost and net realisable value** (NRV) for each item of inventory. Where this is impracticable, the comparison may be done by group or category.

Net realisable value is likely to be less than cost when there has been:

- An **increase in costs** or a fall in selling price
- **Physical deterioration**
- **Obsolescence** of products
- A **marketing decision** to manufacture and sell products at a loss
- Errors in production or purchasing

For work-in-progress, the **ultimate selling price** should be **compared** with the **carrying value** at the year-end plus **costs** to be **incurred** after the year-end to bring work-in-progress to a finished state.

QUESTION — Cost v NRV

Your firm is the auditor of Kasun Electrical Plc and you have been asked to audit the accuracy, valuation and allocation of the company's inventory at 31 May 20X1 in accordance with LKAS 2. Kasun Electrical operates from a single store and purchases domestic electrical equipment from wholesalers and manufacturers and sells them to the general public. These products include video and audio equipment, washing machines, refrigerators and freezers. In addition, it sells small items such as electrical plugs, tapes for video recorders, records and compact discs.

A full physical inventory count was carried out at the year-end, and you are satisfied that the inventory was counted accurately and there are no cut-off errors. Because of the limited time available between the year-end and the completion of the audit, the company has valued the inventory at cost by recording the selling price and deducting the normal gross profit margin.

Inventory which the company believes to be worth less than cost has been valued at net realisable value. The selling price used is that on the item in the store when it was counted.

The inventory has been divided into three categories.

(a) Video and audio equipment: televisions, video recorders, video cameras and audio equipment

(b) Domestic equipment: washing machines, refrigerators and freezers

(c) Sundry inventory: electrical plugs, magnetic tapes and compact discs

The normal gross profit margin for each of these categories has been determined and this figure has been used to calculate the cost of the inventory (by deducting the gross profit margin from the selling price). In answering the question you should assume there are no sales taxes.

Required

(a) **Design** the audit work you will carry out to check that inventory has been correctly valued at cost.

(b) **Design** the audit work you will carry out to:

  (i) Find inventory which should be valued at net realisable value
  (ii) Check that the net realisable value is correct

(c) **Outline** the other work you will perform to check that the inventory value is accurate.

Note. In answering the question you are only required to check that the price per unit of the inventory is correct. You should assume that the inventory quantities are accurate and there are no purchases or sales cut-off errors.

ANSWER

(a) This method of valuation at cost is permitted by LKAS 2, but it is usually applied to large retail concerns with inventory of thousands of low-value items, for example supermarket chains. This method is only permitted when it can be shown that it gives a reasonable approximation of the actual cost.

The following tests should be performed to ensure that the inventory is correctly valued at cost.

(i) Obtain a schedule of the client's calculations of the gross profit margins. Check the mathematical accuracy and consider the reliability of all sources of information used in the calculation.

(ii) Where the normal overall gross margin has been used, check the reasonableness of the figure by comparing it to the monthly management accounts for the year and last year's published accounts.

(iii) Test a sample of items to make sure that gross profit does not vary too much across all items of inventory (which is unlikely for Kasun Electrical). The test will compare selling price to purchase price.

(iv) If a weighted average gross margin has been used, check that the weighting is correct in terms of the proportion of each type of product in closing inventory.

(v) Select a sample of high-value lines and check the reasonableness of the gross profit estimate by calculating the gross profit for each of those lines. Sales price will be compared to inventory sheets and to sales prices in the shop at the year-end. Cost will be checked by examining purchase invoices. The weighted average profit margin for the selected lines can then be calculated and compared to the gross margin applied to the whole inventory.

(vi) Overvaluation of slow-moving inventory is possible when the prices of those items are affected by inflation. To check this, examine the inventory sheets for any slow-moving items (or ask the management of the company or use own observation). Compare the value of the inventory at the end of the accounting period to cost, according to purchase invoices. If an overvaluation has occurred it should be quantified.

(vii) Check whether any goods were being offered for sale at reduced prices at the year-end. If the reduced price is greater than cost, the use of an average gross profit percentage will cause inventory to be undervalued. This undervaluation must be quantified. If full selling price was used in the calculation then the problem will not arise. Check a sample of inventory items to sales invoices issued around the year-end, to make sure that the correct price was used in the costing calculation.

(b) (i) Inventory which may be worth less than cost will include:

– Slow-moving inventory
– Obsolete or superseded inventory
– Seconds and items that have been damaged
– Inventories which are being, or are soon likely to be, sold at reduced prices
– Discontinued lines

Finished goods where the selling price is less than cost will be valued at net realisable value. This is defined as the actual or estimated selling price less costs to completion and marketing, selling and distribution expenses.

To identify inventories which may be worth less than cost the following work will be carried out.

- Examine the computerised inventory control system and list items showing an unacceptably low turnover rate. An unacceptable rate of turnover may be different for different items, but inventory representing more than six months' sales is likely to qualify.
- Review the inventory printout for items already described as seconds or recorded as damaged.
- Discuss with management the current position regarding slow-moving inventories, and their plans and expectations in respect of products that may be discontinued. The standard system must be carefully considered and estimates obtained of the likely selling price of existing inventories. The most likely outcome regarding the use and value of discontinued components must be decided.
- At the physical inventory count, look for inventory which is dusty, inaccessible and in general not moving and mark on the inventory sheets.

- Find out whether any lines are unreliable and therefore frequently returned for repairs, as these may be unpopular.
- Review the trade press or other sources to see whether any of the equipment is out of date.

(ii) Determining the net realisable value of inventory involves management judging how much inventory can be sold and at what price, together with deciding whether to sell off raw materials and components separately or to assemble them into finished products. Each separate type of inventory item should be considered individually in deciding on the level of prudent provision.

The following tests should be carried out.

- Find the actual selling prices from the latest sales invoice. For items still selling, invoices will be very recent, but for slow-moving and obsolete items the invoiced prices will be out of date and allowance will have to be made for this.
- Estimate the value of marketing, selling and distribution expenses using past figures for the types of finished goods concerned as a base. Update and review for reasonableness against the most recent accounting records.
- Discuss with management what selling prices are likely to be where there is little past evidence. Costs to completion will be questioned where these are difficult to estimate and where there are any unusual assembly, selling or distribution problems.

(c) The following procedures would also be performed to check the value of inventory at the year-end.

(i) Compare current results with prior year(s). This would include gross profit margins, sales and turnover. Marked variations from the current year's results should be investigated.

(ii) Consider the effects of new technology and new fashions. The electrical appliance business will be exposed to obsolescence problems. Quantify any necessary write-down.

(iii) Compare selling prices to those charged elsewhere. If the prices elsewhere are lower, than the distortion in selling price might affect the value of the inventory of Kasun Electrical. Alternatively, if prices elsewhere are higher, then the company's prices may occasionally fall below cost. Again, any adjustment discovered to be necessary must be quantified.

(iv) Compare the valuation of inventory this year to that at the end of last year. This will be particularly useful for lines held at both dates. If the values are comparable, taking account of inflation, then the current valuation is more likely to be correct.

(v) Sale prices should be monitored as long after the year-end as possible, to make sure that prices were not kept artificially high over the year-end and then reduced at a later date. Inventory turnover should also be examined on the same basis.

CHAPTER ROUNDUP

- The key assertions relating to inventory are:
  - Existence
  - Completeness
  - Rights and obligations
  - Accuracy, valuation and allocation
  - Cut-off
  - Presentation
- The **valuation** and **disclosure** rules for inventory are laid down in LKAS 2 *Inventories*. Inventory should be valued at the **lower** of cost and net realisable value.
- Audit procedures must be performed at the inventory count and the results followed up subsequently.
- Physical inventory count procedures are vital as they provide evidence which cannot be obtained elsewhere, or at any other time, about the quantities and conditions of inventory and work-in-progress.
- Auditors should test **cut-off** by noting the **serial numbers** of GDNs and GRNs received and despatched just before and after the year-end, and subsequently testing that they have been included in the **correct period**.
- Auditing the **accuracy, valuation and allocation** of inventory includes:
  - Testing the **allocation of overheads** is appropriate
  - Confirming inventory is carried at the **lower** of **cost** and **net realisable value**

PROGRESS TEST

1 Complete the sentence using the words given below.

…………………… is defined by LKAS 2 as comprising all costs of ………… and other costs incurred in bringing the inventory to its …………… …………….. and …………….. .

purchase	condition	present	cost	location

2 List three methods of inventory counting

(1) …………………… (2) …………………… (3) ……………………

3 When should the following inventory counting tests take place? Use the relevant heading from the box below.

(a) Observe whether client staff are following instructions.
(b) Review previous year's inventory count arrangements.
(c) Assess method of accounting for inventories.
(d) Trace counted items to final inventory sheets.
(e) Review replies from third parties about inventory held for them.
(f) Conclude as to whether inventory count has been properly carried out.
(g) Gain an overall impression of levels and values of inventory.
(h) Consider the need for expert help.

BEFORE	DURING	AFTER

4 State four points in the accounting cycle when cut-off is critical.

(1) ……………………………… (3) ………………………………
(2) ……………………………… (4) ………………………………

5 Give four occasions when the net realisable value of inventory is likely to fall below cost.

(1) ……………………………………………………
(2) ……………………………………………………
(3) ……………………………………………………
(4) ……………………………………………………

ANSWERS TO PROGRESS TEST

1 **Cost** is defined by LKAS 2 as comprising all costs of **purchase** and other costs incurred in bringing the inventory to its **present location** and **condition**.

2 (1) Year-end (2) Pre/post year-end (3) Continuous

3

(a)	DURING	(b)	BEFORE	(c)	BEFORE	(d)	AFTER
(e)	AFTER	(f)	DURING	(g)	DURING	(h)	BEFORE

4
(1) The point of purchase and receipt of goods and services
(2) The requisitioning of raw materials for production
(3) The transfer of completed work-in-progress to finished goods
(4) The sale and dispatch of finished goods

5 Any four from:
- An increase in costs or a fall in selling price
- Physical deterioration
- Obsolescence of products
- A marketing decision to manufacture and sell products at a loss
- Errors in production or purchasing

CHAPTER 10

Audit of Revenue and Receivables

INTRODUCTION

Receivables will generally be a material figure on a company's statement of financial position. You must ensure that you are fully conversant with the 'standard' procedures such as the confirmation of receivables. The receivables confirmation is primarily designed to test the client's entitlement to receive the debt, not the customer's ability to pay.

Auditors also need to consider cut-off for receivables. Sales revenue testing is often carried out in conjunction with the audit of receivables as the two are linked. We also briefly consider the audit of prepayments which is normally carried out using analytical procedures.

Knowledge Component			
C	**Gathering Audit Evidence**		
3.1	**Test of Details**	3.1.1	Outline audit procedures to address assertion level risk for non-complex key account balances and classes of transactions
3.2	**External Confirmation**	3.2.1	Apply procedures to design and perform external confirmation to obtain relevant and reliable audit evidence.

CHAPTER CONTENTS	LEARNING OUTCOME
1 Introduction	3.1.1
2 Procedures for receivables	3.1.1
3 The receivables confirmation	3.2.1
4 Auditing sales revenue	3.1.1

1 Introduction

Receivables are usually audited using a combination of **tests of details** and **analytical procedures**.

The audit of receivables is important, as this is likely to be a material area. A combination of analytical procedures and tests of details are used, with sales also being tested in conjunction with trade receivables.

The following table sets out the assertions that apply to receivables. The audit procedures in the remainder of this chapter are used to provide evidence for these assertions.

Table 10.1: Assertions applicable to receivables

Assertions about classes of transactions and related disclosures	• All sales transactions recorded have occurred and relate to the entity **(occurrence)** • All sales transactions that should have been recorded have been recorded **(completeness)** • Amounts relating to transactions have been recorded appropriately **(accuracy)** • All transactions have been recorded in the correct period **(cut-off)** • All transactions are recorded properly **(classification)** • All disclosed events and transactions relating to receivables have occurred and pertain to the entity **(occurrence, rights and obligations)** • All disclosures required have been included **(completeness)**

	• Financial information is appropriately presented and described and disclosures clearly expressed **(presentation)** • Financial and other information is disclosed fairly and at appropriate amounts **(presentation)**
Assertions about account balances at the period end and related disclosures	• Recorded receivables exist **(existence)** • The entity controls the rights to receivables and related accounts **(rights and obligations)** • All receivables that should have been recorded have been recorded **(completeness)** • Receivables are included in the accounts at the correct amounts **(accuracy, valuation and allocation)** • All disclosures required have been included **(presentation)** • Financial information is appropriately presented and described and disclosures clearly expressed **(presentation)** • Financial and other information is disclosed fairly and at appropriate amounts **(presentation)**

1.1 Internal control considerations

The audit of receivables and sales is closely linked to the objectives we looked at when we considered controls over the sales system in Chapter 3.

Segregating responsibilities in this area is a very important control. One person should not be responsible for taking orders, raising sales invoices and receiving and recording monies from customers. The failure to segregate these duties could lead to a fraud such as teeming and lading (explained in Section 3.5.1) which would overstate receivables balances.

From the company's point of view, the reconciliation of the aged receivables accounts with the receivables control account on a regular basis is a key control to highlight anomalies. However, as with a bank reconciliation, the auditor will usually only focus on the year-end reconciliation and listings, as this is often the most efficient way to obtain audit evidence.

As we saw in Chapter 3, a common control over the sales system is having numerically sequenced invoices which are matched to shipping documentation or goods despatched notes (GDNs).

One area in which the auditor may be able to make use of client controls is in relation to the completeness of sales, where the client performs a reconciliation between sales records outside of the accounting system and the sales in the financial statements. However, if they are unable to test and rely on such controls, the auditor often uses samples of documents outside of the accounting system as a starting point for substantive tests of completeness. This might include testing completeness of sales by checking there is an invoice for a sample of GDNs.

Note that the direction of testing is important, depending on what the auditor's objective is. For instance, starting with invoices and agreeing them to GDNs would not provide evidence on completeness.

2 Procedures for receivables

Existence, completeness and **valuation** are the key assertions relating to the audit of receivables.

Audit procedures for receivables are set out in the table below. This covers the audit of sales and prepayments as well as trade receivables. Receivables are often tested in conjunction with sales revenue. The key assertions for sales are occurrence, completeness and accuracy. The receivables confirmation is used as an audit procedure in the table below and is described in more detail in Section 3. Section 4 contains additional information on the audit of sales.

Table 10.2: Audit procedures – receivables

Audit procedures: receivables	
Completeness	• **Agree** the balance from the individual receivables ledger accounts to the aged receivables listing and vice versa. • **Match** the total of the aged receivables listing to the receivables ledger control account. • **Cast and cross-cast** the aged receivables listing before selecting any samples to test. • **Trace** a sample of shipping documentation to sales invoices and into the sales and receivables ledger. • Complete the **disclosure checklist** to ensure that all the disclosures relevant to receivables have been made. • **Compare** the gross profit % by product line with the previous year and industry data. • **Compare** the level of prepayments to the previous year to ensure the figure is materially correct and complete. • **Review detailed statement of financial position** to ensure all likely prepayments have been included.

Audit procedures: receivables	
Existence	• Perform a **receivables circularisation** on a sample of year-end trade receivables (see Section 3 for details of how to undertake the receivables circularisation). • **Follow up** all balance disagreements and non-replies to the receivables confirmation. • **Perform alternative procedures** for any exceptions and non-replies to the receivables confirmation, such as: – **Review after-date cash receipts** by inspecting bank statements and cash receipts documentation. – Examine the **customer's account and customer correspondence** to assess whether the balance outstanding represents specific invoices and confirm their validity. – Examine the **underlying documentation** (purchase order, despatch documentation, duplicate sales invoice etc). – **Enquire from management** explanations for invoices remaining unpaid after subsequent ones have been paid. – **Observe** whether the balance on the account is growing and if so, find out why by discussing with management.
Rights and obligations	• Review **bank confirmation** for any liens on receivables. • Make **enquiries of management, review** loan agreements and review board minutes for any evidence of receivables being sold (eg to factors).

Audit procedures: receivables	
Accuracy, valuation and allocation	• **Compare** receivables turnover and receivables days to the previous year and/or to industry data. • **Compare** the aged analysis of receivables from the aged receivables listing to the previous year. • **Review** the adequacy of the allowance for uncollectable accounts through discussion with management. • **Compare** the irrecoverable debt expense as a % of sales to the previous year and/or to industry data • **Compare** the allowance for uncollectable accounts as a % of receivables or credit sales to the previous year and/or to industry data. • Confirm adequacy of allowance by **reviewing correspondence** with customers and solicitors. • **Examine credit notes** issued after year-end for allowances that should be made against current period balances. • **Examine** large customer accounts individually and compare to the previous year's balances. • For a sample of old debts on the aged receivables listing, obtain further information regarding their recoverability by **discussions** with management and **review** of customer correspondence. • For a sample of prepayments from the prepayments' listing, **recalculate** the amount prepaid to ensure that it has been accurately calculated.
Cut-off	• For a sample of sales invoices around the year-end, **inspect the dates** and compare with the dates of dispatch and the dates recorded in the ledger for application of correct cut-off. • For **sales returns**, select a sample of returns documentation around the year-end and trace to the related credit entries. • Perform **analytical procedures** on sales returns, comparing the ratio of sales returns to sales. • **Review material** after-date invoices, credit notes and adjustments and ensure that they are recorded correctly in the relevant financial period.

Audit procedures: receivables	
Classification	• Take a sample of sales invoices and examine for proper **classification** into revenue accounts.
Occurrence	• For a sample of sales transactions recorded in the ledger, **vouch** the sales invoice back to customer orders and despatch documentation.
Occurrence and rights and obligations	• Determine, through **discussion** with management, whether any receivables have been pledged, assigned or discounted and whether such items require disclosure in the financial statements.
Classification	• **Review** the aged analysis of receivables for any large credits, non-trade receivables and long-term receivables and consider whether such items require separate disclosure. • **Read** the disclosure notes relevant to receivables in the draft financial statements and review for understandability.
Presentation	• **Read** the disclosure notes to ensure the information is accurate and properly presented at the appropriate amounts.

3 The receivables confirmation

A **confirmation of receivables** is a major procedure, usually achieved by **direct contact** with customers. There are two methods of confirmation: **positive** and **negative**.

3.1 Objectives of confirmation

External confirmations are audit evidence obtained as a direct written response to the auditor from a third party, in paper form, or by electronic or other medium.

SLAuS 505 *External confirmations* covers the confirmation of amounts by third parties, including the confirmation of amounts by receivables.

The verification of trade receivables by direct confirmation is the normal means of providing audit evidence to satisfy the objective of testing whether customers exist and owe *bona fide* amounts to the company (**existence** and **rights and obligations**).

Confirmation will produce for the current audit file a written statement from each respondent that the amount owed at the date of the confirmation is correct. This is, *prima facie*, reliable audit evidence, being from an **independent source** and in **documentary** form. The confirmation of receivables on a test basis should not be regarded as replacing other normal audit tests, such as the testing in-depth of sales transactions, but the results may influence the scope of such tests.

3.2 Client's mandate

Confirmation is essentially an act of the **client**, who alone can authorise third parties to divulge information to the auditors.

The SLAuS outlines what the auditors' response should be when management refuses permission for the auditors to contact third parties for evidence. If management asks the auditor not to seek the confirmation, the auditor shall enquire about management's reasons for the refusal and seek audit evidence regarding the validity and reasonableness of the reasons. They shall also evaluate the implications of the refusal on the assessment of the risk of material misstatement and on the nature, timing and extent of other audit procedures. The auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. If the auditor concludes that the refusal is unreasonable, or the auditor cannot obtain relevant and reliable audit evidence elsewhere, the auditor shall communicate with those charged with governance in accordance with SLAuS 260 and consider the implications for the auditor's report.

3.3 Positive v negative confirmation

A **positive confirmation request** is one in which the confirming party responds directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or provides the requested information.

A **negative confirmation request** is one in which the confirming party responds directly to the auditor only if the confirming party disagrees with the information in the request.

When confirmation is undertaken the method of requesting information from the customer may be either **positive** or **negative**.

- Under the **positive** method the customer is requested to confirm the accuracy of the balance shown or state in what respect he is in disagreement.
- Under the **negative** method the customer is requested to reply only if the amount stated is disputed.

The positive method is generally preferable as it is designed to encourage definite replies from those contacted.

The negative method provides less persuasive audit evidence and shall not be used as the sole substantive procedure to audit receivables, unless all of the following are present:

- The **risk** of material misstatement has been assessed as **low**.
- The auditor has obtained sufficient appropriate audit evidence on the operating effectiveness of relevant **controls**.
- The population consists of a **large number of small, homogeneous account balances**.
- A **very low exception rate** is expected.
- The auditor is not aware of circumstances or conditions that would cause customers to **disregard the requests**.

A specimen 'positive' confirmation letter is shown below.

The statements will normally be prepared by the client's staff, from which point the auditors, as a safeguard against the possibility of fraudulent manipulation, must maintain **strict control** over the preparation and despatch of the statements.

Precautions must also be taken to ensure that undelivered items are returned, not to the client, but to the auditors' own office for follow-up by them.

Figure 10.1: Specimen 'positive' confirmation letter

MANUFACTURING PLC
15 Harbour Side
Colombo
Date

Dear (customer)

In accordance with the request of our auditors, ABC Co, we ask that you kindly confirm to them directly your indebtedness to us at [insert date] which, according to our records, amounted to Rs. .... as shown by the enclosed statement.

If the above amount is in agreement with your records, please sign in the space provided below and return this letter direct to our auditors in the enclosed stamped addressed envelope.

If the amount is not in agreement with your records, please notify our auditors directly of the amount shown by your records, and if possible detail on the reverse of this letter full particulars of the difference.

Yours faithfully,

For Manufacturing Plc

Reference No: ....

....

(Tear-off slip)

The amount shown above is/is not * in agreement with our records as at

Account No .... Signature ....

Date .... Title or position ....

* The position according to our records is shown overleaf.

Notes

- The letter is on the client's paper, signed by the client.
- A copy of the statement is attached.
- The reply is sent directly to the auditor in a pre-paid envelope.

3.4 Sample selection

Auditors will normally only contact a **sample** of accounts receivable. If this sample is to yield a meaningful result it must be based upon a **complete list** of all accounts receivable. In addition, when constructing the sample, the following classes of account should receive special attention:

- **Old, unpaid** accounts
- Accounts **written-off** during the period under review
- Accounts with **credit balances**
- Accounts settled by **round sum payments**
- Accounts with **nil balances**
- Accounts which have been **paid** by the date of the examination

3.5 Follow-up procedures

SLAuS 505 states that the auditor may send an additional confirmation request when a reply to a previous request has not been received within a **reasonable time**. For example, the auditor may send an additional or follow-up request having rechecked the accuracy of the original address. Also, with the client's permission, the auditor can phone the customer to request a reply to the original request.

3.5.1 Exceptions and non-responses

An **exception** is a response that indicates a difference between the information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

A **non-response** is a failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Auditors will have to carry out further work in relation to those receivables who:

- **Disagree** with the **balance stated** (positive and negative confirmation), resulting in **exceptions**
- **Do not respond**, resulting in **non-responses**

In the case of disagreements, the customer response should have identified specific amounts which are disputed. These give rise to exceptions and may indicate misstatements or potential misstatements in the financial statements. When a misstatement is identified, the auditor must evaluate whether this is indicative of fraud (in accordance with SLAuS 240). Exceptions might also indicate a deficiency in internal control. Some exceptions, of course, do not represent misstatements, as they may be due to timing, measurement or clerical errors in the confirmation procedures. The table below outlines some reasons for exceptions occurring.

Table 10.3: Reasons for exceptions

Reasons for exceptions
There is a **dispute** between the client and the customer. The reasons for the dispute would have to be identified, and provision made, if appropriate, against the debt.
Cut-off problems exist, because the client records the following year's sales in the current year or because goods returned by the customer in the current year are not recorded in the current year. Cut-off testing may have to be extended (see below).
The customer may have sent the **monies before** the year-end, but the monies were **not recorded** by the client as receipts until **after** the year-end. Detailed cut-off work may be required on receipts.

Reasons for exceptions
Monies received may have been posted to the **wrong account** or a cash-in-transit account. Auditors should check if there is evidence of other mis-posting. If the monies have been posted to a cash-in-transit account, auditors should ensure this account has been cleared promptly.
Customers who are also suppliers may **net-off balances** owed and owing. Auditors should check that this is allowed.
Teeming and lading, stealing monies and **incorrectly posting** other receipts so that no particular customer is seriously in debt is a **fraud** that can arise in this area. Teeming and lading involves an employee first stealing the cash receipts from a receivable (receivable 1) and not recording the receipt against the customer account. Then the employee receives more cash from another receivable (receivable 2) and allocates it against receivable 1 in order to conceal the stolen funds. Similarly, they then allocate monies from receivable 3 against amounts owed from receivable 2, and so on. By allocating the funds in this way, there is only an apparent time lag on posting the receipt of cash, rather than an obvious uncollected debt. If auditors suspect teeming and lading has occurred, detailed testing will be required on cash receipts, particularly on prompt posting of cash receipts.

In the case of **non-responses**, the SLAuS states that the auditor shall perform **alternative audit procedures** to obtain relevant and reliable audit evidence. These could include reviewing subsequent cash receipts, shipping documentation and sales near the period-end.

3.6 Reliability of responses

The SLAuS states that the auditor shall obtain further audit evidence to resolve any **doubts about the reliability** of a response to a confirmation request. This could include contacting the confirming party.

If the auditor concludes that a response to a request is **not reliable**, they shall evaluate the impact of this on the assessment of the risk of material misstatement (including the risk of fraud), and on the related nature, timing and extent of other audit procedures.

4 Auditing sales revenue

Revenue is a material figure in the statement of profit or loss that is often audited by analytical procedures, as it should have predictable relationships with other figures in the financial statements.

Accounts receivable will often be tested in conjunction with sales. Auditors are seeking to obtain evidence that sales pertain to the entity (occurrence), and are **completely** and **accurately recorded**. This will involve carrying out certain procedures to test for **completeness** of sales and also testing **cut-off.** We already looked at some audit procedures relating to sales earlier in this chapter (in Table 10.2 in Section 2). However, we will now look in detail at some important procedures used when testing completeness and occurrence of sales.

4.1 Completeness and occurrence of sales

Analytical procedures are important when testing completeness. A client is likely to have a great deal of information about company sales and should be able to explain any fluctuations and variances. Auditors should consider the following.

- The **level of sales** over the year, compared on a month-by-month basis with the previous year
- The effect on sales value of **changes in quantities** sold
- The effect on sales value of **changes in products** or **prices**
- The level of **goods returned, sales allowances** and **discounts**
- The **efficiency of labour** as expressed in sales or profit per tax per employee

In addition, auditors must record reasons for changes in the **gross profit margin**. Analysis of the gross profit margin should be as detailed as possible, ideally broken down by **product area** and **month or quarter**.

As well as analytical procedures, auditors may feel that they need to carry out a directional test on **completeness of recording** of individual sales in the accounting records. To do this, auditors should start with the documents that first record sales (**goods despatched notes** or **till rolls** for example), and trace sales recorded in these through intermediate documents, such as sales summaries, to the **receivables ledger**.

Auditors must ensure that the population of documents from which the sample is originally taken is itself complete, by checking for example the **completeness** of the **sequence** of goods dispatched notes.

QUESTION — Revenue & Receivables

Dias Textiles Plc manufactures knitted clothes and dyes these clothes and other textiles. You are carrying out the audit of the accounts of the company for the year ended 30 September 20X6 which show a revenue of about Rs. 1,000 million and a profit before tax of about Rs. 80 million.

You are attending the final audit in December 20X6 and are commencing the audit of trade accounts receivables, which are shown in the draft accounts at Rs. 206 million

The interim audit (tests of control) was carried out in July 20X6 and it showed that there was a good system of internal control in the sales system and no serious errors were found in the audit tests. The company's receivables ledger is maintained on a computer, which produces at the end of each month:

(i) A list of transactions for the month

(ii) An aged list of balances

(iii) Open item statements which are sent to customers. (Open item statements show all items which are outstanding on each account, irrespective of their age.)

Required

(a) **Evaluate** the audit tests you would carry out to verify trade accounts receivable at the year-end. You are not required to describe how you would carry out a direct confirmation of receivables.

(b) **Outline** the audit work you would carry out on the following replies to a receivables circularisation:

- (i) Balance agreed by customer.
- (ii) Balance not agreed by customer.
- (iii) Customer is unable to confirm the balance because of the form of records kept by the customer.
- (iv) Customer does not reply to the confirmation letter.

ANSWER

(a) The auditors will carry out the following tests on the list of balances.

- (i) Agree the balances from the individual receivables ledger accounts to the list of balances and vice versa.
- (ii) Agree the total of the list to the receivables ledger control account.
- (iii) Cast the list of balances and the receivables ledger control account.

Other general tests which auditors will carry out will be to:

(i) Agree the opening balance on the receivables ledger control account to ensure that last year's audit adjustments were recorded.

(ii) Inspect ledger balances for unusual entries.

(iii) Perform analytical procedures on trade receivables as follows

- Compare receivables turnover and receivables days to the prior year and/or to industry data.
- Perform an age analysis on trade receivables and compare this to the prior year.
- Compare the irrecoverable debt expense as a % of sales to the prior year and/or to industry data.
- Examine large customer accounts individually and compare them to the prior year.

The determination of whether the company has made reasonable provision for irrecoverable and doubtful debts will be facilitated as the company produces an aged listing of balances.

Auditors will carry out the following procedures to audit the allowance for receivables.

(i) Debts against which specific allowance has been made (and debts written-off) should be examined in conjunction with correspondence, lawyers'/debt collection agencies' letters, liquidators' statements and so on, and their necessity or adequacy confirmed.

(ii) A general review of relevant correspondence may reveal debts where an allowance is warranted, but has not been made.

(iii) Where specific and/or general allowances have been determined using the aged analysis, the auditors should ensure that the analysis has been properly prepared by comparing it with the dates on invoices and matching cash receipts against outstanding invoices. They should check the reasonableness and consistency of any formula used to calculate general allowances.

(iv) Additional tests that should be carried out on individual balances will include ascertaining the subsequent receipt of cash, paying particular attention to round-sum payments on account, examination of specific invoices and, where appropriate, goods received notes, and enquiry into any invoices that have not been paid when subsequent invoices have been paid.

(v) Excessive discounts should be examined, as should journal entries transferring balances from one account to another and journal entries that clear customer balances after the year-end.

(vi) Credit notes issued after the year-end should be reviewed and allowances checked where they refer to current period sales.

In order to audit cut-off and hence completeness, the auditors should, during the physical inventory count, have obtained details of the last serial numbers of goods outwards notes which were issued before the commencement of the count. The following substantive procedures are designed to test that goods taken into inventory are not also treated as sales in the year under review and, conversely, goods despatched are treated as sales in the year under review and not also treated as inventory.

(i) Review goods outwards and returns inwards notes around year-end to ensure that:

(1) Invoices and credit notes are dated in the correct period.

(2) Invoices and credit notes are posted to the receivables ledger and general ledger in the correct period.

(ii) Reconcile entries in the receivables ledger control around the year-end to daily batch invoice totals ensuring batches are posted in correct year.

(iii) Review receivables ledger control account around year end for unusual items.

(iv) Review material after-date invoices and ensure that they are properly treated as following year's sales.

(b) The verification of trade receivables by direct confirmation is the normal means of providing audit evidence to prove that receivables represent *bona fide* amounts due to the company (existence and rights and obligations).

The audit work required on the various replies to a receivables circularisation would be as follows.

(i) *Balances agreed by customer*

All that is required would be to ensure that the debt does appear to be collectable, by reviewing cash received after-date or considering the adequacy of any allowance made for a long-outstanding amount.

(ii) *Balances not agreed by customer*

All balance disagreements must be followed up and their effect on total receivables evaluated. Differences arising that merely represent invoices or cash-in-transit generally do not require adjustment, but disputed amounts, and errors by the client, may indicate that further substantive work is necessary to determine whether material adjustments are required.

(iii) *Customer is unable to confirm the balance because of the form of records maintained*

Certain companies, often computerised, operate systems which make it impossible for them to confirm the balance on their account. Typically in these circumstances their purchase ledger is merely a list of unpaid invoices. However, with sufficient information the customer will be able to confirm that any given invoice is outstanding. Hence the auditors can circularise such enterprises successfully, but they will need to break down the total on the account into its constituent outstanding invoices.

(iv) *Customer does not reply to confirmation letter*

When the positive request method is used the auditors must follow up, by all practicable means, those customers who fail to respond. Second requests should be sent out in the event of no reply being received within two or three weeks and if necessary this may be followed by telephoning the customer with the client's permission.

After two, or even three attempts to obtain confirmation, a list of the outstanding items will normally be passed to a responsible independent company official who will arrange for them to be investigated.

Alternative audit procedures might include the following.

(1) Check receipt of cash after-date by reviewing post year-end bank statements.

(2) Verify valid sales orders, if any.

(3) Examine the account to see if the balance represents specific outstanding invoices.

(4) Obtain explanations for invoices remaining unpaid after subsequent ones have been paid.

(5) Observe whether the balance on the account is growing and, if so, find out why by discussions with management.

(6) Test the company's control over the issue of credit notes and the write-off of irrecoverable debts.

CHAPTER ROUNDUP

- Receivables are usually audited using a combination of **tests of details** and **analytical procedures**.
- **Existence**, **completeness** and **valuation** are key assertions relating to the audit of receivables.
- A **confirmation of receivables** is a major procedure, usually achieved by **direct contact** with customers. There are two methods of confirmation: **positive** and **negative**.
- Revenue is a material figure in the statement of profit or loss that is often audited by analytical procedures, as it should have predictable relationships with other figures in the financial statements.

PROGRESS TEST

1 The negative method of receivables confirmation should only be used if the client has good internal controls and a small number of large customer accounts. True or false?

2 State four types of account which should receive special attention when picking a sample for a receivables confirmation.

(1) ………………………………………… (3) ………………………………………..

(2) ………………………………………… (4) ………………………………………..

3 Complete the following sentences concerning tests which aim to confirm the valuation of an allowance for receivables.

(a) Confirm adequacy of allowance by reviewing correspondence with

(i) ……………………………... (ii) ………………………………………..

(b) Examine ……………… ……………….. issued after the year-end for allowances that should be made against current period balances.

4 List three things that can be considered when undertaking an analytical procedures on sales.

(1) ………………………………………………..

(2) ………………………………………………..

(3) ………………………………………………..

5 Give two examples of tests to verify prepayments.

(1) ………………………………………………..

(2) ………………………………………………..

ANSWERS TO PROGRESS TEST

1 False

2 Any four from:

- Old unpaid accounts
- Accounts written-off during the period under review
- Accounts with credit balances
- Accounts settled by round-sum payments
- Accounts with nil balances
- Accounts which have been paid by the date of the examination

3 (a) (i) customers, (ii) solicitors

(b) Examine **credit notes** issued after the year-end for allowances that should be made against current period balances.

4 (1) Level of sales, month by month
(2) Price
(3) Goods returned

5 From:

- Verify by reference to invoices, cash book, correspondence.
- Check calculations by re-performance.
- Review detailed statement of financial position to ensure all likely prepayments have been included.
- Use analytical procedures to review reasonableness.

CHAPTER 11

Auditing Cash and Bank Balances

INTRODUCTION

Work on cash and bank will concentrate on the completeness and valuation using the bank reconciliation, bank confirmation letter and counting of cash as key audit tests.

Knowledge Component			
C	**Gathering Audit Evidence**		
3.1	**Test of Details**	3.1.1	Outline audit procedures to address assertion level risk for non-complex key account balances and classes of transactions
3.2	**External Confirmation**	3.2.1	Apply procedures to design and perform external confirmation to obtain relevant and reliable audit evidence

CHAPTER CONTENTS	LEARNING OUTCOME
1 Introduction to audit of cash and bank	3.1.1
2 Audit procedures	3.1.1, 3.2.1
3 Cash	3.1.1

1 Introduction to audit of cash and bank

Key audit objectives in relation to cash and bank are existence, completeness, rights and obligations, accuracy, valuation and allocation, and presentation.

'Cash' in the financial statements represents cash-in-hand and cash on deposit in bank accounts. Most accounting transactions pass through the cash account so cash is affected by all of the entity's business processes, and is particularly impacted by the sales and purchases processes. We looked at the controls relating to cash in Chapter 3. In this chapter, we will consider the substantive audit testing applied to the year-end cash figure.

1.1 Audit objectives for cash

The following table demonstrates the audit objectives for cash balances and how these are related to the financial statement assertions relevant to this account area. The audit procedures described in the remainder of this chapter are undertaken to provide audit evidence to support these financial statement assertions.

Table 11.1: Audit objectives for cash

Financial statement assertion	Audit objective
Existence	Recorded cash balances exist at the period-end
Completeness	Recorded cash balances include the effects of all transactions that have occurred
Rights and obligations	The entity has legal title to all cash balances shown at the period-end

Financial statement assertion	Audit objective
Accuracy, valuation and allocation	Recorded cash balances are realisable at the amounts stated
Presentation	Disclosures relating to cash are adequate and in accordance with accounting standards and legislation

1.2 Internal control considerations

We covered internal control over the cash system in Section 4 of Chapter 3. The bank reconciliation is a key control for the company in this area and should be prepared frequently and routinely. However, the auditor is concerned with obtaining sufficient appropriate audit evidence on the year-end bank balance, so they will focus on the year-end reconciliation (in conjunction with other substantive procedures set out in this chapter) when auditing the bank balance included on the statement of financial position.

2 Audit procedures

Bank balances are usually **confirmed directly** with the bank in question.

2.1 Bank confirmation procedures

The audit of bank balances will need to cover **completeness**, **existence**, **rights and obligations and valuation as we saw in Section 1.1**. All of these assertions can be audited directly by obtaining third-party confirmations from the client's banks and reconciling these with the accounting records, having regard to **cut-off**.

- Recorded cash balances exist at the year end **(existence).**
- Recorded cash balances include the effects of all transactions that occurred **(completeness)**.
- Year-end transfers are recorded in the correct period **(cut-off)**.
- Recorded balances are realisable at the amounts stated **(accuracy, valuation and allocation)**.
- The entity has legal title to all cash balances shown at the year end **(rights and obligations)**.

This type of audit evidence is valuable because it comes directly from an **independent source** and, therefore, provides greater assurance of reliability than that obtained solely from the client's own records. The bank letter is mentioned as a source of external third-party evidence in SLAuS 505 *External confirmations*.

2.2 Confirmation requests

The **bank confirmation letter** can be used to ask a variety of questions, including queries about outstanding interests, contingent liabilities and guarantees.

The auditors should decide from which bank or banks to request confirmation, having regard to such matters as **size of balance**, **volume of activity**, **degree of reliance** on **internal control**, and **materiality** within the context of the financial statements.

The auditors should determine which of the following approaches is the most appropriate in seeking confirmation of balances or other information from the bank:

- **Listing balances** and other information, and requesting confirmation of their accuracy and completeness, or
- **Requesting details of balances** and other information, which can then be compared with the requesting client's records

In determining which of the above approaches is the most appropriate, the auditors should weigh the **quality** of **audit evidence** they require in the particular circumstances against the **practicality** of obtaining a reply from the confirming bank.

Difficulty may be encountered in obtaining a satisfactory response, even where the client company submits information for confirmation to the confirming bank. It is important that a response is sought for **all** confirmation requests. Auditors should not usually request a response only if the information submitted is incorrect or incomplete.

2.2.1 Preparation and despatch of requests and receipt of replies

Control over the content and despatch of confirmation requests is the responsibility of the auditors. However, it will be necessary for the request to be **authorised** by the client entity. Replies should be returned directly to the auditors and to facilitate such a reply, a pre-addressed envelope should be enclosed with the request.

2.2.2 Content of confirmation requests

The form and content of a confirmation request letter will depend on the purpose for which it is required and on local practices.

The most commonly requested information is in respect of balances due to or from the client entity on **current, deposit, loan and other accounts**. The request letter should provide the account number and the type of currency for the account.

An example of a letter requesting confirmation of bank balances is as follows:

Figure 11.1: Sample letter requesting bank confirmations

20 November 20X4

The Manager
Big Bank plc
Mawatha
Colombo

Dear Sir/Madam

Subject: Confirmation of year-end Bank Balances as at 31 December 20X4 for Large Company plc (Previous year end 31 December 20X3).

In accordance with the agreed practice for provision of information to auditors, please forward information on our mutual client Large Company plc as detailed below on behalf of the bank, its branches and subsidiaries. This request and your response will not create any contractual or other duty with us.

(1) Details of year-end account balances

Please provide details of the year-end balances (as at 31 December 20X4) of the following accounts.

Company	Sort code	Account number	Currency
Large Company plc	40-51-99	21346767	LKR
Large Company plc	21-41-99	23109888	LKR

(2) Please provide details of any account balances not listed above as at the 31 December 20X4.

(3) Please provide details of any bank accounts opened or closed during the twelve months prior to 31 December 20X4.

Thank you for your help on this matter.

Yours Faithfully

ABC Chartered Accountants
Colombo
Tel: 0094775001222
email: abc@123.com

It may also be advisable to request information about **nil balances** on accounts, and accounts which were **closed** in the 12 months prior to the chosen confirmation date (as in the example above). The client entity may ask for confirmation not only of the balances on accounts but also, where it may be helpful, other information, such as the maturity and interest terms on loans and overdrafts, unused facilities, lines of credit/standby facilities, any offset or other rights or encumbrances, and details of any collateral given or received.

The client entity and its auditors are likely to request confirmation of **contingent liabilities**, such as those arising on guarantees, comfort letter, bills and so on.

Banks often hold **securities** and other items in safe custody on behalf of customers. A request letter may thus ask for confirmation of such items held by the bank.

The procedure is simple but important, and outlined below.

(a) The banks will require **explicit written authority** from their client to disclose the information requested.

(b) The **auditors' request** must **refer** to the **client's letter** of authority and the date thereof. Alternatively it may be countersigned by the client or it may be accompanied by a specific letter of authority.

(c) In the case of joint accounts, **letters of authority** signed by all **parties** will be necessary.

(d) Such **letters of authority** may either **give permission** to the bank to disclose information for a specific request or grant permission for an indeterminate length of time.

(e) The request should **reach** the **branch manager** at least **one month in advance** of the client's **year-end** and should state both that year-end date and the previous year-end date.

(f) The **auditors** should themselves **check** that the bank response covers all the information in the standard and other responses.

2.3 Cut-off

Care must be taken to ensure that there is no **window dressing**, by auditing **cut-off** carefully. Window dressing in this context is usually manifested as an attempt to overstate the liquidity of the company by:

(a) Keeping the cash book open to take credit for **remittances actually received** after the year-end, thus enhancing the balance at bank and reducing receivables

(b) **Recording cheques paid in** the period under review which are not actually despatched until after the year-end, thus decreasing the balance at bank and reducing liabilities

A combination of (a) and (b) can contrive to present an artificially healthy-looking current ratio.

With the possibility of (a) above in mind, where lodgements have not been cleared by the bank until the new period, the auditors should **examine the paying-in slip** to ensure that the amounts were actually paid into the bank on or before the period-end date.

As regards (b) above, where there appears to be a particularly **large number of outstanding cheques** at the year-end, the auditors should check whether these were **cleared within a reasonable time** in the new period. If not, this may indicate that despatch occurred after the year-end.

2.4 Audit plan for auditing the bank balance

Table 11.2: Auditing the bank balance

Audit procedures: bank balance (to confirm completeness, valuation, existence, cut-off and assertions related to disclosure)
Obtain standard bank confirmations from each bank with which the client conducted business during the audit period.
Re-perform arithmetic of bank reconciliation to confirm its accuracy.
Trace cheques shown as outstanding from the bank reconciliation to the cash book prior to the year-end and to the **after-date bank statements** and **obtain explanations** for any **large or unusual items** not cleared at the time of the audit.
Compare cash book(s) and **bank statements** in detail for the last month of the year, and **match items outstanding** at the reconciliation date to bank statements.
Review bank reconciliation previous to the year-end bank reconciliation and test whether **all items** are **cleared** in the last period or **taken forward** to the year-end bank reconciliation.
Obtain satisfactory explanations for **all items** in the **cash book** for which there are **no corresponding entries** in the **bank statement** and vice versa by **discussion** with finance staff.
Verify contra items appearing in the cash books or bank statements with original entry.
Verify, by **inspecting** paying-in slips, that **uncleared bankings** are **paid in** prior to the year-end.

Audit procedures: bank balance (to confirm completeness, valuation, existence, cut-off and assertions related to disclosure)
Examine all lodgements in respect of which payment has been refused by the bank; ensure that they are cleared on representation or that other appropriate steps have been taken to effect recovery of the amount due.
Verify balances per the cash book according to the bank reconciliation by **inspecting** cash book, bank statements and general ledger.
Verify the **bank balances** with reply to **standard bank letter** and with the **bank statements**.
Inspect the cash book and bank statements before and after the year-end for **exceptional entries** or **transfers** which have a material effect on the balance shown to be in-hand.
Identify whether any **accounts** are **secured** on the **assets** of the company by **discussion** with management.
Consider whether there is a **legal right** of **set-off** of overdrafts against positive bank balances.
Determine whether the bank accounts are **subject** to any **restrictions** by **enquiries** with management.
Review draft accounts to ensure that disclosures for bank are complete and accurate and in accordance with accounting standards.

QUESTION — Bank confirmation

(a) **Analyse** the importance of the bank confirmation and **outline** the procedures used to obtain confirmations from the bank.

(b) **Recommend** how you would test the bank reconciliation shown below.

Another Co
Bank Reconciliation 31 December 20X1

	Rs. '000s	Rs.'000s
Balance as per bank statement 31 December 20X1		35,111.91
Add: deposits outstanding		
30 December (ref 1122)	10,222.00	
31 December (ref 1123)	25,000.00	35,222.00
		70,333.91

Another Co
Bank Reconciliation 31 December 20X1

Less: Outstanding cheques		
2411	10,250.00	
2721	2,300.40	
2722	5,000.00	
2723	1,345.25	
2724	1,900.00	
2726	2,200.00	
2728	1,005.50	
2729	1,576.75	
2730	1,255.65	26,833.55
Balance as per bank in the general ledger 31 December 20X1		43,500.36

(c) **Describe** other procedures that should be carried out in respect of bank balances shown in the financial statements

ANSWER

(a) The bank confirmation is important because it is independent confirmation of a number of significant matters in the client's financial statements. It confirms cash and bank balances which may well be a significant asset. It also provides confirmation of customers' assets held as security, customers' other assets held (as custodian) and contingent liabilities. Auditors also ask the bank to give details of other banks and branches that the respondent bank is aware have a relationship with the client.

Audit procedures (all figures are expressed in Rs.'000)

(i) Obtain written authority from the client to the bank to disclose the necessary information.

(ii) Send a bank letter in standard form to the bank in sufficient time for it to arrive at least a month before the year-end. The letter should state both the year-end date and the previous year-end date, and should refer to the client's granting of authority.

(iii) If additional information over and above what is in the standard letter is requested, send a separate letter requesting that information.

(iv) When confirmation is received from the bank, check that the bank has answered all the questions in the letter.

(v) Follow up all points disclosed in the bank letter.

(b) The following procedures should be carried out on the bank reconciliation.

(i) Agree the balance per bank statement at 31 December 20X1 as shown on the reconciliation (Rs. 35,111.91) to the bank statement and to the amount for that account shown on the bank letter.

(ii) Test arithmetic of bank reconciliation by recasting it.

(iii) Review the bank reconciliation previous to the year-end bank reconciliation (30 November reconciliation if carried out monthly) and test whether items shown on it cleared in the last period or have been taken forward to the bank reconciliation at 31 December.

(iv) Trace the cheques shown as outstanding on the bank reconciliation to the cash book prior to the year-end; ensure they have cleared the bank by looking at the after-date bank statements. Obtain explanations for any that have not cleared at the time of the audit. In particular the outstanding cheque for Rs. 10,250 has a reference (2411) which appears to suggest it was raised much earlier in the year than the others and the fact it has not cleared is unusual. Enquiries should be made in respect of this outstanding cheque.

(v) Verify by checking paying-in slips that the uncleared bankings (deposits outstanding – ref 1122 and 1123) were paid in prior to the year-end, and review whether they cleared quickly after the year-end. Any that have not cleared soon after the year end should be investigated.

(vi) Verify the year-end balance per the general ledger according to the reconciliation (Rs. 43,500.36) agrees with the general ledger account balance at 31 December 20X1 and that this has been properly reflected in the financial statements.

(c) (i) Obtain standard bank confirmations from each bank with which the client conducted business during the period.

(ii) Verify the bank balances with reply to standard bank letter and with the bank statements.

(iii) Scrutinise the cash book and bank statements before and after the period-end for exceptional entries or transfers which have a material effect on the balance shown to be in hand.

(iv) Identify whether any accounts are secured on the assets of the company.

(v) Consider whether there is a legal right to set-off overdrafts against positive bank balances.

(vi) Determine whether the bank accounts are subject to any restrictions.

(vii) Review disclosures related to the cash at bank figure included in the financial statements and ensure they are in accordance with Sri Lanka Accounting Standards.

3 Cash

Cash balances should be verified if they are **material** or **irregularities** are suspected.

Cash balances/floats are often individually immaterial but they may require some audit emphasis because of the opportunities for fraud that could exist where internal control is weak and because they may be material in total.

However, in enterprises such as hotels and retail organisations, the amount of cash-in-hand at the period-end could be considerable. Cash counts may be important for internal auditors, who have a role in fraud prevention.

Auditors will be concerned that the cash **exists**, is **complete**, and belongs to the company (**rights and obligations**) and is stated at the correct **value**.

Where the auditors determine that cash balances are potentially material they may conduct a **cash count**, ideally at the period-end. Rather like attendance at an inventory count, the conduct of the count falls into three phases: planning, the count itself, and follow-up procedures.

3.1 Planning the cash count

Planning is an essential element, as it is important that all cash balances are counted at the same time as far as possible. 'Cash' in this context may include unbanked cheques received, IOUs and credit card slips, in addition to notes and coins.

As part of their planning procedures the auditors will need to determine the **locations** where cash is held and which of these locations warrant a count.

Planning decisions will need to be recorded on the current audit file including:

- The **precise time** of the count(s) and location(s)
- The **names** of the **audit staff** conducting the counts
- The **names** of the **client staff** intending to be present at each location

Where a location is not visited it may be appropriate to obtain a letter from the client confirming the balance.

3.2 Cash count

The following matters apply to the count itself.

- All cash/petty cash **books** should be **written up** to date in **ink** (or other permanent form) at the time of the count.
- All **balances** must be **counted** at the **same time**.
- All **negotiable securities** must be **available** and **counted** at the time the cash balances are counted.
- At **no time** should the **auditors** be **left alone** with the cash and negotiable securities.
- **All cash** and securities **counted** must be **recorded** on working papers subsequently filed on the current audit file. **Reconciliations** should be prepared where applicable (for example, imprest petty cash float).

Table 11.3: Audit procedures – cash

Audit procedures: cash count **(to confirm completeness, valuation, existence and disclosure)**
Count cash balances held and agree to petty cash book or other record: – Count all balances simultaneously – All counting to be done in the presence of the individuals responsible – Enquire into any IOUs or cashed cheques outstanding for a long period of time
Obtain certificates of cash-in-hand from responsible officials.
Confirm that bank and cash **balances** as reconciled above are **correctly stated** in the financial statements.
Follow up Obtain **certificates of cash-in-hand** as appropriate.
Verify **unbanked cheques/cash receipts** have subsequently been **paid in** and agree to the bank reconciliation by **inspection** of the relevant documentation.
Ensure **IOUs** and cheques cashed for employees have been **reimbursed**.
Review whether **IOUs or cashed cheques outstanding** for **unreasonable periods** of time have been provided for.
Verify the **balances** as counted are reflected in the accounts (subject to any agreed amendments because of shortages and so on) by **inspection** of draft financial statements.

CHAPTER ROUNDUP

- Key audit objectives in relation to cash and bank are existence, completeness, rights and obligations, accuracy, valuation and allocation, and presentation.
- **Bank balances** are usually **confirmed directly** with the bank in question.
- The **bank confirmation letter** can be used to ask a variety of questions, including queries about outstanding interests, contingent liabilities and guarantees.
- **Cash balances** should be verified if they are **material** or if **irregularities** are suspected.

PROGRESS TEST

1 What are the relevant financial statement assertions for cash in the statement of financial position?

2 Summarise the procedure for obtaining confirmation from a client's bank of the year-end bank balance.

(1) ……………………………………………
(2) ……………………………………………
(3) ……………………………………………
(4) ……………………………………………
(5) ……………………………………………
(6) ……………………………………………

3 Complete the following two sentences concerning audit tests performed to verify the bank reconciliation.

(a) Trace cheques shown as outstanding on the ……………… ……………… to the ……….. ………… prior to the year-end and …………-………… ……………….. ………………….. .

(b) Obtain satisfactory explanations for all items in the ……………….. ………………… for which there is no corresponding entry in the …………………… ……………….. and …………. ………………….. .

4 Give two examples of businesses where cash floats could be considerable.

(1) ……………………………………………
(2) ……………………………………………

5 What planning matters relating to a cash count should be recorded in the current audit file?

(1) ……………………………………………
(2) ……………………………………………
(3) ……………………………………………

ANSWERS TO PROGRESS TEST

1 Existence, completeness, valuation and allocation

2 (1) The banks will require **explicit written authority** from their client to disclose the information requested.

(2) The **auditors' request** must **refer** to the **client's letter** of authority and the date thereof. Alternatively it may be countersigned by the client or it may be accompanied by a specific letter of authority.

(3) In the case of joint accounts, **letters of authority** signed by all **parties** will be necessary.

(4) Such letters of authority may either give **permission** to the bank to disclose information for a **specific request** or grant permission for an **indeterminate length of time.**

(5) The request should **reach** the **branch manager** at least **one month in advance** of the client's **year-end** and should state both that year-end date and the previous year-end date.

(6) The **auditors** should themselves **check** that the bank **answers all the questions** and, where the reply is not received directly from the bank, be responsible for establishing the authenticity of the reply.

3 (a) Trace cheques shown as outstanding on the **bank reconciliations** to the **cash book** prior to the year-end and **after-date bank statements**.

(b) Obtain satisfactory explanations for all items in the **bank statements** for which there is no corresponding entry in the **cash book** and **bank reconciliation**.

4 (1) Hotels

(2) Retail operations

5 (1) Time of count

(2) Names of client staff attending

(3) Names of audit staff attending

CHAPTER 12

Liabilities, Capital and Expenses

INTRODUCTION

In this chapter, we examine the audit of liabilities including payables and accruals, provisions and other long-term liabilities.

When auditing payables, the auditor must test for understatement (ie completeness). Rather than circularising payables, it is more common to obtain audit evidence from suppliers' statements.

Auditing payables and accruals also gives evidence about the related expenses, but other procedures may be carried out targeted at specific statement of profit or loss figures, such as employee costs.

The audit of provisions can be particularly complex due to the accounting treatment and the degree of judgement involved in calculating the provision.

We also take a look at the audit of capital and reserves in this chapter.

Knowledge Component			
C	**Gathering Audit Evidence**		
3.1	**Test of Details**	3.1.1	Outline audit procedures to address assertion level risk for non-complex key account balances and classes of transactions
		3.1.2	Apply specific considerations in obtaining sufficient appropriate audit evidence with respect to inventory, litigation and claims involving the entity, and segment information

CHAPTER CONTENTS	LEARNING OUTCOME
1 Introduction	3.1.1
2 Procedures for trade payables and accruals	3.1.1
3 Auditing deferred taxation liabilities	3.1.1
4 Auditing purchases and expenses	3.1.1
5 Employee expenses and management remuneration	3.1.1
6 Non-current liabilities	3.1.1
7 Provisions and contingencies	3.1.2
8 Capital and reserves	3.1.1
9 Operating segments	3.1.2

1 Introduction

Purchases are often tested in conjunction with the audit of trade payables.

In this chapter we will examine the substantive audit of trade payables and accruals, expenses, long-term liabilities and provisions; we shall end with a look at share capital and reserves. The following table sets out the financial statement assertions to which audit testing in relation to purchases and payables is directed.

Table 12.1: Audit testing – purchases and payables

Assertions about classes of transactions and related disclosures	• All purchase transactions recorded have occurred and relate to the entity **(occurrence)**. • All purchase transactions that should have been recorded have been recorded **(completeness)**. • Amounts relating to transactions have been recorded appropriately **(accuracy)**. • Purchase transactions have been recorded in the correct period **(cut-off)**. • Purchase transactions are recorded properly in the accounts **(classification)**.

	• All disclosed events and transactions relating to liabilities have occurred and relate to the entity **(presentation)**. • All disclosures required have been included **(presentation)**. • Financial information is appropriately presented and described and disclosures clearly expressed **(presentation)**. • Financial information is disclosed fairly and at appropriate amounts **(presentation)**.
Assertions about period-end account balances and related disclosures	• Trade payables and accrued expenses are valid liabilities (**existence)**. • Trade payables and accrued expenses are the obligations of the entity **(rights and obligations)**. • All liabilities have been recorded **(completeness)**. • All liabilities are included in the accounts at appropriate amounts **(valuation and allocation)**. • All disclosures required have been included **(presentation)**. • Financial information is appropriately presented and described and disclosures clearly expressed **(presentation)**. • Financial information is disclosed fairly and at appropriate amounts **(presentation)**.

1.1 Internal control considerations for payables

The audit of payables is closely linked to the procurement to pay system (or purchases system). We looked at controls over this system in Section 2 of Chapter 3, where we saw that they were based around ensuring purchases were authorised, the segregation of duties, matching GRNs with invoices, and prompt recording to minimise cut-off issues.

A specific control often operated by clients over the completeness of trade payables balances is the reconciliation of month-end balances to supplier statements. If the client has carried out this reconciliation at the year-end for all suppliers, the auditor can review these reconciliations.

However, if the client has not carried out these reconciliations, the auditor will need to compare supplier statements with year-end payables balances and investigate differences, so this becomes a substantive procedure that the auditor must undertake.

We look at supplier statement reconciliations and other substantive procedures in Section 2.

2 Procedures for trade payables and accruals

The largest figure in **current liabilities** will normally be **trade accounts payable** which are generally audited by comparison of **suppliers' statements** with **purchase ledger accounts.**

2.1 Audit procedures

As with accounts receivable, trade accounts payable are likely to be a material figure in the statement of financial position of most enterprises. The tests of controls on the procurement-to-pay cycle (Chapter 3) will have provided the auditors with some assurance as to the completeness of liabilities.

Auditors should, however, be particularly aware, when conducting their work on the statement of financial position, of the possibility of **understatement** of **liabilities** to improve liquidity and profits (by understating the corresponding purchases). The primary objective of their work will therefore be to ascertain whether **liabilities** existing at the year-end have been **completely** and **accurately recorded**.

As regards **trade accounts payable**, this primary objective can be subdivided into two detailed objectives.

- Is there a **satisfactory cut-off** between goods received and invoices received, so that purchases and trade accounts payable are recognised in the correct year?
- Do trade accounts payable represent the **actual** amounts due by the company?

Before we ascertain how the auditors design and conduct their tests with these objectives in mind, we need to establish the importance of the list of balances.

The following table sets out audit procedures to test trade accounts payable and accruals. Many of the procedures in the table below are applicable to the related statement of profit or loss items, since the figures in that statement constitute the movement between the current and previous year's statement of financial position balances. Some are also procedures relating to statement of profit or loss figures which indirectly give evidence over the year-end balances. For example, the payroll proof in total is an estimate of the employee costs charge for the year but also provides evidence over the adequacy of any related accrual for payroll costs (eg for unpaid wages).

Table 12.2: Audit procedures – payables and accruals

Audit procedures: trade accounts payable and accruals	
Completeness	• Obtain a listing of trade accounts payable and **agree** the total to the general ledger by casting and cross-casting. • Test for unrecorded liabilities by **enquiries of management** on how unrecorded liabilities and accruals are identified and examining post-year-end transactions. • Obtain selected suppliers' statements and **reconcile** these to the relevant suppliers' accounts (see Section 2.3 for details of suppliers' statements). • Examine files of unmatched purchase orders and supplier invoices for any **unrecorded liabilities**. • Perform a **confirmation of trade accounts payable** for a sample (see Section 2.2 for details of the trade accounts payable confirmation) • Complete the **disclosure checklist** to ensure that all the disclosures relevant to liabilities have been made. • **Compare** the current year balances for trade accounts payable and accruals to the previous year. • **Compare** the amounts owed to a sample of individual suppliers in the trade accounts payables listing to amounts owed to these suppliers in the previous year. • **Compare** the trade accounts payable turnover and payables days to the previous year and industry data. • **Re-perform casts** of **payroll records** to confirm completeness and accuracy. • **Confirm** payment of net pay per payroll records to cheque or bank transfer summary. • **Agree** net pay per cashbook to payroll. • **Inspect** payroll for **unusual items** and **investigate** them further by **discussion** with management. • Perform **proof-in-total (analytical procedures)** on payroll and compare to figure in draft financial statements to assess reasonableness.

Audit procedures: trade accounts payable and accruals	
Existence	• **Vouch** selected amounts from the trade accounts payable listing and accruals listing to supporting documentation such as purchase orders and suppliers' invoices. • Obtain selected suppliers' statements and **reconcile** these to the relevant suppliers' accounts. • Perform a **confirmation of trade accounts payable** for a sample. • Perform **analytical procedures** comparing current year balances to the previous year to confirm reasonableness, and also calculating payables turnover and comparing to the previous year.
Rights and obligations	• **Vouch** a sample of balances to supporting documentation, such as purchase orders and suppliers' invoices, to obtain audit evidence regarding rights and obligations.
Accuracy, valuation and allocation	• **Trace** selected samples from the trade accounts payable listing and accruals listing to the supporting documentation (purchase orders, minutes authorising expenditure, suppliers' invoices etc). • Obtain selected suppliers' statements and **reconcile** these to the relevant suppliers' accounts. • For a sample of **accruals, recalculate** the amount of the accrual to ensure the amount accrued is correct. • **Compare** the current year balances for trade accounts payable and accruals to the previous year. • **Compare** the amounts owed to a sample of individual suppliers in the trade accounts payable listing with amounts owed to these suppliers in the previous year. • **Compare** the payables turnover and payables days with the previous year and industry data. • **Recalculate** the mathematical accuracy of a sample of suppliers' invoices to confirm the amounts are correct. • **Recast** calculation of **remuneration**. • **Reperform** calculation of **statutory deductions** to confirm whether correct. • Confirm validity of **other deductions** by **agreeing** to supporting documentation. • **Recast** calculation of **other deductions**.

Audit procedures: trade accounts payable and accruals	
Cut-off	• For a sample of vouchers, **compare the dates** with the dates they were recorded in the ledger for application of correct cut-off. • **Test transactions** around the year-end to determine whether amounts have been recognised in the correct financial period. • **Perform analytical procedures** on purchase returns, comparing the purchase returns as a % of sales or cost of sales to the previous year.
Occurrence	• For a sample of vouchers, **inspect** supporting documentation such as authorised purchase orders. • **Agree individual remuneration** per payroll to personnel records, records of hours worked, salary agreements etc. • Confirm **existence** of employees on payroll by meeting them, attending wages payout, inspecting personnel and tax records, and confirmation from managers. • **Agree benefits** on payroll to supporting correspondence.
Classification	• **Review** the trade accounts payable listing to identify any large debits (which should be reclassified as receivables or deposits) or long-term liabilities which should be disclosed separately. • **Read** the disclosure notes relevant to liabilities in the draft financial statements and review for understandability.
Presentation	• **Read** the disclosure notes to ensure the information is accurate and properly presented at the appropriate amounts.

2.2 Confirmation of trade accounts payable

We have already discussed the receivables confirmation procedure in Chapter 10. It is also possible to undertake confirmation of trade accounts payable, although this is not used a great deal in practice, because the auditor can test trade accounts payable by examining **reliable, independent evidence** in the form of suppliers' invoices and suppliers' statements. However, where an entity's internal controls are weak, suppliers' statements may not be available and, in this situation, it may be relevant to undertake confirmation procedures. Confirmation of trade accounts payable provides evidence primarily for the **completeness** assertion.

Where the entity has **strong controls** in place to ensure that all liabilities are recorded, the confirmation will focus on **large balances**.

Where the auditor is **concerned** about the presence of **unrecorded liabilities**, regular suppliers with **small or zero balances** on their accounts and a sample of **other accounts** will be confirmed, as well as **large balances**.

Auditors use a **positive confirmation** referred to as a **blank or zero-balance confirmation**. This confirmation **does not state** the balance owed but requires the supplier to declare the amount owed at the year-end and to provide a detailed statement of the account. When the confirmation is received, the amount must be **reconciled** with the entity's records.

The selection and sending out of trade accounts payable confirmations should be controlled using the same procedures as for the receivables confirmation that we discussed in Chapter 10.

2.3 Reconciliations of trade accounts payable accounts with suppliers' statements

Many suppliers provide **monthly statements** to their customers. These may therefore be available in the entity for examination. Because they are a source of documentary evidence originating outside of the entity, they are a **reliable** source of evidence to support suppliers' balances and provide evidence as to the **existence, completeness** and **valuation** of balances.

Having said this, auditors do still need to be **cautious** when using them as they may have been **tampered** with by the entity. The auditor should not rely on **photocopies or faxed statements**. If there is any doubt, the auditor should request a copy **directly** from the supplier or confirm the balance with the supplier (see above).

When selecting accounts for testing, the auditor should consider the **volume of business** during the year, not the balance outstanding at the year-end, because the risk is understatement of balances. Most differences between balances on suppliers' statements and the year-end payables listing are likely to be due to goods and cash-in-transit and disputed amounts; however, all differences need to be investigated thoroughly.

QUESTION — Trade accounts payable and accruals

You have been assigned to the audit of Herath Plc, and you are drafting the audit programme for payables and accruals for the year ended 31 December 20X7.

The company operates from a site in Colombo. All raw materials are received in the stores and all deliveries are checked to the delivery note and purchase order. The stores supervisor raises a goods received note (GRN) and is also responsible for raising credit requests if there are any problems with the raw materials delivered.

When the purchase ledger department staff receive the purchase invoices, they match them to the relevant goods received notes and purchase orders, and post them to the computerised purchase ledger. Suppliers are paid on the last day of each month.

Other payables and accruals consist of tax, wages and other statutory deductions, accruals and time-apportioned expenses such as electricity and telephone.

Required

Design your audit work to:

(a) Compare suppliers' statements with balances recorded on the purchase ledger.

(b) Verify that purchases cut-off has been applied correctly.

(c) Confirm that other payables and accruals have been accurately stated.

ANSWER

(a) Audit work

(i) Select a sample of balances and **compare suppliers' statements with purchase ledger balances**. The extent of the sample will depend on the results of tests of controls and assessment of the effectiveness of controls within the purchases system.

(ii) **Select** the **sample on a random basis**. Selection of only large balances or those with many transactions will not yield an appropriate sample as understatement of liabilities is being tested for. Nil and negative balances will also need to be included in the sample.

(iii) If **no statement** was **available** for the supplier, **confirmation** of the balance **from the supplier** should be requested.

If the balance **agrees exactly**, no further work needs to be carried out.

Where differences arise these need to be categorised as either in-transit items or other (including disputed) items. In-transit items will be either goods or cash.

(iv) If the difference relates to goods-in-transit, **ascertain** whether the **goods** were **received** before the year-end by reference to the GRN and that they are included in year-end inventory and purchase accruals. If not, a cut-off error has occurred and should be investigated. If the goods were received after the year-end, the difference with the suppliers' accounts is correct.

(v) Similarly, cash-in-transit would arise where the payment to the supplier was made by cheque before the year-end but was not received by him until after the year-end. The **date** the **cheque** was **raised** and its subsequent **clearing** through the bank account after the year-end should be **verified by inspecting the cash book** and the post-year-end bank statements.

(vi) However, if the cheque clears after the year-end date, it may indicate that the cheque, though raised before the year-end was not sent to the supplier until after the year-end. The relevant amount should be added back to year-end trade accounts payable and to the end-of-year bank balance.

(vii) Differences which do not arise from in-transit items need to be investigated and **appropriate adjustments** made where necessary.

These differences may have arisen due to **disputed invoices** where, for example, the client is demanding credit against an invoice which the supplier is not willing to agree.

The client may decide not to post the invoice to the supplier account as he does not consider it to be a liability of the company. However, differences may also arise because **invoices** have been **held back** in order to reduce the level of year-end trade accounts payable.

(viii) If significant unexplained differences are discovered it may be necessary to **extend** the **testing**. There may also be a problem if sufficient suppliers' statements are not available. Alternative procedures, eg a circularisation, may then be required.

(b) Audit work

(i) From the inventory count working papers, the **number** of the **last GRN** that was issued before the year-end will have been noted. **Select a sample** of **GRNs** issued in the period immediately before and immediately after the year-end. The period to be covered would be at least two weeks either side of the year-end.

(ii) **Concentrate** the sample on **high-value items**, and more on those GRNs from before the year-end as these represent the greatest risk of cut-off error.

(iii) Check that the **GRNs** have a **correct number**, according to the last GRN issued in the year and whether the **goods** were **received before or after the year-end**.

(iv) For **GRNs** issued **before the year-end**, check whether the **inventory** has been included in the year-end inventory total. Also check whether the **payable** is either **included** in **trade accounts payable** or **purchase accruals** by **inspecting** the relevant documentation.

(v) For **GRNs** issued **after the year-end**, ensure that the **inventory** is **included** in the inventory records **after the year-end**. In addition, review the **purchase ledger** to ensure that the relevant **invoice** has been **posted** to the supplier account after the year-end.

(c) Audit work

(i) **Assess the system of control** instituted by management to identify and quantify accruals and trade accounts payable.

(ii) From the client's sundry payables and accruals listing, check that **accruals** are **calculated correctly** and verify them by reference to subsequent payments. Check that **all time apportionments** have been made correctly (for example, for electricity) by **recalculation**.

(iii) **Taxation balances**

(1) Check the **amount paid to the tax authorities** by inspecting relevant documentation. (Note: we look at deferred taxation in the next section).

(2) For the sales tax balance (VAT and NBT), **review** for **reasonableness** to the **next return**. **Ensure** that the **payment** for the **previous return** was for the **correct** amount and has cleared through the bank.

(iv) **Review the statement of financial position** and **prior-year figures** (for any accruals which have not appeared this year or which did not appear last year) and consider liabilities inherent in the trade (eg weekly wages) to ensure that all likely accruals have been provided.

(v) **Scrutinise payments** made after the year-end to ascertain whether any payments made should be accrued. This will include consideration of any payments relating to the current year which are made a long time after the year-end.

(vi) **Consider and document** the basis for **round-sum accruals** and ensure it is consistent with prior years.

(vii) **Ascertain** why any **payments on account** are being made and **ensure** that the full **liability** is **provided**.

(viii) **Accrued interest** and basic **charges on loans** or overdrafts can be **agreed** to the **bank confirmation** received for audit purposes.

3 Auditing deferred taxation liabilities

The auditor needs to audit the movement on the deferred tax liability.

Deferred tax is accounted for under LKAS 12 *Income taxes*. This is revised briefly below.

LKAS 12 *Income taxes*

- Deferred tax is the tax attributable to temporary differences, which are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.
- **Deferred tax liabilities** are the amounts of income taxes payable in future periods in respect of taxable temporary differences. All taxable temporary differences give rise to a deferred tax liability.
- **Deferred tax assets** are the amounts of income taxes recoverable in future periods in respect of:
  - Deductible temporary differences (eg provisions, unrealised profits on intra-group trading)
  - The carry forward of unused tax losses
  - The carry forward of unused tax credits

  All deductible temporary differences give rise to a deferred tax asset.
- **Temporary differences** are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either:
  - **Taxable temporary differences**, which are temporary differences that will result in taxable amounts in determining taxable profit (or tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

  - **Deductible temporary differences**, which are temporary differences that will result in amounts that are deductible in determining taxable profit (or tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.
- The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Deferred tax is the **tax attributable to timing differences**. For example, where a company 'saves tax' in the current period by having accelerated depreciation for tax purposes, a **provision for the tax charge** is **made in the statement of financial position**.

The provision is made because, over the course of the asset's life, the tax allowances will reduce until the depreciation charged in the accounts is higher than the allowances. This will result in taxable profit being higher than reported profit and the company will be 'suffering higher tax' in this period.

3.1 Examples of taxable temporary difference

Accelerated depreciation for tax

The temporary difference is the difference between the carrying value of the asset in the statement of financial position at the end of the reporting period and its tax depreciated value.

Interest revenue

Interest revenue received in arrears and included in accounting profit on the basis of time apportionment. It is included in taxable profit, however, on a cash basis.

Development costs

The temporary difference is equivalent to the amount capitalised in the statement of financial position at the end of the reporting period. The tax base is nil since they have already been deducted from taxable profits.

3.2 Examples of deductible temporary differences

Provisions

A provision is recognised, for accounting purposes, when there is a present obligation, but may not be deductible for tax purposes until the expenditure is incurred.

Retirement benefit costs

These are deducted from accounting profit as a service is provided by the employee. They are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. (This may also apply to similar expenses.)

Cost of inventories

The **cost of inventories** sold before the end of the reporting period is deducted from accounting profit when goods/services are delivered, but is deducted from taxable profit when the cash is received.

Research costs

Research costs (or organisation/other start-up costs) are recognised as an expense for accounting purposes, but are not deductible against taxable profits until a later period.

Deferred income

Income is **deferred** in the statement of financial position, but has already been included in taxable profit in current/prior periods.

3.3 Measurement of deferred tax

The key points to remember are as follows:

- LKAS 12 adopts the **full provision** method of providing for deferred tax. This recognises that each timing difference at the period end has an effect on future tax payments.
- Deferred tax assets and liabilities are measured at the tax rates expected to apply to the period when the asset is realised or liability settled, based on the tax rates (and tax laws) that have been **enacted** (or substantively enacted) by the end of the reporting period.
- Deferred assets and liabilities **cannot be discounted**.
- Deferred tax assets are only recognised to the extent that it is **probable** that taxable profit will be available against which the deductible temporary difference can be utilised.

3.4 Audit issues and procedures

As part of the **planning process**, if the client receives tax services from the firm, the auditor should consult the tax department as to the company's future tax plans, to ascertain whether they expect a deferred tax liability to arise. This will assist any analytical procedures they carry out on the deferred tax provision.

Remember that **manipulating the deferred tax figure will not affect the actual tax position**. However, a **deferred tax charge** (the other part of the double entry for the statement of financial position provision) **is recognised in profit or loss before dividends**, even if it is not actually paid to the taxation authorities.

The following procedures will be relevant:

- Obtain a copy of the deferred tax workings and the corporation tax computation
- Check the arithmetical **accuracy** of the deferred tax working
- Agree the **figures used** to calculate timing differences to those on the **tax computation** and the **financial statements**
- Consider the assumptions made in the light of your knowledge of the business and any other evidence gathered during the course of the audit to ensure reasonableness
- Agree the opening position on the deferred tax account to the prior-year financial statements
- Review the basis of the provision to ensure:
  - It is in line with accounting practice under LKAS 12
  - It is suitably comparable to practice in previous years
  - Any changes in accounting policy have been disclosed

4 Auditing, purchases and expenses

Evidence in relation to purchases and expenses is gained from trade accounts payable and accruals testing and from additional procedures designed specifically to test expenses in the statement of profit or loss.

Although the table in Section 2 includes details of some procedures which give evidence over items in the statement of profit or loss, the following are procedures specifically related to the audit of purchases and other expenses:

(a) Inspect a sample of purchase invoices to ensure they agree to the amount posted to the general ledger.

(b) Compare expenses making up administrative expenses to the prior-year charge and to expectations on a line-by-line basis. Where differences from expectations are discovered, they should be investigated.

(c) Enquire of management whether there are any unsettled claims or obligations arising before the year-end and ensure these are provided for (to give evidence over the completeness of the charge in the related expense category in the statement of profit or loss)

(d) Recalculate accruals and prepayments to gain evidence that other expenses are not over or understated.

(e) Compare gross profit margin with the previous year, the gross margin per the budget and expectations. Investigate any unexpected fluctuations.

5 Employee expenses and management remuneration

5.1 Employee expenses

One expense that may make up a significant proportion of expenses is the wages cost included in the statement of profit or loss.

Wages (or employee) costs are usually a highly material expense in the statement of profit or loss. It is important you know procedures that can be used when auditing this area. Although a number of these are included in the table in Section 2 as they are related to the statement of financial position balances, they are reproduced here for clarity, along with other relevant procedures:

(a) Reconcile the gross costs on the payroll to the wages cost in the financial statements.

(b) Re-perform casts of payroll records to confirm completeness and accuracy of costs used as a basis for the journals to the financial statements

(c) Confirm payment of net pay per payroll records to cheque or bank transfer summary.

(d) Inspect payroll for unusual items and investigate them further by discussion with management.

(e) Perform proof-in-total (analytical procedures) on payroll by multiplying estimated average wage (using last year's figures plus expected increases) by average number of employees (therefore incorporating starters and leavers) and compare to figure in draft financial statements to assess reasonableness.

(f) Re-perform calculations of statutory deductions to establish whether valid deductions have been included in the payroll expense.

5.2 Pension schemes

Expenses and related liabilities for employee pension schemes need special auditor consideration. There are two types or categories of post-employment benefit plan: **defined contribution plans** and **defined benefit plans**.

You should have covered the accounting treatment for each of these during your accounting studies, but a brief recap follows.

5.2.1 Recap of LKAS 19

Accounting for payments into defined contribution plans is straightforward.

(a) The **obligation** is determined by the amount paid into the plan in each period.

(b) There are no actuarial assumptions to make.

(c) If the obligation is settled in the current period (or at least no later than 12 months after the end of the current period) there is **no requirement for discounting.**

LKAS 19 requires the following.

(a) **Contributions** to a defined contribution plan should be recognised as an **expense** in the period they are payable (except to the extent that labour costs may be included within the cost of assets).

(b) Any liability for **unpaid contributions** that are due as at the end of the period should be recognised as a **liability** (accrued expense).

(c) Any **excess contributions** paid should be recognised as an **asset** (prepaid expense), but only to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund.

(d) **Disclosure** is required of a description of the plan and the amount recognised as an expense in the period.

The auditor's procedures here will be focussed on ensuring the treatment of contributions in the financial statements are as stated in (a) to (c) above. The auditor will also have to review the financial statements to ensure disclosures required in (d) are included and assess whether the facts and amount included in the disclosure are accurate.

Accounting for defined benefit plans is more complex.

(a) The future benefits (arising from employee service in the current or prior years) **cannot be estimated exactly**, but whatever they are, the employer will have to pay them, and the liability should therefore be recognised now. To estimate these future obligations, it is necessary to use **actuarial assumptions.**

(b) The obligations payable in future years should be valued, by discounting, on a **present value** basis. This is because the obligations may be settled in many years' time.

(c) If actuarial assumptions change, the amount of required contributions to the fund will change, and there may be **re-measurement gains or losses**. A contribution into a fund in any period is not necessarily the total for that period, due to actuarial gains or losses.

An outline of the method used for an employer to account for the expenses and obligation of a defined benefit plan is given below.

Step 1 **Determine the deficit or surplus:**

(a) An **actuarial technique** (the **projected unit credit method**), should be used to make a reliable estimate of the amount of future benefits which employees have earned from service in relation to the current and prior years. The entity must determine how much benefit should be attributed to service performed by employees in the current period, and in prior periods. Assumptions include, for example, assumptions about employee turnover, mortality rates, future increases in salaries (if these will affect the eventual size of future benefits such as pension payments).

(b) The benefit should be **discounted** to arrive at the present value of the defined benefit obligation and the current service cost.

(c) The **fair value** of any **plan assets** should be deducted from the present value of the defined benefit obligation.

Step 2 The surplus or deficit determined in Step 1 may have to be adjusted if a net benefit asset has to be restricted by the **asset ceiling**.

Step 3 Determine the amounts to be recognised in **profit or loss:**

(a) **Current service cost**

(b) Any **past service cost** and **gain or loss on settlement**

(c) **Net interest** on the **net defined benefit (asset)**

Step 4 Determine the **re-measurements** of the **net defined benefit (asset)**, to be recognised in **other comprehensive income**:

(a) **Actuarial gains and losses**

(b) **Return on plan assets** (excluding amounts included in net interest on the net defined benefit liability (asset)

(c) Any change in the effect of the **asset ceiling** (excluding amounts included in net interest on the net defined benefit liability (asset)

In the statement of financial position, the amount recognised as a **defined benefit liability** (which may be a negative amount, ie an asset) should be the following.

(a) The **present value of the defined obligation** at the year end, **minus**

(b) The **fair value of the assets of the plan** as at the year end (if there are any) out of which the future obligations to current and past employees will be directly settled.

Plan assets are:

(a) Assets such as stocks and shares, held by a fund that is legally separate from the reporting entity, which exists solely to pay employee benefits.

(b) Insurance policies, issued by an insurer that is not a related party, the proceeds of which can only be used to pay employee benefits.

Investments which may be used for purposes other than to pay employee benefits are not plan assets.

The standard requires that the plan assets are measured at fair value, as 'the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date'.

LKAS 19 includes the following specific requirements:

(a) The plan assets should exclude any contributions due from the employer but not yet paid.

(b) Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, such as trade and other payables.

All of the gains and losses that affect the plan obligation and plan asset must be recognised. The **components of defined benefit cost must be recognised as follows** in the statement of profit or loss and other comprehensive income:

Table 12.3: Recognition of components of benefit cost

Component	Recognised in
(a) **Service cost**	Profit or loss
(b) **Net interest on the net defined benefit liability**	Profit or loss
(c) **Re-measurements of the net defined benefit liability**	Other comprehensive income (not reclassified to P/L)

5.2.2 Audit evidence

Table 12.4: Audit evidence

Area	Procedures
Scheme assets (including quoted and unquoted securities, debt instruments, properties)	• Ask directors to reconcile the scheme assets valuation at the scheme year-end date with the assets' valuation at the reporting entity's date being used for LKAS 19 purposes

Area	Procedures
	• Obtain direct confirmation of the scheme assets from the investment custodian • Consider requiring scheme auditors to perform procedures
Scheme liabilities	• Auditors must follow the principles of SLAuS 620 *Using the work of an auditor's expert* to assess whether it is appropriate to rely on the actuary's work • Specific matters would include – The source data used – The assumptions and methods used – The results of actuaries' work in the light of auditors' knowledge of the business and results of other audit procedures
	Actuarial source data likely to include: • Scheme member data (for example, classes of member and contribution details) • Scheme asset information (for example, values and income and expenditure items)
Actuarial assumptions (for example, mortality rates, termination rates, retirement age and changes in salary and benefit levels)	Auditors will not have the same expertise as actuaries and are unlikely to be able to challenge the appropriateness and reasonableness of the assumptions. Auditors can, however, through discussion with directors and actuaries: • Obtain a general understanding of the assumptions and review the process used to develop them • Compare the assumptions with those which directors have used in prior years

Area	Procedures
	• Consider whether, based on their knowledge of the reporting entity and the scheme, and on the results of other audit procedures, the assumptions appear to be reasonable and compatible with those used elsewhere in the preparation of the entity's financial statements • Obtain written representations from directors confirming that the assumptions are consistent with their knowledge of the business
Items charged to operating profit (current service cost, past service cost, gains and losses on settlements and curtailments, interest)	• Discuss with directors and actuaries the factors affecting current service cost (for example, a scheme closed to new entrants may see an increase year-on-year as a percentage of pay, with the average age of the workforce increasing)

Where the results of actuaries' work is inconsistent with the directors', additional procedures, such as requesting directors to obtain evidence from another actuary, may assist in resolving the inconsistency.

5.3 Management remuneration

The auditor will need to make sure the disclosure of **management remuneration** is complete, accurate and compliant with applicable accounting standards and with local legislation, such as the Companies Act No. 07 of 2007.

Shareholders and other users of financial statements are very interested in identifying how much of a company's wealth is being paid out to the key management personnel, and in particular the directors of the company. As a result this area will always be a material one and it is said to be **material by nature**.

Sri Lanka Accounting Standards require compensation payments to **key management personnel** to be disclosed. It is useful here to look at the requirements in LKAS 24 *Related party disclosures* to illustrate the sorts of payments and benefits a company needs to disclose in respect of management and the board.

LKAS 24 requires that the financial statements of a company disclose **key management personnel** compensation details in total. 'Key management' will include the board of directors and 'compensation' will include:

(a) Short-term employee benefits, such as wages, salaries and Employees Provident Fund (EPF) and Employees Trust Fund (ETF), paid annual leave and paid sick leave, profit-sharing and bonuses and non-monetary benefits for current employees

(b) Post-employment benefits such as pensions, other retirement benefits, post-employment life assurance and post-employment medical care

(c) Other long-term employee benefits, including long-service benefits, and deferred compensation.

(d) Termination benefits

(e) Share-based payments

The auditor must therefore ensure that they are comfortable with the requirements of applicable accounting standards **and** any local legislation. Then procedures adopted must ensure related disclosure is accurate, complete and covers all areas required by local legislation. In Sri Lanka, the key management disclosures must be further analysed to separately identify directors' remuneration.

The table below lists some valid audit procedures when auditing management and directors' remuneration:

Table 12.5: Auditing directors' remunerations

Audit procedures: directors' remuneration
Obtain a schedule of remuneration for the year, split between wages, bonuses, benefits, pension contributions and other emoluments.
Check the addition of the schedule and ensure the totals are in agreement with the disclosure in the financial statements.
Ask each individual to confirm the amounts listed are complete and in line with their expectations.
Compare the remuneration with both the previous year's remuneration and with expectations, taking into account the knowledge obtained during the audit (for example, if you know a director has left during the year, is any compensation for loss of office expected?).
Agree salaries, fees, bonuses and EPF and ETF **to payroll records** for the individual directors and check the amounts paid on the bank statements agree with the payroll records.

Audit procedures: directors' remuneration
Review the **directors' contracts** and ensure remuneration is consistent with the terms of these contracts.
Review **board meeting minutes** and meetings of any remuneration committee for evidence of any bonuses, fees or other emoluments not disclosed.
Review the cash book for any unusual transactions which suggest undisclosed amounts.
Obtain and review **returns to tax authorities** made on behalf of the directors by the company which detail non-cash benefits. Ensure these are consistent with the benefits disclosed in the financial statements.
Consider the adequacy of **disclosure** of directors' remuneration in accordance with applicable accounting standards and local legislation, including the separate disclosure of amounts due to or from directors.

6 Non-current liabilities

Non-current liabilities are usually authorised by the board and should be well documented.

We are concerned here with non-current liabilities comprising debentures, long-term loans and other loans **repayable** at a date **more than one year after the year-end**.

Auditors will primarily try and determine:

- **Completeness**: whether all non-current liabilities have been disclosed
- **Accuracy**: whether interest payable has been calculated correctly and included in the correct accounting period
- **Presentation**: whether long-term loans and interest have been correctly classified and disclosed in the financial statements

The major complication for the auditors is that debenture and loan agreements frequently contain conditions with which the company must comply, including restrictions on the company's total borrowings and adherence to specific borrowing ratios.

The table that follows contains procedures for non-current liabilities in the statement of financial position and the related interest charge in the statement of profit or loss.

Table 12.6: Auditing non-current liabilities

Audit procedures: non-current liabilities
Obtain/prepare schedule of loans outstanding at the year-end date showing, for each loan: name of lender, date of loan, maturity date, interest date, interest rate, balance at the end of the period and security.
Compare opening balances to previous year's papers.
Test the clerical accuracy of the analysis.
Compare balances to the **general ledger**.
Agree name of **lender** etc, to **register** of **debenture holders** or equivalent (if kept).
Trace additions and **repayments** to **entries** in the **cash book**.
Confirm repayments are in accordance with **loan agreement**.
Examine cancelled cheques and **memoranda of satisfaction** for **loans repaid**.
Verify that **borrowing limits** imposed by agreements are **not exceeded**.
Examine signed Board minutes relating to **new borrowings/repayments**.
Obtain direct confirmation from **lenders** of the amounts outstanding, accrued interest and what security they hold.
Verify interest charged for the period is in accordance with statements and supporting agreements, and consistent with known interest rates. Consider the adequacy of accrued interest.
Confirm assets charged have been **entered** in the **register of charges** and **notified** to the **Registrar**.
Review restrictive covenants and provisions relating to default: • **Review** any **correspondence** relating to the loan • **Review confirmation** replies for non-compliance • If a **default** appears to exist, determine its **effect**, and schedule findings
Review minutes, cash book to confirm that all **loans have been recorded**.
Review draft accounts to ensure that **disclosures** for non-current liabilities are correct and in accordance with Sri Lanka accounting standards. Any elements repayable within one year should be classified under current liabilities.

7 Provisions and contingencies

The accounting treatments for provisions and contingencies are complex and involve judgement, which can make them difficult to audit.

7.1 Accounting issues

A **provision** is a liability of uncertain timing or amount.

A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

An **obligating event** is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

A **legal obligation** is an obligation that derives from:

(a) A contract (through its explicit or implicit terms)
(b) Legislation
(c) Other operation of law

A **constructive obligation** is an obligation that derives from an entity's actions where:

(a) By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities, and

(b) As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

A **contingent liability** is:

(a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity, or

(b) A present obligation that arises from past events but is not recognised because:

   (i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or

   (ii) The amount of the obligation cannot be measured with sufficient reliability.

A **contingent asset** is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Under LKAS 37 *Provisions, contingent liabilities and contingent assets*, an entity should not recognise a contingent asset or a contingent liability. However, if it becomes probable that an outflow of future economic benefits will be required for a previous contingent liability, a provision should be recognised. A contingent asset should not be accounted for unless its realisation is virtually certain; if an inflow of economic benefits has become probable, the asset should be disclosed.

Examples of the principal types of contingencies disclosed by companies are:

- **Guarantees** (for group companies, of staff pension schemes, of completion of contracts)
- **Discounted bills of exchange**
- **Uncalled liabilities** on shares or loans
- **Lawsuits** or claims pending
- **Options** to purchase assets

7.2 Obtaining audit evidence of contingencies

Part of SLAuS 501 *Audit evidence – specific considerations for selected items* covers contingencies relating to litigation and legal claims, which will represent the major part of audit work on contingencies. Litigation and claims involving the entity may have a material effect on the financial statements, and so will require adjustment to/disclosure in those financial statements.

The auditor shall design and perform procedures in order to identify any litigation and claims involving the entity which may give rise to a risk of material misstatement.

Such procedures would include the following.

- **Make appropriate enquiries of management** and others, including in-house legal advisers.
- **Review minutes of meetings** of those charged with governance and **correspondence** between the entity and its external legal advisers.
- **Review legal expense** accounts.
- **Use any information** obtained regarding the entity's business including information obtained from discussions with any in-house legal department.

When litigation or claims have been identified or when the auditor believes they may exist, the auditor shall seek **direct communication** with the entity's external legal advisers through a **letter of enquiry** that is prepared by management and sent by the auditor, requesting the legal adviser to communicate directly with the auditor. This assists the auditor in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reasonable.

The letter may be one of **general enquiry** or one of **specific enquiry**.

A letter of **general enquiry** requests the entity's external legal advisers to inform the auditor of any litigation and claims that they are aware of, together with an assessment of the outcome of the litigation and claims, and an estimate of the financial implications, including costs involved.

However, if it is considered **unlikely** that the entity's external legal advisers will respond appropriately to a letter of general inquiry, the auditor may seek direct communication through a letter of **specific enquiry**. This will include:

- A **list** of litigation and claims
- Where available, **management's assessment** of the outcome of each of the identified litigation and claims and its **estimate** of the financial implications, including costs involved
- A request that the entity's external legal advisers **confirm the reasonableness** of management's assessments and provide the auditor with **further information** if they consider the list to be incomplete or incorrect.

In certain circumstances (for example, the matter is a significant risk, the matter is complex, there is disagreement between management and legal advisers), the auditor also may judge it necessary to **meet** with the entity's external legal advisers to discuss the likely outcome of the litigation or claims. These meetings require management's permission and a member of management will be present at the meeting.

If management **refuses** to give the auditor permission to communicate or meet with the entity's external legal advisers, or the entity's external legal advisers refuse to respond appropriately to the letter of enquiry, or are prohibited from responding, and the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures, the auditor shall modify the opinion in the auditor's report in accordance with SLAuS 705 *Modifications to the opinion in the independent auditor's report*.

The auditor shall request management and, where appropriate, those charged with governance to provide **written representations** that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework.

7.3 The audit of provisions

The following audit procedures can be used in the audit of provisions.

Table 12.7: Auditing provisions and contingencies

Audit procedures: provisions/contingencies
Obtain details of all **provisions** which have been included in the **accounts** and all **contingencies** that have been disclosed.
Obtain a **detailed analysis** of all **provisions** showing opening balances, movements and closing balances.
Determine for each material provision whether the company has a **present obligation** as a result of past events by: • **Review** of **correspondence** relating to the item • **Discussion** with the **directors**. Have they created a valid expectation in other parties that they will discharge the obligation?
Determine for each material provision **whether** it is **probable** that a **transfer of economic benefits** will be required to settle the obligation by: • Checking whether any **payments** have been made in the post-year-end period in respect of the item by reviewing after-date cash • **Review of correspondence** with solicitors, banks, customers, insurance company and suppliers both pre and post-year-end • **Sending** a **letter** to the **solicitor** to obtain his views (where relevant) • **Discussing** the **position** of similar **past provisions** with the directors. Were these provisions eventually settled? • **Considering** the **likelihood** of **reimbursement**
Recalculate all provisions made.
Compare the **amount provided** with any post-year-end payments and with any amount paid in the past for similar items.
In the event that it is not possible to estimate the amount of the provision, check that a **contingent liability** is **disclosed** in the accounts.
Consider the **nature** of the **client's business.** Would you expect to see any other provisions, eg warranties?
Consider the adequacy of **disclosure** of provisions, contingent assets and contingent liabilities in accordance with LKAS 37.

8 Capital and reserves

The main concern with **stated capital and reserves** is that the company has complied with the law.

The issued share capital as stated in the accounts must be **agreed** in total with the **share register**. An examination of transfers on a test basis should be made in those cases where a company handles its own registration work. Where the registration work is dealt with by independent registrars, auditors will normally examine the reports submitted by them to the company, and obtain from them at the year-end a certificate of the share capital in issue.

Auditors should check carefully whether clients have complied with local legislation about share issues or purchase of own shares. Auditors should take particular care if there are any movements in reserves that cannot be distributed, and should confirm that these movements are **valid**.

Table 12.8: Auditing capital and related issues

Audit procedures: capital and related issues	
Issue of shares	• **Verify any issue** of share capital or other changes during the year with general and **board minutes**. • **Ensure issue or change** is within the **terms** of the **article**, and directors possess appropriate **authority** to issue shares. • **Confirm** that **cash** or **other consideration** has been **received** or **receivable(s) is included** as called-up share capital not paid. • Ensure that relevant forms/documents have been submitted to the registrar of companies.
Transfer of shares	• **Verify transfers of shares** by reference to: – Correspondence – Completed and stamped transfer forms – Cancelled share certificates – Minutes of directors' meeting • **Review the balances** on **shareholders' accounts** in the register of members and the total list with the amount of issued share capital in the general ledger.

Audit procedures: capital and related issues	
Dividends	• **Agree dividends** paid and declared pre-year-end to **authority** in minute books and **re-perform calculation** with **total share capital** issued to ascertain whether there are any outstanding or unclaimed dividends. • **Agree dividend payments** to **documentary evidence** (say, the returned dividend warrants). • Test that **dividends do not contravene** distribution provisions by reviewing the legislation.
Reserves	• Agree **movements on reserves** to supporting authority. • **Ensure that movements on reserves do not contravene** the **legislation** and the company's article by reviewing the legislation. • **Confirm** that the **company** can **distinguish distributable** reserves from those that are **non-distributable**. • **Ensure appropriate disclosures** of movements on reserves are made in the company's accounts by **inspection** of the financial statements.

9 Operating segments

SLFRS 8 requires that the results of the entity be disclosed on the basis of reportable segments.

SLFRS 8 *Operating Segments*

An **operating segment** is a component of an entity:

- That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity)
- Whose operating results are reviewed regularly by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance
- For which discrete financial information is available

SLFRS 8 requires an entity to report financial and descriptive information about its reportable segments. **Reportable segments** are operating segments or aggregations of operating segments that meet specified criteria:

- Reported revenue, from both external customers and intersegment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments; or
- The absolute measure of reported profit or loss is 10% or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not report a loss and (ii) the combined reported loss of all operating segments that reported a loss; or
- Assets are 10% or more of the combined assets of all operating segments.

If the total external revenue reported by operating segments constitutes less than 75% of the entity's revenue, additional operating segments must be identified as reportable segments (even if they do not meet the quantitative thresholds set out above) until at least 75% of the entity's revenue is included in reportable segments.

SLAuS 501 *Audit Evidence – Specific Considerations for Selected Items* contains specific guidance on segment reporting.

The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by:

(a) Obtaining an understanding of the methods used by management in determining segment information, and:

  (i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and

  (ii) Where appropriate, testing the application of such methods; and

(b) Performing analytical procedures or other audit procedures appropriate in the circumstances.

The following procedures are relevant:

- Obtain a client schedule of revenue workings
- Discuss with management the basis for the segmentation and ensure that the basis for segmentation mirrors that used for internal reporting purposes
- Verify a sample of items to backing documentation (invoices) to ensure disclosure is correct

A key risk for auditors here is **management bias** in disclosure. This risk is particularly pronounced because SLFRS 8 takes a **management approach** to reportable segments, which opens up the possibility of management adjusting its approach in order to change the way segment information is disclosed. For example, there is a risk that loss-making segments could effectively go unreported or be hidden within other segments.

CHAPTER ROUNDUP

- Purchases are often tested in conjunction with the audit of trade accounts payable.
- The largest figure in **current liabilities** will normally be **trade accounts payable** which are generally audited by comparison of **suppliers' statements** with **purchase ledger accounts**.
- The auditor needs to audit the movement on the deferred tax liability.
- Evidence in relation to purchases and expenses is gained from trade accounts payable and accruals testing and from additional procedures designed specifically to test expenses in the statement of profit for loss.
- One expense that may make up a significant proportion of expenses is the wages cost included in the statement of profit or loss.
- The auditor will need to make sure the disclosure of **management remuneration** is complete, accurate and compliant with applicable accounting standards and with local legislation such as the Companies Act No. 07 of 2007.
- Non-current liabilities are usually authorised by the board and should be well documented.
- The accounting treatments for provisions and contingencies are complex and involve judgement, which can make them difficult to audit.
- The main concern with **stated capital and reserves** is to be sure that the company has complied with the law.
- SLFRS 8 requires that the results of the entity be disclosed on the basis of reportable segments.

PROGRESS TEST

1 What are the two primary objectives of year-end work on liabilities?

(1) ……………………………………………………..
(2) ……………………………………………………..

2 Give two instances where trade accounts payable confirmation is required.

(1) ……………………………………………………..
(2) ……………………………………………………..

3 Link the following assertion names (1-3) in respect of non-current liabilities with the appropriate description (a-c).

(1) Completeness
(2) Accuracy
(3) Classification and understandability

(a) Whether long-term loans and interest have been correctly disclosed in the financial statements

(b) Whether interest payable has been calculated correctly and included in the correct period

(c) Whether all non-current liabilities have been disclosed

4 Management remuneration is less likely to be of interest to shareholders and users of the financial statements than other financial statement areas.

Is the above statement true or false?

5 Complete the sentence.

Non-current liabilities comprise ……………………., ……………-…..……… ………..….. and other loans ……………………… at a date …………………. …………………... a year …………… the year-end.

6 What are the audit objectives relating to share capital?

(1) ……………………………………………………..
(2) ……………………………………………………..
(3) ……………………………………………………..

ANSWERS TO PROGRESS TEST

1 To ensure (1) completely and (2) accurately recorded.

2 (1) Supplier statements are unavailable

(2) Weak internal controls

3 (1) (c)

(2) (b)

(3) (a)

4 False. Management remuneration is one area users of the financial statements will be most interested in. This makes it an area for which performance materiality is set at an amount much lower than the materiality for the financial statements as a whole.

5 Non-current liabilities comprise **debentures**, **long-term loans** and other loans **repayable** at a date **more than** a year **after** the year-end.

6 Share capital has been (1) properly classified, and (2) disclosed in the financial statements, and changes are (3) properly authorised.

CHAPTER 13

Sampling and Audit Procedures

INTRODUCTION

In this chapter we look at audit sampling, which is an important aspect of the audit since auditors cannot usually test every balance and transaction making up the financial statements. We consider different types of audit sampling and the evaluation of any misstatements found.

We then examine how the auditor should approach opening balances, particularly where the financial statements were not audited in the previous period or were audited by another auditor.

Finally we will consider the requirements in relation to corresponding figures.

Knowledge Component			
C	**Gathering Audit Evidence**		
3.3	**Opening Balances and Corresponding Figures**	3.3.1	Discuss the requirements to be considered by an auditor in an initial engagement and in relation to corresponding figures
3.4	**Selecting Items for Testing and the Use of Audit Sampling**	3.4.1	Apply different methods of selecting items for audit testing including audit sampling

CHAPTER CONTENTS	LEARNING OUTCOME
1 Audit sampling	3.4.1
2 Auditing opening balances and corresponding figures	3.3.1

1 Audit sampling

Auditors usually seek evidence from less than 100% of items of the balance or transaction being tested by using **sampling techniques**.

1.1 Introduction to audit sampling

Audit sampling is the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor to obtain and evaluate audit evidence about some characteristic of the items selected, in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The **population** is the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

Auditors do not normally examine all the information available to them, as it would be impractical to do so; using audit sampling will produce valid conclusions. SLAuS 530 *Audit sampling* provides guidance to auditors.

Some testing procedures do **not** involve sampling, such as:

- **Testing 100%** of items in a population
- Testing all items with a **certain characteristic** as selection is not representative

Auditors are unlikely to test 100% of items when carrying out tests of controls, but 100% testing may be appropriate for certain substantive procedures. For example, if the population is made up of a small number of high-value items, where there is a high risk of material misstatement and other means do not provide sufficient appropriate audit evidence, then 100% examination may be appropriate.

Audit sampling can be done using either **statistical sampling** or **non-statistical sampling** methods.

Statistical sampling is an approach to sampling that has the following characteristics: (a) Random selection of the sample items, and (b) The use of probability theory to evaluate sample results, including measurement of sampling risk.

Non-statistical sampling is a sampling approach that does not have the characteristics (a) and (b) above.

So, bearing in mind the definitions above, sampling is non-statistical when it does not meet the criteria required of statistical sampling. If each item of the population does not have an equal chance of selection, the sampling technique is non-statistical.

The difference between the two types of sampling is that, with statistical sampling, the sampling risk can be measured and controlled (we look at sampling risk in Section 1.2). With non-statistical sampling it cannot be measured.

Although the audit procedures performed on the items in the sample will be the same, whether a statistical or non-statistical approach is used, meaningful extrapolation can only occur from a statistical sample which has been selected randomly.

The auditor may, alternatively, select certain items from a population because of specific characteristics they possess. The results of items selected in this non-statistical way cannot be projected onto the whole population but may be used in conjunction with other audit evidence concerning the rest of the population.

- **High-value or key items.** The auditor may select high-value items or items that are suspicious, unusual or prone to error.
- **All items over a certain amount**. Selecting items this way may mean a large proportion of the population can be verified by testing a few items.
- **Items to obtain information** about the client's business, the nature of transactions, or the client's accounting and control systems.
- **Items to test procedures,** to see whether particular procedures are being performed.

1.2 Design of the sample

Sampling risk is the risk that the auditor's conclusion based on a sample of a certain size may be different from the conclusion if the entire population were subjected to the same audit procedure.

Non-sampling risk arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample such as, for example, the use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognise a misstatement or deviation.

Sampling unit is the individual items constituting a population.

This may be a physical item (eg credit entries on bank statements, sales invoices, receivables balances), or a monetary unit.

Stratification is the process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

The auditor must consider the **purpose** of the audit procedure when designing an audit sample. The auditor must also consider the **characteristics of the population**. When considering the characteristics of the population, the auditor might determine that **stratification** or **value-weighted selection** is appropriate.

QUESTION — Stratification

The auditor is selecting a sample of receivables balances for testing. There are 200 outstanding balances, mostly balances from small customers but 35% of the balances outstanding from individually significant customers.

Required

How might the auditor stratify these balances in order to select from the population?

ANSWER

The auditor may decide to stratify the receivables based on the number of days outstanding. For example, they may have one population in the amounts outstanding less that 30 days, another for 30 – 60 days outstanding, 60 – 90 days outstanding and one for over 90 days outstanding. The sample selection from the over 90 days outstanding could then be larger due to the greater risk attached.

The auditor must design a sample size sufficient to reduce sampling risk to an **acceptably low level**. Sampling risk can lead to two types of erroneous conclusions:

- For tests of controls, that they are more effective than they actually are; or for tests of details, that a material misstatement does not exist when it actually does
- For tests of controls, that controls are less effective than they actually are; or for tests of details, that a material misstatement exists when it actually does not.

The lower the risk the auditor is willing to accept, the greater the sample size will need to be. Sample size can be determined using a statistically-based formula or through the use of judgement.

SLAuS 530 also requires the auditor to select items for the sample in such a way that each sampling unit in the population has a chance of selection. When statistical sampling is used, each sampling unit has a **known probability** of being selected. When non-statistical sampling is used, judgement is applied. However, it is important that the auditor selects a **representative sample**, free from bias, by choosing sample items that have **characteristics typical** of the population. The main methods of selecting samples are **random selection, systematic selection** and **haphazard selection**. We discuss these, and other methods, below.

(a) **Random selection** ensures that all items in the population have an equal chance of selection, eg by use of random number tables or random number generators.

(b) **Systematic selection** involves selecting items using a constant interval between selections, the first interval having a random start. When using systematic selection auditors must ensure that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population.

(c) **Monetary unit sampling** is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

QUESTION **Monetary unit sampling**

The auditor is selecting a sample from a total receivables population amounting to Rs. 32,000,000. The sample size has been set at 42.

Required

How might the auditor undertake monetary unit sampling in order to select from the population?

ANSWER

The auditor will first calculate the sampling interval as (32,000,000/42) Rs. 761,904. The receivables balances will then be added in a cumulative total (see table below) and a random starting point identified, say Rs. 346,389 (chosen at random). The item (receivables balance) that takes the cumulative total over that random starting point will be selected as the first sample. From then on Rs. 761,904 will be added in increments and the receivables balance that causes the cumulative total to exceed that amount will be chosen as a sample, for example the next selected total would be (346,389 + 761,904) Rs. 1,108,394 and the receivable balance that took the cumulative total beyond that would be the second selection (see table below for example).

Sample	*Receivable Ref*	*Amount*	*Cumulative total*	*Selected total*
		Rs	Rs	Rs
1	000124	3,000	347,230	346,389
2	000168	6,340	1,108,394	1,108,293
3	000179	2,678	1,871,100	1,870,197

(d) **Haphazard selection** may be an alternative to random selection, provided auditors are satisfied that the sample is representative of the entire population. This method requires care to guard against making a selection which is biased, for example towards items which are easily located, as they may not be representative. It should not be used if auditors are carrying out statistical sampling.

(e) **Block selection** may be used to check whether certain items have particular characteristics. For example, an auditor may use a sample of 50 consecutive cheques to test whether cheques are signed by authorised signatories rather than picking 50 single cheques throughout the year. Block sampling may, however, produce samples that are not representative of the population as a whole, particularly if errors only occurred during a certain part of the period, and hence the errors found cannot be projected onto the rest of the population.

1.3 Performing audit procedures

Once the sample has been selected, the auditor must perform **appropriate audit procedures** on each item in the sample. If the audit procedure is not applicable to the selected item, the test must be performed on a **replacement item**. This could happen if, for example, a voided cheque is selected when testing for evidence of authorisation of payment.

If the auditor cannot apply the designed audit procedures (eg if documentation relating to the item has been lost), or suitable alternative audit procedures, to the selected item, that item must be treated as a **deviation** from the prescribed control (for tests of controls) or a **misstatement** (for tests of details).

1.4 Deviations and misstatements

An **anomaly** is a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

Once the sample has been tested, the auditor must investigate the nature and cause of any deviations or misstatements found and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.

In rare cases, a deviation or misstatement may be considered an **anomaly**, in which case the auditor must obtain a high degree of certainty that this is not representative of the population, by carrying out additional audit procedures.

QUESTION **Anomalies**

The auditor is conducting tests of completeness on the sales invoices and finds that some of the invoices chosen are missing. On further investigation, the auditor finds that there was a power outage on the day the batch of invoices should have been recorded that led to the system not recording them. Such outages are very rare and a secondary power system has now been installed.

Required

What action should the auditor now take?

ANSWER

The missing invoices in the sample would usually lead the auditor to surmise that there may be more incomplete records within the population as a whole and extrapolate the misstatement accordingly. However, the missing invoices were due to a one-off event which is now unlikely to recur and would therefore be considered an anomaly. The auditor may carry out some additional procedures to satisfy themselves that this is the case but so long as it is they would not extrapolate this misstatement to the population as a whole.

1.5 Projection of misstatements

For **tests of details**, the auditor shall **project** misstatements found in the sample to the population to obtain a broad view of the scale of the misstatement but this may not be enough to determine an amount to be recorded.

Misstatements established as **anomalies** can be excluded when projecting sample errors to the population. However, note that the effect of any uncorrected anomalies still needs to be considered. Projected errors and anomalies are combined together when considering the possible effect of errors on the total class of transactions or account balance. Where the audited entity has corrected specific errors found in the sample, the projected error may be reduced by the amount of these corrections.

SLAuS 530 states that, for **tests of controls**, no explicit projection of errors is necessary because the sample deviation rate is also the projected deviation rate for the population as a whole. So for example, if in a sample of 75, four errors are discovered, the projected deviation rate is 4/75, ie 5%.

1.6 Evaluating the results

Tolerable misstatement is a monetary amount set by the auditor, in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

Tolerable rate of deviation is a rate of deviation from prescribed internal control procedures set by the auditor, in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

SLAuS 530 requires the auditor to evaluate the results of the sample.

For tests of controls, an unexpectedly high deviation rate in the sample may result in an increase in the assessed risk of material misstatement, unless further audit evidence to substantiate the initial assessment of risk is obtained.

For tests of details, an unexpectedly high misstatement amount in the sample may lead the auditor to conclude that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no misstatement exists.

For tests of details, the total of the projected misstatement and anomalous misstatement is the auditor's best estimate of misstatement in the population. If the total exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population. The closer the total figure is to tolerable misstatement, the more likely it is that actual misstatement in the population could exceed tolerable misstatement. The auditor must therefore also consider the results of other audit procedures to assist in determining the risk that actual misstatement in the population exceeds tolerable misstatement. The risk may be reduced if additional audit evidence is obtained.

The auditor must also evaluate whether the use of sampling has provided a reasonable basis for conclusions about the population from which the sample was drawn. If the conclusion is that sampling has not provided this, the auditor may request management to investigate misstatements that have been identified and make any necessary adjustments, or tailor the nature, timing and extent of further audit procedures to best achieve the assurance required.

1.7 Summary

Key stages in the sampling process are as follows.

- Determining **objectives and characteristics of the population**
- Determining **sample size**
- Choosing method of **sample selection**
- **Projecting errors** and **evaluating** the **results**

2 Auditing opening balances

Auditors must ensure that the **opening balances** and **comparative information** are fairly stated in the financial statements.

2.1 Opening balances

Opening balances are those account balances that exist at the beginning of the period. They are based on the closing balances of the prior period and reflect the effects of transactions of prior periods and accounting policies applied in the prior period. They also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

An **initial audit engagement** is one in which either: (a) the financial statements for the prior period were not audited; or (b) the financial statements for the prior period were audited by a predecessor auditor.

SLAuS 510 *Initial audit engagements – opening balances* provides guidance to auditors on the audit of opening balances when conducting an initial audit engagement.

The SLAuS states that, for initial audit engagements, the auditor's objective is to obtain sufficient appropriate audit evidence whether:

- Opening balances contain **misstatements** that **materially** affect the current period's financial statements.
- **Appropriate accounting policies** are **consistently** applied or changes have been properly accounted for and adequately presented and disclosed.

3.1.1 Audit evidence for opening balances

SLAuS 510 states that the auditor shall **read** the most recent financial statements and the predecessor auditor's report for information relevant to opening balances.

The auditor shall obtain sufficient appropriate audit evidence about whether opening balances contain misstatements that materially affect the current period's financial statements by:

- Determining whether the prior period's closing balances have been correctly brought forward or restated
- Determining whether the opening balances reflect the application of appropriate accounting policies
- Performing one or more of the following:
  - Where the prior period's financial statements were audited, reviewing the predecessor auditor's working papers
  - Evaluating whether audit procedures performed in the current period provide evidence relevant to opening balances
  - Performing specific audit procedures to obtain evidence regarding opening balances

3.1.2 Opening balances – audit conclusions and reporting

If the auditor cannot obtain **sufficient appropriate audit evidence** for opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion.

If the opening balances contain misstatements that **materially affect** the current year's financial statements, the auditor shall express a qualified opinion or an adverse opinion.

If the auditor concludes that the current period's **accounting policies** are not consistently applied in relation to opening balances, or changes have not been properly accounted for and adequately presented and disclosed, the auditor shall express a qualified opinion or an adverse opinion.

If a prior-period modification remains **relevant and material** to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements accordingly.

3.2 Comparative information

Comparative information is amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

This comparative information may be presented in one of two ways:

Corresponding figures, where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period. The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

Comparative financial statements where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion.

SLAuS 710 *Comparative information – corresponding figures and comparative financial statements* provides guidance to auditors on comparatives, both corresponding figures and comparative financial statements. Whether corresponding figures or comparative financial statements are required is usually dictated by law or regulation, but may also be specified in the terms of engagement.

In terms of audit reporting, for corresponding figures, the auditor's opinion refers to the current period only. For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

3.2.1 Auditor's responsibilities for comparative information

The SLAuS states that the auditor must determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether it is appropriately classified. This includes an evaluation of whether:

- The **accounting policies** used for corresponding figures or comparative financial statements are consistent with the current period.
- The corresponding figures or comparative financial statements **agree** with the amounts and other disclosures presented in the prior period.

If the auditor becomes aware of a possible material misstatement regarding the comparative information, the auditor must perform additional audit procedures to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists.

SLAuS 710 requires the auditor to obtain a **written representation** for all periods referred to in the auditor's opinion and a specific written representation regarding any restatements made to correct a material misstatement in prior period financial statements that affect the comparative information.

3.2.2 Corresponding figures – reporting

In terms of reporting, the audit report does not specifically refer to the corresponding figures because the opinion is on the current period's financial statements as a whole, and this includes the corresponding figures.

3.2.3 Comparative financial statements – reporting

Comparative financial statements are not required in Sri Lanka. The only requirement is to include corresponding figures.

CHAPTER ROUNDUP

- Auditors usually seek evidence from less than 100% of items of the balance or transaction being tested by using **sampling techniques**.
- Auditors must ensure that the **opening balances** and **comparative information** are fairly stated in the financial statements.

PROGRESS TEST

1 Give three examples of sample selection methods that can be used in audit sampling.

(1) ……………………………………….

(2) ……………………………………….

(3) ……………………………………….

ANSWERS TO PROGRESS TEST

1 Any three from:

- Random
- Systematic
- Haphazard
- Block
- Monetary unit sampling

CHAPTER 14

Audit Review and Finalisation

INTRODUCTION

Related parties are a difficult area to obtain audit evidence on. The auditor must bear in mind who the evidence is from and how extensive it is. We start by looking at this in Section 1.

The remainder of this chapter will consider the reviews that take place during the completion stage of the audit, which include subsequent events and going concern. These are both important disclosure issues in the financial statements, because if the disclosures are not correct, this will impact on the auditor's report.

Financial reporting knowledge is particularly important at the review stage of the audit. Auditors need to be able to interpret accounts and understand the requirements of specific accounting standards. Analytical procedures must be used when undertaking the final review of the financial statements.

Knowledge Component			
C	**Gathering Audit Evidence**		
2.6	**Complex Issues**	2.6.1	Apply risk assessment procedures to identify risks relating to related party transactions, going concern and accounting estimates including fair value and measurement
3.6	**Complex Account Balances**	3.6.1	Design audit procedures to address complex items including accounting estimates, fair valuation, related party transactions and going concern
3.7	**Subsequent Events**	3.7.1	Outline procedures required to deal with events occurring between the date of the financial statements and the date of the auditor's report and facts that become known to the auditor after the date of the auditor's report

CHAPTER CONTENTS	LEARNING OUTCOME
1 Related party transactions	2.6.1, 3.6.1,
2 Subsequent events	3.7.1
3 Going concern	2.6.1, 3.6.1
4 Auditing accounting estimates	2.6.1, 3.6.1

1 Related party transactions

It can be a difficult to gain audit evidence about related party transactions.

1.1 Importance of related parties

A number of government investigations into companies trading with external parties have occurred because the **transactions between the two or more parties were not 'at arm's length'**.

Such transactions were made possible by a degree of control or influence exercised by directors over both parties to the transactions and the parties were therefore **related parties**. Where transactions are not on an arm's-length basis the directors can artificially change the amounts involved in order to manipulate the revenues, profits and financial position of companies; this may impact on the truth and fairness of the financial statements.

In addition, knowledge of the relationship between parties to a transaction may affect the way in which the transaction is viewed by the users of financial statements, even if it is conducted on normal commercial terms.

For both of these reasons it is important for auditors to identify any related party relationships and scrutinise transactions between the entity and those related parties.

SLAuS 550 *Related parties* covers this area.

Related party: a party that is either:

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

(b) Where the applicable financial reporting framework establishes minimal or no related party requirements:

  (i) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;

  (ii) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or

  (iii) Another entity that is under common control with the reporting entity through having:

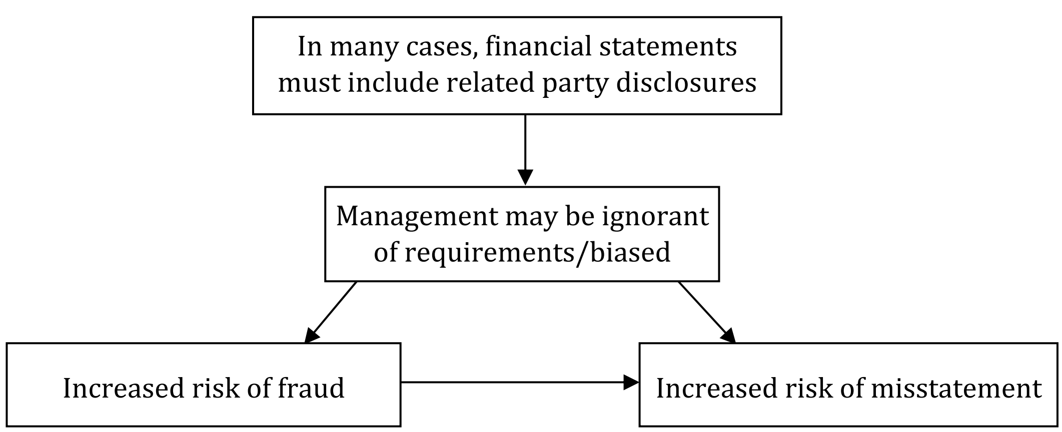
  - Common controlling ownership;
  - Owners who are close family members; or
  - Common key management.

(SLAuS 550)

Management is responsible for the identification of related party transactions. Such transactions should be properly approved as they are frequently not at arm's length. Management is also responsible for the **disclosure** of related party transactions.

It may not be self-evident to management whether a party is related. Furthermore, many accounting systems are not designed to either distinguish or summarise related party transactions, so management will have to carry out additional analysis of accounting information.

Figure 14.1: Problems of related party transactions



An audit cannot be expected to detect all material related party transactions. The risk that undisclosed related party transactions will not be detected by the auditors is especially high when:

- **Related party transactions** have **taken place without charge**.
- **Related party transactions** are **not self-evident** to the auditors.
- Transactions are with a party that the auditors could **not reasonably** be expected to **know** is a **related party**.
- **Active steps** have been taken by **management** to **conceal** either the full terms of a transaction, or that a transaction is, in substance, with a related party.
- The **corporate structure** is **complex**.

SLAuS 550.9

The objectives of the auditor are:

(a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:

(i) To recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud, and

(ii) To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:

– Achieve fair presentation (for fair presentation frameworks), or
– Are not misleading (for compliance frameworks)

(b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

1.2 Assessment and identification of risks

As part of the risk assessment procedures required by SLAuS 315, the auditor must carry out the following procedures to obtain information relevant to identifying risks associated with related parties.

- Audit team discussion of risk shall include specific consideration of susceptibility of financial statements to material misstatement through related parties and their transactions
- Auditor shall inquire of management:
  - The identity of related parties including changes from prior period
  - The nature of the relationships between the entity and its related parties
  - Whether any transactions occurred between the parties, and if so, what
  - What controls the entity has to identify, account for and disclose related party relationships and transactions
  - What controls the entity has to authorise and approve significant transactions and arrangements with related parties
  - What controls the entity has to authorise and approve significant transactions and arrangements outside the normal course of business

  (The auditor may have to perform risk assessment procedures, in addition, in respect of the latter three points.)
- Maintain alert for evidence of related party transactions when obtaining other audit evidence, in particular, when scrutinising bank and legal confirmations and minutes of meetings
- If significant transactions outside the normal course of business are discovered, enquire of management the nature of the transactions and whether related parties could be involved
- Share information obtained about related parties with the audit team.

The following procedures may be helpful:

- **Enquire of management** and the directors as to whether transactions have taken place with related parties that are required to be disclosed by the disclosure requirements which are applicable to the entity
- **Review prior-year working papers** for names of known related parties
- **Review minutes** of meetings of shareholders and directors and other relevant statutory records such as the register of directors' interests

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

If risks relating to related parties and their transactions are identified, they should be treated as **significant risks** in accordance with SLAuS 315. Also, due to the close connection between related parties and possible fraud, the auditor must consider the overlap with SLAuS 240, as well.

1.3 Responses to the risks

SLAuS 550.20

As part of the SLAuS 330 requirement that the auditor respond to assessed risks, the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions....

The audit procedures discussed above must include the following.

Table 14.1: Audit procedures – related party transactions

Further audit procedures: risk of misstatement due to related parties	
Situation	**Actions by auditor**
Auditor suspects existence of related parties not disclosed by management	Determine whether the information does confirm the existence of related parties.
Auditor identifies related parties not disclosed by management	• Tell the rest of the audit team • Request management to identify all transactions with identified related party • Enquire as to why company controls failed to identify related party • Perform substantive procedures relating to related party and its transactions with entity – Making enquiries of third parties presumed to have knowledge, such as legal counsel – Conducting an analysis of accounting records for transactions with the related party (using a CAAT?) – Verifying terms and conditions of transactions by looking at the contract • Reconsider the risk of further related parties existing and not being disclosed to the auditor • If non-disclosure appears intentional, and therefore indicative of fraud, evaluate implications for audit
Auditor identifies related party transactions outside normal course of business	• Inspect contracts/agreements and evaluate whether – The business rationale (or lack thereof) suggests a fraudulent purpose (is it overly complex, does it have unusual terms of trade, does it lack a logical business purpose?) – The terms of the transactions are consistent with management's explanations – The transactions have been accounted for and disclosed properly

Further audit procedures: risk of misstatement due to related parties	
Situation	**Actions by auditor**
Management has asserted in the financial statements that related party transactions were conducted at arm's length	• Obtain sufficient appropriate evidence that this is true by looking at the terms of the contract and assessing: – Price – Credit terms – Contingencies – Specific charges

1.4 Written representations

SLAuS 550.26

Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management, and where relevant, those charged with governance, that they have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware, and they have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

1.5 Audit conclusions and reporting

If the auditor is unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties or concludes that their disclosure in the financial statements is not adequate, the auditor should modify the auditor's opinion appropriately.

The auditor must communicate all significant matters arising during the audit in connection with the entity's related parties (unless all those charged with governance are involved in managing the entity).

Table 14.2: Problems to be anticipated when applying SLAuS 550

Problems with applying SLAuS 550	
Identification of controlling party	Auditors may find it very difficult to identify the controlling party if the entity is part of a multi-national group. If the controlling party is a trust, auditors may have problems determining who, if anyone, controls the trust. Alternatively, the directors may state that they do not know the identity of the controlling party or that there is no controlling party. These statements may be difficult to disprove.
Materiality	This problem has two aspects: (a) Auditors may not be able to determine **whether transactions** are **material** to related parties who are individuals (directors, key management and their families). (b) Auditors may have particular problems **applying** the **definition** of **materiality** (an item is material if it affects the decisions of the users of the accounts). As materiality depends on circumstances as well as amounts, auditors have to decide whether the fact that certain transactions are on normal commercial terms influences whether they are disclosed.

1.6 Transactions with directors and management

Auditors may find it difficult to obtain sufficient assurance that they have identified all disclosable transactions because of:

(a) The **low value of certain transactions**, making them difficult to detect when using normal audit procedures

(b) Any **requirements** for **disclosure of transactions** between the company and the connected persons of a director, given that it may not always be easy for the auditors to identify such connected persons

(c) The fact that there may be little or no **documentary evidence** of **transactions** requiring disclosure

The complexity of the relevant legislation may give rise to difficulties of interpretation. For example, advances of expenses or remuneration on account may constitute a disclosable loan if the monies are outstanding for a long time.

1.6.1 Company procedures

Auditors should enquire as to the company's procedures for ensuring that all disclosable transactions are properly identified and recorded. Such procedures are likely to include the following.

- **Advise** all **directors** and **officers** that they have a **responsibility** to disclose transactions in which they have an interest, either directly or through connected persons (such disclosure should take place at a meeting of the directors)
- **Record** all **transactions** notified in the minutes of directors' meetings
- **Maintain** a **register** in which details of all transactions requiring disclosure are recorded
- **Establish** some **method** of:
  - **Identifying proposed transactions** which will require the approval of the members in general meeting
  - **Ensuring** that the **company does not enter** into any **illegal transaction**
- **Monitor the system** by checking on a regular basis (as a minimum, once a year) that each director is in agreement with the company's record of his disclosable transactions and is satisfied that such records are both complete and accurate
- **Obtain** from **each director** at the end of each financial year a **formal statement** indicating the disclosures necessary for the purposes of the statutory accounts

With smaller organisations, auditors may well find that there may be no formalised procedures or that they are inadequate. Auditors should **advise each director** of his statutory responsibilities, and make a **written request** for **confirmation** of any disclosable transaction in which he has an interest.

1.6.2 Audit procedures

Further audit procedures to be adopted should include the following.

- **Inspect** the **board minutes** and other records of transactions with directors and connected persons to consider their adequacy and whether or not they appear to have been kept up to date
- **Examine** any **agreements** and **contracts** involving **directors and connected persons**, including tracing the details of such transactions to any source documentation available
- **Consider** whether **transactions** disclosed are on **commercial** terms

- **Assess** the **recoverability** of amounts due from directors or connected persons
- **Review** the **legality** of the disclosable transactions recorded by the company. Where auditors are of the opinion that a transaction is illegal, they should:
  - Immediately advise the directors of their view
  - Give careful consideration as to whether any reference to the matter will be required in the audit report
- **Advise** the **client** to **seek legal advice** in those cases where there are doubts as to the legality and/or disclosable nature of a transaction
- **Consider** the **possibility** that the **company's details** of **disclosable transactions** may be incomplete as regards those directors (and connected persons) who have not been in office throughout the year
- **Review subsequent events** in order to consider whether they might have any impact on the matters requiring disclosure

Finally, auditors should consider obtaining **written representations** from each director giving confirmation of any disclosable transaction which relates to himself and any persons connected with him.

QUESTION — Related party transactions

You are the senior in charge of the audit of AB Fernando Ltd (ABF) for the year ended 31 May 20X1. Details of AB Fernando Ltd and certain other companies are given below.

AB Fernando Ltd

A building company formed by Anishka Fernando and his brother, Baba.

AB Fernando Ltd has issued share capital of 500 ordinary shares, owned as shown below.

Anishka Fernando	210	42%	Founder and director
Baba Fernando	110	22%	Founder and director
Chandrika Fernando (Baba's wife)	100	20%	
Eromi Thennakoon	20	4%	
Arjuna Mathews	60	12%	Director

Arjuna Mathews is a local businessman and a close friend of both Anishka and Baba Fernando. He gave the brothers advice when they set up the company and remains involved through his position on the board of directors. His own company, Mathews Design Ltd, supplies AB Fernando Ltd with stationery and publicity materials.

Eromi Thennakoon is Anishka Fernando's ex-wife. She was given her shares as part of the divorce settlement and has no active involvement in the management of the company. Anishka's girlfriend, Sara Dias, is the company's solicitor. She is responsible for drawing up and reviewing all key building and other contracts, and frequently attends board meetings so that she can explain the terms of a particular contract to the directors. Her personal involvement with Anishka started in May 20X1 and, since that time, she has spent increasing amounts of time at the company's premises.

Cuts and Curls Ltd

A hairdresser, of which 50% of the issued shares are owned by Eromi Thennakoon and 50% by Gillian Fernando, who is Anishka and Eromi's daughter.

Cuts and Curls operates from premises owned by AB Fernando Ltd, for which it pays rent at the normal market rate.

Perera Fernando Roofing Ltd

A roofing company owned 60% by AB Fernando Ltd and 40% by Sunil Perera, the managing director.

Perera Fernando Roofing Ltd carries out regular work for AB Fernando Ltd and also does roofing work for local customers. Anishka Fernando is a director of Perera Fernando Roofing Ltd and Chandrika Fernando is the company secretary. All legal work is performed by Sara Dias.

Required

(a) Based on the information given above, **analyse** the potential related party transactions you expect to encounter during the audit of AB Fernando Ltd and summarise, giving your reasons, what disclosure, if any, will be required in the full statutory accounts.

(b) Design a training session for junior staff on how to identify related party transactions. Your notes should include:

 (i) An **outline** of possible features which could lead you to investigate a particular transaction to determine whether it is in fact a related party transaction; and

 (ii) A summary of the general audit procedures you would perform to ensure that all material related party transactions have been identified.

ANSWER

(a)

Person/entity	Related party	Why	Transaction
Anishka Fernando	✓	Director	No transactions mentioned
Baba Fernando	✓	Director	
Chandrika Fernando	✓	Wife of director	
Arjuna Mathews	✓	Director	Purchases of stationery
Mathews Designs	✓	Sub of director	
Eromi Thennakoon	×	No longer close family and ≥ 20%	
Sara Dias	✓	Presumed close family and shadow director	Contracts drawn
Cuts and Curls	?	(see below)	Rental agreement
Perera Fernando Roofing	✓	Sub of AB Fernando	Work done for AB (see below)
Sunil Perera	✓/×	Could be considered key management of group	

Cuts and Curls is not clear cut. For it to be a related party, Gillian Fernando would need to be in a position to control Cuts and Curls and then due to her relationship with Anishka Fernando her company would come under the related party umbrella. Gillian only holds 50% and therefore holds joint control with her mother.

Disclosure

Once a related party has been identified then LKAS 24 *Related Party Disclosures* requires disclosure of the nature of the relationship, as well as information about the transactions and outstanding balances.

Transactions with subsidiaries, that is, Perera Fernando Roofing:

Disclosure is not required of transactions which are cancelled on consolidation. However, if group accounts are not prepared due to a small/medium group exemption, material transactions between the two companies would need to be disclosed.

Disclosure should include:

(i) The amount of the transactions;

(ii) The amount of outstanding balances, including commitments, and:

(1) Their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and

(2) Details of any guarantees given or received;

(iii) Allowances for doubtful debts related to the amount of outstanding balances; and

(iv) The expense recognised during the period in respect of irrecoverable or doubtful debts due from related parties.

(b) Notes for staff training sessions:

(i) A logical place to start the audit of related party transactions would be to identify all possible related parties. This would always include

- Directors and shadow directors
- Group companies
- Pension funds of the company
- Associates

It is likely that the other related parties would include:

- Key management (perhaps identified by which staff have 'key man' cover)
- Shareholder owning > 20% of the shares
- Close relatives, associates of any of the above

A related party transaction needs to be reported if it is material either to the reporting entity or to the other party to the transaction.

Related party transactions do not necessarily have to be detrimental to the reporting entity, but those which are will be easier to find. Features which may indicate this may include:

- Unusually generous trade or settlement discounts
- Unusually generous payment terms
- Recorded in the general ledger code of any person previously identified as a related party (for example, director)
- Unusual size of transaction for customers (for example, if ABF were paying a suspiciously high legal bill for a building company)

(ii) Audit steps to find related party transactions may include:

- Identification of excessively generous credit terms by reference to aged trade accounts receivable analysis
- Identification of excessive discounts by reference to similar reports
- Scrutiny of cash book/cheque stubs for payments made to directors or officers of the company (probably more realistic for smaller entities)
- Review of Board minutes for evidence of approval of related party transactions (directors are under a fiduciary duty not to make secret profits)
- Written representations from directors to give exhaustive list of all actual/potential related parties (that is, allow us to make the materiality assessment, not them)
- Review of accounting rewards for large transactions, especially near the year end and with non-established customers/suppliers
- Identification of any persons holding > 20% of the shares in the entity by reference to the shareholders' register

2 Subsequent events

Subsequent events are events occurring between the period-end and the date of the auditor's report and also include facts discovered after the auditor's report has been issued. Auditors shall consider the effect of such events on the financial statements and on their audit opinion.

Subsequent events are events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

LKAS 10 *Events after the reporting period* deals with the treatment in the financial statements of events, both favourable and unfavourable, occurring after the period-end. There are two types of event defined by LKAS 10:

- Those that provide evidence of conditions that existed at the year-end date (**adjusting events**)
- Those that are indicative of conditions that arose after the year-end date (**non-adjusting events**)

You should be familiar with adjusting and non-adjusting events from your financial reporting studies. Here are some examples.

Table 14.3: Adjusting and non-adjusting events

Adjusting events	Non-adjusting events
Settlement of a court case	Dividends declared after the year-end
Sale of inventory after year-end providing evidence of its NRV at year-end	Fire causing destruction of major plant
Fraud or error showing the accounts are incorrect	Announcement of a major restructuring

SLAuS 560 *Subsequent events* provides guidance to auditors in this area. The objectives of the auditor are:

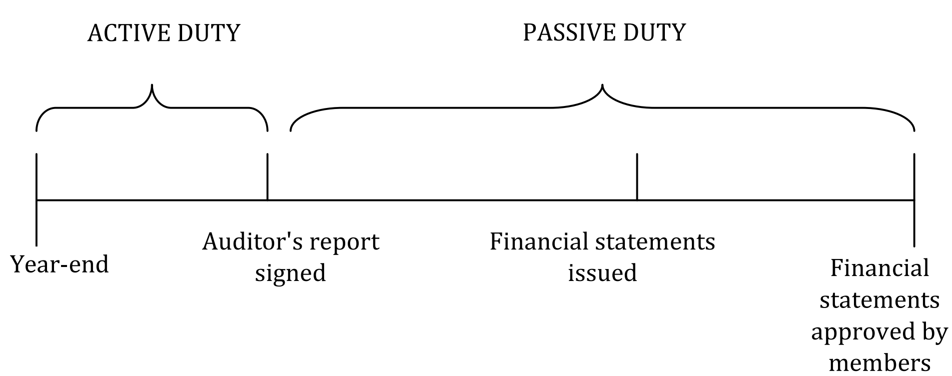
- To obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that need adjustment or disclosure in the financial statements are properly reflected in the financial statements
- To respond appropriately to facts that become known to the auditor after the date of the auditor's report that may have caused the auditor to amend the auditor's report, had they been known to the auditor at the date of the report

2.1 Procedures

Auditors have a **responsibility** to **review subsequent events** before they sign the auditor's report, and may have to take action if they become aware of subsequent events between the date they sign the auditor's report and the date the financial statements are issued.

The following timeline is helpful when considering subsequent events and the auditor's responsibilities concerning them.

Figure 14.2: Timeline of events and auditor's responsibilities



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

The auditor shall perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified.

These procedures should be applied to any matters examined during the audit which may be susceptible to change after the year-end. They are in addition to tests on specific transactions after the period end, eg cut-off tests.

SLAuS 560 lists procedures to identify subsequent events which may require adjustment or disclosure. They should be performed as near as possible to the date of the auditors' report.

Table 14.4: Audit procedures – subsequent events

Audit procedures to test subsequent events	
Enquiries of management	Status of items involving **subjective judgement.** Status of items accounted for using **preliminary or inconclusive** data. Whether there are any new **commitments, borrowings or guarantees.** Whether there have been any: • **Sales** or destruction of **assets** • **Issues** of **shares/debentures** or changes in business structure • **Developments** involving **risk areas, provisions** and **contingencies** • **Unusual accounting adjustments** • **Major events** (eg going concern problems) affecting appropriateness of accounting policies for estimates • Litigations or claims
Other procedures	**Review** management procedures for identifying subsequent events to ensure that such events are identified. **Read minutes** of general board/committee meetings and enquire about unusual items. **Review latest available interim financial statements** and budgets, cash flow forecasts and other management reports. **Obtain evidence** concerning any litigation or claims from the company's solicitors (only with client permission). Obtain **written representation** that all events occurring subsequent to the period-end which need adjustment or disclosure have been adjusted or disclosed.

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

The financial statements are the management's responsibility. They should therefore inform the auditors of any material subsequent events between the date of the auditors' report and the date the financial statements are issued. The auditor does **not** have any obligation to perform procedures, or make enquires regarding the financial statements, **after** the date of the report.

However, if the auditor becomes aware of a fact that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- **Discuss** the matter with management and those charged with governance.
- **Determine** whether the financial statements need amendment.
- If amendment is required, **enquire** how management intends to address the matter in the financial statements.

If amendment is required to the financial statements and management makes the necessary changes, the auditor must carry out a number of procedures:

- Undertake any **necessary audit procedures** on the changes made.
- **Extend audit procedures** for identifying subsequent events that may require adjustment of, or disclosure, in the financial statements to the date of the new auditor's report.
- Provide a **new auditor's report** on the amended financial statements.

If management does not amend the financial statements:

- If the auditor's report has not yet been provided to the entity, the auditor shall **modify the opinion** and then provide the auditor's report.
- If the auditor's report has already been provided to the entity, the auditor shall notify management and those charged with governance **not to issue** the financial statements before the amendments are made; but if the financial statements are issued anyway, the auditor shall take action to seek to **prevent reliance** on the auditor's report.

2.1.3 Facts discovered after the financial statements have been issued

Auditors have **no obligations** to perform procedures or make enquiries regarding the financial statements **after** they have been issued.

However, if the auditor becomes aware of a fact that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- **Discuss** the matter with management and those charged with governance.
- **Determine** whether the financial statements need amendment.
- If amendment is required, **enquire** how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall carry out any necessary procedures on the amendment and review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements is **informed**.

The auditor shall also issue a **new or amended auditor's report,** which will include an **explanatory paragraph** (known as an **emphasis of matter paragraph** or **other matter paragraph** – we discuss these further in Chapter 16) that refers to a note in the financial statements that discusses the reason for the amendment. Audit procedures will be extended up to the date of the new report.

If management does not take the necessary steps, the auditor shall **notify** management and those charged with governance that the auditor will **seek to prevent future reliance** on the report. If management still does not act, the auditor shall take appropriate action to **seek to prevent reliance** on the auditor's report.

3 Going concern

If the entity has inappropriately prepared financial statements under the going concern basis of accounting or a material uncertainty exists, this may affect the auditor's report.

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. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

The financial statements should be prepared on the going concern basis unless management either intends to liquidate the entity or has no realistic alternative but to do so. Therefore, as we discuss in Section 3.1, the going concern assumption is a fundamental principle in the preparation of the financial statements and LKAS 1 *Presentation of financial statements* therefore requires management to assess whether the entity is a going concern.

It is vital that the going concern assumption is considered as it is fundamental and pervasive to the financial statement. It affects the value of many areas of the financial statements, how account balances are presented and the financial statement disclosures.

If the going concern basis is not appropriate, the financial statements are prepared on another basis, such as the **liquidation basis**.

Using the liquidation basis is likely to result in non-current assets and liabilities being reclassified as current assets and liabilities. Asset values will need to be stated at their realisable value, as they are no longer to be used in an ongoing business. More liabilities may also arise as a result of closing down operations, and extra provisions may be necessary (for example, in respect of inventories to be sold at a reduced price). Management will also need to disclose the fact that the going concern assumption has not been used and explain why.

Since the going concern basis has such significance in the preparation of the financial statements, the going concern review is a very important part of the audit. As we will see in Section 3.5, the outcome of this review can have a direct effect on the auditor's report.

SLAuS 570 (Revised) *Going concern* provides guidance to auditors in this area. The objectives of the auditor are:

- To obtain sufficient appropriate audit evidence regarding, and conclude on, the **appropriateness** of management's use of the going concern basis of accounting in the preparation of the financial statements;
- To conclude, based on the evidence obtained, whether a **material uncertainty** exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
- To determine the **implications** for the auditor's report

SLAuS 570 includes examples of events or conditions that may cast doubt about the going concern assumption. These are sometimes referred to as **going concern indicators** and fall under three headings: 'financial', 'operating' and 'other', and are shown in the table below.

Table 14.5: Going concern indicators

Events or conditions that may cast doubt about the going concern assumption (potential indicators that an entity is not a going concern)	
Financial	• Net liability or net current liability position • Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment

Events or conditions that may cast doubt about the going concern assumption (potential indicators that an entity is not a going concern)	
	• Indications of withdrawal of financial support by creditors • Negative operating cash flows (historical or prospective) • Adverse key financial ratios • Substantial operating losses or significant deterioration in the value of assets used to generate cash flows • Arrears or discontinuance of dividends • Inability to pay creditors on due dates • Inability to comply with terms of loan agreements • Change from credit to cash-on-delivery transactions with suppliers • Inability to obtain financing for essential new product development or other essential investments
Operating	• Management intentions to liquidate or cease operations • Loss of key management without replacement • Loss of a major market, key customers, licence, or principal suppliers • Labour difficulties • Shortages of important supplies • Emergence of a highly successful competitor
Other	• Non-compliance with capital or other statutory requirements • Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy • Changes in laws/regulations/government policy expected to adversely affect the entity • Uninsured or underinsured catastrophes when they occur

3.1 Management's responsibilities for going concern

Management has specific responsibilities relating to going concern that may be set out in law or regulation and in the financial reporting framework. LKAS 1 *Presentation of financial statements* contains a specific requirement that management makes an assessment of an entity's ability to continue as a going concern.

Since general purpose financial statements are prepared on a going concern basis, the going concern basis is a **fundamental principle** in the preparation of financial statements. Therefore management's responsibility for the preparation and presentation of the financial statements also encompasses a responsibility to assess the entity's ability to continue as a going concern, even if there is no explicit requirement to do so in the financial reporting framework.

Management's assessment involves making a **judgement** about inherently uncertain future outcomes of events or conditions. This judgement is affected by the following:

- **Degree of uncertainty**, which increases the further into the future an event/condition/outcome occurs
- **Size and complexity** of the entity
- **Nature and condition** of the business
- Judgement about the future is based on **information available** at the time the judgement is made, but **subsequent events** may result in **inconsistent outcomes**

If, during their assessment, management becomes aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, then those **uncertainties must be disclosed** in the financial statements.

As discussed earlier in the chapter, if management conclude the going concern assumption is not appropriate they will need to prepare the accounts on a different basis. When this happens they must disclose the fact the going concern assumption has not been used and explain why.

This section highlights why audit work on a going concern is crucial – because of the **judgements** used by management in making its assessment of going concern.

3.2 Management's assessment

Management may have performed a **preliminary assessment** of whether the entity can continue as a going concern. If it has, the auditor shall discuss it with management. If the assessment has not been performed, the auditor shall discuss with management the basis for the intended use of the going concern assumption.

3.2.1 Auditor's responsibilities in relation to management's assessment

The auditor must **remain alert** throughout the audit for evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. However, the auditor also has specific responsibilities in relation to management's assessment.

The auditor shall **evaluate** management's assessment of the entity's ability to continue as a going concern. However, if this assessment covers less than 12 months from the date of the financial statements, the auditor shall ask management to extend its assessment period to **at least 12 months** from that date. The auditor shall also enquire of management its knowledge of events or conditions beyond the period of the assessment that may cast significant doubt on the entity's ability to continue as a going concern.

3.3 Events or conditions identified

If events or conditions are identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether a material uncertainty exists by:

- Requesting management to make its **assessment**, where this has not been done
- Evaluating management's **plans for future action**
- Evaluating the **reliability of underlying data** used to prepare a cash flow forecast and considering the **assumptions** used to make the forecast
- Considering whether any **additional facts or information** have become available since the date that management made its assessment
- Requesting **written representations** from management and those charged with governance about plans for future action and the feasibility of these plans

3.4 Audit procedures applied in performing going concern reviews

Specific audit procedures the auditor might carry out could include the following:

- **Analyse and discuss cash flow**, profit and other relevant forecasts with management
- **Analyse and discuss** the entity's latest available **interim financial statements** (or management accounts)
- **Review the terms of debentures and loan agreements** and determine whether they have been breached
- **Read minutes** of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties
- **Enquire** of the entity's lawyer regarding **litigation and claims**
- **Confirm the existence, legality and enforceability** of arrangements to provide or maintain financial support with related and third parties
- **Assess** the **financial ability** of such parties to **provide additional funds**
- **Consider the entity's position** concerning unfulfilled customer orders

- **Review events after the period-end** for items affecting the entity's ability to continue as a going concern
- Confirm the existence, terms and **adequacy of borrowing facilities**
- Obtaining and **reviewing reports of regulatory actions**
- Determining the **adequacy of support for any planned disposals** of assets

3.5 Auditor reporting

The auditor shall consider whether a **material uncertainty** exists related to events or conditions which may cast doubt on the entity's ability to continue as a going concern, as this will have an impact on the opinion issued in the auditor's report because the uncertainty must be disclosed. The following information would need to be included by management for the auditors to conclude that the disclosure is adequate:

- The main events or conditions which have created the doubt about whether the going concern basis of accounting is appropriate
- Management's plans to deal with these events or conditions
- That there is a material uncertainty that may cast significant doubt on the entity's ability to continue as a going concern
- That the entity may not be able to realise its assets and settle its liabilities in the normal course of business

The following table summarises the possible scenarios that could arise following the auditor's review of going concern. We discuss audit reporting in detail in Chapter 16, so you may wish to revisit this section again after having studied Chapter 16.

SLAuS 570 does provide example extracts in respect of the following scenarios and these are presented in the following table.

Scenario	Impact on auditor's report
1 Going concern assumption appropriate but material uncertainty which is adequately disclosed	Unmodified opinion Section headed 'Material Uncertainty Related to Going Concern'
2 Going concern assumption appropriate but material uncertainty which is not adequately disclosed	Qualified or adverse opinion (ie modified opinion)

Scenario	Impact on auditor's report
3 Use of going concern assumption inappropriate	Adverse opinion (ie modified opinion)
4 Management unwilling to make or extend its assessment	Qualified or disclaimer of opinion (ie modified opinion)

Scenario 1: Going concern assumption appropriate but material uncertainty which is adequately disclosed

In this situation, the opinion on the financial statements will be **unmodified** but the auditor's report will include a Material Uncertainty Related to Going Concern paragraph which explains the uncertainty.

Here is an example of an auditor's report where there is a **material uncertainty**, with **adequate disclosure**. The report is standard/unmodified, except for this new paragraph, placed straight after the 'Basis for Opinion' (SLAuS 570: Appendix Illustration 1):

Material Uncertainty Related to Going Concern

We draw attention to Note 6 in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Scenario 2: Going concern basis of accounting appropriate but material uncertainty which is not adequately disclosed

In this situation, as inadequate disclosure has been made of the material uncertainty, the auditor's opinion will be modified – either a qualified or adverse opinion will be issued depending on the magnitude of the uncertainty. An extract from the auditor's report where a qualified opinion is issued is provided by the SLAuS as follows.

Qualified Opinion

In our opinion, except for the incomplete disclosure of the information referred to in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements present fairly, in all material respects (or 'give a true and fair view of') the financial position of the Company as at December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

Basis for Qualified Opinion

As discussed in note YY, the Company's financing arrangements expire and amounts outstanding are payable on 19 March 20X2. The Company has been unable to conclude re-negotiations or obtain replacement financing. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not fully disclose this matter.

(SLAuS 570: Appendix Illustration 2)

Scenario 3: Use of going concern basis of accounting inappropriate

When the going concern basis of accounting has been used but this is considered inappropriate by the auditor, an adverse opinion must be issued, regardless of whether the financial statements include disclosure of the inappropriateness of management's use of the going concern basis of accounting (ISA 570: para. 21).

Scenario 4: Management unwilling to make or extend its assessment

In some circumstances, the auditor may ask management to make or extend its assessment. If management does not do this, a qualified opinion or a disclaimer of opinion may be appropriate, because it may not be possible for the auditor to obtain **sufficient appropriate audit evidence** regarding the use of the going concern basis of accounting in the preparation of the financial statements (SLAuS 570: para. 24). Examples of auditor's reports with a disclaimer of opinion are provided in Chapter 16 which looks at modifications to the auditor's opinion in detail.

3.6 Communicating to those charged with governance

The auditor shall **communicate with those charged with governance** events or conditions that may cast doubt on the entity's ability to continue as a going concern. This will include:

- Whether the events or conditions constitute a material uncertainty
- Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements
- The adequacy of related disclosures

4 Auditing accounting estimates

When auditing **accounting estimates** auditors must:

- Test the management process
- Use an independent estimate
- Review subsequent events

in order to assess whether the estimates are reasonable.

4.1 The nature of accounting estimates

SLAuS 540 *Auditing accounting estimates, including fair value accounting estimates, and related disclosures* provides guidance on the audit of accounting estimates contained in financial statements. The auditor's objective is to obtain sufficient appropriate audit evidence about whether accounting estimates are reasonable and related disclosures are adequate.

An **accounting estimate** is an approximation of a monetary amount in the absence of a precise means of measurement.

Estimation uncertainty is the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

Management's point estimate is the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

Auditor's point estimate or **auditor's range** is the amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.

Examples of accounting estimates include:

- Allowance for doubtful accounts
- Inventory obsolescence
- Warranty obligations
- Depreciation method or asset useful life
- Outcome of long-term contracts
- Costs arising from litigation settlements and judgements
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability

Some financial statement items cannot be measured precisely, only estimated. The **nature and reliability** of information available to management to support accounting estimates can vary enormously and this, therefore, affects the **degree of uncertainty** associated with accounting estimates, which in turn affects the **risk of material misstatement** of accounting estimates.

Management use its discretion when arriving at accounting estimates. Balances and transactions related to accounting estimates are, therefore, more susceptible to management bias, especially where management has an incentive to manipulate trading results (eg remuneration is linked to the profit for the year).

Unless the actual outcome of an issue that has given rise to an accounting estimate is known at the time of the audit (eg settlement has occurred post-year-end), it is often difficult for auditors to obtain conclusive evidence over the reliability of estimates.

In particular it may be difficult for an auditor to arrive at their own point estimate due to the uncertainties and assumptions involved. For example, there may be a warranty provision included in the financial statements relating to a relatively new product, for which there is little data available on the level of returns.

Even if the auditor can formulate a reasonable estimate, it will be difficult for auditors to challenge management's estimate on the basis that the auditor's point estimate is different. Management will often argue it is better placed to make estimates due to its ongoing involvement with the business and its environment. However, despite any resistance from management, the auditor has a responsibility to assess and, if necessary, challenge management's estimates.

4.2 Risk assessment procedures

SLAuS 540 states that the auditor shall obtain an understanding of the following to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

- The requirements of the applicable financial reporting framework
- How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates
- How management makes the accounting estimates and an understanding of the data on which they are based, including:
  - Method
  - Relevant controls
  - Assumptions
  - Whether change from prior period in method used
  - Whether management has assessed the effect of estimation uncertainty

The SLAuS also states that the auditor shall review the **outcome** of accounting estimates included in the **prior period**.

4.3 Risk identification and assessment

The auditor shall also evaluate the degree of **estimation uncertainty** associated with an accounting estimate. Where estimation uncertainty is assessed as high, the auditor shall determine whether these give rise to **significant risks**.

4.4 Responding to the assessed risks

The SLAuS requires the auditor to perform one or more of the following:

- Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.
- Test how management made the accounting estimate and the data on which it is based.
- Test the operating effectiveness of controls over how the accounting estimate was made.
- Develop a point estimate or a range to evaluate management's point estimate.

4.5 Substantive procedures in response to significant risks

Where the auditor judges that the accounting estimate gives rise to a significant risk, he shall evaluate the following in accordance with SLAuS 540:

- How management has considered alternative assumptions and why these have been rejected
- Whether the assumptions used are reasonable
- Management's intent to carry out specific courses of action and its ability to do so

If the auditor considers that management has not adequately addressed the effects of estimation uncertainty on accounting estimates that give rise to significant risks, he shall, if necessary, develop a **range** with which to evaluate the reasonableness of the accounting estimate.

4.6 Other audit procedures

SLAuS 540 requires the auditor to do the following:

- Evaluate whether the accounting estimates are either **reasonable or misstated**.
- Obtain sufficient appropriate audit evidence about whether **disclosures** are correct.
- For accounting estimates that give rise to significant risks, evaluate the adequacy of **disclosure of their estimation uncertainty**.
- Review the judgements and decisions of management in making the accounting estimates to identify if there are indications of **possible management bias**.
- Obtain **written representations** from management whether management believes significant assumptions used are reasonable.

CHAPTER ROUNDUP

- It can be a difficult to gain audit evidence about related party transactions.
- **Subsequent events** are events occurring between the period-end and the date of the auditor's report and also include facts discovered after the auditor's report has been issued. Auditors shall consider the effect of such events on the financial statements and on their audit opinion.
- Auditors have a **responsibility** to **review subsequent events** before they sign the auditor's report, and may have to take action if they become aware of subsequent events between the date they sign the auditor's report and the date the financial statements are issued.
- If the entity has inappropriately prepared financial statements under the going concern basis of accounting or a material uncertainty exists, this may affect the auditor's report.
- When auditing **accounting estimates** auditors must:
  - Test the management process
  - Use an independent estimate
  - Review subsequent events

  in order to assess whether the estimates are reasonable.

PROGRESS TEST

1 Give five reasons why the nature of related party relationships and transactions may give rise to increased risk.

(1) …………………………..
(2) …………………………..
(3) …………………………..
(4) …………………………..
(5) …………………………..

2 State three enquiries that should be made of management to test subsequent events.

(1) …………………………………………………
(2) …………………………………………………
(3) …………………………………………………

3 Complete the sentence using the words given below.

Under the …………………….. …………………… basis of accounting, an entity is viewed as ……………….. in business for the …………………….. …………

future	going	continuing	foreseeable	concern

4 The auditors must satisfy themselves that the use of the going concern basis in the financial statements is appropriate. True or false?

5 Complete the sentence.

An accounting estimate is an ………………………………….. of the ………………… of an item in the absence of a ……………………. ………………… of measurement.

ANSWERS TO PROGRESS TEST

1 (1) Related parties may operate through a **wide** and **complex** range of relationships and structures

(2) **Management unaware** of the existence of all related party relationships and transactions

(3) **Information systems may be ineffective** at identifying or summarising transactions and outstanding balances between an entity and its related parties

(4) Related party transactions may not be conducted under **normal market terms and conditions**.

(5) Related party relationships provide a greater opportunity for **collusion, concealment or manipulation** by management.

2 Any three from:

- What the status is of items involving subjective judgement
- Whether there are any new commitments, borrowings or guarantees
- Whether any assets have been sold or destroyed
- Whether any new shares/debentures have been issued
- Whether there have been any developments in risk areas
- Any unusual accounting adjustments
- Any major events

3 Under the **going concern** basis of accounting, an entity is viewed as **continuing** in business for the **foreseeable future**.

4 True

5 An accounting estimate is an **approximation** of the **amount** of an item in the absence of a **precise means** of measurement.

Part D - Auditing in a Digital Environment

THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

CHAPTER 15

Auditing in a Digital Environment

INTRODUCTION

In this chapter we look at the digital business environment to gain an understanding of current developments and how they may have an effect on internal controls and audit. The use of audit automation and data analytics are likely to have a major impact on the role of the auditor in the future.

Computer-assisted audit techniques (CAATs). CAATs are an important tool in the audit and we examine the two main types of CAATs, audit software and test data.

Finally, we will consider the risks around cyber security and the controls that a business should have in place to mitigate those risks.

Knowledge Component			
D	**Auditing in a Digital Environment**		
4.1	**Digital Business Environment**	4.1.1	Recognise trends in a digital business environments including Artificial Intelligence (AI), Robotic Process Automation (RPA), Block chain, digital currencies and their impacts on internal controls and audit
		4.1.2	Recognise the use of big data and analytics as business intelligence tools and potential risk associated with big data
4.2	**Audit Automation**	4.2.1	Demonstrates the use of cloud based audit working papers, audit automation tools and their limitations.
4.3	**Data Analytics**	4.3.1	Discuss the use of data analytics software including CAATs in planning and gathering audit evidence
4.4	**Cyber Security**	4.4.1	Outline controls required to mitigate cyber security risk

CHAPTER CONTENTS	LEARNING OUTCOME
1 Digital business environment	4.1.1, 4.1.2
2 Audit automation	4.2.1
3 Computer assisted audit techniques	4.3.1
4 Cyber security	4.4.1

1 Digital business environment

Digital business is revolutionising the commercial environment by reducing the distinction between businesses and processes in the digital world and the real world.

Artificial intelligence (AI) refers to machines or computers completing tasks that require human intelligence.

Robotic process automation (RPA) is the use of software to complete rules-based tasks more efficiently than is possible using manual processes.

Block chain uses 'blocks' of information with a unique code for each, to store and record information on a digital 'chain' once verified. The blockchain is recorded and distributed across a large network of computers but cannot be edited.

Digital currency uses blockchain to store transactions as a block on the digital chain. 'Currency' is created by rewarding computers that compete to successfully verify the transaction by solving an algorithm.

1.1 Current trends

Artificial intelligence (AI) is currently based on machine learning and continues to reduce the requirement for human input into verification and vouching processes. It may be that, in the future, aspects of judgement may also be adopted by AI software.

The use of Robotic process automation (RPA) in audit relates to the execution of repetitive tasks such as testing of specific transactional cycles or payroll and enables much wider testing, sometimes enabling the auditor to test 100% of transactions that have occurred. This means that RPA using data analytics can evaluate **all** transactions with precision. The auditor can then determine whether something has actually gone wrong, rather than focus on evaluating the mere risk that something might have gone wrong in the control environment.

This has the potential both to make audit much more accurate (through the identification of anomalous transactions) and to increase the expectations of the client in terms of detection of fraud and error. There is also the potential that the client firm will have access to much better internal control software, based on the same software used by the auditor. This may reduce the need for external audit and result in much more reliance on automated internal audit processes (see Section 2.1 below).

The increased complexity of these systems will result in a different risk profile in client firms being audited and increased need for assurance services related to these risks. The value in providing such engagements will come from the expertise and skill set of the audit firm.

The 'real time' nature of using blockchain technology to record transactions means that it will be possible in the future for the auditor to move towards continuous transaction monitoring (CTM), as the distributed nature of the technology means that a copy of the blockchain will be instantly available to the auditor as it is created.

1.2 Big data and data analytics

Big data is a broad term for the larger, more complex datasets that can be held by modern computers. The term refers to a qualitative shift in the amount of data that is available in comparison with the past.

Data analytics is the examination of data to try to identify patterns, trends or correlations. As the quantity of data has increased, it has become more and more necessary to evolve ways of processing and making sense of it.

It has been said that there are 3 Vs of big data: there are larger **V**olumes of data, at faster **V**elocity, with more **V**ariety.

The general idea is that having so much more data around allows a surprising number of new things to be done. One example of this is **Google Maps**, which uses 'big data' to help predict traffic flows. Google is able to process speed data obtained from people's Android smartphones to work out where traffic is moving more slowly than usual. This is then indicated on the Maps app. The whole process, then, is dependent on the collection of enormous quantities of data from smartphones; something that would not have been possible 20 years ago, before the expansion of computing and data collection.

2 Audit automation

Audit automation, through the use of data analytics, makes it possible to test 100% of transactions and improve efficiency.

Audit automation is the increased use of data analytics and automated testing to reduce human intervention in the audit process.

2.1 Revolutionising audit?

Big data has wide ranging implications for auditors. Recent advances in IT make it increasingly possible for auditors to examine a complete data set – **100% of the transactions** – and to represent trends graphically, almost instantly. Some have claimed that these techniques may bring about a **long-term revolution** in audit approaches, since they enable auditors to focus on 100% of the transactions rather than just a sample (as auditing standards assume).

This raises a question not only about sampling, but about the whole approach of placing reliance on an entity's internal controls. It is a basic assumption of the concept of an audit contained in ISAs that it is impractical to test 100% of transactions. It is because of this that the audit is conceived of a risk-management exercise, in which the auditor obtains evidence of the effectiveness of the entity's own internal controls, as a way of assessing the risk of there being a material misstatement. But if the auditor can now test 100% of the transactions, why worry about controls at all?

Even if nothing else, the auditor relying on data analytics would still have to understand the system which produced the data being analysed. The auditor would also need to understand and test how data got into the system in the first place: for example, a data set might show that a certain amount of cash has been received by an entity, but the only way you can really tell whether this is reliable is by testing the actual cash receipts. Data analytics is unlikely to help here.

It appears likely that, even if they do not eliminate controls testing *in toto*, data analytics will lead to a reconsideration of how controls are tested, particularly controls in an IT environment. Data analytics are also likely to lead to an **improvement in audit quality**, although this is of course dependant on data analytics processes being implemented intelligently.

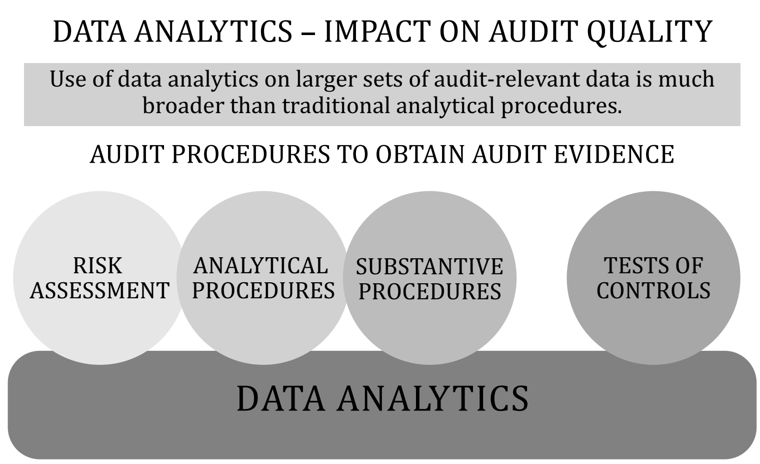
Here are some more practical examples of how data analytics might help auditors:

- Analyses of revenue trends into product or region
- Matches of orders to cash and of purchases to payments
- Three-way matches between purchase/sales orders, goods received/ despatched documentation and invoices
- Testing of user codes for appropriateness of segregation of duties is appropriate, and for whether any inappropriate combinations of users have been involved in processing transactions

2.1.1 IAASB 'Request for input': exploring the growing use of technology in the audit, with a focus on data analytics

The IAASB is considering how the increasing use of audit data analytics (ADA) may affect the development of ISAs in the future. This paper was issued in September 2016.

ADA may have a broad effect on audit, far beyond mere analytical procedures:



IAASB, 2016e: p7

The use of ADA may also help the auditor to obtain an understanding of the entity and its environment, which in turn can help improve professional scepticism (another hot topic).

There are also **limitations** to the use of audit automation through ADA (IAASB, 2016e: para. 8):

- Auditors need to have a clear understanding of the data they are analysing. There is a **risk that the data analysed is not actually relevant to the audit**.
- It should **not** be thought that if, in the future, auditors are able to test 100% of a population, the auditor's opinion could provide more than just **reasonable assurance**. It cannot, because **professional judgement** is always involved.
- Both accounting estimates and qualitative disclosures require professional judgement. ADA can be a useful aid to this, but judgement and scepticism will always be needed.
- Although technology can help obtain evidence, auditors and stakeholders should not become overconfident in technology.

Current ISAs neither encourage or stimulate the use of ADA. However, they were created before ADA came into being. Some auditors have said that they find it hard to fit ADA into the current model of ISA 500 *Audit evidence*. In relation to analysing 100% of a population, some key issues include (IAASB, 2016e: para.11):

- How this affects the identification of risks of material misstatement – can ADA help with this?
- Whether ADA can also be used to provide substantive audit evidence – are these tests of controls, tests of detail or substantive analytical procedures?
- Whether ADA has an effect on the evidence required from other audit procedures.

Challenges to the increased use of ADA include (IAASB, 2016e: para.18):

- **Data acquisition** – the auditor needs to acquire and store large amounts of the entity's data. This can pose technical difficulties.
- **Conceptual challenges** – the auditor will need to think about how to use data in ways that are different from how the entity has used it in the past.
- **Legal and regulatory challenges** – eg concerning data security.
- **Resource availability** – if ADA involves the use of centralised highly-skilled data scientists, then there may not be enough of this resource to support audit teams.
- **How regulators can maintain oversight** – regulators may not have experience of ADA, so they may find it hard to inspect audits.
- **Re-training/re-skilling auditors** – this will require significant time and investment in training.

The following issues may affect standard setting (ie **the development of ISAs**) (IAASB, 2016e: para.19):

- **General IT controls** – how much IT controls testing is needed in order to perform ADA on data extracted from that system? What happens if the system cannot be relied upon?
- **ADA may use mainly entity-produced information** – ISAs require the auditor to determine whether this information is accurate and complete, and whether it is suitable for audit purposes. What procedures should this involve for ADA?
- **Relevance/reliability of data** – the auditor cannot assume that third-party data is more reliable, since it may only be an aggregation of other data (eg from the entity itself). Does this affect the premise in current ISAs that data from outside the entity is more reliable? What should the auditor do with third-party data to ensure that it is reliable?
- **Nature of ADA evidence in risk assessment** – current ISAs state that audit evidence for risk assessment purposes is not sufficient appropriate evidence by itself, but evidence obtained from ADA at this stage could also be useful as evidence in itself.
- **Risk and response model of ISAs** – ADA may not fit into the existing categories of risk assessment, tests of controls and substantive procedures. Is there another category for ADA?
- **ADA may collapse risk and response into one step** – should ISAs be redrafted to reflect this?
- **How much work to do for exceptions that are identified** – at present, an auditor can extrapolate the effect of an error, but it is not clear what to do if 100% of a population has been tested. What should the auditor do if a high number of outliers is identified?
- **Risk measurement** – if all transactions in a particular area have been analysed, how can the auditor measure the risk of unexpected transactions/errors?
- **Documentation** – ISAs do not currently require auditors to document how items were chosen for testing – but should this change with ADA?
- **Quality control** – it is important that processes are established regarding the use of ADA. If the auditor uses a third-party ADA tool, should they have to assess its reliability?

The IAASB does not intend to make wholesale changes to ISAs in the near future, as these may have unintended consequences – particularly given that studies that seek to understand the use of ADA are currently still underway. However, the following projects may be affected by the use of ADA (IAASB, 2016e: paras. 28–38):

- Professional scepticism
- ISA 315 (Revised)
- Quality control
- Group audits
- ISA 540

3 Computer assisted audit techniques

Computer assisted audit techniques (CAATs) are the use of computers for audit work. The two most commonly used CAATs are **audit software** and **test data**.

Computer assisted audit techniques (CAATs) are the applications of auditing procedures using the computer as an audit tool.

The overall objectives and scope of an audit do not change when an audit is conducted in a computerised environment. However, the application of auditing procedures may require auditors to consider techniques that use the computer as an audit tool. These uses of the computer for audit work are known as **computer assisted audit techniques**.

CAATs may be used in performing various auditing procedures, including the following.

- **Tests of details** of transactions and balances
- **Analytical review procedures**
- **Tests of computer information system controls**

The advantages of using CAATs are:

- Auditors can test programme controls as well as general internal controls associated with computers.
- Auditors can test a greater number of items more quickly and accurately than would be the case otherwise.
- Auditors can test transactions rather than paper records of transactions that could be incorrect.
- CAATs are cost-effective in the long term if the client does not change its systems.
- Results from CAATs can be compared with results from traditional testing – if the results correlate, overall confidence is increased.

The disadvantages associated with using CAATs include:

- Setting up the software needed for CAATs can be time consuming and expensive
- Audit staff will need to be trained so they have a sufficient level of IT knowledge to apply CAATs
- Not all client systems will be compatible with the software used with CAATs
- There is a risk that live client data is corrupted and lost during the use of CAATs

The major steps to be undertaken by the auditors in the application of a CAAT are as follows.

- **Set the objective** of the CAAT application
- **Determine** the **content** and **accessibility** of the entity's files
- **Define** the **transaction types** to be tested
- **Define** the **procedures** to be performed on the data
- **Define** the **output requirements**
- **Identify** the audit and computer **personnel** who may participate in the design and application of the CAAT
- **Refine** the estimates of **costs** and **benefits**
- Ensure that the **use of the CAAT is properly controlled** and **documented**
- Arrange the **administrative activities**, including the necessary skills and computer facilities
- Execute the **CAAT application**
- **Evaluate the results**

There are two particularly common types of CAAT: **audit software** and **test data**.

3.1 Audit software

Audit software consists of computer programs used by the auditors, as part of their auditing procedures, to process data of audit significance from the entity's accounting system. It may consist of generalised audit software or custom audit software. Audit software is used for substantive procedures.

Generalised audit software allows auditors to perform tests on computer files and databases, such as reading and extracting data from a client's systems for further testing, selecting data that meets certain criteria, performing arithmetical calculations on data, facilitating audit sampling and producing documents and reports. Examples of generalised audit software are ACT and IDEA.

Custom audit software is written by auditors for specific tasks when generalised audit software cannot be used.

The following table provides some examples of the use of audit software in the course of an audit.

Table 15.1: Use of audit software

Audit software: examples of use
• Perform calculations and comparisons in analytical procedures • Sampling programs to extract data for audit testing, eg select a sample of receivables for confirmation • Scan a file to ensure that all documents in a series have been accounted for, or to search for large and unusual items • Compare data elements in different files for agreement, eg prices on sales invoices to authorised prices in master file • Re-perform calculations, eg totalling sales ledger • Prepare documents and reports, eg produce receivables' confirmation letters and monthly statements

Earlier we looked at the advantages and disadvantages of CAATs in general and, although some may be similar, we will now look specifically at the benefits of audit software along with the potential difficulties of using audit software.

Benefits of using audit software

(a) Audit software can perform calculations and comparisons more quickly than those done manually.

(b) Audit software makes it possible to test more transactions than when simply manually scanning printouts. For example, audit software may facilitate searches for exceptions, such as negative or very high quantities, when auditing inventory listings. The additional information will give the auditor increased comfort that the figure being audited is reasonably stated.

(c) Audit software may allow the actual computer files (the source files) to be tested from the originating program, rather than printouts from spool or previewed files which are dependent on other software (and therefore could contain errors or could have been tampered with following export).

(d) Using audit software is likely to be **cost-effective in the long term** if the client does not change its systems.

Difficulties of using audit software

(a) The **costs** of designing tests using audit software can be substantial, as a great deal of planning time will be needed in order to gain an in-depth understanding of the client's systems so that appropriate software can be produced.

(b) The **audit costs in general may increase,** because experienced and specially trained staff will be required to design the software, perform the testing and review the results of the testing.

(c) If errors are made in the design of the audit software, **audit time, and hence costs, can be wasted** in investigating anomalies that have arisen because of flaws in how the software was put together rather than by errors in the client's processing.

(d) If audit software has been designed to carry out procedures during live running of the client's system, there is a risk that this **disrupts** the client's systems. If the procedures are to be run when the system is not live, extra costs will be incurred by carrying out procedures to verify that the version of the system being tested is identical to that used by the client in live situations.

3.2 Test data

Test data techniques are used in conducting audit procedures by entering data (eg a sample of transactions) into an entity's computer system, and comparing the results obtained with pre-determined results. Test data is used for tests of controls.

Examples include:

(a) Test data used to test **specific controls** in computer programs such as online password and data access controls.

(b) Test transactions selected from previously processed transactions or created by the auditors to test **specific processing characteristics** of an entity's computer system. Such transactions are generally processed separately from the entity's normal processing. Test data can, for example, be used to check the controls that prevent the processing of **invalid data** by entering data with, say, a non-existent customer code or worth an unreasonable amount, or a transaction which may, if processed, break customer credit limits.

(c) Test transactions used in an **integrated test facility**. This is where a 'dummy' unit (eg a department or employee) is established, and to which test transactions are posted during the normal processing cycle.

Bearing the examples above in mind, we can see the main **benefits of using test data techniques** are:

(a) Test data provides evidence that the software or computer system used by the client is working effectively by testing the program controls; in some cases there may be no other way to test some program controls.

(b) Once the basic test data have been designed, the level of ongoing time needed and costs incurred is likely to be relatively low until the client's systems change.

However, there are some **problems with using test data**:

(a) A significant problem with test data is that any **resulting corruption of data files** has to be corrected. This is difficult with modern real-time systems, which often have built-in (and highly desirable) controls to ensure that data entered **cannot** be easily removed without leaving a mark.

(b) Test data only tests the operation of the system at a **single point of time** and therefore the results do not prove that the program was in use throughout the period under review.

(c) **Initial computer time and costs can be high** and the client may change their programs in subsequent years.

3.3 Cloud based audit working papers

Cloud based audit working papers are generated through the use of cloud based software that enables collaboration between the audit team and efficient management of working papers.

Cloud based software can be used by the auditor to manage the audit process and to generate audit working papers which are then stored safely and securely online. The cloud based nature of the software means that the audit data is always accessible and is always backed up, thereby reducing the risk of loss of data.

Real-time dashboards are available that enable audit managers to quickly assess the status of the audit and take corrective action where problems arise. The integration of up-to-date auditing standards and requirements means that compliance is made easier for the audit firm.

Cloud based systems will often have state-of-the-art security and encryption which reduces the risk of storing data in comparison with storage on local hard drives. Security systems may then be updated more regularly in response to new threats.

The accessibility of the working papers is enhanced in a cloud based system as it will be accessible in any location on any device and is usually supported by smartphones, laptop and tablets as well as desktop computers.

Other benefits of cloud based working papers include:

- Cloud based systems will often integrate easily with a wide variety of other software used by the auditor and the client.
- There is often a large capacity for file storage which can be calibrated to the requirements of the firm.
- The nature of the software enables the audit team to collaborate more effectively with easy access from anywhere in the world.

4 Cyber security

Organisations require controls to reduce the risk of cyber attacks on their systems or unauthorised access

Cyber risks are risks that arise from holding customer data, intellectual property or digital information that may be of use or value to cyber criminals.

Cyber controls are controls that an organisation should put in place to minimise cyber risk and prevent loss of data or unauthorised access.

4.1 Cyber security risk

In todays fast-moving digital environment, it is important that organisations have in place sufficient controls to mitigate the risk related to cyber attacks. Such attacks have the potential to disrupt business, cause major reputational risk, and potentially lead to legal action against the organisation.

Many of the largest attacks by cyber criminals have been aimed at organisations with large databases of customer data. Criminals use various means (outlined below) to access the database and remove the data which can then be sold or security information used to access bank accounts.

Many examples can be found of attacks of this nature, since they happen often and are frequently extremely damaging to the organisations involved. In October 2016, major Indian Banks reported that the debit card details of up to 3.2 million customers had been stolen in a malware attack on a payment gateway, leading to the requirement to replace up to 600,000 debit cards.

Whilst the risk around cyber security is high, there are controls that companies and senior managers can implement to reduce the risk.

4.2 Cyber security controls

Cyber security risks can manifest themselves in many different ways. As a result of the dynamic nature of the digital environment, the most important aspect of cyber security is to have a risk management process in place to identify and quantify the risks in the first place.

Responsibility should be allocated within the organisation for this process, which should be treated as an ongoing piece of work that continually attempts to identify the risks, assess what security measures are in place, and determine whether the measures are sufficient to mitigate the risk.

Some of the major current risks and controls that should be in place to mitigate those risks are outlined in the table below:

Cyber security risk	Control to mitigate
Ransomware and Malware Mostly delivered via email, it encrypts data and demands a ransom for its release	• Installation of anti-virus and malware protection software. • Installation of a firewall to manage inward and outward communications. • Raising awareness of staff to be wary of unusual or unsolicited email. • Regular upgrading of operating systems. • Regular updating of software. • Regular back-ups of data to revert to the unencrypted version.
Phishing/Spear phishing Contact from an apparently trustworthy source in an attempt to gain sensitive information	• Checking that spam filters are enabled on all email accounts. • Raising awareness of employees. • Adequate reporting procedures of suspicious emails.
Hacking Hackers gaining access to IT systems from outside the organisation to steal data	• All networks protected by firewalls. • All user accounts protected by passwords and user names. • Sensitive documents password protected. • Access restrictions amongst employees. • Detailed audit trail of all access to each area of the system.

Cyber security risk	Control to mitigate
Data leakage Use of smartphones and tablets to deliver threats onto the network or for theft of data	• Restrict the use of personal devices on the company network. • Ensure that all such company devices have adequate anti-virus software and are updated. • Ensure all devices have passcode locks. • Encrypt all portable devices and enable remote data wiping facility if available. • Discourage employees from using devices on third party networks such as internet in cafes etc.
Insider threat Mistaken or malicious leaking of data by employees	• Provision of mandatory training on the risk of leaks due to mistakes. • Limiting staff access to the system to the minimum required to undertake their roles. • Restrict use of portable storage devices. • Immediate removal of access for employees who leave the company.
External disks and Drives Loss of data or introduction of threats via external data storage devices	• Restrict all such devices to those owned and purchased by the company. • Restrict the use of company devices with third party computers. • Track who is using all company owned devices via a logging system and erase after use. • Scan all devices with anti-malware software each time they are connected to a company computer.

4.3 Recovery planning

It is very difficult to make any system 100% secure and as such, companies should have a plan in place to deal with a security breach a situation that leads to an inability to serve customers' needs for a period of time.

There should be procedures in place to identify at an early stage whether there is a problem and to enable preventative action to be taken. IT specialists should be made aware as soon as possible, and a contact list for those involved in addressing any issues kept updated and off site.

Consideration should be given to how business continuity would be maintained in the event of critical systems being made unavailable for a period of time, and regular back-ups made that are easily available but saved off-site.

Those who would be involved in such a situation should be trained and the plan laid out in a document with access restricted to those individuals and to the risk management team.

CHAPTER ROUNDUP

- Digital business is revolutionising the commercial environment by reducing the distinction between businesses and processes in the digital world and the real world.
- Audit automation, through the use of data analytics, makes it possible to test 100% of transactions and improve efficiency.
- Advances in **artificial intelligence**, **robotic process automation** and **blockchain** are likely to have a big impact on internal controls and the audit in the near future.
- The availability of **big data** and the use of **data analytics** have the capacity to revolutionise the audit process away from a risk focus towards a transactional approach by testing 100% of the transactions.
- **Computer assisted audit techniques (CAATs)** are the use of computers for audit work. The two most commonly used CAATs are **audit software** and **test data**.
- **Cloud based working papers** are generated by cloud based software and enable collaboration across teams and across devices.
- **Cyber security** is now a major concern to all businesses and there should be controls in place to mitigate cyber security risk.
- Organisations require controls to reduce the risk of cyber attacks on their systems or unauthorised access.

PROGRESS TEST

1 Give three examples of trends in the digital business environment that may have a significant effect on internal controls and the audit process.

(1) ……………………………………..

(2) ……………………………………..

(3) ……………………………………..

2 If the auditor is able to test 100% of the transactions using advanced data analytics then the assurance that can be provided is absolute. True or false?

3 Name two types of CAAT that are commonly used.

(1) ……………………………………..

(2) ……………………………………..

4 Outline two benefits provided by cloud based working papers and audit management software.

(1) ……………………………………..

(2) ……………………………………..

5 Which of the following controls would be best to prevent a phishing attack?

(a) Installation of anti-virus and malware protection software

(b) Raising awareness of staff to be wary of unusual or unsolicited email

(c) Restrict use of portable storage devices

ANSWERS TO PROGRESS TEST

1 Any three from:

- Artificial intelligence
- Robotic process automation
- Blockchain
- Advanced data analytics
- Big data

2 False. Due to the professional judgement involved the assurance would be reasonable only.

3 (1) Audit software
(2) Test data

4 Any two from:

- Integration with other software
- Ease of collaboration with colleagues
- Large file storage capacity

5 Raising awareness of staff to be wary of unusual or unsolicited email.

Part E - Evaluating Evidence and Audit Reporting

THE INSTITUTE OF
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CHAPTER 16

Audit Reporting

INTRODUCTION

The auditor's report is the means by which the external auditors express their opinion on the truth and fairness of a company's financial statements. It is for the benefit of the shareholders principally, but also for other users as the audit report is usually kept on public record with the filed financial statements.

Many of the contents of the auditor's report are prescribed by statute. They are also subject to professional requirements in the form of SLAuS 700 *Forming an opinion and reporting on financial statements.* The auditor's report may contain an unmodified or a modified opinion. The different types of modified opinion are considered in detail in this chapter. Sometimes it is necessary to bring matters to the user's attention without modifying the audit opinion. We will see how 'emphasis of matter' and 'other matter' paragraphs can be used to do just that.

We also look at the auditor's responsibilities and procedures to be applied in other areas which may impact on the auditor's report. These areas include other information in documents containing audited financial statements.

Knowledge Component			
E	**Evaluating Evidence and Audit Reporting**		
5.1	**Audit Report**	5.1.1	Evaluate the effects of material misstatements on audit the audit opinion
		5.1.2	Evaluate the effect of misstatements in opening balances and corresponding figures on current year audit opinion
5.2	**Key Audit Matters**	5.2.1	Explain matters to be communicated with those charged with governance
		5.4.1	Apply key audit matters (KAM) for a given scenario
5.3	**Modified Audit Report**	5.3.1	Apply modified audit opinions and going concern reporting requirements for a given scenario
5.4	**Emphasis of Matters and Other Matters (SLAuS 706)**	5.4.1	Apply emphasis of matter and other matter for a given scenario of audit reporting
5.5	**Special Purpose Audit**	5.5.1	Apply special purpose audits including audit of single financial statements/elements to a given scenario
5.6	**Other Information**	5.6.1	Explain auditor's responsibility towards other information included in documents containing audited financial statements

CHAPTER CONTENTS	LEARNING OUTCOME
1 The auditor's report	5.1.1, 5.2.1, 5.3.1, 5.4.1, 5.5.1
2 Modified opinions in the auditor's report	5.3.1
3 Other information in documents containing the auditor's report	5.6.1

1 The auditor's report

The auditor is required to produce an **auditor's report** at the end of the audit which sets out their **opinion** on the truth and fairness of the financial statements. The report contains a number of **consistent elements** so that users know the audit has been conducted according to **recognised standards**.

Auditor's reports are covered by the following SLAuSs:

- SLAuS 700 (Revised) *Forming an Opinion and Reporting on Financial Statements*
- SLAuS 701 *Communicating Key Audit Matters in the Independent Auditor's Report*
- SLAuS 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*
- SLAuS 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

These SLAuSs were revised in 2017, bringing Sri Lanka auditor reporting in line with the latest IAASB standards. The IAASB believes that the revisions are essential to the continued relevance of the audit profession globally. The aims of the revisions were to respond to users, who said that:

- The audit opinion is valued, but could be more informative
- More relevant information is needed about the entity and the audit

(IAASB, 2016)

The main response was to include **key audit matters** in the middle of the auditor's report. The audit opinion is placed at the start of the report, and there is a more detailed description of the auditor's responsibilities and of the key features of an audit.

SLAuS 700 *Forming an opinion and reporting on financial statements* establishes standards and provides guidance on the form and content of the auditor's report issued as a result of an audit performed by an independent auditor on the financial statements of an entity. It states that the auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the **applicable financial reporting framework** (Sri Lanka accounting standards).

In order to form the opinion, the auditor needs to conclude as to whether reasonable assurance has been obtained that the financial statements are free from material misstatement. The auditor's conclusion needs to consider the following.

- Whether **sufficient appropriate audit evidence** has been obtained (SLAuS 330)
- Whether **uncorrected misstatements are material** (SLAuS 450)
- **Qualitative aspects of the entity's accounting practices**, including indicators of **possible bias** in management's judgements
- Whether the financial statements **adequately disclose the significant accounting policies selected and applied**
- Whether the accounting policies selected and applied are **consistent** with the applicable financial reporting framework and are **appropriate**
- Whether **accounting estimates** made by management are **reasonable**
- Whether **the information** in the financial statements is **relevant, reliable, comparable and understandable**
- Whether the financial statements provide **adequate disclosures** to allow users to understand the effect of material transactions and events on the information presented in the financial statements
- Whether the **terminology** used in the financial statements is **appropriate**
- The **overall presentation, structure and content** of the financial statements
- Whether the financial statements represent the underlying transactions and events so as to achieve **fair presentation**
- Whether the financial statements **adequately refer to or describe the applicable financial reporting framework**

1.1 Unmodified opinions in the auditor's report

An **unmodified opinion** is the opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

SLAuS 700 states that the auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

If the auditor concludes that the financial statements as a whole are not free from material misstatement or cannot obtain sufficient appropriate audit evidence to make this conclusion, the auditor must modify the opinion in accordance with SLAuS 705 *Modifications to the opinion in the independent auditor's report*. We discuss modifications to the opinion later in this chapter.

The following extract from an audit report shows an example of the opinion paragraph for an unmodified report, in accordance with SLAuS 700, which contains illustrations of unmodified auditors' reports in its appendix. The full unmodified report was also set out in Chapter 1 of this Study Text.

Figure 16.1: Extract from auditor's report – unmodified opinion

> In our opinion, the financial statements present fairly, in all material respects, [or *give a true and fair view of*] the financial position of ABC Company as of December 31, 20X1, and [*of*] its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

1.2 Basic elements of the auditor's report

A measure of **consistency** in the form and content of the auditor's report is desirable because it **promotes credibility** in the global marketplace and also helps to promote the **reader's understanding** of the report and to **identify unusual circumstances** when they occur.

The auditor's report must be **in writing** and includes the following basic elements, usually in the following layout.

Table 16.1: Elements of the auditor's report

Basic elements of audit report	Explanation
Title	The auditor's report must have a title that clearly indicates that it is the report of the independent auditor. This signifies that the auditor has met all the ethical requirements concerning independence and therefore distinguishes the auditor's report from other reports.
Addressee	The addressee will be determined by law or regulation, but is likely to be the shareholders or those charged with governance.
Opinion section	The opinion section must identify the entity being audited, state that the financial statements have been audited, identify the title of each statement that comprises the financial statements being audited, refer to the summary of significant accounting policies and other explanatory notes, and specify the date or period covered by each statement comprising the financial statements. If the auditor expresses an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the opinion shall use one of the following equivalent phrases: • The financial statements present fairly, in all material respects, …in accordance with [the applicable financial reporting framework]; or • The financial statements give a true and fair view of … in accordance with [the applicable financial reporting framework].
Basis for opinion	The basis for opinion section must state that the audit was conducted in accordance with the SLAuSs, and refer to the 'Auditor's responsibilities for the audit of the financial statements' section which describes the auditor's responsibilities under the SLAuSs. The auditor must also state that they are independent of the audited entity, in accordance with the relevant ethical requirements relating to the audit. Finally, the auditor must state that they believe the audit evidence obtained is sufficient and appropriate to provide a basis for the audit opinion.

Basic elements of audit report	Explanation
Going concern	Where the auditor considers a material uncertainty related to going concern exists, this should be described in a separate section headed 'Material uncertainty related to going concern'.
Key audit matters	For the audit of listed entities, or where required by law or regulation, the auditor should include a 'Key audit matters' section. This section describes the matters that, in the auditor's professional judgement, are most significant to the audit. (See section below.)
Other information	For the audit of listed entities or any other entity where the auditor has obtained other information, an 'Other information' section should be included in the auditor's report. This section should include: • A statement that management is responsible for the other information; • An identification of the other information obtained before the date of the auditor's report (for listed entities, also the other information expected to be obtained after the date of the auditor's report); • A statement that the auditor's opinion does not cover the other information; • A description of the auditor's responsibilities for reading, considering and reporting on other information; and • Where other information has been obtained, either a statement that the auditor has nothing to report, or a description of any uncorrected material misstatement.
Responsibilities for the financial statements	This part of the report describes the responsibilities of those who are responsible for the preparation of the financial statements. This section should describe management's responsibility including the following: • The preparation of the financial statements in accordance with the applicable financial reporting framework; • The implementation of such internal control as are necessary to enable the preparation of financial statements that are free from material misstatement, whether due to error or fraud. • The assessment of the entity's ability to continue as a going concern, the appropriateness of the going concern basis of accounting and adequacy of related disclosures;

Basic elements of audit report	Explanation
	Reference shall be made to 'the preparation and fair presentation of these financial statements' (or 'the preparation of financial statements that give a true and fair view') where the financial statements are prepared in accordance with a fair presentation framework.
Auditor's responsibilities for the audit of the financial statements	The report must state that: • The auditor's objectives are to obtain **reasonable assurance** whether the financial statements as a whole are free from material misstatement, and to **issue an auditor's report** that includes the auditor's opinion; and • Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with the SLAuSs will always detect a material misstatement when it exists. The report must also: • Explain that misstatements can arise from fraud or error • Describe the meaning of materiality • Explain that the auditor exercises professional judgement and maintains professional scepticism throughout the audit • Describe the auditor's responsibilities in an audit. The description of the auditor's responsibilities must either be set out in the body of the auditor's report, in an appendix to the auditor's report or by including a specific reference in the body of the auditor's report to such a description on the website of an appropriate authority, where this is permitted by law and regulation.
Other reporting responsibilities	If the auditor is required by law to report on any other matters, this must be done in an additional section entitled 'Report on other legal and regulatory requirements' or otherwise as appropriate.
Membership number of the engagement partner	The CASL membership number of the engagement partner should be disclosed for PLCs.

Basic elements of audit report	Explanation
Auditor's address	The location where the auditor practises must be included.
Date of the report	The report must be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements.

1.3 Auditor's reports on general purpose and special purpose financial statements

The guidance set out in SLAuS 700 described above is in relation to audit reports on financial statements prepared in accordance with a **general purpose framework**. These are often referred to generically as general purpose audit reports.

A **general purpose framework** is a financial reporting framework designed to meet the needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework. (SLAuS 700)

In Sri Lanka, Sri Lanka Accounting Standards make up the general purpose framework on which financial statements are based and are a **fair presentation framework.**

A **fair presentation framework** is one that requires compliance with the requirements of the framework and:

(a) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or

(b) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in rare circumstances. (SLAuS 700)

A fair presentation framework can be contrasted with a **compliance framework** that requires compliance with the requirements without permitting the departures above. Compliance frameworks are therefore less flexible than fair presentation frameworks.

For your AAA assessment, you will be mostly concerned with general purpose financial statements prepared in accordance with Sri Lanka Accounting Standards and the audit issues arising from them.

However, you should note that sometimes financial statements are prepared to meet the specific needs of users and in accordance with a special purpose (rather than general purpose) framework. There is a separate auditing standard that deals with special considerations when auditing these financial statements – SLAuS 800 *Special considerations – Audits of financial statements prepared in accordance with special purpose frameworks.*

SLAuS 800 defines a special purpose framework as follows.

A **special purpose framework** is a financial reporting framework designed to meet the needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework. (SLAuS 800)

The special considerations discussed in SLAuS 800 revolve around understanding the purpose of the financial statements, the needs of the intended users and assessing whether the financial reporting framework is acceptable.

1.3.1 Special purpose auditor's report

When preparing an audit report on financial statements, prepared in accordance with a special purpose framework, the provisions of SLAuS 700 must be followed. In accordance with SLAuS 800, however, the following additional information must also be included:

- A description of the purpose for which the financial statements are prepared and, if necessary, the intended users. If the notes to the special purpose financial statements already include this information, then the audit report will refer to the note instead.
- If management has a choice of financial reporting frameworks, the section of the audit report which includes an explanation of management's responsibility for the financial statements must also make reference to its responsibility for determining that the applicable financial reporting framework is acceptable.
- An emphasis of matter paragraph, alerting users of the audit report to the fact that the financial statements are prepared in accordance with a special purpose framework and, as a result, may not be suitable for other purposes.

1.4 Key audit matters

SLAuS 701 *Communicating Key Audit Matters in the Independent Auditor's Report report* sets out the auditor's responsibility to communicate key audit matters (KAMs).

Key audit matters are 'those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance'.

Reporting on KAMs aims to improve **transparency** by helping users to understand the most significant issues the auditor faced. This should enhance the **communicative value** of the auditor's report.

KAMs are part of every listed company auditor's report, and can be included by other auditors if needed **KAMs do not constitute a modification of the report** or of the opinion. They are a part of the standard report which must be tailored to each company's circumstances. KAMs are not a substitute for disclosures, for EoM/OM paragraphs, nor for modified opinions. Matters which the auditor may determine to be KAMs include:

- Areas of **higher risk** of material misstatement, or 'significant risks' identified in line with SLAuS 315 (eg at the planning stage)
- **Significant judgements** in relation to areas where management made judgements
- The effect of **significant events or transactions**

The key part of the definition of KAMs above is that these are the **most significant matters**. Identifying the most significant matters involves using the auditor's **professional judgement**.

Other factors to consider when determining KAMs include:

- The importance of the matter to intended **users' understanding**, including **materiality**
- The nature of the underlying accounting policy relating to the matter or the **complexity** or **subjectivity** involved
- Any **misstatements** related to the matter
- The nature and extent of **audit effort** needed to address the matter
- The nature and severity of **difficulties** in applying audit procedures, obtaining evidence or forming conclusions, including **more subjective judgements**
- The severity of any **control deficiencies**

- Whether **several separate issues** interacted, eg if a long-term contract had repercussions in several areas (revenue recognition, litigation or contingencies).

KAMs are communicated in a separate paragraph of the auditor's report. The description of each KAM says **two main things**:

SLAuS 701

The description of each key audit matter in the Key Audit Matters section of the auditor's report shall include a reference to the related disclosure(s), if any, in the financial statements and shall address:

(a) Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter; and

(b) How the matter was addressed in the audit.

Here is an example of how KAMs could appear, taken from the IAASB's guidance publication *Auditor Reporting – Illustrative Key Audit Matters*:

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Goodwill

Under SLAuSs, the Group is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the balance of XX as of December 31, 20X1 is material to the financial statements. In addition, management's assessment process is complex and highly judgmental and is based on assumptions, specifically [describe certain assumptions], which are affected by expected future market or economic conditions, particularly those in [name of country or geographic area].

Our audit procedures included, among others, using a valuation expert to assist us in evaluating the assumptions and methodologies used by the Group, in particular those relating to the forecasted revenue growth and profit margins for [name of business line]. We also focused on the adequacy of the Group's disclosures about those assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill.

The Company's disclosures about goodwill are included in Note 3, which specifically explains that small changes in the key assumptions used could give rise to an impairment of the goodwill balance in the future.

Revenue Recognition

The amount of revenue and profit recognised in the year on the sale of [name of product] and aftermarket services is dependent on the appropriate assessment of whether or not each long-term aftermarket contract for services is linked to or separate from the contract for sale of [name of product]. As the commercial arrangements can be complex, significant judgment is applied in selecting the accounting basis in each case. In our view, revenue recognition is significant to our audit as the Group might inappropriately account for sales of [name of product] and long-term service agreements as a single arrangement for accounting purposes and this would usually lead to revenue and profit being recognised too early because the margin in the long-term service agreement is usually higher than the margin in the [name of product] sale agreement.

Our audit procedures to address the risk of material misstatement relating to revenue recognition, which was considered to be a significant risk, included:

- Testing of controls, assisted by our own IT specialists, including, among others, those over: input of individual advertising campaigns' terms and pricing; comparison of those terms and pricing data against the related overarching contracts with advertising agencies; and linkage to viewer data; and
- Detailed analysis of revenue and the timing of its recognition based on expectations derived from our industry knowledge and external market data, following up variances from our expectations.

1.4.1 Relationship with the auditor's opinion

The KAMs are the key matters for the audit of the whole financial statements. They are **not** separate auditor's opinions for each part of the financial statements, but merely further information on the process that led up to the opinion on the financial statements as a whole. Likewise, the auditor's opinion refers to the financial statements as a whole: as a whole they might give a true and fair view, or as a whole they might be true and fair 'except for' one area (and so on).

If a **modified opinion** is expressed, the matter that gives rise to the modified opinion will be described in the 'basis for modified opinion' paragraph, so it **must not be included as a KAM** (although the KAM section will include a reference to the 'basis for modified opinion paragraph) SLAuS 701 emphasises this:

> 'The auditor shall not communicate a matter in the Key Audit Matters section of the auditor's report when the auditor would be required to modify the opinion in accordance with SLAuS 705 (Revised) as a result of the matter.'

Note that where the auditor **disclaims an opinion** on the financial statements, a Key Audit Matters section must not be included in the auditor's report.

SLAuS 701 also makes special mention of **going concern** problems, which we have covered previously. Where there is a material uncertainty in relation to going concern, this is described in the 'Material uncertainty related to going concern' section. **Going concern issues should not be included as a KAM** (although the KAM section will include a reference to the 'Material uncertainty related to going concern section).

1.4.2 Relationship with Emphasis of Matter (EoM) and Other Matter (OM) paragraphs

There is potentially some degree of overlap between matters which could be disclosed as KAMs or in an EoM paragraph. Where SLAuS 701 applies, SLAuS 706 states that the use of an EoM is not a substitute for a description of individual key audit matters. In other words if the matter meets the definition of a KAM it should be disclosed as such. Where a KAM is also judged to be fundamental to the users' understanding of the financial statements the auditor may wish to highlight its relative importance. This could be done, for example, by presenting the matter as the first matter in the KAM section. If a matter is not determined to be a KAM but is fundamental to the users' understanding and the auditor wishes to draw attention to the matter it should be disclosed in the EoM paragraph.

A similar principle applies to the potential overlap between matters that may be included as 'Other Matters'. SLAuS 706 states that the matter must be included in an 'Other Matter' paragraph provided, where SLAuS 701 applies, the matter has not been determined to be a KAM.

1.5 Emphasis of matter paragraphs and other matter paragraphs in the auditor's report

Emphasis of matter paragraphs and **other matter paragraphs** can be included in the auditor's report under certain circumstances. Their use does not modify the auditor's opinion on the financial statements

SLAuS 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* provides guidance to auditors on the inclusion of paragraphs in the auditor's report that either draw users' attention to a matter that is of such importance that it is fundamental to their understanding or that is relevant to their understanding of the audit, the auditor's responsibilities or the auditor's report**.**

1.5.1 Emphasis of matter paragraphs

An **emphasis of matter paragraph** is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements.

Emphasis of matter paragraphs are used to draw readers' attention to a matter **already presented or disclosed** in the financial statements that the auditor feels is **fundamental** to their understanding, provided that the auditor has obtained sufficient appropriate audit evidence that the matter is **not materially misstated**.

Note that an emphasis of matter paragraph is **not used** when the issue has been covered as a **key audit matter**.

SLAuS 706 (Revised) calls on the auditor to exercise judgement in deciding where to place the emphasis of matter paragraph in the auditor's report. This decision depends on the nature of the information to be communicated in the emphasis of matter paragraph, and the relative significance of this information to the intended users of the financial statements.

Where there is a Key Audit Matters section, the emphasis of matter paragraph can come either before or after the KAMs, depending on how significant the matters discussed is.

The paragraph must contain a **clear reference** to the matter being emphasised and to where relevant disclosures that fully describe it can be found in the financial statements. The paragraph must state that **the auditor's opinion is not modified** in respect of the matter emphasised. In addition, the paragraph must clearly state that the audit opinion is not modified.

The following are examples of situations in which the auditor might include an emphasis of matter paragraph in the auditor's report.

- An uncertainty relating to the future outcome of **exceptional litigation or regulatory action**
- A significant subsequent event which occurs between the date of the financial statements and the date of the auditor's report
- **Early application of a new accounting standard** that has a **pervasive effect** on the financial statements
- A **major catastrophe** that has had, or continues to have, **a significant effect** on the entity's financial position

SLAuS 706 (Appendix 3) contains an example auditor's report that contains an emphasis of matter paragraph, relevant extracts of which are shown below.

Emphasis of Matter

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

1.5.2 Other matter paragraphs

An **other matter paragraph** is a paragraph included in the auditor's report that refers to a matter **other than those presented or disclosed** in the financial statements that, in the auditor's judgement, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Other matter paragraphs are used where the auditor considers it necessary to draw readers' attention to a matter that is relevant to their understanding of the audit, the auditor's responsibilities or the auditor's report.

The other matter paragraph can be used whenever the auditor judges the matter to be relevant to users' understanding of the audit. Examples include:

- The auditor is unable to withdraw from the engagement and yet is unable to obtain sufficient appropriate audit evidence;
- The auditor has been requested to report on other matters or to provide more clarifications in line with the legal jurisdiction of the country.

An other matter paragraph must not refer to something that has been included as a key audit matter.

The following is an example of an other matter paragraph, taken from the appendix to SLAuS 710.

Other Matter

The financial statements of ABC Company for the year ended December 31, 20X0, were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X1.

Again, the auditor must exercise judgement in deciding where to place the other matter paragraph. SLAuS 706 states:

(a) When an 'Other Matter' paragraph is included to draw users' attention to a matter relating to Other Reporting Responsibilities addressed in the auditor's report, the paragraph may be included in the Report on Other Legal and Regulatory Requirements section.

(b) When relevant to all the auditor's responsibilities or users' understanding of the auditor's report, the 'Other Matter' paragraph may be included as a separate section following the Report on the Audit of the Financial Statements and the Report on Other Legal and Regulatory Requirements.

The content of the other matter paragraph must reflect clearly that the other matter is not required to be presented and disclosed in the financial statements, and does not include information that the auditor is prohibited from providing by law and regulations or other standards, or information that is required to be provided by management.

1.5.3 Communication with those charged with governance

SLAuS 706 states that when the auditor expects to include an emphasis of matter paragraph or an other matter paragraph, the auditor must communicate with those charged with governance the circumstances and the proposed wording of the paragraph in the auditor's report.

QUESTION **Audit report implications**

You are the auditor of Angalis Plc and are completing the audit work for the year ended 31 December 20X9. The following items have come to your attention:

Angalis is a manufacturer of steel framework for large construction projects and imports the raw steel from China. In order to provide certainty of cashflows, Angalis enters into forward purchase contracts. These are unquoted and their valuation is undertaken by the recently established treasury department which is relatively inexperienced in such valuations.

One week after the year-end there was a major fire in a warehouse containing a significant amount of completed inventory ready for shipping to customers. This is likely to have a significant impact on the financial position of Angalis, as although it is insured, there will be significant disruption to customers who are reliant on the products to complete construction on their projects. Angalis have disclosed the nature and potential financial effect of the fire in a note to the financial statements.

In the current year Angalis has implemented a new accounting standard as required under SLFRS; this has been correctly disclosed and accounted for.

In the next 6 months, Angalis has several loans which are up for renewal amounting to 30% of their capital structure. The directors are confident that these loans will be renewed so have not disclosed this information, but trading conditions have deteriorated in the weeks since the year-end date and there now is potential for the banks involved to revoke the finance.

Required

Discuss whether reference will be made to any of the items described above in the audit report for the year ended 31 December 20X9 and, if so, in which section it will appear.

ANSWER

Forward contracts

The use of the unquoted forward contracts would amount to an area of significant risk which is increased by the fact that it is the relatively inexperienced members of the newly established treasury department who are estimating the value of the contracts. As such this should be included as a Key Audit Matter and the auditor should explain how the auditor determined that it is a significant matter and how it was addressed in the audit.

Fire in warehouse

The fire in the warehouse is a non-adjusting event under LKAS 10 and as such the nature and effect should be disclosed in a note to the financial statements. This has been done by management so there is no material misstatement. However, the major financial affect that this is likely to have means that the auditor may well decide to include an Emphasis of Matter paragraph to draw the attention of the users to the disclosure note where management have described the event. Alternatively, the auditor may decide that this is a Key Audit Matter, however the one-off nature of the event would suggest that an Emphasis of Matter paragraph would be appropriate (note that the matter should be included in one or the other, not both sections).

New accounting standard

The application of a new accounting standard should be included as a Key Audit Matter in the audit report as this is an area of complexity and will have been addressed specifically as a significant matter during the audit.

Loans to be renewed

The potential non-renewal of the loans that make up 30% of the capital structure is a material uncertainty around going concern and should be disclosed by management as such. The auditor should ask management to disclose this information in a note to the financial statements. If management refuse this will lead to a modification of the audit opinion with a qualified or adverse opinion (see below).

If management correctly and adequately disclose the material uncertainty in the financial statements, then the auditor will draw the attention of the users to the note in a going concern paragraph in the audit report.

2 Modified opinions in the auditor's reports

There are three types of **modified opinion**: a **qualified opinion**, an **adverse opinion**, and a **disclaimer of opinion**.

SLAuS 705 *Modifications to the opinion in the independent auditor's report* sets out the different types of modified opinions that can result. It identifies three possible types of modifications:

- A **qualified** opinion
- An **adverse** opinion
- A **disclaimer** of opinion

2.1 Types of modifications

Pervasiveness is a term used to describe the effects or possible effects on the financial statements of misstatements or undetected misstatements (due to an inability to obtain sufficient appropriate audit evidence). There are three types of pervasive effect:

- Those that are not confined to specific elements, accounts or items in the financial statements
- Those that are confined to specific elements, accounts or items in the financial statements and represent or could represent a substantial portion of the financial statements
- Those that relate to disclosures which are fundamental to users' understanding of the financial statements

The type of modification issued depends on the following:

- The **nature of the matter** giving rise to the modifications (ie whether the financial statements **are materially misstated**, or whether they **may be misstated** when the auditor cannot obtain sufficient appropriate audit evidence)
- The auditor's judgement about the **pervasiveness** of the effects/possible effects of the matter on the financial statements

A modified opinion is required when:

- The auditor concludes that the financial statements as a whole are not free from material misstatements; or
- The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

2.1.1 Pervasiveness

When considering whether a matter is pervasive we have seen, in the definition in Section 2.1, that there are three tests as to whether a material misstatement is pervasive:

(1) **Material misstatements or omissions are not confined to specific elements, accounts or items in the financial statements**

This is where multiple account areas are impacted by the misstatement. An example may be where the results and assets of a division of a company have not been included in the financial statements, resulting in understatement of assets, liabilities, revenues, costs and profit.

(2) **A material misstatement (or misstatements) only impacts on one area of the financial statements but represents (or could represent) a substantial proportion of the financial statements**

This is where the misstatement of the area of the financial statement affected is very material and therefore has a significant impact on users, despite being confined to one element. For example, imagine a company owning investment property. The key balance a shareholder will consider will be the value of the property shown on the statement of financial position. If there is a material misstatement such that that the property is shown at, for example, double its true value as required by Sri Lanka Accounting Standards – this misstatement would be pervasive.

(3) **Material misstatements or omissions relate to disclosures which are fundamental to users' understanding of the financial statements**

The most common example of this is where disclosures in relation to going concern are misleading or missing. Such disclosures can be essential to the users' understanding, when the going concern basis is threatened.

2.2 Qualified opinions

A qualified opinion must be expressed in the auditor's report in the following two situations:

(1) The auditor concludes that misstatements are material, but not pervasive, to the financial statements.

Material misstatements could arise in respect of:

- The appropriateness of selected accounting policies (for example, selecting a revenue recognition policy not in accordance with SLFRS 15).
- The application of selected accounting policies (for example, inventory that should be stated at the lower of cost and net realisable value (NRV) per the accounting policy has all been valued at cost despite NRV being lower for some lines of inventory).
- The appropriateness or adequacy of disclosures in the financial statements (for example, going concern disclosures are inadequate where there is a material uncertainty over the entity's ability to continue as a going concern).

(2) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion but concludes that the possible effects of undetected misstatements, if any, could be material but not pervasive.

The auditor's inability to obtain sufficient appropriate audit evidence is also referred to as a limitation on the scope of the audit, and could arise from:

- Circumstances beyond the entity's control (eg accounting records destroyed)
- Circumstances relating to the nature or timing of the auditor's work (eg the timing of the auditor's appointment prevents the observation of the physical inventory count)
- Limitations imposed by management (eg management prevents the auditor from requesting external confirmation of specific account balances)

2.3 Adverse opinions

An adverse opinion is expressed when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements are both **material and pervasive** to the financial statements. The table below gives one example of why an adverse opinion might be expressed for each of the three possible reasons for misstatements being determined as pervasive.

Table 16.2: Adverse opinions, and reasons for them

Reason deemed pervasive	Example
Misstatements are not confined to specific elements, accounts or items in the financial statements	No depreciation has been provided on plant and equipment, a receivable balance consisting half of total receivables is irrecoverable and has not been provided and trade payables have been significantly understated. All misstatements are material and these balances are significant on the statement of financial position.
Misstatements are confined to specific elements, accounts or items in the financial statements and represent a substantial portion of the financial statements	A house building company has included all the houses it has constructed in the year as non-current assets rather than inventory. The value of these houses constitutes 90% of the total asset value on the statement of financial position.
Misstatements relate to disclosures which are fundamental to users' understanding of the financial statements	There is a material uncertainty in respect of going concern which has not been adequately disclosed.

Sometimes it is easier to think in more general terms when deciding whether an adverse opinion is warranted (apart from specific instances where reasons for adverse opinions are specified by SLAuSs, such as in relation to going concern).

The question to ask yourself is this: 'Am I significantly diverted from the real financial position of the company as a result of the misstatement(s)?'

In the house builder example above, the accounts presented would suggest that the company was holding no property for sale but had significant company property that was being utilised by the business. The effects of the misstatement are clearly pervasive.

2.4 Disclaimers of opinion

An opinion must be disclaimed when the auditor **is unable to obtain sufficient appropriate audit evidence** on which to base the opinion and concludes that the **possible effects** on the financial statements of undetected misstatements, if any, **could be both material and pervasive**.

The opinion must also be disclaimed in situations involving **multiple uncertainties** when the auditor concludes that, despite having obtained sufficient appropriate audit evidence for the individual uncertainties, it is not possible to form an opinion on the financial statements due to the **potential interaction of the uncertainties and their possible cumulative effect** on the financial statements.

One example of when a disclaimer of opinion is used was given in Chapter 14 where, in relation to going concern, management is unwilling to make or extend its assessment. Another example might be where the auditor is unable to attend the inventory count and unable to request receivable confirmations, and there is no other realistic means of gathering evidence on these two areas. If these two areas form a significant element of the total assets value, a disclaimer may be appropriate.

2.5 Impact on the auditor's report

When the auditor has had to modify the auditor's opinion, the auditor's report must include a paragraph after the opinion paragraph, which provides a description of the matter giving rise to the modification. This paragraph will be entitled 'Basis for qualified opinion' or 'Basis for adverse opinion' or 'Basis for disclaimer of opinion' depending on the type of modification

The section of the auditor's report containing the opinion will be headed either 'Qualified opinion', 'Adverse opinion' or 'Disclaimer of opinion', again depending on the type of modification.

When the auditor expresses a qualified or adverse opinion, the section of the report on the auditor's responsibilities must be amended to state that the auditor believes that the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion.

When the auditor disclaims an opinion due to being unable to obtain sufficient appropriate audit evidence, the section on the auditor's responsibilities must be amended to include the following 'Because of the matter(s)' described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.'

We will now look at some examples of extracts from auditors' reports with modified opinions for each of the situations we have discussed above.

e.g.

Example 1: Qualified opinion due to material misstatement

In this example, inventories are materially misstated but the effect is not pervasive.

Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of ABC Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

Basis for qualified opinion

The company's inventories are carried in the statement of financial position at xxx. Management has not stated inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from Sri Lanka Accounting Standards. The company's records indicate that, had management stated the inventories at the lower of cost and net realisable value, an amount of xxx would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

We conducted our audit in accordance with Sri Lanka Auditing Standards. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Group in accordance with the Code of Ethics issued by CA Sri Lanka (CA Sri Lanka Code), and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

e.g.

Example 2: Adverse opinion due to material misstatement with a pervasive effect

This example is an adverse opinion due to a pervasive material misstatement in the consolidated financial statements.

Adverse Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements do not present fairly (or do not give a true and fair view of) the consolidated financial position of the Group as at December 31, 20X1, and (of) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

Basis for adverse opinion

As explained in Note X, the Group has not consolidated subsidiary XYZ Company that the Group acquired during 20X1 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under Sri Lanka Accounting Standards, the Company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

We conducted our audit in accordance with Sri Lanka Auditing Standards. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of the Group in accordance with the Code of Ethics issued by CA Sri Lanka (CA Sri Lanka Code), and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

Example 3: Qualified opinion due to inability to obtain sufficient appropriate audit evidence

In this example, the inventory count was not attended by the auditor, but, in the context of the financial statements, even though inventory could be materially misstated (which the auditor cannot conclude on – so the phrase 'possible effects' is used), the effects would not be pervasive.

Qualified Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying consolidated financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of the Group as at December 31, 20X1, and (of) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

Basis for qualified opinion

With respect to inventory having a carrying amount of $X the audit evidence available to us was limited because we did not observe the counting of the physical inventory as at 31 December 20X1, since that date was prior to our appointment as auditor of the company. Owing to the nature of the company's records, we were unable to obtain sufficient appropriate audit evidence regarding the inventory quantities by using other audit procedures.

We conducted our audit in accordance with Sri Lanka Auditing Standards. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of the Group in accordance with the Code of Ethics issued by CA Sri Lanka (CA Sri Lanka Code), and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Example 4: Disclaimer of opinion due to inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements

In this example, the auditor has not only been unable to attend the inventory count, but has also been unable to gain evidence over other areas. As a result, the auditor has concluded that the effects of the possible misstatements could be material and pervasive.

Disclaimer of Opinion

We were engaged to audit the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying consolidated financial statements of the Group. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

Basis for disclaimer of opinion

We were not appointed as auditors of the company until after December 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at December 31, 20X0 and 20X1 which are stated in the statement of financial position at xxx and xxx, respectively. In addition, the introduction of a new computerised accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our auditor's report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the statement of financial position at a total amount of xxx as at December 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of profit or loss, statement of changes in equity and cash flow statement.

2.6 Communication with those charged with governance

SLAuS 705 states that when the auditor expects to express a modified opinion, the auditor must **communicate with those charged with governance** the circumstances leading to the expected modification and the proposed wording of the modification in the auditor's report.

This allows the auditor to give **notice** to those charged with governance of the intended modification and the reasons for it, to **seek agreement or confirm disagreement** with those charged with governance with respect to the modification, and to give those charged with governance an **opportunity to provide further information and explanations** on the matter giving rise to the expected modification.

2.7 Summary of modifications and impact on the auditor's report

The following table summarises the different types of modified opinion that can arise.

Nature of circumstances	Material but not pervasive	Material and pervasive
Financial statements are materially misstated	QUALIFIED OPINION	ADVERSE OPINION
Auditor is unable to obtain sufficient appropriate audit evidence	QUALIFIED OPINION	DISCLAIMER OF OPINION

QUESTION **Modified opinions**

During the course of your audit of the non-current assets of Eastern Engineering Inc at 31 March 20X4, two problems have arisen.

(a) The calculations of the cost of direct labour incurred on assets in the course of construction by the company's employees have been accidentally destroyed for the early part of the year. The direct labour cost involved is $10,000.

(b) The company incurred development expenditure of $25,000 spent on a viable new product which will go into production next year and which is expected to last for ten years. These costs have been expensed in full to the statement of profit or loss.

(c) Other relevant financial information is as follows.

	$
Profit before tax	100,000
Non-current asset additions (excluding constructed assets)	133,000
Assets constructed by company	34,000
Carrying amount of non-current assets	666,667

Required

(a) List the general forms of modified opinion available to auditors in drafting their report and state the circumstances in which each is appropriate.

(b) State whether you feel that a modified audit opinion would be necessary for each of the two circumstances outlined above, giving reasons in each case.

(c) On the assumption that you decide that a modified audit opinion is necessary with respect to the treatment of the development expenditure, draft the section of the report describing the matter (the whole report is not required).

ANSWER

(a) SLAuS 705 *Modifications to the Opinion in the Independent Auditor's Report* suggests that the auditor may need to modify the opinion under one of two main circumstances:

(i) The auditor concludes that the financial statements as a whole are not free from material misstatements, or

(ii) The auditor cannot obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

For both circumstances there can be two 'levels' of modified opinion.

(i) **Material but not pervasive**, where the circumstances prompting the misstatement or possible misstatement are material. These circumstances will result in a qualified opinion.

(ii) **Material and pervasive** to the overall view shown by the financial statements, ie the financial statements are or could be misleading. These will result in an adverse opinion (financial statements are misstated) or a disclaimer of opinion (the auditor is unable to obtain sufficient appropriate audit evidence).

(b) Whether a modification of the audit opinion would be required in the circumstances described would depend on whether or not the auditors considered either of them to be material to the financial statements as a whole. An item is likely to be considered material in the context of a company's financial statements if its omission, misstatement or non-disclosure would prevent a proper understanding of those statements on the part of a potential user.

(i) **Loss of records relating to direct labour costs for assets in the course of construction**

The loss of records supporting one of the asset figures in the statement of financial position would mean that the auditor would be unable to obtain sufficient appropriate audit evidence. The $10,000 represents 29.4% of the expenditure incurred during the year on assets in course of construction but only 6% of total additions to non-current assets during the year and 1.5% of the year-end carrying amount for non-current assets. The total amount of $10,000 represents 10% of pre-tax profit but, the real consideration by the auditor should be the materiality of any over or understatement of assets resulting from error in arriving at the $10,000 rather than the total figure itself.

Provided there are no suspicious circumstances surrounding the loss of these records and the total figure for additions to assets in the course of construction seems reasonable in the light of other audit evidence obtained, then it is unlikely that this matter would be seen as sufficiently material to merit any modification of the audit opinion. If other records have been lost as well, however, it may be necessary for the auditor to comment on the directors' failure to maintain proper books and records.

(ii) **Development cost debited to the statement of profit or loss**

The situation here is one of misstatement in the financial statements, since LKAS 38 requires that development costs should be taken to the statement of profit or loss over the useful life of the product to which they relate.

This departure from LKAS 38 does not seem to be justifiable and would be material to the reported pre-tax profits for the year, representing 25% of that figure.

While this understatement of profit would be material to the financial statements, it is not likely to been seen as pervasive and therefore a qualified opinion would be appropriate.

(c) **Qualified audit opinion extract**

Qualified opinion

We have audited the financial statements of Eastern Engineering Inc, which comprise the statement of financial position as at March 31, 20X4, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of Eastern Engineering Inc as at March 31, 20X4, and (of) its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

Basis for qualified opinion

As explained in note ... development costs in respect of a potential new product have been deducted in full against profit instead of being spread over the life of the relevant product as required by LKAS 38; the effect of so doing has been to decrease profits before and after tax for the year by $25,000.

We conducted our audit in accordance with Sri Lanka Auditing Standards. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by CA Sri Lanka (CA Sri Lanka Code), and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

2.8 Communication with those charged with governance

SLAuS 706 states that when the auditor expects to include an emphasis of matter paragraph or an other matter paragraph, the auditor must communicate with those charged with governance the circumstances and the proposed wording of the paragraph in the auditor's report.

QUESTION — Audit report implications

You are the auditor of BigBuild Plc, a listed company which distributes materials to the construction industry from eight depots in the south of the country, and you are currently finalising the audit for the year ended 31 March 20X1. Your audit tests have proved satisfactory with the exception of the following four matters.

(a) The physical inventory count sheets for one of the depots were lost before they were made available to you, and you have not been able to confirm the inventory quantities and values for this depot by alternative methods. The directors have valued this part of the inventory at Rs. 75 million and this figure is included in the overall inventory valuation of Rs. 640 million.

(b) Included in trade receivables, which total Rs. 580 million, is a debt amounting to Rs. 45 million from a customer which went into liquidation on 15 June 20X1. You have ascertained from the liquidator that your client is unlikely to receive a distribution. The statement of profit or loss for the year shows a pre-tax profit of Rs. 100 million but the directors are not prepared to provide for this debt.

(c) The financial statements of BigBuild Plc do not contain a statement of cash flows.

(d) A substantial claim has been lodged against the company by a major customer. The matter is fully explained in the notes to the accounts, but no provision has been made for legal costs or compensation payable as it is not possible to determine with reasonable accuracy the amounts, if any, which may become payable. The directors have received legal advice which appears to be reliable in indicating that the claim can be successfully defended.

Required

Analyse how the above items will influence the auditor's report you will issue.

ANSWER

(a) This represents a potential material limitation on scope because the 'missing' inventory represents 12% of the total. The auditor would expect all inventory counting sheets to be available. The auditor's opinion would be modified.

The auditor's report would include a basis of qualified opinion paragraph before the opinion paragraph which would refer to the fact that the inventory counting sheets for this depot were lost. The qualified opinion paragraph would state that 'except for' adjustments that may have been necessary in relation to this inventory, the financial statements present fairly, in all material respects (or give a true and fair view).

(b) This represents a material misstatement. The debt represents 8% of the total receivables balance and 45% of the profit for the year.

The auditor's opinion would be modified. A qualified opinion would be issued.

The basis of qualified opinion paragraph would refer to the fact that the customer is in liquidation and there is little prospect of payment. It would also state that net assets and profits are overstated by Rs. 45 million.

The qualified opinion paragraph would state that 'except for' the absence of this allowance the financial statements are presented fairly, in all material respects (or give a true and fair view), in accordance with the applicable financial reporting framework.

(c) As the client is listed, its financial statements should include a statement of cash flows.

The auditor's opinion should therefore be qualified as the financial statements are materially misstated. This disagreement is not pervasive to the financial statements, it is limited to the statement of cash flows, so this would be a qualified opinion.

The basis of qualified opinion paragraph will refer to the fact that the financial statements do not contain a statement of cash flows and include the figures required, and the qualified opinion paragraph will state that the financial statements give a true and fair view and have been prepared, in all material respects, in accordance with an applicable financial reporting framework except for the omission of a statement of cash flows.

(d) The auditors need to determine whether the legal claim is a material matter and even whether it is pervasive to the financial statements as a whole. For example, if the customer involved is a major customer, it could be that an adverse outcome could affect the going concern basis of the company.

It appears that the disclosure in the financial statements is adequate and there appears to be no basis on which to make a provision in the financial statements. However, the auditor's report will be affected by the fact that there is an uncertainty affecting the business. The auditor will have to decide whether the inherent uncertainty is fundamental to users' understanding. If so, the auditor's report should include an emphasis of matter paragraph beneath the opinion paragraph with details of this matter. It should also state that the auditor's opinion on the financial statements is not modified in relation to this matter.

3 Other information in documents containing the auditor's report

Auditors shall review the **other information** to determine whether there are any material inconsistencies or whether other information is materially misstated.

SLAuS 720 (Revised) *The Auditor's Responsibilities Relating to Other Information* provides guidance to auditors in this area. The objective of the auditor is to respond appropriately when documents containing audited financial statements include other information that could **undermine the credibility** of the financial statements and the auditor's report.

Other information is financial or non-financial information (other than the financial statements and the auditor's report thereon) included in an entity's annual report.

An **annual report** is a document, or combination of documents, prepared typically on an annual basis by management or those charged with governance in accordance with law, regulation or custom.

Its purpose is to provide owners (or similar stakeholders) with information on the entity's operations and the entity's financial results and financial position as set out in the financial statements.

A **misstatement of the other information** exists when the other information is incorrectly stated or otherwise misleading (including because it omits or obscures information necessary for a proper understanding of a matter disclosed in the other information).

Examples of other amounts or other items that may be included as other information are as follows:

- Overview of strategy
- Financial summaries or highlights
- Planned capital expenditures
- Financial ratios
- Explanations of critical accounting estimates and related assumptions

3.1 Material misstatements of the other information

SLAuS 720 states that the auditor shall **read** the other information to identity **material inconsistencies** with the audited financial statements. If a material inconsistency is identified, the auditor shall determine whether the audited financial statements or other information is **misstated**.

If the **financial statements** are materially misstated but management refuses to correct the misstatement, the auditor shall **modify** the audit opinion.

If the **other information** is materially misstated and needs to be revised but management refuses, the auditor shall **communicate** this matter to those charged with governance and:

- Consider the implications for the auditor's report, or
- **Withdraw** from the engagement (where this is legally permitted).

In reading and considering the other information, the auditor should also consider whether the auditor's understanding of the entity and its environment needs to be updated.

3.2 Reporting

The auditor's report will always include a separate Other Information section when the auditor has obtained some or all of the other information as of the date of the auditor's report. For listed entities, the section is also included if other information is expected to be received after the date of the auditor's report.

The Other Information section is placed after the Key Audit Matters section and where the other information is not materially misstated it would be worded as follows:

Other information

Management is responsible for the other information. The other information comprises the [information included in the X report, but does not include the financial statements and our auditor's report thereon.]

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

If the auditor concludes that there is a material misstatement of the other information, the 'Other Information' section is placed immediately after the basis of opinion section. It will state:

> 'As described below, we have concluded that such a material misstatement of the other information exists.'

This statement is followed by a description of the misstatement.

CHAPTER ROUNDUP

- The auditor is required to produce an **auditor's report** at the end of the audit which sets out their **opinion** on the truth and fairness of the financial statements. The report contains a number of **consistent elements** so that users know the audit has been conducted according to **recognised standards**.
- An **other matter paragraph** is a paragraph included in the auditor's report that refers to a matter **other than those presented or disclosed** in the financial statements that, in the auditor's judgement, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.
- Listed company auditor's reports include a description of the key audit matters.
- There are three types of **modified opinion**: a **qualified opinion**, an **adverse opinion**, and a **disclaimer of opinion**.
- **Emphasis of matter paragraphs** and **other matter paragraphs** can be included in the auditor's report under certain circumstances. Their use does not modify the auditor's opinion on the financial statements.
- Auditors shall review the **other information** in documents containing audited financial statements for material inconsistencies and misstatements of fact.

PROGRESS TEST

1 In accordance with SLAuS 700 the audit report includes a description of the responsibilities of those who are responsible for the preparation of the financial statements. True or false?

2 Draw a table that summarises the different modified opinions that can arise in the auditor's report.

3 The inclusion of an emphasis of matter paragraph in the auditor's report does not affect the auditor's opinion on the financial statements. True or false?

ANSWERS TO PROGRESS TEST

1 True

2 Modification table

Nature of circumstances	Material but not pervasive	Material and pervasive
Financial statements are materially misstated	QUALIFIED OPINION	ADVERSE OPINION
Auditor unable to obtain sufficient appropriate audit evidence	QUALIFIED OPINION	DISCLAIMER OF OPINION

3 True

Part F - Assurance and Related Services

THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

CHAPTER 17

Assurance and Related Services

INTRODUCTION

In this chapter we look at audit-related services and other assurance services.

Audit-related services include review engagements, such as interim financial information reviews and due diligence reviews. We consider the differences between the external audit and audit-related services.

Assurance services are also considered in this chapter and we examine the different levels of assurance that can be provided on such engagements. In particular we look at risk assessments, performance measurement and value for money audits.

Finally we look at assurance engagements related to prospective financial information and the requirements for undertaking such work.

Knowledge Component			
F Assurance and Related Services			
5.7	**Review Engagements**	5.7.1	Explain procedures required in conducting review engagements
6.1	**Assurance Framework**	6.1.1	Apply framework for assurance engagements in identifying and accepting assurance engagements
6.2	**Assurance Engagements**	6.2.1	Apply Sri Lanka Standard on assurance engagement together with subject matter specific assurance standards to provide reasonable or limited assurance as required in the engagement circumstances
6.3	**Related Services**	6.3.1	Apply Sri Lanka Standard on related services relating to agreed up on procedures and compilation as required by engagement circumstances
6.4	**Reporting**	6.4.1	Outline key elements of reports used in assurance and related services

CHAPTER CONTENTS	LEARNING OUTCOME
1 Audit related services	5.7.1, 6.1.1
2 Assurance engagements	6.2.1, 6.3.1, 6.4.1
3 Prospective financial information	6.2.1

1 Audit related services

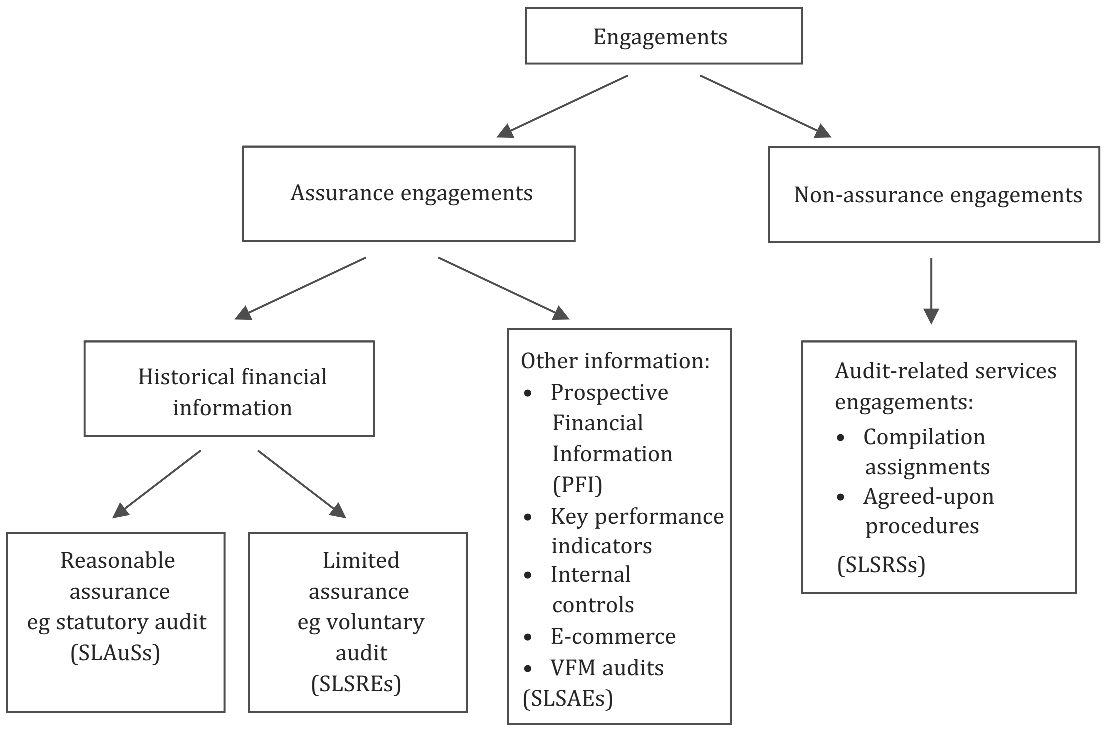
Audit-related services may be either assurance engagements or non-assurance engagements.

Review engagement. The objective of a review engagement is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework.

1.1 Types of engagement

A client would generally engage an auditor to undertake an audit-related engagement either because the client needs to make use of expertise that the auditor possesses but the client itself does not, or because it needs a relatively independent third party to provide assurance regarding some specific matter. For example, the client may lack the expertise to carry out a financial due diligence assignment on a potential acquisition, and may therefore engage the auditor to do this for it. Or it may be that the client needs to obtain new finance in the form of a bank loan, and engages the auditor to provide assurance over its prospective financial information because this will help strengthen its case with the bank.

There are many different types of audit-related services, which are summarised by the following diagram. The types of standard which apply to each type of engagement are given in brackets.



One important kind of engagement not included in this diagram is **due diligence**, as it could be placed within several of the above categories. It is covered later in this chapter.

This section focuses on reviews of historical financial information, which are limited assurance engagements. This includes several types of engagement:

- Review of financial statements (SLSRE 2400)
- Review of interim financial information by the entity's auditor (SLSRE 2410)

These are both types of review engagement:

This is an exercise similar to an audit, except that in a review engagement the practitioner will rely more heavily on procedures such as **enquiry and analytical review** than on detailed substantive testing. The reasons for this are:

- He is seeking a **lower level of assurance than for an audit**, so these forms of evidence are sufficient due to risk being lower.
- Such techniques provide **indicators** that direct work to risk areas and from which to draw conclusions, and they are **quick** and, therefore, **cost-effective**.

You may be interested to note that Sri Lankan Standards on Review Engagements (SLSREs) and Sri Lankan Standards on Assurance Engagements (SLSAEs) use the term 'the practitioner', as opposed to 'the professional accountant' (used in the *Code of Ethics*) and of course 'the auditor' (SLAuSs). A 'practitioner' is defined as 'a professional accountant in public practice'.

1.2 Review of financial statements

A limited assurance engagement involves the use of primarily **inquiry and analytical procedures** to obtain sufficient appropriate evidence.

Although inquiry and analytical procedures are the main sources of evidence, if the practitioner becomes aware of something that makes them think there may be a material misstatement, then further procedures may be necessary (such as substantive procedures).

Many of the requirements of the SLSRE are similar to the requirements of an audit. Only **relevant** requirements must be complied with, but if a requirement is relevant then it must be complied with (SLSRE 2400: para. 19).

SLSRE 2400: paras. 21-23

The practitioner shall **comply with relevant ethical requirements**, including those pertaining to independence.

The practitioner shall plan and perform the engagement with **professional** recognizing that circumstances may exist that cause the financial statements to be materially misstated.

The practitioner shall **exercise professional judgment** in conducting a review engagement.

1.2.1 Quality control

The SLSRE contains requirements on quality control, in addition to the strictures of SLSQC 1:

- The engagement partner is **competent** in assurance and financial reporting.
- The engagement partner is **responsible** for the engagement overall.
- The engagement partner must remain alert for **ethical issues** during the course of the engagement.
- A **monitoring** process must be in place to ensure that quality controls are sufficient and are working effectively.

1.2.2 Acceptance/continuation

The practitioner must **not** accept an engagement if:

- There is not a **rational purpose** for the engagement, or a review is not appropriate to the circumstances
- **Ethical requirements** will not be satisfied

- Information is likely to be **unavailable** or **unreliable**
- There is cause to doubt **management's integrity**
- The scope of the review has been limited such that a **disclaimer of opinion will be issued**

Preconditions must be present, including:

- An **acceptable financial reporting framework**
- Management **acknowledges its responsibilities** for internal control, for the financial statements and for providing access to information

1.2.3 Agreeing terms

SLSRE 2400: para. 36

The practitioner shall agree the terms of the engagement with management or those charged with governance, as appropriate, prior to performing the engagement.

This should be done in an **engagement letter** or other written form.

On recurring engagements, the practitioner assesses whether the terms need to change, or whether the engaging party needs to be reminded of the terms.

Sometimes, the nature of an assignment being carried out by a practitioner might change, and the responsible party might request that the practitioner provides less or no assurance on an engagement. In this case, the terms should be changed unless there is reasonable justification for not doing so.

1.2.4 Communication

SLSRE 2400 includes a **requirement** to **communicate** with those charged with governance all matters that are important enough to merit their attention.

1.2.5 Performing the engagement

SLSRE 2400: para. 43

The practitioner shall determine **materiality** for the financial statements as a whole, and apply this materiality in designing the procedures and in evaluating the results obtained from those procedures.

Materiality must also be **revised** as the engagement progresses (like an audit).

> **SLSRE 2400: para. 45**
>
> The practitioner shall **obtain an understanding** of the entity and its environment, and the applicable financial reporting framework [...]

Procedures are then designed to address all material items and to focus on areas where material misstatements are more likely. The main procedures are **enquiry** and **analytical procedures**.

Procedures should be performed to address any specific issues, such as:

- **Related parties** (remain alert and if they are identified, inquire about them)
- **Fraud** and **non-compliance** with laws or regulations (if found, communicate and consider effect on conclusion)
- **Going concern**
- Use of **work performed by others** (take steps to ensure it is adequate for the purposes of the review)

It is a requirement to obtain evidence that the **financial statements agree to accounting records**.

If a material misstatement is discovered then **additional procedures** are performed to enable a conclusion to be formed.

Responsibilities in relation to **subsequent events** are similar to those on an audit.

1.2.6 Written representations

Various written representations are required:

- To confirm that management has fulfilled its responsibilities as set out in the engagement letter
- To confirm that management has disclosed various matters to the practitioner, eg the identity of any related parties, facts relating to any frauds

If these are not provided, then **discuss** the matter with management or those charged with governance, and **re-evaluate management's integrity**. If management lacks integrity, then the practitioner must **disclaim a conclusion.**

1.2.7 Reporting

There are some important differences between a review report and an auditor's report:

Review report	Auditor's report
Conclusion	Opinion
Limited assurance	Reasonable assurance
Negative form of words	Positive form of words

An **unmodified conclusion** uses a negative form of words, such as:

> 'Based on our review, nothing has come to our attention that causes us to believe that the financial statements do not present fairly, in all material respects (or do not give a true and fair view), … in accordance with the applicable financial reporting framework.'

The term 'negative assurance' does not exist in the current SLSRE. The correct term is 'limited assurance', which is logical: this is still positive assurance, but there is just less of it than when 'reasonable assurance' is provided. The only thing that **is** negative is the way the conclusion is worded.

Modified conclusions are expressed in the same terms as the auditor's report (the terminology used for assurance conclusions and reports is now aligned with the Sri Lankan Standards on Auditing (ISAs)). And just like the auditor's report, a modified conclusion paragraph must be preceded by a 'Basis for' modified conclusion paragraph.

The type of modified conclusion given will depend on two things: the materiality of the issue, and the availability of evidence.

Nature of matter giving rise to the modification	Practitioner's judgment about the pervasiveness of the effects or possible effects on the subject matter information	
	Material but not pervasive	Material and pervasive
Subject matter information is materially misstated	QUALIFIED CONCLUSION	ADVERSE CONCLUSION
Inability to obtain sufficient appropriate audit evidence	QUALIFIED CONCLUSION	DISCLAIMER OF CONCLUSION

It is also possible to modify the assurance report without modifying the actual conclusion, by including an Emphasis of Matter or an Other Matter paragraph. These are defined as follows.

SLSRE 2400: paras. 87 and 90

[An **Emphasis of Matter** paragraph will] draw intended users' attention to a matter presented or disclosed in the financial statements that, in the practitioner's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

[An **Other Matter** paragraph will] communicate a matter other than those that are presented or disclosed in the financial statements that, in the practitioner's judgment, is relevant to users' understanding of the review, the practitioner's responsibilities or the practitioner's report and this is not prohibited by law or regulation.

The key difference here is:

Emphasis of Matter	Other Matter
Matter **is** already presented or disclosed in the subject matter information.	Matter **is not** already presented or disclosed in the subject matter information.

SLSRE 2400 includes a sample unmodified report in its Appendix:

INDEPENDENT PRACTITIONER'S REVIEW REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have reviewed the accompanying financial statements of ABC Company, which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the Sri Lanka Accounting Standard for Small and Medium-sized Entities, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Practitioner's Responsibility

Our responsibility is to express a conclusion on the accompanying financial statements. We conducted our review in accordance with Sri Lankan Standard on Review Engagements (SLSRE) 2400 (Revised), *Engagements to Review Historical Financial Statements*. SLSRE 2400 (Revised) requires us to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects in accordance with the applicable financial reporting framework. This Standard also requires us to comply with relevant ethical requirements.

A review of financial statements in accordance with SLSRE 2400 (Revised) is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with Sri Lankan Standards on Auditing. Accordingly, we do not express an audit opinion on these financial statements.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that these financial statements do not present fairly, in all material respects, (or do not give a true and fair view of) the financial position of ABC Company as at 31 December 20X1, and (of) its financial performance and cash flows for the year then ended, in accordance with the Sri Lanka Accounting Standard for Small and Medium-sized Entities.

Report on Other Legal and Regulatory Requirements

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

[Practitioner's signature]

[Date of the practitioner's report]

[Practitioner's address]

A report with a **modified conclusion** would replace the 'Conclusion' paragraph above with the following.

Basis for Qualified Conclusion

The company's inventories are carried in the statement of financial position at xxx. Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from the requirements of the Financial Reporting Framework (XYZ Law) of Jurisdiction X. The company's records indicate that, had management stated the inventories at the lower of cost and net realisable value, an amount of xxx would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx respectively.

Qualified Conclusion

Based on our review, except for the effects of the matter described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the financial statements of ABC Company are not prepared, in all material respects, in accordance with the Financial Reporting Framework (XYZ Law) of Jurisdiction X.

1.3 Review of interim financial information performed by the independent auditor of the entity

This subject is covered by SLSRE 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*.

1.3.1 General principles

The auditor should comply with **ethical principles** relevant to the audit when carrying out an interim review and should apply **quality control procedures** applicable to the individual engagement. In addition, the auditor should plan and perform the engagement with an attitude of **professional scepticism**. The auditor should agree the terms of the engagement with the client (these will not be the same terms as for the audit, as the review will result in a lower level of assurance than the annual audit), with a view to providing negative assurance.

1.3.2 Procedures

The procedures outlined below follow the same pattern as an audit, but, because this is a review not an audit, they are not as detailed as audit procedures.

The auditor should possess sufficient understanding of the entity and its environment to understand the types of misstatement that might arise in interim financial information and to plan the relevant procedures (mainly enquiry and analytical review) to enable them to ensure that the financial information is prepared in accordance with the applicable financial reporting framework. This will usually include:

- Reading last year's audit and previous review files
- Considering any significant risks that were identified in the prior year audit
- Reading the most recent and comparable interim financial information
- Considering materiality
- Considering the nature of any corrected or uncorrected misstatements in last year's financial statements
- Considering significant financial accounting and reporting matters of ongoing importance
- Considering the results of any interim audit work for this year's audit
- Considering the work of internal audit
- Asking management what their assessment is of the risk that the interim financial statements might be affected by fraud
- Asking management whether there have been any significant changes in business activity, and if so, what effect they have had

- Asking management about any significant changes in internal controls and the potential effect on preparing the interim financial information
- Asking how the interim financial information has been prepared and the reliability of the underlying accounting records (SLSRE 2410)

A recently appointed auditor should obtain an understanding of the entity and its environment, as it relates to both the interim review and final audit.

The key elements of the review will be:

- **Enquiries** of accounting and finance staff
- **Analytical procedures**

Ordinarily procedures would include:

- Reading the minutes of meetings of shareholders, those charged with governance and other appropriate committees
- Considering the effect of matters giving rise to a modification of the audit or review report, accounting adjustments or unadjusted misstatements from previous audits
- If relevant, communicating with other auditors auditing different components of the business
- Analytical procedures designed to identify relationships and unusual items that may reflect a material misstatement
- Reading the interim financial information and considering whether anything has come to the auditors' attention indicating that it is not prepared in accordance with the applicable financial reporting framework
- Agreeing the interim financial information to the underlying accounting records (SLSRE 2410)

The auditor should make enquiries of members of management responsible for financial and accounting matters about:

- Whether the interim financial information has been prepared and presented in accordance with the applicable financial reporting framework
- Whether there have been changes in accounting policies
- Whether new transactions have required changes in accounting policies
- Whether there are any known uncorrected misstatements
- Whether there have been unusual or complex transactions, eg disposal of a business segment
- Significant assumptions relevant to fair values

- Whether related party transactions have been accounted for and disclosed correctly
- Significant changes in commitments and contractual obligations
- Significant changes in contingent liabilities including litigation or claims
- Compliance with debt covenants
- Matters about which questions have arisen in the course of applying the review procedures
- Significant transactions occurring in the last days of the interim period or the first days of the next
- Knowledge or suspicion of any fraud
- Knowledge of any allegations of fraud
- Knowledge of any actual or possible non-compliance with laws and regulations that could have a material effect on the interim financial information
- Whether all events up to the date of the review report that might result in adjustment in the interim financial information have been identified
- Whether management has changed its assessment of the entity being a going concern

(SLSRE 2410)

The auditor should evaluate discovered misstatements individually and in aggregate to see if they are material.

The auditor should obtain **written representations** from management that it acknowledges its responsibility for the design and implementation of internal control, that the interim financial information is prepared and presented in accordance with the applicable financial reporting framework and that the effect of uncorrected misstatements are immaterial (a summary of these should be attached to the representations). The auditor should also obtain representations that all **significant facts** relating to **frauds or non-compliance with law and regulations**, and all **significant subsequent events**, have been disclosed to the auditor.

The auditor should read the other information accompanying the interim financial information to ensure that it is not inconsistent with it.

If the auditors believe a matter should be adjusted in the financial information, they should **inform management** as soon as possible. If management does not respond within a reasonable time, then the auditors should inform those charged with governance. If they do not respond, then the auditor should consider whether to modify the report or to withdraw from the engagement and the final audit if necessary. If the auditors uncover fraud or non-compliance with laws and regulations, they should communicate that promptly with the **appropriate level of management**. The auditors should communicate matters of interest arising to those charged with governance.

1.3.3 Reporting

The SLSRE gives the following example standard report.

Note: SLSRE 2410 has not yet been updated for the changes in terminology introduced by the revision of LKAS 1 *Presentation of Financial Statements*.

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying balance sheet of ABC Entity as of 31 March 20X1 and the related statements of income, changes in equity and cash flows for the three-month period then ended, and a summary of significant accounting policies and other explanatory notes. Management is responsible for the preparation and fair presentation of this interim financial information in accordance with (indicate applicable financial reporting framework). Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with Sri Lanka Standard on Review Engagements 2410, 'Review of Interim Financial Information Performed by the Independent Auditor of the Entity'. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Sri Lankan Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of (or 'does not present fairly, in all material respects,') the financial position of the entity as at 31 March 20X1, and of its financial performance and its cash flows for the three-month period then ended in accordance with (applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Sri Lankan Financial Reporting Standards).

AUDITOR

Date

Address

It also gives examples of modified reports:

Review report: Departure from the applicable financial reporting framework

Previous paragraphs as per standard report.

Basis for Qualified Conclusion

Based on information provided to us by management, ABC Entity has excluded from property and long-term debt certain lease obligations that we believe should be capitalised to conform with (indicate applicable financial reporting framework). This information indicates that if these lease obligations were capitalised at 31 March 20X1, property would be increased by Rs. ________, long-term debt by Rs. ________, and net income and earnings per share would be increased (decreased) by (Rs. ________, Rs. ________), Rs. ________, and Rs. ________ respectively for the three-month period then ended.

Qualified Conclusion

Based on our review, with the exception of the matter described in the preceding paragraph, nothing has come to our attention that caused us to believe that the accompanying interim financial information does not give a true and fair view of (or 'does not present fairly, in all material respects,') the financial position of the entity as at 31 March 20X1, and of its financial performance and its cash flows for the three-month period then ended in accordance with (indicate applicable financial reporting framework, including the reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Sri Lankan Financial Reporting Standards).

AUDITOR

Date

Address

Review report: Limitation on scope not imposed by management

Introduction paragraph – as per standard report

Scope paragraph

Except as explained in the following paragraph …. – as per standard report.

Basis for Qualified Conclusion

As a result of a fire in a branch office on (date) that destroyed its accounts receivable records, we were unable to complete our review of accounts receivable totalling Rs. ________ included in the interim financial information. The entity is in the process of reconstructing these records and is uncertain as to whether these records will support the amount shown above the related allowance for uncollectible accounts. Had we been able to complete our review of accounts receivable, matters might have come to our attention indicating that adjustments might be necessary to the interim financial information.

Qualified Conclusion

Except for the adjustments to the interim financial information that we might have become aware of had it not been for the situation described above, 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 of (or 'does not present fairly, in all material respects,') the financial position of the entity as at 31 March 20X1, and of its financial performance and its cash flows for the three-month period then ended in accordance with (indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Sri Lankan Financial Reporting Standards).

AUDITOR

Date

Address

1.4 Due diligence

Due diligence is a kind of review engagement, but in practice its definition is flexible and can mean a variety of different things.

Information gathering

Due diligence is a fact-finding mission, aiming to gather information about a company.

Due diligence is typically done where one company is planning to take over another, and needs an independent adviser to assess the risks of the transaction (including validating the assumptions underlying the purchase). The aim is to ensure that the acquirer has all the necessary facts and that the perceived business opportunities are in fact real. This is important when determining purchase price. In principle, but in practice less commonly, due diligence can be requested by sellers.

Due diligence may include some following aspects, often combining them together in one assignments.

- **Financial** due diligence (a review of the financial position and obligations of a target to identify such matters as covenants and contingent obligations)
- **Operational and IT** due diligence (extent of operational and IT risks, including quality of systems, associated with a target business)
- **People** due diligence (key staff positions under the new structure, contract termination costs and costs of integration)

- **Regulatory** due diligence (review of the target's level of compliance with relevant regulation)
- **Environmental** due diligence (environmental, health and safety and social issues in a target)

A typical due diligence review could include enquiries into:

(a) **Assets/liabilities**, in order to **value** the company

(b) **Management's representations** about the company, which may need to be substantiated by evidence

(c) **Structure**, including how the target is owned and constituted and what changes will be necessary

(d) **Acquisition planning**, looking at potential benefits/drawbacks of the acquisition (eg synergies with the acquirer's business, or potential economies of scale)

(e) **Financial health**, based on a detailed examination of past financial statements and an analysis of the existing asset base

(f) **Credibility of the owners**, directors and senior managers, including validation of the career histories of all the main players in the business

(g) **Future potential**, reflected in the strengths of its products or services and the probability of earnings growth over the medium to long term

(h) **Assessment of the risk** to the acquiring business, in terms of its markets, strategy and likely future events

(i) **The business plan**, in terms of how realistic it is, how solid the assumptions used are and how well it conveys the potential

When it comes to placing it in an engagement category, due diligence is something of a wildcard. It can be performed as any of the following.

- As a review of historical financial information (limited assurance)
- As an assurance engagement (limited assurance)
- As agreed-upon procedures (no assurance)

There is no Sri Lanka standard on due diligence engagements, so in practice the engagement would be conducted in accordance with whichever standard best fits the particular engagement being conducted – perhaps SLSRE 2400, SLSAE 3000 or SLSRE 4400.

Attempt the following question, even though you may not yet feel confident in your technical knowledge, you should still be able to score well if you answer the requirements specifically, and base your answer as much as possible on the scenario.

QUESTION — Due diligence

Your audit client, Balasuriya Ltd. is a national hotel group with substantial cash resources. Its accounting functions are well managed and the group accounting policies are rigorously applied. The company's financial year end is 30 June.

Balasuriya has been seeking to acquire a construction company for some time in order to bring in-house the building and refurbishment of hotels and related leisure facilities (e.g. swimming pools, squash courts and restaurants). Balasuriya's management has recently identified Jayakody Construction Co as a potential target and has urgently requested that you undertake a limited due diligence review lasting two days next week.

Further to its preliminary talks with Jayakody's management, Balasuriya has provided you with the following brief on Jayakody Construction Ltd.

- The chief executive, managing director and finance director are all family members and major shareholders. The company name has an established reputation for quality constructions.
- Due to a recession in the building trade the company has been operating at its overdraft limit for the last 18 months and has been close to breaching debt covenants on several occasions.
- Jayakody's accounting policies are generally less prudent than those of Balasuriya (eg assets are depreciated over longer estimated useful lives).
- Contract revenue is recognised on the percentage of completion method, measured by reference to costs incurred to date. Provisions are made for loss-making contracts.
- The company's management team includes a qualified and experienced quantity surveyor. Their main responsibilities include:
  - Supervising quarterly physical counts at major construction sites
  - Comparing costs to date against quarterly rolling budgets
  - Determining profits and losses by contract at each financial year end
- Although much of the labour is provided under subcontracts all construction work is supervised by full-time site managers.

In February 20X2 Jayakody received a claim that a site on which it built a housing development in 20W4 was not properly drained and is now subsiding. Residents are demanding rectification and claiming damages. Jayakody has referred the matter to its legal counsel and denied all liability, as the site preparation was subcontracted to Sarwar Services Co. No provisions have been made in respect of the claims, nor has any disclosure been made.

The auditor's report on Jayakody's financial statements for the year to 31 December 20X1 was signed, without modification, in September 20X2.

Required

(a) Explain the meaning of the term 'due diligence' and identify some practical examples of this type of assignment.

(b) Identify and explain the specific matters to be clarified in the terms of engagement for this due diligence review of Jayakody Construction Co.

(c) Recommend the principal additional information that should be made available for your review of Jayakody Construction Co, and explain the need for the information.

ANSWER

(a) **Due diligence** reviews are a specific type of review engagement. A typical due diligence engagement is where an adviser (often an audit firm) is engaged by one company planning to take over another to perform an assessment of the material risks associated with the transaction (including validating the assumptions underlying the purchase), to ensure that the acquirer has all the necessary facts. This is important when determining purchase price. Similarly, due diligence can also be requested by sellers.

Practical examples include:

- **Financial due diligence** (a review of the financial position and obligations of a target to identify such matters as covenants and contingent obligations)
- **Operational and IT due diligence** (extent of operational and IT risks, including quality of systems, associated with a target business)
- **People due diligence** (key staff positions under the new structure, contract termination costs and cost of integration)
- **Regulatory due diligence** (review of the target's level of compliance with relevant regulation)
- **Environmental due diligence** (environmental, health and safety and social issues in a target)

(b) **Matters to be clarified in engagement letter**

(i) The nature of the opinion must be agreed. On this assignment it is likely to be expressed as negative assurance, saying 'nothing has come to our attention to indicate that the information is not free from material misstatement'. This is a normal form of words used to express a moderate level of assurance.

(ii) The timescale of the review should be set out. Balasuriya has requested a limited review over two days. The deadline for reporting should also be set.

(iii) A liability disclaimer should be included to confirm that the engagement should not be relied on to disclose errors or other irregularities.

(iv) The terms of reference of the review should be set out, ie its aims and objectives. It should also state that the investigation will be mainly in the form of inquiry and analytical procedures.

(v) The letter should state that any decision made on whether to go ahead with the acquisition will be the responsibility of Balasuriya's management.

(vi) The engagement letter should contain the fee for the engagement and details of the team undertaking the review.

(c) **Additional information**

(i) Previous years' financial statements should be obtained for details of the accounting policies used by Jayakody, any provisions/contingent liabilities made in the accounts, and the assumptions made in estimating completion of construction contracts.

(ii) Recent management accounts and cash flow forecasts are required to assess the quality of management information. Jayakody has been operating at its overdraft limit for the last 18 months so the accuracy of this information will be critical to decision making.

(iii) The loan agreement with the bank and other lenders should be obtained so that details of the overdraft limit and other debt covenants are understood. The terms should be reviewed closely to determine whether any penalties or similar would be triggered by a takeover of Jayakody.

(iv) Any legal correspondence regarding the claim on the site on which Jayakody built a housing development in 20W4 should be obtained, together with any other claims or disputes that the company is involved with.

(v) The quantity surveyor's working papers for the last count they supervised and the latest quarterly rolling budgets should be obtained. Their assessment of profits/losses/degree of completion of recent contracts will need to be reviewed.

(vi) Information on the types of building work that Jayakody does is important. Balasuriya wants to acquire the company to undertake the building of hotels and other leisure facilities, such as swimming pools.

(vii) Details of current contract agreements with customers are required to get information on any guarantees, penalties etc that may be incurred.

1.5 Agreed-upon procedures

Agreed-upon procedures assignment. In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. The recipients of the report must form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.

Agreed-upon procedures assignments are discussed in SLSRE 4400 *Engagements to Perform Agreed-upon Procedures Regarding Financial Information*.

1.5.1 Accepting appointment

SLSRE 4400: para. 9

The auditor should ensure with representatives of the entity, and ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement.

1.5.2 Carrying out procedures and reporting

The auditor should plan the assignment. They should carry out the agreed-upon procedures, documenting their process and findings.**R4400: para. 18**

The report of factual findings should contain:

(a) Title;

(b) Addressee (ordinarily the client who engaged the auditor to perform the agreed-upon procedures);

(c) Identification of specific financial or non-financial information to which the agreed-upon procedures have been applied;

(d) A statement that the procedures performed were those agreed upon with the recipient;

(e) A statement that the engagement was performed in accordance with the Sri Lankan Standard on Related Services applicable to agreed-upon procedure engagements, or with relevant national standards or practices;

(f) When relevant, a statement that the auditor is not independent of the entity;

(g) Identification of the purpose for which the agreed-upon procedures were performed;

(h) A listing of the specific procedures performed;

(i) A description of the auditor's factual findings including sufficient details of errors and exceptions found;

(j) Statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed;

(k) A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported;

(l) A statement that the report is restricted to those parties that have agreed to the procedures to be performed;

(m) A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole;

(n) Date of the report;

(o) Auditor's address; and

(p) Auditor's signature.

QUESTION — Assertions

Kandro Co is a small manufacturer of hand-made furniture pieces for distribution to three large furniture sales companies. The management team at Kandro Co is concerned that the inventory system currently in place is not fit for purpose. They suspect that there may be discrepancies in the number and value of inventory items between the recorded amounts in the system and what exists on the warehouse floor. Kandro Co is not required to have a statutory audit and as such Lantos and Co registered auditors have been approached by the management team to perform procedures on the inventory system and provide a report that addresses their concerns.

Required

Discuss what assertions the auditor will need to test when performing any procedures, suggest the nature of the tests that may be performed, and the report that will be provided.

ANSWER

The key assertions at risk here are **existence** and **accuracy, valuation and allocation.** The auditor will also need to consider the risk of fraud if the client is concerned that inventory items may be misappropriated.

As such the auditor will likely undertake **tests of control** to determine the level of controls currently in place and whether these have been designed correctly and are operating effectively. Based on the level of controls, the auditor will then need to consider **sample counts** comparing what is physically visible on the warehouse floor and comparing to the inventory records to ensure that they match. The opposite will also be applied with a sample of amounts taken from the inventory list and matched to the items on the warehouse floor to verify that the amounts included in the inventory records match what is physically there. **Three-way-matching** of documentation will likely be undertaken to ensure that supplies purchased are being controlled effectively and the **age and condition** of inventory will be observed.

The auditor will provide a report that makes it clear that the engagement is not an assurance engagement and that there is no conclusion formulated. The report will outline the **procedures applied** and may express the **professional views** of the auditor as to the **robustness of the controls** at Kandro Co. The auditor will also likely make **control recommendations** and outline the condition and age of observed inventory as well as the potential for any incorrect valuation of inventory amounts as a result of the testing undertaken.

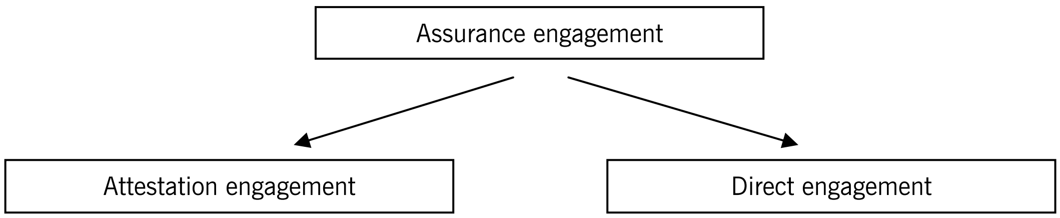
2 Assurance engagements

Assurance services improve the quality of decision making for users of information.

Assurance engagement. An engagement in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the subject matter information (that is, the outcome of the measurement or evaluation of an underlying subject matter against criteria).

2.1 Engagement Type

Assurance engagements may be attestation engagements or direct engagements.



SLSAE 3000's rather complex definitions of these terms are summarised below.

Attestation engagement. An assurance engagement in which a party other than the practitioner measures or evaluates the underlying subject matter against the criteria. A party other than the practitioner also often presents the resulting subject matter information in a report or statement. In some cases, however, the subject matter information may be presented by the practitioner in the assurance report. In an attestation engagement, the practitioner's conclusion addresses whether the subject matter information is free from material misstatement.

Direct engagement. An assurance engagement in which the practitioner measures or evaluates the underlying subject matter against the applicable criteria and the practitioner presents the resulting subject matter information as part of, or accompanying, the assurance report. In a direct engagement, the practitioner's conclusion addresses the reported outcome of the measurement or evaluation of the underlying subject matter against the criteria.

(SLSAE 3000: para. 12)

Broadly speaking, an **attestation engagement** is one in which the client prepares the information and the practitioner gives assurance on it. The auditor's report on the financial statements would be an example of this, except that auditor's reports are not within the scope of the SLSAE.

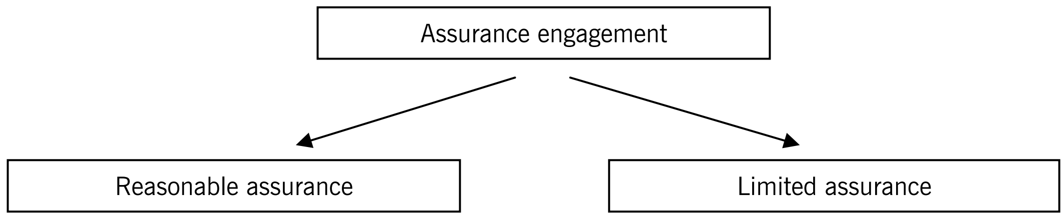
A **direct engagement** is one in which the practitioner prepares the information and at the same time gives assurance on it.

Example

A professional accountant is engaged to provide assurance on the sales figures of Ocean Gift Shop Co, for its overseas owners. The company prepares the sales report itself, measuring its sales in line with the owners' criteria, and the professional accountant provides a limited assurance report which is appended to the sales report. This is an **attestation engagement**.

2.2 Assurance Provided

The level of assurance may be **reasonable** or **limited**.



These levels of assurance were discussed in your earlier studies. Remember that absolute assurance can **never** be given on an assurance engagement due to the **inherent limitations** of such engagements.

The SLSAE 3000 definitions are as follows. They are worth reading, but not memorising.

Reasonable assurance engagement. An assurance engagement in which the practitioner reduces engagement **risk** to an acceptably low level in the circumstances of the engagement as the basis for the practitioner's conclusion. The practitioner's conclusion is expressed in a form that conveys the practitioner's opinion on the outcome of the measurement or evaluation of the underlying subject matter against criteria.

Limited assurance engagement. An assurance engagement in which the practitioner reduces engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement as the basis for expressing a conclusion in a form that conveys whether, based on the procedures performed and evidence obtained, a matter(s) has come to the practitioner's attention to cause the practitioner to believe the subject matter information is materially misstated.

The nature, timing and extent of procedures performed in a limited assurance engagement is limited compared with that necessary in a reasonable assurance engagement but is planned to obtain a level of assurance that is, in the practitioner's professional judgment, meaningful. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential.

(SLSAE 3000: para. 12)

Some of the salient points here may be summarised as follows:

Assurance	Level of risk	Conclusion	Procedures
Reasonable	Low	Positive expression – opinion expressed	High
Limited	Acceptable in the circumstances	Negative expression – whether matters have come to attention indicating material misstatement	Limited, but still provides a meaningful level of assurance

2.3 Accepting and continuing appointment

Assurance engagements should only be accepted if the firm meets the requirements of the CA Sri Lanka *Code of Ethics* and SLSQC 1.

The standard requires that practitioners ensure they comply with Parts A and B of the CA Sri Lanka Code related to assurance engagements (SLSAE 3000: para. 20).

Acceptance or continuation procedures must be followed, and the engagement can only be undertaken if:

- The practitioner has no reason to believe that **ethical requirements** will not be satisfied.
- The practitioner is satisfied that those who are to perform the engagement are **competent.**
- The basis for the engagement has been agreed, ie:
  - **Preconditions** for an assurance engagement are present
  - There is a common understanding with the client regarding the reporting **responsibilities**

2.3.1 Preconditions for an assurance engagement

The practitioner must ensure that the preconditions for an assurance engagement are present.

Preconditions include:

- The roles and responsibilities of the parties are suitable
- The engagement has the following characteristics:
  - **Subject matter** is **appropriate**.
  - **Criteria** to be applied are **suitable** – ie they are relevant, complete, reliable, neutral and understandable.

- **Criteria** to be applied will be **available to users**.
- **Evidence** should be **obtainable** (to support the conclusion).
- Conclusion will be contained in a written report.
- Engagement has a **rational purpose**, and a meaningful level of assurance may be obtained.

If the preconditions are not present then decline the engagement. If the engagement is a legal requirement, then it may be performed but without referring to SLSAEs in the report.

If there is a limitation on the scope of the work such that the practitioner will disclaim a conclusion, then the engagement should not be accepted.

2.3.2 Agreeing terms

> **SLSAE 3000: para. 27**
>
> The practitioner shall agree on the terms of the engagement with the engaging party.

This should be done in an **engagement letter** or other written form.

On recurring engagements, the practitioner assesses whether the terms need to change, or whether the engaging party needs to be reminded of the terms.

Sometimes, the nature of an assignment being carried out by a practitioner might change, and the responsible party might request that the practitioner provides less or no assurance on an engagement. In this case, the terms should be changed unless there is reasonable justification for doing so, and the practitioner must not disregard evidence obtained prior to the change.

2.3.3 Report prescribed by law or regulation

If the **layout** or **wording** of the report are prescribed by law or regulation, then:

> **SLSAE 3000: para. 30**
>
> […] the practitioner shall evaluate:
>
> (a) Whether intended **users might misunderstand** the assurance conclusion; and
>
> (b) If so, whether **additional explanation** in the assurance report can **mitigate possible misunderstanding**.

2.4 Quality control

Quality control requirements must be met in relation both to the engagement and to the firm.

The **engagement partner** must be a member of a firm which applies SLSQC 1 (or another equivalent set of requirements), and must be **competent** both in **assurance skills** and in the **underlying subject matter**.

Further, the **team** must have the competence and capabilities to provide the required assurance.

If an expert is to be used (or another practitioner from outside the engagement team), then the partner must be able to be involved in their work to the extent that is necessary for the partner to accept responsibility for the conclusion expressed.

The **engagement partner** is responsible for the overall quality of the engagement, including responsibility for:

- **Client acceptance** procedures
- **Compliance** with professional standards, and legal and regulatory requirements
- **Reviews** being performed in line with the firm's procedures
- **Documentation** being maintained
- Appropriate **consultation** being taken on difficult or contentious matters

The engagement partner must be alert for evidence of the team not complying with ethical requirements. Moreover, they must consider the results of the firm's monitoring process and whether any deficiencies noted may affect the engagement.

If an engagement quality control reviewer is required by law or regulation, then the engagement partner must take responsibility for discussing significant matters with the reviewer.

2.5 Professional scepticism, judgment, skills and techniques

In common with many other recent standards, SLSAE 3000 emphasises professional scepticism and the exercise of professional judgment. It adds into the mix the necessity of applying assurance skills and techniques.

SLSAE 3000: paras. 37–39

The practitioner shall plan and perform an engagement with professional skepticism, recognizing that circumstances may exist that cause the subject matter information to be materiality misstated [sic].

The practitioner shall exercise professional judgment in planning and performing an assurance engagement, including determining the nature, timing and extent of procedures.

The practitioner shall apply assurance skills and techniques as part of an iterative, systematic engagement process.

2.6 Planning and performing the engagement

SLSAE 3000: para. 40

The practitioner shall plan the engagement so that it will be performed in an effective manner[…].

This involves:

- Setting the scope, timing and direction of the engagement
- Determining the nature, timing and extent of procedures
- Considering whether the criteria are suitable

Once the engagement has been accepted, if it is then discovered that preconditions are not present, the practitioner must discuss the matter with the appropriate parties and determine whether the issue can be resolved, and whether the engagement can be continued with. The practitioner should consider withdrawing from the engagement, or if this is not possible then what the effect might be on the conclusion expressed.

The practitioner must consider **materiality** in planning the engagement, and must **accumulate uncorrected misstatements** (other than those that are 'clearly trivial'). This is just like an audit engagement. Interestingly (or not), the SLSAE says the following about 'clearly trivial': 'When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial' (SLSAE 3000: para. A119).

2.7 Understanding the underlying subject matter

Some terminology:

Underlying subject matter. The phenomenon that is measured or evaluated by applying criteria.

Subject matter information. The outcome of the measurement or evaluation of the underlying subject matter against the criteria, ie the information that results from applying the criteria to the underlying subject matter.

(SLSAE 3000: para. 12)

An example here might be the entity's actual environmental performance (underlying subject matter), and a set of KPIs that are calculated thereon (subject matter information).

The extent of the understanding required depends on the level of assurance being provided.

Limited assurance	Reasonable assurance
Understanding must: • Enable practitioner to **identify areas** where a material misstatement is likely • Provide a basis for designing procedures to address these **areas**	Understanding must: • Enable practitioner to **identify and assess the risks** of material misstatement • Provide a basis for designing procedures to respond to assessed **risks**
Practitioner must consider the process used to prepare the subject matter information.	Practitioner must obtain understanding of **internal control** over the preparation of subject matter information. This includes evaluating the design of controls and performing procedures to test their implementation.
If practitioner becomes aware that there may be a material misstatement, they must **perform procedures** to determine whether or not there is a material misstatement.	If practitioner becomes aware that there may be a material misstatement, they must **revise the risk assessment done at the planning stage** and perform additional procedures where necessary (ie rather than just addressing the misstatement itself, consider the impact on the whole of the subject matter information).

2.8 Using the work of an expert

The term 'practitioner's expert' appears in SLSAE 3000 as the equivalent of 'auditor's expert' in SLAuS 620. There is no exact equivalent of 'management's expert' – it is either 'responsible party's expert', 'measurer's expert' or 'evaluator's expert'.

SLSAE 3000: para. 52

When the work of a **practitioner's expert** is to be used, the practitioner shall also:

(a) Evaluate whether the practitioner's expert has the necessary **competence**, **capabilities** and **objectivity** for the practitioner's purposes [...]

(b) **Obtain a sufficient understanding** of the field of expertise of the practitioner's expert;

(c) Agree with the practitioner's expert on the **nature**, **scope** and **objectives** of that expert's work; and

(d) **Evaluate the adequacy** of the practitioner's expert's work for the practitioner's purposes.

The issues with a responsible party's expert are similar to these, except that clearly the practitioner does not need to agree the scope of the work to be done with the expert ((c) above), and the work must be evaluated as evidence, rather than for the practitioner's purposes ((d) above).

2.8.1 Using the work of internal audit

If planning to use the work of internal audit (IA), evaluate:

- IA's **organisational status** and relevant **policies and procedures**
- IA's **competence**
- Whether IA applies a **systematic and disciplined approach**
- Whether IA's **work is adequate** for the **purposes** of the engagement

2.9 Written representations

Some written representations must be requested in all engagements:

- That all relevant information of which the 'appropriate party' (ie management) are aware has been provided
- Confirmation of the measurement of subject matter information (ie what the amounts are), and that this information is complete

Written representations can be requested where necessary, but they must be evaluated for **reasonableness** and for the **competence** of the person making them.

If there are **doubts about reliability**, then discuss the matter with the appropriate party, re-evaluate any other representations received and take any 'appropriate actions'.

2.10 Subsequent events

The responsibilities here are similar to an audit:

- Consider events up to the date of the report.
- Respond appropriately to facts that 'become known' after the date of the report.
- There is no responsibility to perform procedures after the date of the report.

2.11 Other information

The practitioner **must read other information** in documents containing the assurance report. The action is the same for both material inconsistencies and material misstatements of fact that are identified: **discuss the matter with the appropriate party and take further action as appropriate**.

2.12 Concluding and reporting

2.12.1 Drawing a conclusion

Whereas an auditor's report gives an 'opinion', an assurance report gives a 'conclusion'.

The SLSAE makes the following observations about reporting.

SLSAE 3000: paras. 64 and 67

The practitioner shall evaluate the sufficiency and appropriateness of the evidence obtained in the context of the engagement and, if necessary in the circumstances, attempt to obtain further evidence.

The assurance report shall be in writing and shall contain a clear expression of the practitioner's conclusion about the subject matter information.

2.12.2 Unmodified conclusions

A **reasonable assurance** engagement will result in a conclusion expressed in a **positive form of words**, giving a higher level of assurance. For example, the conclusion of a reasonable assurance report on forecast financial information might say:

> 'In our opinion, the forecast of the entity's financial performance is properly prepared, in all material respects, based on XYZ criteria.'

A **limited assurance** engagement will result in a conclusion expressed in a **negative form of words**, giving a lower level of assurance. For example, the conclusion of a limited assurance report on a company's compliance with some specified piece of law might say:

> 'Based on the procedures performed and evidence obtained, nothing has come to our attention that causes us to believe that [the entity] has not complied, in all material respects, with XYZ law.'

2.12.3 Modified conclusions

Although the level of assurance differs between a reasonable and a limited assurance engagement, the reasons for modifying the conclusion given are the same for both. The practitioner has several different types of modified conclusion to pick from. These are similar to those available for an auditor's report, and the same as those in SLSRE 2400, covered earlier in this chapter.

The type of modified conclusion given will depend on two things: the materiality of the issue, and the availability of evidence.

Nature of matter giving rise to the modification	Practitioner's judgment about the pervasiveness of the effects or possible effects on the subject matter information	
	Material but not pervasive	Material and pervasive
Subject matter information is materially misstated	QUALIFIED CONCLUSION	ADVERSE CONCLUSION
Inability to obtain sufficient, appropriate audit evidence	QUALIFIED CONCLUSION	DISCLAIMER OF CONCLUSION

It is also possible to modify the assurance report without modifying the actual conclusion, by including an Emphasis of Matter or an Other Matter paragraph.

CASE STUDY

Independent Assurance Report

[The following report is an amended example of an independent verification statement for a social and environmental audit. It is prepared in line with a superseded version of SLSAE 3000, and combines a limited assurance report on a company's sustainability report, with a reasonable assurance report on some specific pieces of performance information. The report gives unmodified conclusions for both aspects.]

INDEPENDENT LIMITED ASSURANCE STATEMENT

To: The Stakeholders of AstraZeneca Plc

Bureau Veritas UK Limited (Bureau Veritas) has been engaged by AstraZeneca Plc (AstraZeneca) to provide limited assurance over selected sustainability information reported in its Sustainability Report 2017. This Assurance Statement applies to the related information included within the scope of work described below.

Selected Information

The scope of our work was limited to providing assurance over AstraZeneca's statuses against the following commitments, as detailed in the Sustainability Report 2017 ('the Report') for the period 1st of January to the 31st of December 2017 (the 'Selected Information'):

- Disease prevention;
- Health systems development;
- Healthcare reform;
- Environmental safety of our products;
- Protecting natural resources;
- Ethical business conduct;
- Supply chain management;
- Clinical trial transparency;
- Bioethics;
- Workplace health and safety;
- Diversity and inclusion;
- Employee development;
- Human rights; and
- Community investment.

Limitations and Exclusions

Excluded from the scope of our work is any verification of information relating to:

- Activities outside the defined verification period;
- Positional statements (expressions of opinion, belief, aim or future intention by AstraZeneca) and statements of future commitment; and
- Financial data taken from the Annual Report which are audited by an external financial auditor, including but not limited to any statements relating to production, tax, sales, and financial investments; and
- Other information included in the Report other than scope defined above.

This limited assurance engagement relies on a risk-based selected sample of sustainability data and the associated limitations that this entails. This independent statement should not be relied upon to detect all errors, omissions or misstatements that may exist.

Responsibilities

The preparation and presentation of the Selected Information in the Report is the sole responsibility of the management of AstraZeneca.

Bureau Veritas was not involved in the drafting of the Report. Our responsibilities were to:

- Obtain limited assurance about whether the Selected Information has been appropriately and accurately prepared;
- Form an independent conclusion based on the assurance procedures performed and evidence obtained; and
- Report our conclusions to the Directors of AstraZeneca.

Assessment Standard

We performed our work in accordance with International Standard on Assurance Engagements (ISAE) 3000 (Revised) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*, and in accordance with International Standard on Assurance Engagements 3410 *Assurance Engagements on Greenhouse Gas Statements* (ISAE 3410), issued by the International Auditing and Assurance Standards Board.

Summary of work performed

As part of its independent verification, Bureau Veritas undertook the following activities:

1 Assessed the appropriateness and accuracy of the Selected Information;

2 Conducted interviews with relevant personnel of AstraZeneca;

3 Reviewed the data collection and consolidation processes used to compile the Selected Information, including assessing assumptions made, the data scope and reporting boundaries;

4 Reviewed documentary evidence provided by AstraZeneca;

5 Reperformed a selection of aggregation calculations of the Selected Information;

6 Agreed a selection of the Selected Information to the corresponding source documentation: and

7 Reviewed the current sustainability issues that could affect AstraZeneca and are of interest to stakeholders.

Conclusion

On the basis of our methodology and the activities described above, nothing has come to our attention to indicate that the Selected Information has not been properly prepared, in all material respects.

Statement of Independence, Integrity and Competence

Bureau Veritas is an independent professional services company that specialises in quality, environmental, health, safety and social accountability with over 185 years' history. Its assurance team has extensive experience in conducting verification over environmental, social, ethical and health and safety information, systems and processes.

Bureau Veritas operates a certified1 Quality Management System which complies with the requirements of ISO 9001:2008, and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

Bureau Veritas has implemented and applies a Code of Ethics, which meets the requirements of the International Federation of Inspections Agencies (IFIA) across the business to ensure that its employees maintain integrity, objectivity, professional competence and due care, confidentiality, professional behaviour and high ethical standards in their day-to-day business activities.

The assurance team for this work does not have any involvement in any other Bureau Veritas projects with AstraZeneca.

Bureau Veritas UK Limited

London
05 March 2018

2.13 Documentation

SLSAE 3000 requires practitioners to prepare engagement documentation that should 'enable an experienced practitioner' to understand the procedures performed (and their results), together with significant matters arising.

The important point here is that documentation should include more than just the results of testing: it should extend to professional judgments made.

Finally, once the engagement file has been completed, the practitioner must not delete any information from it!

2.14 References for a client

Sometimes a professional accountant will be asked for a reference concerning a client, particularly in relation to their ability to **service a loan**. Where **no additional work is required** to provide a reference, the following matters should be considered:

- Inherent uncertainty of future income and expenditure
- The difficulty of reporting on present solvency (given that the audit is a historic exercise. Such information might be available if a **separate engagement** was made)
- The possibility of a **duty of care** arising
- That clarification might be required (there has been no engagement and no fees, and that liability might have to be expressly disclaimed)

However, the professional accountant might be able to provide certain information without difficulty:

- The length of time they have acted for the client
- The results declared to the taxation authorities over past years
- A statement of a level of negative assurance given past performance

Where it is necessary to create a separate engagement in order to provide the relevant information, the professional accountant should consider the guidance in SLSAE 3000, discussed above.

In the following sections we shall start to consider some examples of areas where the professional accountant can provide assurance services.

2.15 Assurance reports on compiled pro forma information

SLSAE 3420 *Assurance engagements to report on the compilation of pro forma financial information included in a prospectus* does not deal with compilation engagements, but assurance engagements on financial information that has been compiled. This is different from other assurance engagements because its scope is limited to compiled pro forma information.

SLSAE 3420 was developed in the context of the increasing globalisation of **capital markets**. Its main points are:

- **Pro forma financial information** is information that has been adjusted to show the impact of a future event or transaction. The 'pro forma adjustments' might be for eg an investment being made or sold.
- The professional accountant does not compile the information – this is done by eg the client (the 'responsible party'). The accountant then reports on whether the information has been compiled in line with 'applicable criteria'.
- The professional accountant must assess whether the **applicable criteria** are **suitable** (ie not misleading or in conflict with laws and regulations). The accountant then assesses whether the information has actually been compiled in line with these criteria.
- This involves (i) determining whether information has been extracted appropriately from its source; (ii) obtaining an understanding of the events or transactions being adjusted for; and (iii) evaluating whether the adjustments made are appropriate and in line with the engagement criteria.
- SLSAE 3420 allows two alternative forms of wording for the **opinion**:
  - The pro forma financial information has been compiled, in all material respects, on the basis of the (applicable criteria).
  - The pro forma financial information has been properly compiled on the basis stated.

2.16 Assurance reports on service organisations

SLSAE 3000 covers assurance engagements in general, and SLSAE 3402 *Assurance reports on controls at a service organization* deals with how SLSAE 3000 is to be applied to reasonable assurance engagements on a service organisation's controls. SLSAE 3402 only covers reports on service organisations relevant to an entity's financial reporting. Examples of these might include payroll services, actuaries, or mortgage services.

SLSAE 3402 requires the service auditor to carry out the following procedures.

- Consider **acceptance** and continuance issues
- Assess the **suitability of the criteria** used by the service organisation
- Consider **materiality**
- **Obtain an understanding** of the service organisation's system
- Obtain evidence about:
  - The service organisation's **description of its system**
  - **Whether controls implemented** to achieve the control objectives are **suitably designed**
  - The **operating effectiveness** of controls (when providing a type 2 report)
- Determine whether, and to what extent, to use the work of the **internal auditors** (where there is an internal audit function)

'Type 1 report' and 'Type 2 report' are terms from SLSAE 3000. A type 1 report only provides assurance on the description and design of controls, whereas a type 2 report includes their operating effectiveness as well.

The form of opinion expressed in the report should be **positive**, providing reasonable assurance. SLSAE 3402 gives the following example of an **unmodified opinion** in a type 2 report.

Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion are those described at page [aa]. In our opinion, in all material respects:

(a) The description fairly presents the [the type or name of] system as designed and implemented throughout the period from [date] to [date]

(b) The controls related to the control objectives stated in the description were suitably designed throughout the period from [date] to [date]

(c) The controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period from [date] to [date]

2.17 Compilation engagements

Compilation engagements are **not assurance engagements** (in spite of their inclusion at this point in your Study Text). However, SLSRE 4410 *Compilation Engagements* is an examinable document for AAA, so you need to be aware of its contents.

The SLSRE states that the practitioner must comply with **ethical requirements** (ie at a minimum, the Sri Lanka *Code of Ethics*), and that the engagement partner must take responsibility for **engagement level quality control**.

Before **accepting or continuing** an engagement, the practitioner must **agree the terms of the engagement**. This will include: the **intended use** and distribution of the information (eg is it going to be made public?); applicable **FR framework,** the objective and scope of the engagement; the **practitioner's responsibilities**; **management's responsibilities**; and the expected **form and content of the report**.

The practitioner must **obtain an understanding of the entity** – its business, and the applicable FR framework. The information must then be compiled using records provided by management, but the practitioner must:

- Discuss any **significant judgments** made
- Bring it to management's attention **if information is incomplete**, inaccurate or unsatisfactory. The practitioner must **request additional or corrected information.**
- **Withdraw** from the engagement if management **fails to provide information**, or if management does not make any proposed changes to the financial information
- Read the financial information in light of the **understanding of the business** obtained

In order to carry out a compilation engagement the accountant will conduct **procedures** such as:

- Obtain an understanding of the business and the accounting practices and principles of the industry.
- Enquire of management personnel as to the nature of the business transactions and the form of accounting records and information.
- Read the compiled information to ensure it is appropriate in form and content.

It is not necessary for the accountant to assess the completeness or reliability of the information, assess the internal controls or verify matters and explanations.

No opinion is provided, because no assurance is provided. There is neither reasonable assurance nor negative assurance, because no procedures have been performed to verify the information. Therefore, the compilation report includes a sentence that states simply that:

'These financial statements and the accuracy and completeness of the information used to compile them are your responsibility.'

QUESTION — Approaching financial statements

You have been requested by Andaro Co to compile their financial statements for the year ended 31 March 20X9. Andaro operates in the fitness industry providing gym equipment to gym owners across Sri Lanka. The equipment is either sold up-front at a cash price, which accounts for 60% of sales generated, or it is leased to the customer over a three-year term. Andaro Co has a computerised accounting system, run by a team of 12 accounting staff, that produce the financial information up to the trial balance stage. The work you will be engaged in will be to produce statutory accounts suitable for all regulatory requirements from the trial balance provided by the client.

Required

Discuss the approach that you will take to providing Andaro Co with the compiled financial statements requested.

ANSWER

The first aspect that will need to be considered in providing this service to Andaro Co is to clearly outline the terms of the engagement so that there is no misunderstanding between the client and the accountant. The nature of the engagement and the information to be received must be clarified as well as outlining clearly that it is the responsibility of management for the completeness and accuracy of the compiled information. Clarification will also be provided to the client that the engagement is not designed to detect fraud or error. Finally, the form of the report and the basis of the accounting information will need to be confirmed. This can all be included in an engagement letter that clearly outlines the terms.

The work should then be planned, beginning with obtaining a general knowledge of the fitness industry and the accounting principles and practices that exist in that industry. The transactions being entered into by Andaro Co need to be understood, particularly the provision of the equipment on a lease. The nature of transactions such as this requires enquiry so that it can be disclosed adequately and the information properly compiled. Likewise, it will be important to enquire of management or staff personnel as to the nature of the accounting records and how the financial information has been produced in order to enhance the understanding of the nature of the business. Once this understanding has been obtained to the satisfaction of the accountant, they can proceed to compile the information as required.

If it appears that the information provided is incorrect or incomplete then management should be asked to provide additional information. If this is refused, the accountant should withdraw from the engagement.

2.18 Value for money audits

2.18.1 Purpose

The purpose of a value for money (VFM) audit is to examine the **economy**, **efficiency** and **effectiveness** of activities and processes within a business. These are known as the **three Es** of VFM audits (National Audit Office, 2016). It is often the role of the internal audit department within an organisation to carry out value for money audit work, but an external auditor could be required to carry out a specific piece of work in this area in the form of an assurance engagement.

We will consider the purpose, nature and problems with value for money audits in Chapter 20 from the perspective of internal audit. However, all of these apply equally to the undertaking an assurance engagement of this nature by the external auditor.

Similarly to due diligence, there is no Sri Lankan standard on value for money engagements, so in practice the work would be conducted in accordance with whichever standard best fits the particular engagement being conducted – perhaps SLSRE 2400, SLSAE 3000 or SLSRE 4400.

3 Reporting on prospective financial information (PFI)

Prospective financial information is difficult to give assurance about because it is highly subjective.

Prospective financial information (PFI) is information based on assumptions about events that may occur in the future and possible actions by an entity.

From the definition given above, you can see that PFI is highly subjective. This makes it a difficult area to examine and report on. Guidance on reporting on PFI is given in SLSAE 3400 *The Examination of Prospective Financial Information*.

The key issues that projections relate to are:

- Capital expenditure
- Profits
- Cash flows

These are the key areas which we will focus on in the procedure part of this chapter.

3.1 Principles of PFI

Increasingly, company directors are producing PFI, either voluntarily or because it is required by regulators, for example in the case of a public offering of shares.

Markets and investors need PFI that is understandable, relevant, reliable and comparable. Some specific issues arise in applying these principles to PFI.

Principle	Issue arising
Understandable	Disclosure is required of sources of uncertainty, assumptions made, determining factors that will affect whether the assumptions will be borne out, and alternative outcomes.
Relevant	No PFI-specific issues arise other than the need for the information to be relevant to the decision-making of investors or other users of the information.
Reliable	The reliability of PFI cannot be confirmed by evidence of past transactions or events. Its reliability depends on it being supported by analysis of the entity's business, strategies and plans.
Comparable	The PFI should be capable of comparison with eventual outcomes in the form of historical financial information (HFI). The accounting policies used in its preparation should also be disclosed.

3.2 Types of prospective financial information

PFI can be of two types (or a combination of both):

Forecast. PFI based on assumptions as to future events which management expects to take place and the actions management expects to take (best-estimate assumptions).

Projection. PFI based on hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations, or a mixture of best-estimate and hypothetical assumptions. Such information illustrates the possible consequences as of the date the information is prepared if the events and actions were to occur (a 'what-if' scenario). (SLSAE 3400)

3.3 Accepting Engagements

The Sri Lanka Standard on Assurance Engagements (SLSAE) gives the following guidance about accepting an engagement to examine PFI.

SLSAE 3400: para. 11

The auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

SLSAE 3400: para. 12

The auditor and the client should agree on the terms of the engagement.

The SLSAE also lists the following **factors** which the auditor should consider:

- The **intended use** of the information
- Whether the information will be for general or limited **distribution**
- The **nature of the assumptions**; that is, whether they are best estimate or hypothetical assumptions (hypothetical assumptions are based on events that may not take place, eg 'if the entity does *x*, then *y* may follow')
- The **elements** to be **included** in the information
- The **period covered** by the information

It also states that the auditor should have sufficient knowledge of the business to be able to evaluate the significant assumptions made.

A firm must also consider practical matters, such as the time available to them, their experience of the staff member compiling the information, any limitations on their work, and the degree of secrecy required beyond the normal duty of confidentiality.

Procedures could include:

- Analytical review (against similar historical projects)
- Verification of projected expenditure to quotes or estimates

3.4 General matters

In carrying out their review, the general matters to which attention should be directed are:

- The nature and background of the company's business
- The accounting policies normally followed by the company
- The assumptions on which the forecast is based
- The procedures followed by the company in preparing the forecast

3.4.1 The nature and background of the company's business

The accountant will review the company's character and recent history, with reference to such matters as the nature of its activities and its main products, markets, customers, suppliers, divisions, locations and trend of results.

3.4.2 The accounting policies normally followed by the company

The accountant will wish to establish the accounting principles normally followed by the company and ensure that they have been consistently applied in the preparation of forecasts.

3.4.3 The procedures followed by the company in preparing the forecast

In carrying out their review of the accounting bases and calculations for forecasts, and the procedures followed by the company for preparing them, the main points which the reporting accountant will wish to consider include:

(a) Whether the forecast under review is based on forecasts regularly prepared for the purpose of management, or whether it has been separately and specially prepared for the specific purpose.

(b) Where forecasts are regularly prepared for management purposes, the degree of accuracy and reliability previously achieved, and the frequency and thoroughness with which estimates are revised.

(c) Whether the forecast under review represents the management's best estimate of results which they reasonably believe can and will be achieved rather than targets which the management have set as desirable.

(d) The extent to which forecast results for expired periods are supported by reliable interim accounts.

(e) The details of the procedures followed to generate the forecast and the extent to which it is built up from detailed forecasts of activity and cash flow.

(f) The extent to which profits are derived from activities having a proven and consistent trend and those of a more irregular, volatile or unproven nature.

(g) How the forecast takes account of any material extraordinary items and prior year adjustments, their nature, and how they are presented.

(h) Whether adequate provision is made for foreseeable losses and contingencies and how the forecast takes account of factors which may cause it to be subject to a high degree of risk, or which may invalidate the assumptions.

(i) Whether working capital appears adequate for requirements (normally this would require the availability of properly prepared cash flow forecasts) and, where short-term or long-term finance is to be relied on, whether the necessary arrangements have been made and confirmed.

(j) The arithmetical accuracy of the forecast and the supporting information and whether forecast statements of financial position and statements of cash flows have been prepared (as these help to highlight arithmetical inaccuracies and inconsistent assumptions).

SLSAE 3400: para. 17

When determining the nature, timing and extent of examination procedures, the auditor's considerations should include:

(a) The likelihood of material misstatement;

(b) The knowledge obtained during any previous engagement;

(c) Management's competence regarding the preparation of prospective financial information;

(d) The extent to which the prospective financial information is affected by the management's judgement; and

(e) The adequacy and the reliability of the underlying data.

The SLSAE goes on to say that the auditor should **seek appropriate evidence** on those areas that are **particularly sensitive to variation** and have a **material effect** on the information.

3.5 Specific matters

The following list of procedures may also be relevant when assessing prospective financial information. The auditor should undertake the review procedures discussed above in addition to these.

Profit forecasts

- Verify projected **income** figures to suitable evidence. This may involve:
  - Comparison of the basis of projected income to similar existing projects in the firm
  - Review of current market prices for that product or service

- Verify projected **expenditure** figures to suitable evidence. There is likely to be more evidence available about expenditure in the form of:
  - Quotations or estimates provided to the firm
  - Current bills for things such as services which can be used to reliably estimate
  - Market rate prices, for example, for advertising
  - Interest rate assumptions can be compared with the bank's current rates
  - Costs such as depreciation should correspond with relevant capital expenditure projections

Capital expenditure

The auditor should check the capital expenditure for **reasonableness**. For example, if the projection relates to buying land and developing it, it should include a sum for land.

- Projected costs should be **verified to estimates and quotations** where possible.
- The projections can be reviewed for **reasonableness**, including a comparison with prevailing **market rates** where such information is available (such as for property).

Cash forecasts

- The auditor should review cash forecasts to ensure the **timings involved** are **reasonable**.
- The auditor should check the cash forecast for **consistency with any profit forecasts** (income/expenditure should be the same, just at different times).
- If there is no comparable profit forecast, the income and expenditure items should be verified as they would have been on a profit forecast.

Working capital

- **Confirm sources** of short-term and long-term finance to evidence from external finance providers.
- Compare the reasonableness of **available** finance to cash flow forecasts.
- Assess the reasonableness of **projected working capital ratios** such as trade receivables days and the assumptions made in calculating these.
- Compare working capital projections to **historical trends** to assess reasonableness.

3.6 Expressing an opinion

It is impossible to give the same level of assurance about PFI as it is for historical financial information, but negative assurance may be given.

It is clear that, as PFI is subjective information, it is **impossible** for an auditor **to give the same level of assurance** regarding it as they would on **historical financial information**.

The SLSAE suggests that the auditor express an opinion including:

- A statement of **negative assurance** as to whether the **assumptions** provide a reasonable basis for the prospective financial information
- An opinion as to whether the PFI is **properly prepared** on the basis of the assumptions and the relevant reporting framework
- Appropriate **caveats as to the achievability** of the forecasts

Limited assurance is assurance of something in the absence of any evidence arising to the contrary. In effect, this means the auditor is saying, 'I believe that this is reasonable because I have no reason to believe otherwise.' (SLSAE 3000: para. 12)

3.7 Reports under SLSAE 3400

SLSAE 3400: para. 27

The report by an auditor on an examination of prospective financial information should contain:

(a) Title;

(b) Addressee;

(c) Identification of the prospective financial information;

(d) A reference to the SLSAE or relevant national standards or practices applicable to the examination of prospective financial information;

(e) A statement that management is responsible for the prospective financial information including the assumptions on which it is based;

(f) When applicable, a reference to the purpose and/or restricted distribution of the prospective financial information;

(g) A statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information;

(h) An opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework;

(i) Appropriate caveats concerning the achievability of the results indicated by the prospective financial information;

(j) Date of the report which should be the date procedures have been completed;

(k) Auditor's address; and

(l) Signature.

SLSAE 3400: para. 30

When the auditor believes that the presentation and disclosure of the prospective financial information is not adequate, the auditor should express a qualified or adverse opinion in the report on the prospective financial information, or withdraw from the engagement as appropriate.

SLSAE 3400: para. 31

When the auditor believes that one or more significant assumptions do not provide a reasonable basis for the prospective financial information prepared on the basis of best-estimate assumptions or that one or more significant assumptions do not provide a reasonable basis for the prospective financial information given the hypothetical assumptions, the auditor should either express an adverse opinion in the report on the prospective financial information or withdraw from the engagement.

QUESTION **Prospective financial information**

A new client of your practice, Peter Lawrence, has recently been made redundant. He is considering setting up a residential home for elderly people, as he is aware that there is an increasing need for this service with an ageing population (more people are living to an older age). He has been shown a large house by an estate agent, which he plans to convert into an old people's home. Each resident will have a bedroom, there will be a communal sitting room and all meals will be provided in a dining room. No long-term nursing care will be provided, as people requiring this service will either be in hospital or in another type of accommodation for the elderly.

The large house is in a poor state of repair, and will require considerable structural alterations (building work) and repairs to make it suitable for an old people's home. The following will also be required.

- New furnishings (carpets, beds, wardrobes and so on for the resident's rooms; carpets and furniture for the sitting room and dining room)

- Decoration of the whole house (painting the woodwork and covering the walls with wallpaper)
- Equipment (for the kitchen and for helping disabled residents)

Mr Lawrence and his wife propose to work full time in the business, which he expects to be available for residents six months after the purchase of the house. Mr Lawrence has already obtained some estimates of the conversion costs and information on the income and expected running costs of the home.

Mr Lawrence has received about Rs. 30,000 from his redundancy. He expects to receive about Rs. 30,000 from the sale of his house (after repaying his house loan). The owners of the house he would like to buy are asking Rs. 50,000 for it, and Mr Lawrence expects to spend Rs. 50,000 on conversion of the house (building work, furnishing, decorations and equipment).

Mr Lawrence has prepared a draft capital expenditure forecast, a profit forecast and a cash flow forecast, which he has asked you to check before he submits them to the bank in order to obtain finance for the old people's home.

Required

Describe the procedures you would carry out on:

(a) The capital expenditure forecast
(b) The profit forecast
(c) The cash flow forecast

ANSWER

All three of the forecasts to be reviewed should be prepared on a monthly basis and the following work would be required in order to consider their reasonableness.

(a) **Capital expenditure forecast**

(i) Read estate agent's details and solicitors' correspondence and compare to the capital expenditure forecast to ensure that all expenditure (including sale price, surveyors' fees, legal costs, taxes on purchase) is included.

(ii) Confirm the estimated cost of new furnishings by agreeing them to supplier price lists or quotations.

(iii) Verify any discounts assumed in the forecast are correct by asking the suppliers if they will apply them to this transaction.

(iv) Confirm projected building and decoration costs to the relevant suppliers' quotation.

(v) Confirm the projected cost of specialist equipment (and relevant bulk discounts) to suppliers' price lists or websites.

(vi) In the light of experience of other such ventures, consider whether the forecast includes all relevant costs.

(b) **Profit forecast**

As a first step it will be necessary to recognise that the residential home will not be able to generate any income until the bulk of the capital expenditure has been incurred in order to make the home 'habitable'. However, while no income can be anticipated, the business will have started to incur expenditure in the form of loan interest, rates and insurance.

The only income from the new building will be rent receivable from residents. The rentals which Mr Lawrence is proposing to charge should be assessed for reasonableness in the light of rental charged to similar homes in the same area. In projecting income it would be necessary to anticipate that it is likely to take some time before the home is fully occupied and it would be prudent to allow for some periods where vacancies arise because of the loss of some of the established residents.

The expenditure of the business is likely to include:

(i) **Wages and salaries.** Although Mr and Mrs Lawrence intend to work full time in the business, they will undoubtedly need to employ additional staff to care for residents, cook, clean and tend to the gardens. The numbers of staff and the rates of pay should be compared with those of similar local businesses of which the firm has knowledge.

(ii) **Rates and water rates.** The estimate of the likely cost of these can be confirmed by asking the local council and/or the estate agents dealing with the sale of property.

(iii) **Food.** The estimate of the expenditure for food should be based on the projected levels of staff and residents, with some provision for wastage.

(iv) **Heat and light.** The estimates for heat, light and cooking facilities should be compared to similar clients' actual bills.

(v) **Insurance.** This cost should be verified to quotes from the insurance broker.

(vi) **Advertising.** The costs of newspaper and brochure advertising costs should be checked against quotes obtained by Mr Lawrence.

(vii) **Repairs and renewals.** Adequate provision should be made for replacement of linen, crockery and such like and maintenance of the property.

(viii) **Depreciation.** The depreciation charge should be recalculated with reference to the capital costs involved being charged to the capital expenditure forecast.

(ix) **Loan interest and bank charges.** These should be checked against the bank's current rates and the amount of the principal agreed to the cash forecast.

(c) **Cash flow forecast**

(i) Check that the timing of the capital expenditure on the cash flow forecast is consistent with that shown on the capital expenditure forecast.

(ii) Compare the cash flow forecast to the details within the profit forecast to ensure they tie up, for example:

- Income from residents would normally be receivable weekly/monthly in advance.
- The majority of expenditure for wages etc would be payable in the month in which it is incurred.
- Payments to the major utilities (gas, electricity, telephone) will normally be payable quarterly, as will the bank charges.
- Rates and taxes are normally paid half-yearly.
- Insurance premiums will normally be paid annually in advance.

(iii) Redo the additions on the cash forecast and check that figures that appear on other forecasts are carried over correctly.

CHAPTER ROUNDUP

- Audit-related services may be assurance engagements or non-assurance engagements.
- Assurance services improve the quality of decision making for users of information.
- Assurance engagements may be attestation engagements or direct engagements.
- Assurance engagements may give reasonable assurance or limited assurance.
- Assurance engagements should only be accepted if the firm meets the requirements of the CA Sri Lanka *Code of Ethics* and SLSQC 1.
- The practitioner must ensure that the preconditions for an assurance engagement are present.
- Quality control requirements must be met in relation both to the engagement and to the firm.
- Prospective financial information is difficult to give assurance about because it is highly subjective.
- It is impossible to give the same level of assurance about PFI as it is on historical financial information but negative assurance may be given.

PROGRESS TEST

1 Name the three types of engagement which comprise audit-related services.

(1) ....

(2) ....

(3) ....

2 Link the review assignment with its description.

Review assignment:

(a) Attestation engagement

(b) Direct engagement

Descriptions:

(i) The accountant is required to confirm whether:

(1) Accounting policies are consistent with those in prior year financial statements

(2) Any material modifications to the presented information are required

(ii) The accountant is required to conduct a review and report on issues arising.

3 In an assurance engagement, the responsible party can also be an intended user.

A Never
B If there is more than one intended user
C If there are more than ten intended users
D In exceptional circumstances

4 When carrying out an assurance engagement the practitioner must assess the appropriateness of the subject matter and the criteria. True or false?

5 The assurance report should be in writing. True or false?

ANSWERS TO PROGRESS TEST

1 (1) Review assignments
(2) Agreed-upon procedures assignments
(3) Compilation assignments

2 (a)(i)
(b)(ii)

3 B

4 True

5 True

Part G - Audit Quality and Ethics

THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

CHAPTER 18

Audit Quality Control

INTRODUCTION

The role performed by auditors represents an activity of significant public interest. Quality independent audit is crucial, both to users and to the audit profession as a whole.

A system of quality control is important at a firm level and quality control procedures are equally important at the audit engagement level.

We will look at each of these aspects in turn before examining engagement quality control review processes.

Knowledge Component			
G	**Audit Quality and Ethics**		
7.1	**Framework for Audit Quality**	7.1.1	Demonstrate the elements of the framework for audit quality
7.2	**System of Quality Controls**	7.2.1	Demonstrate the elements of a system of quality controls of the firm
7.3	**Audit Quality**	7.3.1	Explain the requirements to implement quality control procedures at the audit engagement level including the engagement quality control review

CHAPTER CONTENTS	LEARNING OUTCOME
1 Quality control at a firm level	7.2.1
2 Quality control on an individual audit	7.3.1
3 Quality control framework	7.1.1

1 Quality control at a firm level

There is no simple definition of audit quality because there is no one 'correct' way to audit. It is often a matter of conducting an audit in line with the spirit as well as the letter of professional guidance.

The Sri Lankan standard on Quality Control (SLSQC 1) helps audit firms establish quality standards for their business.

SLSQC 1 relates to the overall quality within all aspects of the firm, not just to the provision of assurance services. As such we can see SLSQC 1 as guidance for firms as to how they maintain quality across all the services they provide. We will look in the next section at SLAuS 220, which gives guidance as to quality control over individual audit engagements.

Audit quality is not defined in law or through regulations, and neither do auditing standards provide a simple definition.

Although each stakeholder in the audit will give a different meaning to audit quality, at its heart it is about delivering an **appropriate** professional **opinion** supported by the necessary **evidence** and **judgements**.

Many principles contribute to audit quality including good leadership, experienced judgement, technical competence, ethical values and appropriate client relationships, proper working practices and effective quality control and monitoring review processes.

The fact that auditors follow auditing standards provides a general quality control framework within which audits should be conducted. There are also specific quality control standards.

1.1 Purpose of SLSQC 1

SLSQC 1.11

The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that:

(a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and

(b) Reports issued by the firm or engagement partners are appropriate in the circumstances.

All quality control policies and procedures should be **documented** and **communicated** to the firm's personnel.

We have already considered the sections of this standard relating to ethics in and those relating to client acceptance. We shall now consider the requirements of the rest of the standard, which fall into the following areas.

- Firm and leadership responsibilities for quality within the firm;
- Human resources;
- Engagement performance (see also below, the requirements of ISA 220);
- Monitoring

1.2 Firm and leadership responsibilities for quality within the firm

SLSQC 1.13

Personnel within the firm responsible for establishing and maintaining the firm's system of quality control shall have an understanding of the entire text of this SLSQC, including its application and other explanatory material, to understand its objective and to apply its requirements properly.

Firms are required to ensure that the appropriate training is provided to ensure there is complete understanding of the objectives and procedures under ISQC 1. The standard stipulates further that some firms may need to apply additional procedures (beyond those of the standard) to ensure that the objectives are met.

The standard requires that the firm implements policies such that the **internal culture** of the firm is one where **quality** is considered to be **essential**. Such a culture must be inspired by the leaders of the firm, who must promote this culture by the example of their actions and messages. In other words, the entire business strategy of the audit firm should be driven by the need for quality in its operations.

The firm may appoint an individual or group of individuals to oversee quality in the firm. Such individuals must have:

- Sufficient and appropriate experience
- The ability to carry out the job
- The necessary authority to carry out the job

1.3 Human resources

The firm's overriding desire for quality will necessitate policies and procedures on ensuring excellence in its staff, to provide the firm with 'reasonable assurance that it has sufficient personnel with the **capabilities**, **competence**, and **commitment to ethical principles** necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances'.

These will cover the following issues.

- Recruitment
- Capabilities
- Career development
- Compensation
- Performance evaluation
- Competence
- Promotion
- The estimation of personnel needs

The firm is responsible for the ongoing excellence of its staff, through continuing professional development, education, work experience and coaching by more experienced staff.

1.3.1 Assignment of engagement teams

The assignment of engagement teams is an important matter in ensuring the quality of an individual assignment.

This responsibility is given to the audit engagement partner. The firm should have policies and procedures in place to ensure that:

- Key members of client staff and those charged with governance are aware of the identity of the audit engagement partner
- The engagement partner has appropriate capabilities, competence, authority and time to perform the role
- The engagement partner is aware of his responsibilities as engagement partner

The engagement partner should ensure that he assigns staff of sufficient capabilities, competence and time to individual assignments so that he will be able to issue an appropriate report.

1.4 Engagement performance

The firm should take steps to ensure that engagements are performed correctly, that is, in accordance with standards and guidance. Firms often produce a **manual of standard engagement procedures** to give to all staff so that they know the standards they are working towards. These may be in an electronic format.

Ensuring good engagement performance involves a number of issues:

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

Many of these issues will be discussed in the context of an individual audit assignment (see Section 3 below).

SLSQC 1.34

The firm shall establish policies and procedures designed to provide it with reasonable assurance that:

(a) Appropriate consultation takes place on difficult or contentious matters

(b) Sufficient resources are available to enable appropriate consultation to take place

(c) The nature and scope of, and conclusions resulting from, such consultations are documented and are agreed by both the individual seeking consultation and the individual consulted

(d) Conclusions resulting from consultations are implemented

This may involve consulting externally, for example with other firms, or the related professional body, particularly when the firm involved is small.

When there are differences of opinion on an engagement team, a report should not be issued until the dispute has been resolved. This may involve the intervention of the quality control reviewer.

A **peer review** is a review of an audit file carried out by another partner in the assurance firm.

A **hot review** is a peer review carried out before the audit report is signed.

A **cold review** is a peer review carried out after the audit report is signed.

The firm should have policies and procedures to determine when a quality control reviewer will be necessary for an engagement. This will include all audits of financial statements for listed companies. When required, such a review must be completed before the report is signed.

The firm must also have standards as to what constitutes a suitable quality control review (the nature, timing and extent of such a review, the criteria for eligibility of reviewers and documentation requirements).

Quality control reviews	
Nature, timing and extent	It ordinarily includes discussion with the engagement partner, review of the financial statements/other subject matter information and the report, and consideration of whether the report is appropriate. It will also involve a selective review of working papers relating to significant judgements made.
Eligibility	The reviewer must have sufficient technical expertise and be objective towards the assignment.
Documentation	Documentation showing that the firm's requirements for a review have been met, that the review was completed before the report was issued and a conclusion that the reviewer is not aware of any unresolved issues.
Listed companies	The review should include: • The engagement team's evaluation of the firm's independence in relation to the specific engagement • Significant risks identified during the engagement and the responses to those risks • Judgements made, particularly with respect to materiality and significant risks • Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations • The significance and disposition of corrected and uncorrected misstatements identified during the engagement • The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies • Whether working papers selected for review reflect the work performed in relation to the significant judgements and support the conclusions reached • The appropriateness of the report to be issued

QUESTION **Evaluation of quality control procedures**

Company X specialises in the export of bespoke sustainable furniture. They have engaged your firm to conduct their annual audit.

Required

Outline the specific areas that a periodic inspection of completed engagements will investigate.

ANSWER

- Significant risks identified during the engagement
- Any judgments made, particularly with respect to materiality and risks
- The significance of any misstatements identified in the accounts
- The matters to be communicated to management and other interested parties

1.5 Monitoring

The standard states that firms must have policies in place to ensure that their quality control procedures are:

- **Relevant**
- **Adequate**
- **Operating effectively**
- **Complied with**

In other words, they must monitor their system of quality control. Monitoring activity should be reported on to the management of the firm on an annual basis.

There are two types of monitoring activity; an ongoing evaluation of the system of quality control, and periodic inspection of a selection of completed engagements. An ongoing evaluation might include such questions as, 'have we kept up to date with regulatory requirements?' A periodic inspection cycle would usually fall over a period such as three years, in which time at least one engagement per engagement partner would be reviewed.

The people monitoring the system are required to evaluate the effect of any **deficiencies** found. These deficiencies might be one-offs. Monitors will be more concerned with **systematic or repetitive deficiencies that require corrective action**. When evidence is gathered that an inappropriate report might have been issued, the audit firm may want to take legal advice.

Corrective action

- Remedial action with an individual
- Communication of findings with the training department
- Changes in the quality control policies and procedures
- Disciplinary action, if necessary

QUESTION — Quality control issues

Ansehst, a firm of Chartered Certified Accountants, has 20 partners and 87 audit staff. The firm provides a range of audit, assurance, tax and advisory services. The firm has 4 offices around the country and clients ranging from sole traders to a number of small plcs (none of which are quoted companies).

The quality control partner has recently resigned to take up a position in industry. They have not yet been replaced as the managing board of Ansehst have not been able to find a suitable replacement. On their departure, the quality control partner was in the process of implementing a system of ethical compliance for assurance staff. Staff would be required to confirm in writing their compliance with the CASL *Code of Ethics*. Implementation of this system is incomplete.

Oste plc is one of the firm's largest clients for whom Ansehst provides audit services, preparation of tax computations and other advisory services. A new engagement partner has been assigned to the audit, as the previous partner has retired. The fee for the audit work and other services has been set at the same level as last year in spite of the fact that additional work will need to be performed as Oste has introduced a new computer system. The starting date of the audit has been delayed due to problems with the new system. The management of Oste was very insistent that the fee should not be increased because of this.

Required

(a) **List** the six elements of a firm's system of quality control identified by SLQC 1 *Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements*.

(b) **Identify** and **explain** the quality control issues in the scenario above and the action which should be taken by Ansehst.

ANSWER

(a) The six elements of a firm's system of quality control are:

- Leadership responsibilities for quality within the firm
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

(b) The issues are:

Firm culture

SLQC 1 *Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements* requires that firms implement policies such that the internal culture of the firm emphasises the importance of quality control. It is the leaders of the firm who are responsible for creating and maintaining this culture through their actions and messages. In other words, the entire business strategy of the firm should be driven by the need for quality in its operations. The personnel responsible for establishing and maintaining the firm's system of quality control must understand SLQC 1.

In this case two factors indicate that there is a lack of leadership on quality control:

(i) The partner responsible for quality control has resigned and has not been replaced. While this may not have a direct impact on the audit of Oste plc, the fact that there is no one responsible for quality control in the firm increases the risk that quality control deficiencies will go undetected.

(ii) The firm is under pressure to complete the audit and provide other services for the same fee as last year, in spite of the fact that additional work will be required. There is a risk that quality will suffer, as audit work will not be carried out as thoroughly as it should be in order to complete the work within budget. This problem is exacerbated by the potential lack of proper quality control review due to the departure of the quality control partner.

The quality control partner should be replaced as soon as possible. The budget for the audit of Oste should be monitored carefully. The audit should be conducted properly and in accordance with SLauS's. Any cost overruns should be discussed with the client and additional fees negotiated if necessary.

Ethical requirements

A firm should have procedures in place to ensure that staff are aware of ethical requirements and comply with these. In this case the implementation of the system has not been completed. While members of staff who are members of a professional body should be aware of their responsibilities, they may not have all the relevant information to avoid an inadvertent breach of the regulations eg details of all companies who are clients of the firm. The implementation of the system started by the previous ethics partner should be completed.

Monitoring

The fact that the auditor partner is new, and the previous partner is no longer with the firm, increases the risk regarding audit monitoring. Also, because the current audit partner is new they will not have an extensive knowledge of the audit client initially. The tight deadline for the audit accentuates this problem.

To decrease this risk, the audit partner must gain an understanding of the business in accordance with SLAUS. If possible, it may be appropriate to retain the audit manager and audit senior from the previous year to aid continuity. Ansehst may also consider a second partner review to ensure that quality control standards have been maintained.

2 Quality control on an individual audit

SLAUS 220 requires firms to implement quality control procedures over individual audit engagements.

Audit quality is not defined in law or through regulations, and neither do auditing standards provide a simple definition. Although each stakeholder in the audit will give a different meaning to audit quality, at its heart it is about delivering an **appropriate** professional **opinion** supported by the necessary **evidence** and **judgments**.

Audit firms are required to implement quality control procedures in two main areas: for the firm as a whole and for individual audits. The relevant standard is SLAUS 220 *Quality control for an audit of financial statements*.

SLAUS 220: para. 6

The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

(a) The audit complies with professional standards and applicable legal and regulatory requirements; and

(b) The auditor's report issued is appropriate in the circumstances.

The responsibility for this falls largely on the audit engagement partner, who is responsible for the audit and the ultimate conclusion.

2.1 Leadership responsibilities

The engagement partner is required to set an example with regard to the importance of quality (SLAUS 220: para. A3).

2.2 Ethical requirements

The engagement partner must ensure that the audit team complies with applicable ethical requirements, including independence, throughout the course of the audit (SLAUS 220: para. 9).

2.3 Acceptance/continuance of client relationships and specific audit engagements

The partner is required to ensure that appropriate procedures in respect of accepting and continuing with the audit are followed. If the engagement partner obtains information that would have caused them to decline the audit in the first place they should communicate that information to the firm so that swift action may be taken (SLAUS 220: paras. 12–13). They must document conclusions reached about accepting and continuing the audit.

2.4 Assignment of engagement teams

The engagement partner must ensure that the audit team as a whole, as well as any auditor's experts, has the appropriate competence to:

- Perform the audit in accordance with professional standards, laws and regulations; and
- Ensure that the auditor's report issued is appropriate to the circumstances.

(SLAUS 220: para. 14)

2.5 Engagement performance

Ensuring good engagement performance involves:

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

(SLAUS 220: para. 15)

2.5.1 Direction

The partner directs the audit. They are required by other auditing standards to hold a meeting with the audit team to discuss the audit, in particular the risks associated with the audit.

SLAUS 220 (para. A13) states that direction includes 'informing members of the engagement team of:

(a) Their responsibilities (including objectivity of mind and professional scepticism)
(b) Responsibilities of respective partners where more than one partner is involved in the conduct of the audit engagement
(c) The objectives of the work to be performed
(d) The nature of the entity's business
(e) Risk-related issues
(f) Problems that may arise
(g) The detailed approach to the performance of the engagement'

2.5.2 Supervision

The audit is supervised overall by the engagement partner, but more practical supervision is given within the audit team by senior staff to more junior staff, as is also the case with review. It includes:

- Tracking the progress of the audit engagement
- Considering the capabilities and competence of individual members of the team, and whether they have sufficient time and understanding to carry out their work
- Addressing significant issues arising during the audit engagement and modifying the planned approach appropriately
- Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement

(SLAUS 220: para. A15)

2.5.3 Review

Review includes consideration of whether:

- The work has been performed in accordance with professional standards and regulatory and legal requirements
- Significant matters have been raised for further consideration
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented
- There is a need to revise the nature, timing and extent of work performed
- The work performed supports the conclusions reached and is appropriately documented

- The evidence obtained is sufficient and appropriate to support the auditor's report
- The objectives of the engagement procedures have been achieved

(SLAUS 220: para. A17)

Before the auditor's report is issued, the engagement partner must be sure that sufficient and appropriate audit evidence has been obtained to support the audit opinion. Reviews should be carried out at the appropriate stage of the audit, in order to ensure that any significant matters are resolved on a timely basis.

The audit engagement partner need not review all audit documentation, but may do so. They should review critical areas of judgement, significant risks and other important matters (SLAUS 220: para. A18).

2.5.4 Consultation

The partner is also responsible for ensuring that if difficult or contentious matters arise the team takes appropriate consultation on the matter and that such matters and conclusions are properly recorded.

If differences of opinion arise between the engagement partner and the team, or between the engagement partner and the quality control reviewer, these differences should be resolved according to the firm's policy for such differences of opinion (SLAUS 220: para. 18).

2.5.5 Engagement quality control review

The audit engagement partner is responsible for **appointing** a reviewer, if one is required. They are then responsible for discussing significant matters that arise with the reviewer and for not issuing the audit report until the engagement quality control review has been completed.

Engagement quality control reviewers (also known as independent review partners) are appointed for the audit of listed entities, or other entities which the meet audit firm's criteria for engagement quality control reviews. Engagement quality control reviews are likely to be carried out on audits which are assessed to be high risk, as a safeguard against a potential ethical threat.

An engagement quality control review should include:

- An evaluation of the **significant judgements** made by the engagement team
- An evaluation of the **conclusions** reached in formulating the auditor's report

(SLAUS 220: para. 20)

SLAUS 220: para. 25

The engagement quality control reviewer shall document, for the audit engagement reviewed, that:

(a) The procedures required by the firm's policies on engagement quality control review have been performed;

(b) The engagement quality control review has been completed on or before the date of the auditor's report; and

(c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgements the engagement team made and the conclusions it reached were not appropriate.

A quality control review for a listed entity will include a review of:

- Discussion of significant matters with the engagement partner
- Review of financial statements and the proposed report
- Review of selected audit documentation relating to significant audit judgements made by the audit team and the conclusions reached
- Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the auditor's report is appropriate
- The engagement team's evaluation of the firm's independence towards the audit
- Whether appropriate consultations have taken place on differences of opinion/contentious matters and the conclusions drawn
- Whether the audit documentation selected for review reflects the work performed in relation to significant judgements/supports the conclusions reached

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

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

(SLAUS 220: paras. 21 and A28)

2.6 Monitoring

The audit engagement partner is required to consider the results of monitoring of the firm's (or network firm's) quality control systems and consider whether they have any impact on the specific audit they are conducting (SLAUS 220: para. 23).

QUESTION **Quality control issues**

You are an audit senior working for the firm Chandrasena & Co. You are currently carrying out the audit of Wicker Co, a manufacturer of waste paper bins. You are unhappy with Wicker's inventory valuation policy and have raised the issue several times with the audit manager. The audit manager has dealt with the client for a number of years and does not see what you are making a fuss about. He has refused to meet you on site to discuss these issues.

The former engagement partner to Wicker retired two months ago. As the audit manager had dealt with Wicker for so many years, the other partners have decided to leave the audit of Wicker in their capable hands.

Required

Comment on the situation outlined above.

ANSWER

Several quality control issues are raised in the above scenario:

Engagement partner

An **engagement partner** is usually appointed to each audit engagement undertaken by the firm, to take responsibility for the engagement on behalf of the firm. Assigning the audit to the experienced audit manager is not sufficient.

The lack of an audit engagement partner also means that several of the requirements of SLAUS 220 about ensuring that arrangements in relation to independence and directing, supervising and reviewing the audit are not in place.

Conflicting views

In this scenario the audit manager and senior have conflicting views about the valuation of inventory. This does not appear to have been handled well, with the manager refusing to discuss the issue with the senior.

SLAUS 220 (para. 22) requires that the audit engagement partner takes responsibility for settling disputes in accordance with the firm's policy in respect of resolution of disputes as required by SLQC 1. In this case, the lack of engagement partner may have contributed to this failure to resolve the disputes. In any event, at best, the failure to resolve the dispute is a breach of the firm's policy under SLQC 1. At worst, it indicates that the firm does not have a suitable policy concerning such disputes as required by SLQC 1.

3 Framework for audit quality

The Framework for Audit Quality (The Framework) describes the factors that contribute to audit quality both at the firm level and the engagement level as well as at national level.

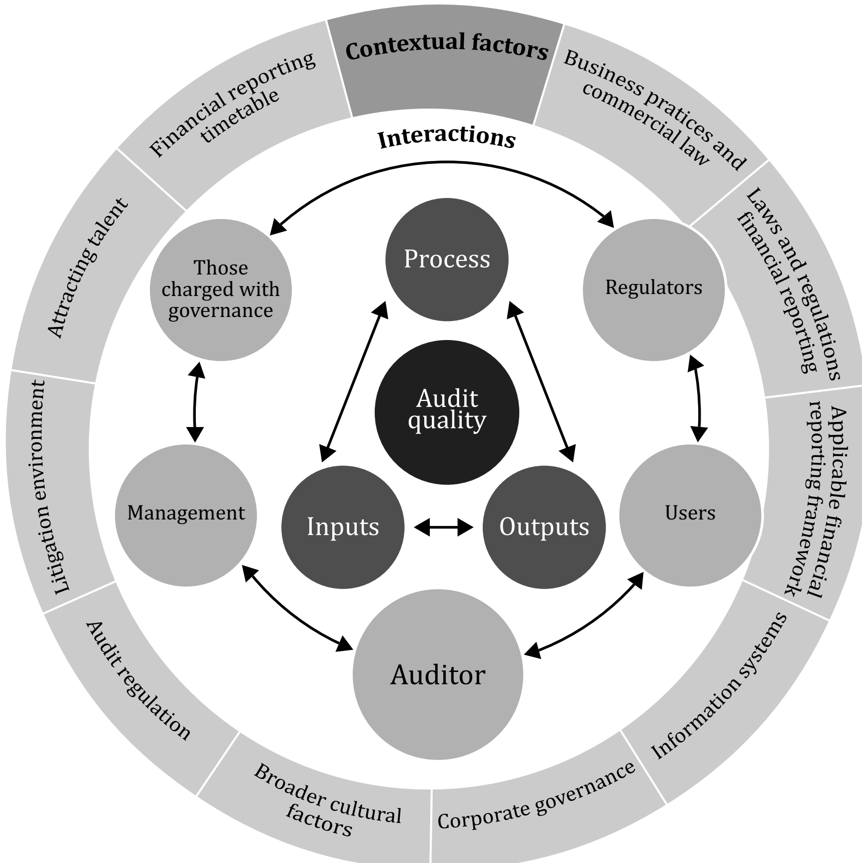
As we mentioned in Section 1 of this chapter, audit quality is not defined in law or through regulations, and neither do auditing standards provide a simple definition. The Framework is a separate document that seeks to provide guidance as to the factors that have an impact on audit quality through an input-output-process model framed in the interactions of the parties involved and the environment in which the audit is conducted.

We have described above how SLQC 1 and SLAUS 220 seek to embed quality at the firm and audit engagement level retrospectively. The Framework seeks to inform stakeholders as to the elements of audit quality, encourage firms to improve and communicate quality and enable stakeholders to identify key factors related to audit quality in addition to the application of SLQC 1 and SLAUS 220.

The Framework identifies the elements that influence the quality of the audit as:

- Inputs
- Process
- Outputs
- Key interactions within the financial reporting supply chain
- Contextual factors

The Framework can be depicted as follows:



We will look at each of the elements in turn.

3.1 Inputs

Inputs are grouped into the following input factors:

The Framework for Audit Quality: para. 9

(a) The values, ethics and attitudes of auditors, which in turn, are influenced by the culture prevailing within the audit firm; and

(b) The knowledge, skills, and experience of auditors and the time allocated for them to perform the audit.

Within the above input factors, quality attributes are further organized between those that apply directly at:

(a) The audit engagement level;

(b) The level of an audit firm, and therefore indirectly to all audits undertaken by that audit firm; and

(c) The national (or jurisdictional) level and therefore indirectly to all audit firms operating in that country and the audits they undertake.

The responsibility for these input factors falls largely on the audit engagement partner, who is responsible for the audit and the ultimate conclusion.

The partner should ensure that the engagement team exhibits the **values, ethics and attitudes** necessary with sufficient **objectivity, integrity, independence, competence and professional scepticism** at the engagement level. At the firm level the tone should be set at the top with the required characteristics promoted, professional development promoted and robust systems for acceptance of clients.

The requisite **knowledge, skills and experience** again should be present at a firm level through the provision of sufficient time to deal with difficult issues, proper team structures and sufficient training. At a national level there should be robust **licencing and educational** requirements for auditors as well as arrangements for updating current auditors.

3.2 Process

The audit process and the quality control procedures will obviously have a significant influence on audit quality. The process that is undertaken throughout the audit should therefore be in line with SLQC 1 and SLAUS 220 to ensure that the methodology that is undertaken is sufficiently rigorous.

3.3 Outputs

The Framework describes outputs as:

The Framework for Audit Quality: para. 14

…reports and information that are formally prepared and presented by one party to another, as well as outputs that arise from the auditing process that are generally not visible to those outside the audited organization. For example, these may include improvements to the entity's financial reporting practices and internal control over financial reporting, that may result from auditor findings.

The outputs will therefore depend on the context and legislative requirements as well as the access that individual stakeholders have to such information. The auditor may provide reports to those charged with governance, management as well as to regulators but the primary report will be the auditors opinion provided to the users. The Framework therefore suggests expanding on the information and explanations provided in the audit report.

3.4 Key interactions within the financial reporting supply chain

The financial reporting supply chain has been described by IFAC as 'the people and processes involved in the preparation, approval, audit, analysis and use of financial reports'.

The links in this chain need to be high quality, meaning that although each part plays a vital role, it is the interactions that can have a particular impact on the quality of the audit. There will be interactions between **auditors, management, users, those charged with governance, and regulators.** All of these interactions must be considered in order to ensure audit quality.

For example, management should prepare the financial information on a timely basis and ensure that the auditor has access to it. In turn, the auditor should discuss informational needs and agree a timetable as well as provide observations on improvements, new reporting regulations or observations on legal or regulatory issues.

Those charged with governance in a listed entity will usually be the audit committee in relation to the financial reporting process and there should be an effective two-way communication between the auditor and the audit committee.

Interactions between the users and the auditor may involve appointment and re-appointment, presentations by the auditor in the case of public sector audits and professional accountancy forums and high-level meetings.

There will also be interactions between management and regulators, users and those charged with governance. The overriding principle is that all of these interactions must allow a dynamic relationship to exist between the inputs and the outputs described above to ensure audit quality.

3.5 Contextual factors

Contextual factors are those that are contextual or environmental and have the potential to influence audit quality. The factors that The Framework identifies as having the potential to have such an impact are:

- Applicable financial reporting framework
- Corporate governance
- Information systems
- Broader cultural factors
- Financial reporting timetable
- Attracting talent
- Litigation environment

- Audit regulation
- Business practices and commercial law
- Laws and regulations relating to financial reporting

Each of these factors has the potential to impact the quality of financial reporting and as such the quality of audit and auditors should have consideration of these when determining how best to obtain sufficient appropriate audit evidence.

CHAPTER ROUNDUP

- The Sri Lanka standard on quality control (SLQC 1) helps audit firms to establish quality standards for their business.
- SLAuS 220 requires firms to implement quality control procedures over individual audit engagements. An important part of quality control is adequate audit documentation and proper review of that documentation.
- ISQC 1 sets out what a firm must consider and document in relation to accepting or continuing an engagement which is the integrity of the client, whether the firm is competent to do the work, and whether the firm meets ethical requirements in relation to the work.
- The auditor must agree terms of the audit engagement with relevant personnel at the client and must ensure that preconditions for an audit exist in order to agree to those terms.
- The Framework for Audit Quality identifies the factors that impact audit quality in an input-process-output model framed by key interactions between those involved and contextual factors.

PROGRESS TEST

1 Who is responsible for the overall audit quality on an audit engagement?

2 List 3 elements of good engagement quality.

3 Complete the sentence.

A **………… …………** (also known as a ………………….. review) is a peer review carried out before the auditor's report is signed.

4 What should an engagement quality control review include?

5 Name 4 contextual factors identified by the Framework for Audit Quality.

1 The audit engagement partner.

2 Any 3 of:

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

3 A **hot review** (also known as a **pre-issuance** review) is a peer review carried out before the auditor's report is signed.

4
- An evaluation of the **significant judgements** made by the engagement team
- An evaluation of the **conclusions** reached in formulating the auditor's report

5 Any 4 of:

- Applicable financial reporting framework
- Corporate governance
- Information systems
- Broader cultural factors
- Financial reporting timetable
- Attracting talent
- Litigation environment
- Audit regulation
- Business practices and commercial law
- Laws and regulations relating to financial reporting

CHAPTER 19

Ethics and Ethical Threats

INTRODUCTION

The ethical matters discussed in this chapter are very important and should be at the forefront of the auditor's mind throughout the audit.

Auditors must be aware of and adhere to the five fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

There are various threats to these fundamental principles and, in particular, to an auditor's independence. When the auditor becomes aware of such threats they must put appropriate safeguards in place to mitigate them.

Knowledge Component			
G	**Audit Quality and Ethics**		
7.4	**Threats to Compliance with Fundamental and Ethical Principles**	7.4.1	Analyse threats applicable to professional accountants in public practice in complying with fundamental and ethical principle
7.5	**Auditors Independence**	7.5.1	Apply conceptual framework approach to analyse threats relating to auditors independence
		7.5.2	Evaluate threats associated with provision of non-assurance service and methods of mitigating such threat
		7.5.3	Apply conceptual framework approach to evaluate specific non-assurance services

CHAPTER CONTENTS	LEARNING OUTCOME
1 The CA Sri Lanka Code of Ethics	7.5.1
2 Fundamental principles of professional ethics	7.5.1
3 Threats to the fundamental principles	7.4.1, 7.5.1
4 Reducing ethical threats	7.5.1, 7.5.2, 7.5.3

1 The CA Sri Lanka Code of Ethics

The CA Sri Lanka *Code of Ethics for Professional Accountants* provides ethical guidance for auditors.

1.1 The Code of Ethics for Professional Accountants

The *Code of Ethics for Professional Accountants* issued by the Institute of Chartered Accountants of Sri Lanka (the CA Sri Lanka Code) sets out five fundamental principles of professional ethics and provides a conceptual framework for applying those principles. Members must apply this conceptual framework to identify threats to compliance with the principles, evaluate their significance and apply appropriate safeguards to eliminate or reduce them so that compliance is not compromised.

The CA Sri Lanka Code is based on the *Code of Ethics for Professional Accountants* published by the International Federation of Accountants (IFAC), and the latest version of it, available on the CA Sri Lanka website, is effective for all members (not just auditors) on July 15, 2017, with early adoption permitted. The Code is made up of three parts. Part A contains the fundamental principles of the Code and is applicable to all members; part B is applicable to professional accountants in public practice and part C is applicable to professional accountants in business.

The conceptual framework for the Code is outlines in paragraph 100.6 and is as follows:

> 'A professional accountant has an obligation to evaluate any threats to compliance with the fundamental principles when the professional accountant knows, or could reasonably be expected to know, of circumstances or relationships that may compromise compliance with the fundamental principles.'

2 Fundamental principles of professional ethics

Members of CA Sri Lanka must comply with the fundamental principles set out in the *Code of Ethics for Professional Accountants* (**integrity, objectivity, professional competence and due care, confidentiality and professional behaviour**).

The five fundamental principles (as set out in Part A of the code) are summarised in the table which follows.

Table 19.1: Five fundamental principles

The fundamental principles of professional ethics	
Integrity	To be straightforward and honest in all professional and business relationships.
Objectivity	To not allow bias, conflicts of interest or undue influence of others to override professional and business judgements.
Professional competence and due care	To maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing **professional services**.
Confidentiality	To respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.
Professional behaviour	To comply with relevant laws and regulations and avoid any action that discredits the profession.

2.1 Confidentiality

Although auditors have a professional duty of **confidentiality**, they may be compelled by **law** or there may be a **professional right or duty** to disclose details of clients' affairs to third parties.

Confidentiality requires members to refrain from disclosing information acquired in the course of professional work except where:

(a) Disclosure is permitted by law and is **authorised by the client** or the employer;

(b) Disclosure is **required by law**, for example:

  (i) Production of documents or other provision of evidence in the course of legal proceedings; or

  (ii) Disclosure to the appropriate public authorities of infringements of the law that come to light; and

(c) There is **a professional duty or right to disclose**, when not prohibited by law:

  (i) To comply with the quality review of a member body or another professional body;

  (ii) To respond to an inquiry or investigation by a member body or a regulatory body;

  (iii) To protect the professional interests of a professional accountant in legal proceedings; or

  (iv) To comply with technical standards and ethics requirements.

There are a number of factors to consider when deciding whether to disclose confidential information; the following are set out in the CA Sri Lanka Code:

- Whether the interests of all parties, (including affected third parties) could be harmed if the client or employer consents to the disclosure of information by the professional accountant
- Whether all the relevant information is known and substantiated, to the extent it is practicable
- The type of communication that is expected and to whom it is addressed
- Whether the parties to whom the communication is addressed are appropriate recipients

A member acquiring information in the course of professional work should neither use nor appear to use that information for his **personal advantage** or for the **advantage of a third party**.

In general, where there is a right (as opposed to a duty) to disclose information, a member should only make disclosure in pursuit of a public duty or professional obligation.

A member must make clear to a client that he may only act for him if the client agrees to disclose in full to the member all information relevant to the engagement.

Where a member agrees to serve a client in a professional capacity, both the member and the client should be aware that it is an **implied term** of that agreement that the **member will not disclose** the client's affairs to any other person except with the client's consent or within the terms of certain **recognised exceptions.**

2.2 Non-compliance with laws and regulations (NOCLAR)

SLAuS 250 *Consideration of laws and regulations in an audit of financial statements* provides guidance for auditors in the area of suspected or identified instances of non-compliance with laws and regulations and was covered in detail in Chapter 6.

The **objectives** of the auditor when responding to non-compliance or suspected non-compliance ('NOCLAR') are:

(a) To comply with the fundamental principles of integrity and professional behaviour;

(b) By alerting management or, where appropriate, those charged with governance of the client, to seek to:

   (i) Enable them to rectify, remediate or mitigate the consequences of the identified or suspected non-compliance; or

   (ii) Deter the commission of the non-compliance where it has not yet occurred; and

(c) To take such further action as appropriate in the public interest.

Examples of laws and regulations covered by the Code include the following:

Fraud, corruption and bribery.
Money laundering, terrorist financing and proceeds of crime.
Securities markets and trading.
Banking and other financial products and services.
Data protection.
Tax and pension liabilities and payments.
Environmental protection.
Public health and safety

Procedures suggested for the auditor when considering NOCLAR are to:

- Obtain an understanding of the NOCLAR matter.
- Discuss with an appropriate level of management (at least one above those parties involved or potentially involved).
- Advise the client to rectify the consequences, deter any future instances or disclose to whoever is considered in a position to need to know.
- Consider the client's response and whether it indicates any concerns over their integrity.
- Consider whether disclosure to an appropriate authority should be made (if applicable laws and regulations allow) or if withdrawal from the engagement may be necessary.
- Document all decisions, discussions and judgements.

2.3 Integrity, objectivity and independence

The fundamental principles require that members behave with integrity in all professional and business relationships and they strive for objectivity in all their professional and business judgements. Objectivity is a state of mind but, in certain roles, the preservation of objectivity has to be shown by the maintenance of **independence** from those influences which could impair objectivity.

What is required in order to be, and be seen to be, independent?

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

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

It is very important that the auditor is **impartial** and **independent** of management, so that he can give an **objective** view on the financial statements of an entity. The onus is always on the auditor not only to be ethical but also to be **seen** to be ethical.

Independence and objectivity matter because of:

(a) The **expectations** of those directly affected, particularly the members of the company. The audit should be able to provide **objective** assurance on the truth and fairness of the financial statements that the directors can never provide.

(b) The **public interest**. Companies are public entities, governed by rules requiring the disclosure of information.

What can the auditor do to preserve objectivity? The simple answer would be to **withdraw from any engagement** where there is the **slightest threat** to objectivity. However, there are disadvantages in this strict approach.

- Clients may lose an auditor who knows their business.
- It denies clients the freedom to be advised by the accountant of their choice.

A better approach would be to **consider** whether the **auditors' own objectivity** and the **general safeguards** operating in the professional environment are **sufficient** to offset the threat and to **consider** whether **safeguards over and above** the general safeguards are required, for example specified partners or staff not working on an assignment.

Although it may not be desirable to withdraw from an engagement or to refuse to act for a client, in some cases this may be the only option if the threat to independence is too great.

3 Threats to the fundamental principles

Threats to independence and objectivity may arise in the form of **self-interest, self-review, advocacy, familiarity** and **intimidation threats**. Appropriate **safeguards** must be put in place to eliminate or reduce such threats to acceptable levels.

3.1 Threats to independence and objectivity

Compliance with the fundamental principles of professional ethics may potentially be threatened by a wide range of different circumstances. These generally fall into five categories:

- Self-interest
- Self-review
- Advocacy
- Familiarity
- Intimidation

Although we may talk about circumstances resulting in threats under a particular threat heading (such as self-interest) it is important to note that certain situations give rise to more than one type of threat.

As we progress through the rest of the chapter you will see there are some ethical requirements relating purely to **public interest entities**.

The code defines public interest entities as:

(a) All listed entities; and

(b) Any entity:

   (i) Defined by regulation or legislation as a public interest entity; or

   (ii) For which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities. Such regulation may be promulgated by any relevant regulator, including an audit regulator.

Firms and member bodies are encouraged to determine whether to treat additional entities, or certain categories of entities, as public interest entities because they have a large number and wide range of stakeholders. Factors to be considered include:

- The nature of the business, such as the holding of assets in a fiduciary capacity for a large number of stakeholders. Examples may include financial institutions, such as banks and insurance companies, and pension funds;
- Size; and
- Number of employees.

3.1.1 Self-interest

The CA Sri Lanka *Code of Ethics for Professional Accountants* highlights a number of areas in which a self-interest threat might arise. A self-interest threat is the threat that a financial or other interest will inappropriately influence the professional accountant's judgement or behaviour.

Self-interest threats may arise as a result of the financial or other interests of members or of immediate or close family and are summarised in Figure 2.1.

Figure 2.1: Self-interest threats

3.1.2 Self-review threat

Self-review threats arise when a member reviews their own work or advice as part of an assurance engagement. Circumstances that may give rise to such threats include the following:

Figure 2.2: Self-review threats

The key area in which there is likely to be a self-review threat is where a firm provides services other than assurance services to an audit client (providing multiple services).

3.1.3 Advocacy threat

Advocacy threats arise in those situations where the audit firm promotes a position or opinion to the point that subsequent objectivity is compromised. Examples include commenting publicly on future events in particular circumstances, having made assertions without detailing the assumptions, or acting as an advocate on behalf of an audit client in litigation or disputes with third parties. Advocacy threats might also arise if the firm promoted shares in a listed audit client.

Acting in an advocacy role for an audit client in resolving a dispute or litigation when the amounts involved are material to the financial statements on which the firm will express an opinion is not permitted by the CA Sri Lanka Code. In addition the Code does not allow the appointment of a partner or an employee of the firm as General Counsel for legal affairs of an audit client.

Where advocacy threats arise, and the work or actions are permitted by the Code, then relevant safeguards might include using different departments to carry out the work and making disclosures to the audit committee. Remember, the audit firm has the option to withdraw from an engagement if the risk to independence is too high.

3.1.4 Familiarity threat

Having an audit client for a **long period of time may create a familiarity threat** to independence. The severity of the threat depends on factors such as how long an individual has been on the audit team, how senior the person is, whether the client's management has changed and whether the client's accounting issues have changed in nature or complexity.

Possible **safeguards** include:

- **Rotating** the **senior personnel** off the **audit team**
- Having a **professional accountant** who was not a member of the audit team to **review** the work of the senior personnel
- **Regular** independent **internal or external quality reviews** of the engagement

The rules for **public interest entities** are stricter. If an individual is a **key audit partner** for **seven years**, they must be rotated off the audit for **two years**. During this time they cannot be on the audit team, and cannot consult with the audit team or the client on any issues that may affect the engagement (including giving just general industry advice).

The Code does allow some flexibility here. If key partner **continuity** is particularly beneficial to **audit quality**, and there is some **unforeseen circumstance** (such as the intended engagement partner becoming seriously ill), the key audit partner may remain on the audit team for up to one additional year.

If a client that was not a public interest entity becomes one, then the seven-year limit still applies, starting from the date when the key audit partner originally became the key partner for that audit client. However, if the individual has served the audit client as a key audit partner for six or more years when the client becomes a public interest entity, the partner may continue to serve in that capacity for a maximum of two additional years before rotating off the engagement.

If the firm has only a few people capable of being a key audit partner for a public interest client, it is possible for an independent regulator to give permission for an audit partner to remain a key audit partner indefinitely, provided alternative safeguards specified by that regulator are applied (such as external review).

3.1.5 Intimidation threat

An intimidation threat arises when members of the audit team may be deterred from acting objectively by threats, actual or perceived. These could arise from family and personal relationships, litigation or close business relationships. These are also examples of self-interest threats, largely because intimidation may only arise significantly when the audit firm has something to lose.

The most obvious example is when the client threatens to sue, or does sue, the audit firm for work that has been done previously. The firm is then faced with the risk of losing the client, bad publicity and the possibility that it will be found to have been negligent. This could lead to the firm being under pressure to produce an unmodified audit opinion in the auditor's report.

Generally, audit firms should seek to avoid such situations arising. If they do arise, factors to consider are:

- The materiality of the litigation
- The nature of the audit engagement
- Whether the litigation relates to a prior audit engagement

The following safeguards could be considered:

- Disclosing to the audit committee the nature and extent of the litigation
- Removing specific affected individuals from the engagement team
- Involving an additional professional accountant on the team to review work

However, if the litigation is at all serious, it may be necessary to resign from the engagement, as the threat to independence may be too great.

4 Reducing ethical threats

The ethical code outlines appropriate **safeguards** that must be put in place to eliminate or reduce such threats to acceptable levels.

4.1 Ethical safeguards for accountants in practice

There are two general categories of ethical safeguard identified in the guidance:

- Safeguards created by the profession, legislation or regulation
- Safeguards within the assurance client/the firm's own systems and procedures

4.1.1 Examples of ethical safeguards created by the profession, legislation or regulation

- Educational training and experience requirements for entry into the profession
- Continuing professional development requirements
- Corporate governance regulations
- Professional standards
- Professional or regulatory monitoring and disciplinary procedures

IFAC issues ethical standards, quality control standards and auditing standards that work together to ensure independence is safeguarded and quality audits are carried out.

4.1.2 Examples of ethical safeguards in the firm's own systems and procedures

If CA Sri Lanka members work for an accountancy practice, the firm should have the following safeguards in place in relation to the firm.

- The firm's leadership stressing **compliance with fundamental principles**
- Leadership of the firm establishing the expectation that **employees will act in the public interest**
- **Quality control policies and procedures**
- Documented policies on **identification and evaluation of threats** and **identification and application of safeguards**
- Documented policies covering **independence threats and safeguards** in relation to assurance engagements
- Documented internal procedures requiring **compliance with fundamental principles**

- Policies and procedures enabling **identification of interests and relationships between the firm's team** and **clients**
- Policies and procedures to **manage reliance on revenue from a single client**
- Using **different teams for non-assurance work**
- Prohibiting individuals who are not team members from **influencing the outcome of the engagement**
- **Timely communication of policies and procedures** and appropriate training and education
- Designating a senior manager to be **responsible for overseeing quality control**
- Advising staff of **independence requirements** in relation to specific clients
- **Disciplinary measures**
- **Promotion of communication** by staff to senior management of any ethical compliance issue that concerns them

There should also be safeguards relating to specific assignments:

- Involving an additional professional accountant to review the work done or otherwise advise as necessary
- Consulting an independent third party, such as a committee of independent directors, a professional regulatory body or another professional accountant
- Rotating senior personnel
- Discussing ethical issues with those in charge of client governance
- Disclosing to those charged with governance the nature of services provided and extent of fees charged
- Involving another firm to perform or reperform part of the engagement
- Rotating senior assurance team personnel

4.2 Ethical threats to compliance with the fundamental principles for accountants in business

Table 19.2: Threat examples

Threat	Examples
Self-interest	Financial interests, loans and guarantees, incentive compensation arrangements, personal use of corporate assets, external commercial pressures, acceptance of a gift.
Self-review	Business decisions being subject to review and justification by the same accountant responsible for making those decisions or preparing the data supporting them.
Advocacy	Furthering the employer's cause aggressively without regard to reasonableness of statements made (furthering legitimate goals of employer organisation would not generally create an advocacy threat).
Familiarity	Long association of a business contact.
Intimidation	Threats of dismissal from employment, influence of a dominant personality.

4.3 Ethical safeguards for accountants in business

The safeguards created by the profession, legislation or regulation also apply to accountants in business.

4.3.1 Ethical safeguards in the workplace for accountants in business

- The employer's oversight systems
- The employer's ethics and conduct programs
- Recruitment procedures
- Strong internal controls
- Appropriate disciplinary processes
- Leadership that stresses ethics
- Policies and procedures that promote and monitor employee performance
- Timely communication of the employer's policies and procedures to all employees
- Training and education of employees
- Whistleblowing provisions
- Consultation with another professional accountant

In other words, a strong control environment.

However, if these safeguards are ineffective, the professional accountant may have to seek legal advice or resign.

4.4 Specific ethical issues

Sections 220 to 270 of the CA Sri Lanka Code of Ethics provide for specific issues which threaten compliance with fundamental principles of practicing members. They have been summarised below.

Section 220

Conflicts of interest

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

The significance of any threats should be evaluated, and safeguards applied when necessary to eliminate the threats or reduce them to an acceptable level. Depending upon the circumstances giving rise to the conflict, if might be necessary to notify the client.

Additional safeguards might include:

(a) Use of separate engagement teams;

(b) Procedures to prevent access to information;

(c) Clear guidelines for members of the engagement team on issues of security and confidentiality;

(d) The use of confidentiality agreements signed by employees and partners of the firm; and

(e) Regular review of the application of safeguards by an independent senior individual.

Where a conflict of interest creates a threat to one or more of the fundamental principles that cannot be eliminated or reduced to an acceptable level through the application of safeguards, the engagement cannot be accepted.

Section 230

Second opinions

Situations where a professional accountant in public practice is asked to provide a second opinion on transactions by a company or an entity that is not an existing client may create threats to compliance with the fundamental principles. For example, there may be a threat to professional competence and due care. Examples of safeguards in this area include seeking client permission to contact the existing accountant. If this permission is not granted then the assignment may have to be declined.

Section 240

Fees and other types of remuneration

When entering into negotiations regarding professional services, a professional accountant in public practice may quote whatever fee is deemed appropriate. However, a self-interest threat to professional competence and due care is created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable standards.

Examples of safeguards in this area include:

- Making the client aware of the terms of the engagement
- Assigning appropriate time and qualified staff to the task

Contingent fees and referral fees are widely used for certain types of engagement, but they may create a self-interest threat to objectivity. The existence and significance of such threats will depend on factors including:

- The nature of the engagement
- The range of possible fee amounts
- The basis for determining the fee
- Whether the outcome or result of the transaction is to be reviewed by an independent third party

Examples of safeguards include:

- An advance written agreement with the client as to the basis of remuneration;
- Disclosure to intended users of the work performed
- Quality control policies and procedures

Section 250

Marketing professional services

When a professional accountant in public practice engages in marketing professional services, there may be a threat to compliance with the fundamental principles. For example, a self-interest threat to compliance with the principle of professional behaviour is created if services, achievements, or products are marketed in a way that is inconsistent with that principle. The professional accountant in public practice shall be honest and truthful, and not:

(a) Make exaggerated claims for services offered, qualifications possessed, or experience gained; or

(b) Make disparaging references or unsubstantiated comparisons to the work of another.

Section 260

Gifts and hospitality

A professional accountant in public practice, or an immediate or close family member, may be offered gifts and hospitality from a client. Such an offer may create threats to compliance with the fundamental principles. For example, a self-interest or familiarity threat to objectivity may be created if a gift from a client is accepted that is anything outside what could be considered either insignificant or in the normal course of business.

Section 270

Custody of client assets

A professional accountant in public practice shall not assume custody of client monies or other assets unless permitted to do so by law. A professional accountant in public practice entrusted with money (or other assets) belonging to others shall therefore:

(a) Keep such assets separately from personal or firm assets;
(b) Use such assets only for the purpose for which they are intended;
(c) At all times be ready to account for those assets; and
(d) Comply with all relevant laws and regulations.

4.5 Independence

In the 2016 revision of the Code, substantive additions were made in respect of independence, in particular to provide stronger independence provisions regarding long association of personnel with audit clients.

Section 290 covers independence in audit and review engagements, and Section 291 covers independence in other assurance engagements.

Section 290.4 states that:

> 'In the case of audit engagements, it is in the public interest and, therefore, required by this Code, that members of audit teams, firms and network firms shall be independent of audit clients.'

Independence in fact and **independence in appearance** are separate factors in establishing auditor objectivity and integrity.

Independence in fact – that the auditor is actually independent of their audit client – is essential. A lack of independence, however, is often not noticed. The effects of independence violations on the audit profession can be very damaging: penalties, lost revenues, damaged reputations and potentially devastating legal liability. Audited financial statements may be regarded as worthless by external stakeholders such as banks or capital markets.

Unlike actual bias, **independence in appearance** is based entirely on perceptions. If the parents of a partner in charge of an audit engagement hold shares in that particular client, is that a problem? The fundamental problem is that independence *in appearance* has become a substitute for independence *in fact,* because the former can be observed and judged, while the latter sometimes cannot. The public may believe a firm is not truly independent even when it is. Conversely, it may believe it to be independent when it is not.

The Code advocates the use of the conceptual framework approach to independence. It states that:

'he conceptual framework approach shall be applied by professional accountants to:

(a) Identify threats to independence;

(b) Evaluate the significance of the threats identified; and

(c) Apply safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level.

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

A professional accountant shall use professional judgment in applying this conceptual framework.'

You will have encountered the guidance relating to external auditors in your earlier studies, but we cover the main threats here.

Independence is most important for accountants acting as auditors and assurance providers (the assurance team) for the following reasons:

(a) **Reliability of financial information**

Corporate governance reports have highlighted **reliability of financial information** as a key aspect of corporate governance. Shareholders and other stakeholders need a trustworthy record of **directors' stewardship** to be able to take decisions about the company. Assurance provided by independent auditors is a key quality control on the reliability of information.

(b) **Credibility of financial information**

An unqualified report by independent external auditors on the accounts should give them more **credibility**, enhancing the appeal of the company to investors. It should represent the views of independent experts, who are not motivated by personal interests to give a favourable opinion on the annual report.

(c) **Value for money of audit work**

Audit fees should be set on the basis of charging for the work **necessary to gain sufficient audit assurance**. A lack of independence here seems to mean important audit work may not be done, and the shareholders are not receiving value for the audit fees.

(d) **Threats to professional standards**

A lack of independence may lead to a failure to **fulfil professional requirements** to obtain enough evidence to form the basis of an audit opinion, here to obtain details of a questionable material item. Failure by auditors to do this **undermines the credibility of the accountancy profession** and the standards it enforces.

Most of the guidance also applies to the assurance team as well as audit.

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.

There are **two general types** of assurance engagement:

(a) An **assertion based** engagement where the accountant declares that a given premise (assertion) is either correct or not

(b) A **direct reporting** engagement, where the accountant reports on issues that have come to his attention during his evaluation

Assurance engagements are designed to enhance intended users' degree of confidence about the outcome of the evaluation or measurement of a subject – for example, the auditors' report on the annual report and accounts is a form of assurance engagement.

4.5.1 Example

The management of Company A Ltd has fulfilled its responsibility by evaluating the entity's financial position, financial performance and changes in cash flows by publishing financial statements in accordance with Sri Lanka Financial Reporting Standards, and confirming that the assets and liabilities are recognised, measured, presented and disclosed in the financial statements as per the requirements of SLFRSs.

The auditor is appointed by the shareholders to express his opinion in the form of a report that the recognition, measurement, presentation and disclosures (ie the financial statements made by the management) are actually in accordance with SLFRSs and the actual financial position, performance and changes in cash flow.

In the case of an assurance engagement it is in the public interest that members of **assurance teams**, firms and **network firms** be independent of assurance clients.

A customised **assurance team** can provide a variety of services ranging from information systems security reviews to customer satisfaction surveys. The independence of team members is as important as for a regular audit, because a range of stakeholders will be relying upon their work. Assurance engagements are covered in more detail in Chapter 17.

Firms frequently form associations with other firms. Such an arrangement is considered to be a **network firm** if it shares significant professional resources with other firms in the larger structure, including profits and costs. A firm would also be considered to be part of a network if it is under common control. Such associations range from those created only to facilitate referral of work to those where the firms operate under a common brand name and have common audit methodology and system of quality control.

4.6 Safeguards against self-interest threat

We will look at each of these areas in turn.

(i) **Financial interests**

A **financial interest** exists where an audit firm has a financial interest in a client's affairs, for example, the audit firm owns shares in the client, or is a trustee of a trust that holds shares in the client.

The CA Sri Lanka Code does not allow the following to own a direct financial interest, or an indirect material financial interest, in a client:

- The **audit** firm, or a network firm (see note below)
- A **member** of the audit team
- An **immediate family member of a member** of the audit team

(Note: Network firms are discussed in Section 3.2.)

The following safeguards will therefore be relevant:

- Disposing of the interest
- Removing the individual from the team, if required
- Keeping the client's audit committee informed of the situation
- Using an independent partner to review work carried out, if necessary

Audit firms should have quality control procedures requiring staff to disclose relevant financial interests for themselves and close family members. They should also foster a culture of voluntary disclosure on an ongoing basis, so that any potential problems are identified in a timely manner.

(ii) **Close business relationships**

Close business relationships between a firm, or an audit team member, or a member of that individual's immediate family, and the audit client (or its management), arise from commercial relationships or common financial interests.

Examples of when an audit firm and an audit client have a close business relationship include:

- Having a financial interest in a joint venture with either the client or a controlling owner, director, officer or other individual who performs senior managerial activities for that client

- Arrangements to combine one or more services or products of the firm with one or more services or products of the audit client and to market the package with reference to both parties
- Distribution or marketing arrangements under which the firm acts as distributor or marketer of the audit client's products or services or vice versa

It will be necessary for the partners to judge the materiality of the interest and therefore its significance. However, **unless the interest is clearly insignificant, an audit provider should not participate in such a venture with an audit client**. Appropriate safeguards are therefore to end the assurance provision or to terminate the (other) business relationship.

If an individual member of an audit team has such an interest, he should be removed from the audit team.

If the business relationship is between an immediate family member of a member of the audit team and the audit client or its management, the significance of any threat must be evaluated and safeguards applied, when necessary, to eliminate the threat or reduce it to an acceptable level.

Generally speaking, **purchasing goods and services from an audit client on an arm's-length basis does not constitute a threat to independence**. However, the transactions may be of such a nature or magnitude that they create a self-interest threat. If this results in a threat to independence then safeguards may be necessary.

(iii) **Employment with an audit client**

It is possible that staff might transfer between an audit firm and a client, or that negotiations or interviews to facilitate such movement might take place. Both situations are a threat to independence:

- An audit staff member might be motivated by a desire to impress a future possible employer (objectivity is therefore affected: self-interest threat)
- A former audit partner turned Finance Director has too much knowledge of the audit firm's systems and procedures

In general there may be **familiarity** and **intimidation threats** when a member of the audit team joins an audit client. If a **'significant connection'** still **remains** between the audit firm and the former employee/partner, **then it may be that no safeguards could reduce the threat to an acceptable level**. This would be the case where:

- The individual is entitled to benefits from the audit firm (unless fixed and predetermined, and not material to the firm)
- The individual continues to participate in the audit firm's business or professional activities.

If there is no significant connection, then the threat depends on:

- The **position** the individual has taken at the client;
- Any **involvement** the individual will have **with the audit team**;
- The **length of time** since the individual was a member of the audit team or partner of the firm; and
- The **former position** of the individual **within the audit team or firm**, for example, whether the individual was responsible for maintaining regular contact with the client's management or those charged with governance.

Safeguards could include:

- **Modifying** the **audit plan**;
- **Assigning individuals** to the audit team **who have sufficient experience** in relation to the individual who has joined the client; or
- Having an independent professional accountant **review** the work of the former member of the audit team.

(iv) **Temporary staff assignments**

Staff may be loaned to an audit client, but only **for a short period of time. Staff must not assume management responsibilities**, nor undertake any audit work that is prohibited elsewhere in the Code.

The audit client must be responsible for directing and supervising the activities of the loaned staff. Possible safeguards include:

- Conducting an additional review of the work performed by the loaned staff;
- Not giving the loaned staff audit responsibility for any function or activity on the audit, which they performed during the temporary staff assignment; or
- Not including the loaned staff in the audit team.

(v) **Partner on client board**

A partner or employee of an audit firm should not serve on the board of an audit client.

It may be acceptable for a partner or an employee of an audit firm to perform the role of company secretary for an audit client, if the role is essentially administrative.

(vi) **Family and personal relationships**

Family or close personal relationships between audit firm and client staff could seriously threaten independence. Each situation has to be evaluated individually. Factors to consider are:

- The individual's responsibilities on the audit engagement
- The closeness of the relationship
- The role of the other party at the audit client

When an immediate family member of a member of the audit team is a director, an officer or an employee of the audit client in a position to exert direct and significant influence over the subject matter information of the audit engagement, the individual should be removed from the audit team.

The audit firm should also consider whether there is any threat to independence if an employee who is not a member of the audit team has a close family or personal relationship with a director, an officer or an employee of an audit client.

A firm should have quality control policies and procedures under which staff should disclose if a close family member employed by the client is promoted within the client.

If a firm inadvertently violates the rules concerning family and personal relationships they must apply additional safeguards, such as undertaking a quality control review of the audit and discussing the matter with the audit committee of the client, if there is one.

(vii) **Compensation and evaluation policies**

There is a self-interest threat when a member of the audit team is evaluated on selling non-assurance services to the client. The significance of the threat depends on:

- The proportion of the individual's compensation or performance evaluation that is based on the sale of such services
- The role of the individual on the audit team
- Whether promotion decisions are influenced by the sale of such services.

The firm should either revise the compensation plan or evaluation process, or put in place appropriate safeguards. Safeguards include:

- Removing the member from the audit team
- Having the team member's work reviewed by a professional accountant.

(viii) **Gifts and hospitality**

Unless the value of the gift or hospitality is **clearly insignificant**, a firm or a member of an audit team should not accept.

(ix) **Loans and guarantees**

The advice on loans and guarantees falls into two categories:

- The client is a bank or other similar institution
- Other situations

If a lending institution client (eg a bank) lends an immaterial amount to an audit firm or member of assurance team on normal commercial terms, there is no threat to independence. If the loan is material it will be necessary to apply appropriate safeguards to bring the risk to an acceptable level. A suitable safeguard is likely to be an independent review (by a partner from another office in the firm).

Loans to members of the audit team from a bank or other lending institution client are likely to be material to the individual, but provided that they are on normal commercial terms, these do not constitute a threat to independence.

An audit firm or individual on the audit engagement should not enter into any loan or guarantee arrangement with a client that is not a bank or similar institution (unless immaterial to both parties, which is unlikely). The self-interest threat created by entering into such an arrangement would be so significant that no safeguard would be able to reduce the threat to an acceptable level. In addition, loans should not be made by an audit firm or an audit team member to an audit client.

(x) **Overdue fees**

A self-interest threat arises if fees due from an audit client remain unpaid for a long time, especially if a significant part is not paid before the issue of the audit report for the following year. Generally the firm will require payment of such fees before such audit report is issued.

However, if fees remain unpaid after the report has been issued, the existence and significance of any threat must be evaluated and safeguards applied when necessary. One safeguard might be to arrange for an additional professional accountant who did not take part in the audit engagement to review the work performed.

Also, in a situation where there are overdue fees, the auditor runs the risk of, in effect, making a loan to a client, whereupon the guidance above becomes relevant.

Audit firms should guard against significant fees building up by discussing the issues with those charged with governance and, if necessary, the possibility of resigning if overdue fees are not paid.

(xi) **Contingent fees**

Contingent fees are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed.

A firm is not permitted to enter into any fee arrangement for an audit or assurance engagement under which the amount of the fee is contingent on the result of the assurance work or on items that are the subject matter of the assurance engagement.

It would also usually be inappropriate to accept a contingent fee for non-assurance work from an audit client, as it will create a self-interest threat. The engagement should not be accepted if the amount of the fee for a non-assurance engagement was agreed to, or contemplated, during an assurance engagement and was contingent on the result of that assurance engagement.

Where contingent fees on non-assurance services are not prohibited by the rules above, the following factors must be considered in deciding whether a contingent fee is acceptable or not:

- The range of possible fee outcomes
- The degree of variability
- The basis of the fee
- Any independent review
- The effect of the transaction on the assurance engagement

The significance of the threats should be evaluated and safeguards should be considered and applied as necessary, such as:

- Disclosing to the audit committee the extent and nature of fees charged
- Independent review or determination of the final fee
- Quality and control policies and procedures

(xii) **High percentage of fees**

When a firm receives a high proportion of its fee income from just one audit client, there is **a self-interest** or **intimidation threat**, as the firm will be concerned about losing the client. This depends on:

- The operating **structure** of the **firm**
- Whether the **firm** is established or **new**
- The **significance of the client** to the firm (both quantitatively and qualitatively)

Possible safeguards include:

- **Reducing** the **dependency** on the client;
- **External** quality control **reviews**; or
- **Consulting a third party**, such as a professional regulatory body or a professional accountant, **on key audit judgments**.

It is not just a matter of the audit firm actually being independent in terms of fees, but also of it being seen to be independent by the public. It is as much about public perception as reality.

The Code also states that a threat may be created where an individual partner or office's percentage fees from one client are high. The safeguards are as above, except that internal quality control reviews are also relevant.

For audit clients that are **public interest entities**, the Code states that where **total fees** from the client represent **more than 15% of the firm's total fees for two consecutive years**, the firm shall:

- **Disclose** this to **those charged with governance**, and
- **Arrange for a review to be conducted**, either by an external professional accountant or by a regulatory body; this review can be either before the audit opinion on the second year's financial statements is issued (a '**pre-issuance review**') or after it is issued (a '**post-issuance review**')

(xiii) **Lowballing**

When a firm quotes a significantly lower fee level for an audit service than would have been charged by the predecessor firm, there is a significant self-interest threat. If the firm's tender is successful, the firm should apply safeguards such as:

- Maintaining records such that the firm is able to demonstrate that appropriate staff and time are allocated to the engagement
- Complying with all applicable auditing standards, guidelines and quality control procedures

(xiv) **Recruitment**

Recruiting senior management for an audit client, particularly those able to affect the subject matter of an audit engagement, creates a self-interest threat for the audit firm.

Audit providers should not make management decisions for the client. Their involvement could be limited to reviewing a shortlist of candidates, providing that the client has drawn up the criteria by which they are to be selected.

For a public interest entity audit client the firm is not allowed to provide the following services in respect of a director, officer or senior management in a position to exert significant influence over the preparation of the financial statements:

- Searching for candidates
- Undertaking reference checks

In addition to the self-interest threats discussed above, the **holding of client assets** also creates a self-interest threat to professional behaviour and may also create a self-interest threat to objectivity. A professional accountant in public practice should not assume custody of client monies or other assets unless permitted to do so by law. If permitted by law the assets are kept separately and closely controlled and accounted for.

Safeguards against self Review threats

(i) **Recent service with an audit client**

Individuals who have been a **director or officer of the audit client, or an employee in a position to exert direct and significant influence** over the preparation of the accounting records or financial statements in the period covered by the audit report should not be assigned to the audit team.

If an individual had been closely involved with the client before the period covered by the audit report, the audit firm should consider the threat to independence arising and apply appropriate safeguards, such as:

- Obtaining a quality control review of the individual's work on the assignment
- Discussing the issue with the audit committee

(ii) **Provision of general other (non-audit) services**

Providing non-assurance services to audit clients may create threats to the independence of the firm or members of the audit team. Audit firms must evaluate any threat arising and decline to provide a non-audit service if the application of safeguards will not reduce the threat to an acceptable level.

Provision of some non-audit services to audit clients will not create an insurmountable threat and can be provided when certain safeguards are in place. Depending on the nature of the other service safeguards may not even be necessary.

An important question to ask when deciding whether provision of non-audit services to an audit client is acceptable is 'does providing the service result in the audit firm carrying out activities that would generally be considered a **management responsibility**?'

Whether an activity is a management responsibility depends on the circumstances and requires the relevant partners at the audit firm to use judgement. The following are generally considered to be management responsibilities:

- Setting policies and strategic direction
- Directing and taking responsibility for the actions of the entity's employees
- Authorising transactions
- Deciding which recommendations of the firm or other third parties to implement
- Taking responsibility for the preparation and fair presentation of the financial statements
- Taking responsibility for designing, implementing and maintaining internal control

Activities that are **routine and administrative**, or involve matters that are insignificant, generally are deemed **not** to be a management responsibility.

(iii) **Preparing accounting records and financial statements**

There is clearly a significant risk of self-review if a firm prepares accounting records and financial statements and then audits them. However, in practice, auditors routinely assist management with the preparation of financial statements and give advice about accounting treatments and journal entries.

Audit firms must therefore analyse the risks arising and put safeguards in place to ensure that the risk is at an acceptable level. Safeguards include:

- Using staff members other than audit team members to carry out work
- If non-audit services are performed by a member of the audit team, using an independent partner or senior staff member (not part of the audit team) to review the work performed
- Obtaining client approval for work undertaken

The rules are more stringent when the client is listed or public interest. A firm must not provide a public interest audit client with accounting and bookkeeping services, including payroll services, or prepare financial statements on which the firm will express an opinion. The same rule applies to financial information which forms the basis of the financial statements

(iv) **Valuation services**

A **valuation** comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.

If an audit firm performs a valuation which will be included in financial statements audited by the firm, a self-review threat arises.

Audit firms should not carry out valuations on matters which will be material to the financial statements which involve a significant degree of subjectivity.

It the audit client is a public interest entity, **the audit firm is not permitted to provide valuation services if the valuations would have a material effect, separately or in the aggregate**, on the financial statements on which the firm will express an opinion. Note that for a public interest client the degree of subjectivity is irrelevant.

If the valuation is for an immaterial matter, the audit firm should apply safeguards to ensure that the risk is reduced to an acceptable level. Matters to consider when applying safeguards are the extent of the audit client's knowledge of the relevant matters in making the valuation and the degree of judgement involved, how much use is made of established methodologies and the degree of uncertainty in the valuation. Safeguards include:

- Second partner review
- Confirming that the client understands the valuation and the assumptions used
- Ensuring the client acknowledges responsibility for the valuation
- Using separate personnel for the valuation and the audit

(v) **Taxation services**

The Code divides taxation services into four categories:

(i) Tax return preparation
(ii) Tax calculations for the purpose of preparing the accounting entries
(iii) Tax planning and other tax advisory services
(iv) Assistance in the resolution of tax disputes

Guidance in respect of each of these categories is as follows:

(i) **Tax return preparation generally does not threaten independence**, as long as management takes responsibility for the returns.

(ii) **Tax calculations for the purpose of preparing the accounting entries may not be prepared for public interest entities**. For non public interest entities, it is acceptable to do so provided that safeguards are applied.

(iii) **Tax planning may be acceptable in certain circumstances**, eg where the advice is clearly supported by tax authority or other precedent. However, if the effectiveness of the tax advice depends on a particular accounting treatment or presentation in the financial statements, the audit team has reasonable doubt about the accounting treatment, and the consequences of the tax advice would be material, then the service should not be provided.

(iv) **Assistance in the resolution of tax disputes may be provided** in some cases. However, if the firm is acting as an advocate of the client and the effect of the matter is material to the financial statements to be audited the firm is not permitted to act. The firm must also consider whether it provided the service which is the subject of the dispute itself, as this will increase the threat. If the firm can provide the service, the safeguards include using professionals who are not members of the audit team to perform the service, and obtaining advice on the service from an external tax professional.

(vi) **Internal audit services**

A firm may provide certain internal audit services for an audit client depending on the nature of the services and the type of entity being audited.

An audit firm's personnel **must not assume a management responsibility** as a result of providing internal audit services. Internal audit services where management responsibilities would be assumed include:

'(i) Setting internal audit policies or the strategic direction of the internal audit department

(ii) Directing and taking responsibility for the actions of the entity's internal audit employees

(iii) Deciding which recommendations resulting from internal audit activities are implemented

(iv) Reporting the results of the internal audit activities to those charged with governance on behalf of management

(v) Performing procedures that form part of the internal control

(vi) Taking responsibility for designing, implementing and maintaining internal control

(vii) Performing outsourced internal audit services, comprising all or a substantial portion of the internal audit function, where the firm is responsible for determining the scope of the internal audit work and may have management responsibilities'

To avoid inadvertently assuming a management responsibility the audit firm must make sure senior management at the client accepts responsibility for internal control and internal audit services.

Client management should also remain responsible for evaluating and acting on internal audit findings and for reporting significant findings to those charged with governance.

Internal audit services must not be provided for **public interest entities** if they relate to:

(i) A **significant** part of **the internal controls** over **financial reporting**;

(ii) Financial accounting systems generating information which is significant to the financial statements; or

(iii) Amounts or disclosures which are **material** to the financial statements.

For internal audit services that are permitted but still create a threat safeguards may be used, such as using personnel not involved in the audit, ensuring that an employee of the client is designated responsible for internal audit activities and ensuring that the client approves all the work that internal audit does.

(vii) **Corporate finance**

Certain aspects of corporate finance will create self-review threats that cannot be reduced to an acceptable level by safeguards.

Where the effectiveness of corporate finance advice depends on a particular accounting treatment or presentation in the financial statements, and the audit team has reasonable doubt as to the appropriateness of that treatment and the consequences of the corporate finance advice will have a material effect on the financial statements, the corporate finance advice must not be provided.

In addition, **assurance firms are not allowed to promote, deal in or underwrite an assurance client's shares**. They are also not allowed to commit an assurance client to the terms of a transaction or consummate a transaction on the client's behalf.

Other corporate finance services, such as assisting a client in defining corporate strategies, assisting in identifying possible sources of capital and providing structuring advice may be acceptable providing that safeguards are used, such as using different teams of staff and ensuring no management decisions are taken on behalf of the client.

(viii) **IT systems services**

In general, IT systems work for audit clients not related to internal control over financial reporting is not deemed to create a threat, as long as no management responsibility is assumed by the audit firm's personnel. The implementation of 'off-the-shelf' accounting or financial information reporting software, and making recommendations in relation to a system not designed, implemented or operated by the audit firm, is also permitted.

However significant threats arise when the audit firm provides **services to an audit client involving the design or implementation of IT systems** that:

(a) Form a **significant part of the internal control** over financial reporting, or

(b) Generate **information that is significant to** the client's **accounting records or financial statements**

If the client is a public interest entity the audit firm must not provide such a service.

Services relating to design and implementation of IT systems of the nature discussed above may be provided, but only if the client acknowledges its responsibility for establishing and monitoring a system of internal controls, and management (or a competent employee at the client) maintains responsibility for making all relevant management decisions, evaluation of the system and the operation of the system.

(ix) **Other services**

The audit firm might sell a variety of other services to audit clients, such as:

- Litigation support
- Legal services

The audit firm should consider whether there are any barriers to independence and consider whether the threat to independence could be reduced to an acceptable level by appropriate safeguards.

QUESTION **Independence**

You are an audit manager in Jayakody & Co and are preparing for the audit of Bigcorp plc for the year ending 31 December 20X5.

Bigcorp plc has rapidly expanded its operations over the past few years, and is now one of your firm's biggest clients. Bigcorp plc has been an audit client for nine years and Jayakody & Co has provided audit, taxation and management consultancy advice during this time. The client has been satisfied with the services provided, although the taxation fee for the period to 31 March 20X5 remains unpaid.

The audit team available for this year's audit is most of the staff from last year, including Mr Ranatunga, an audit partner and Mr Liyanage, an audit senior. Mr Ranatunga has been the audit partner since Bigcorp plc became an audit client. You are aware that Nisha Ranatunga, the daughter of Mr Ranatunga, has recently been appointed the financial director at Bigcorp plc.

Nisha has asked all of the audit staff out to an expensive restaurant prior to the start of the audit work for this year. Nisha has said it is a celebration of her new appointment.

Required

Analyse the risks to independence arising in carrying out your audit of Bigcorp plc for the year ending 31 December 20X5, and suggest safeguards to mitigate each of the risks identified.

ANSWER

Risks to independence

Audit Partner

Mr Ranatunga has been the audit partner on the audit of Bigcorp plc for the last nine years. His independence and objectivity are likely to be impaired as a result of this close relationship with a key client and its senior management. The CA Sri Lanka Code requires key audit partners to be rotated after seven years and Mr Ranatunga's involvement for nine years already contravenes this rule.

This threat could (and should) be addressed by appointing another audit partner to the audit of Bigcorp plc and rotating partners at suitable intervals thereafter.

Tax Fees Outstanding

There are taxation fees outstanding from Bigcorp plc for work that was done over nine months previously. In effect, Jayakody & Co are providing an interest-free loan to Bigcorp plc. This can threaten independence and objectivity of the audit firm as it may not want to modify the audit opinion in case the outstanding fees are not paid.

This can be addressed by discussing the issue with the directors of Bigcorp plc and finding out why the fees have not been paid. If the fee is still not paid the firm should consider delaying the start of the audit work or even the possibility of resigning.

Fee Dependence

Bigcorp plc is one of Jayakody & Co's most important clients and the firm provides other services to this client as well as audit, including taxation services. Also the company is growing rapidly. Objectivity and independence are considered to be threatened to the degree that an independent engagement review is needed by an external firm or regulator (and disclosure to those charged with governance) if the fees for audit and recurring work are a significant proportion of the firm's total fees for a listed client such as Bigcorp plc.

This threat could be mitigated by reviewing the total of the audit and recurring fee income from Bigcorp plc as a percentage of Jayakody & Co's total fee income on a regular basis, and possibly limiting the provision of the other services if deemed necessary to maintain independence.

Relationship to Financial Director of Bigcorp plc

Nisha Ranatunga, the daughter of Mr Ranatunga, has recently been appointed the Financial Director of Bigcorp plc. The independence of Mr Ranatunga could be threatened because of their close family relationship. The extent of the threat depends on the position the immediate family member holds with the client and the role of the professional on the assurance team.

As Financial Director, Nisha has direct influence over the financial statements and as engagement partner, Mr Ranatunga has ultimate responsibility for the audit opinion, so there is a clear threat to objectivity and independence.

This threat to independence could (and should) be mitigated by the appointment of another audit partner to this client.

Meal

The fact that Nisha Ranatunga wants to take the audit team out for an expensive meal before the audit commences could be considered a threat to independence as it might influence the audit team's decisions once they start the audit of the financial statements. The ethics rules state that gifts or hospitality from the client should not be accepted unless the value is trivial and inconsequential. This threat could be mitigated by declining the invitation.

4.7 Networks and network firms

Several accountancy firms have moved towards network models over recent years. This is where member firms are part of a larger structure, often sharing a name (or using a similar name) and professional resources. As part of a global network, member firms have been able to sell services based on the value and reputation of their global brand name.

A network firm is a firm or entity belonging to a network. A network is defined in the CA Sri Lanka Code as a larger structure aimed at cooperation and:

(a) Aimed at profit or cost sharing; or
(b) Shares common ownership, control or management; or
(c) Shares common quality control policies and procedures;

(d) Shares common business strategy;
(e) Uses a common brand name; or
(f) Shares a significant part of professional resources (eg staff are shared).

Where a firm is a network firm it must be **independent** of the financial statement audit clients of other firms within its network.

When considering the threats to independence and related safeguards discussed in Section 3.1, the auditor must also consider any implications arising as a result of being in a network.

For example when considering if a financial interest exists in an audit client which could impair independence (see Section 3.1.1) the financial interests of both the firm **and** any network firm must be considered and the appropriate safeguards (disposing the interest) applied.

4.8 Conflicts of interest

In some ways conflict of interest issues are similar to the difficulties firms have in maintaining independence. They can arise in a variety of circumstances and each problem has to be dealt with on its own merits.

A professional accountant must take reasonable steps to identify circumstances that could pose a conflict of interest because such circumstances may create threats to compliance with the fundamental principles.

When considering whether to accept a client or when there is a change in a client's circumstances, audit firms must take reasonable steps to ascertain whether there is a conflict of interest or if there is likely to be one in the future.

4.8.1 Conflicts between members' and clients' interests

A conflict between members' and clients' interests might arise if members compete directly with a client, or have a joint venture or similar with a company that is in competition with the client. This may threaten the member's objectivity.

Members and firms should not accept or continue engagements in which there are, or are likely to be, significant conflicts of interest between members, firms and clients. Any form of financial gain which accrues or is likely to accrue to the member as a result of an engagement, or as a result of using information known to them about a client, will usually always amount to a significant conflict of interest between the member and client.

Members should evaluate the threats arising from a conflict of interest that are not significant and apply safeguards where necessary to reduce them to an acceptable level. One applicable safeguard is notifying the client of the conflict of interest and obtaining their consent to act.

4.8.2 Conflicts between the interests of different clients

Conflicts of interest can arise when a firm has two (or more) audit clients, both of which have reason to be unhappy that their auditors are also auditors of the other company. This situation frequently arises when the companies are in **direct competition** with each other, and particularly when the **auditors have access to** particularly **sensitive information**. In such circumstances objectivity and confidentiality may be threatened.

Audit firms are at liberty to have clients who are in competition with each other. However, the firm should ensure that it is not the subject of a dispute between the clients. It must also manage its work so that the interests of one client do not adversely affect another client.

However, **where acceptance or continuance of an engagement would, even with safeguards, materially prejudice the interests of any client, the appointment should not be accepted or continued**.

Where interests are **not** materially prejudiced but threats to objectivity or confidentiality arise due to the auditor acting for two clients whose interests are in conflict, then the firm must:

(a) Evaluate the significance of any threats

(b) Apply safeguards when necessary to eliminate the threats or reduce them to an acceptable level

Conflicts can, of course, be avoided by not accepting any appointment or assignment in which they seem likely to occur, but this may not be practicable.

Where threats may arise as a result of a conflict of interests, the primary safeguard will always be to notify all known relevant parties that the member or firm is acting (or plans to act) for two or more parties in respect of a matter where their respective interests are in conflict and **obtaining their consent to act.**

As well as obtaining consent additional safeguards include:

(a) The use of separate engagement teams

(b) Procedures to prevent access to information (such as strict physical separation of such teams, confidential and secure data filing, password protection)

(c) Clear guidelines for members of the engagement team on issues of security and confidentiality

(d) The use of confidentiality agreements signed by employees and partners of the firm

(e) Regular review of the application of safeguards by a senior individual not involved with relevant client engagements

(f) Advising one or more clients to seek additional independent advice.

Larger firms can often apply the safeguards (a) to (d) above by building **information barriers** within the firm. This would mean that the respective audits are undertaken by different audit 'groups', the engagement partners are different and all the other audit staff are allowed to work on only one of the clients. In addition records are only accessible to the teams working on their particular client.

Small firms, on the other hand, may struggle to implement such procedures.

A final point to note is that if consent to act for another party has not been obtained from an existing client then the firm should not act for one of the parties.

CHAPTER ROUNDUP

- The CA Sri Lanka *Code of Ethics for Professional Accountants* provides ethical guidance for auditors.
- Members of CA Sri Lanka must comply with the fundamental principles set out in the *Code of Ethics for Professional Accountants* (**integrity, objectivity, professional competence and due care, confidentiality and professional behaviour**).
- Although auditors have a professional duty of **confidentiality**, they may be compelled by **law** or there may be a **professional right or duty** to disclose details of clients' affairs to third parties.
- Threats to independence and objectivity may arise in the form of **self-interest, self-review, advocacy, familiarity and intimidation threats**. Appropriate **safeguards** must be put in place to eliminate or reduce such threats to acceptable levels.

PROGRESS TEST

1 Match each ethical principle to the correct definition.

(a) Integrity
(b) Objectivity
(c) Professional competence and due care
(d) Confidentiality
(e) Professional behaviour

(i) To not allow bias, conflicts of interest or undue influence of others to override professional and business judgements.

(ii) To maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing **professional services**.

(iii) To be straightforward and honest in all professional and business relationships.

(iv) To comply with relevant laws and regulations and avoid any action that discredits the profession.

(v) To respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.

2 The CA Sri Lanka *Code of Ethics* applies only to statutory audits. True or false?

3 Complete the sentence.

.... arise in those situations where the audit firm promotes a position or opinion to the point that subsequent objectivity is compromised.

4 Which of the following are legitimate reasons for breach of client confidentiality?

(i) Auditor **suspects** client has committed treason
(ii) Disclosure **needed** to protect auditor's own interests
(iii) Information is **required** for the auditor of another client
(iv) Auditor **knows** client has committed terrorist offence
(v) It is in the **public interest** to disclose
(vi) Auditor **considers** there to be non-compliance with law
(vii) Auditor **suspects** a client has committed fraud

ANSWERS TO PROGRESS TEST

1 (a) (iii)
(b) (i)
(c) (ii)
(d) (v)
(e) (iv)

2 False. The spirit of the guidance applies equally to other audit situations.

3 **Advocacy threats** arise in those situations where the audit firm promotes a position or opinion to the point that subsequent objectivity is compromised.

4 (i), (ii), (iv), (v), (vi)

(Note. In the case of (vii), the auditor should not take action outside the company until he is certain. When he is certain, he should seek legal advice.)

Part H – Professional Practice of Internal Audit

THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

CHAPTER 20

Internal Audit

INTRODUCTION

This chapter revises internal audit but also takes the subject further by considering wider issues in relation to its role, performance, ethics and management.

Knowledge Component			
8	**Professional practice of internal audit**		
8.1	**International Professional Practice Framework**	8.1.1	Recognise the importance of professional practice in internal audit using the elements of the International Professional Practice Framework (IPPF) of the Institute of Internal Auditors
8.2	**Internal Audit Charter**	8.2.1	Propose an internal audit charter to govern an internal audit function for a given entity considering entity specific circumstances
8.3	**Audit Universe and Plan**	8.3.1	Develop an audit universe and a plan aligned to organisations strategies, objectives and risks
8.4	**Risk Role of Internal Auditor**	8.4.1	Advise the extent to which internal auditor can support risk management initiatives of an entity using assurance and advisory services
8.5	**Managing an Internal Audit**	8.5.1	Outline key considerations in setting engagement objectives, engagement planning and conducting an internal audit engagement for a given business scenario
8.6	**Governance and Culture Audit**	8.6.1	Advise on the process of structuring a governance audit and a culture audit
8.7	**Audit Committee and Internal Audit**	8.7.1	Advise on the oversight role to be played by the audit committee in ensuring the independence and effectiveness of internal audit function

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1 The role of internal audit	8.3.1, 8.2.1
2 Internal audit and enterprise risk management	8.4.1
3 Independence of internal audit	8.3.1
4 Managing internal audit	8.3.1, 8.5.1, 8.7.1
5 Internal audit engagements	8.5.1, 8.6.1

1 The role of internal audit

The role of internal audit will **vary** according to the **organisation's objectives** but is likely to include review **of internal control systems, risk management, legal compliance** and **value for money**.

1.1 The development of internal audit as a discipline

While many of its techniques are derived from consultancy practice and public accounting professions (external auditors) the theory of internal auditing was conceived in the middle of the 20th century and is now defined by the **International Professional Practices Framework (IPPF)** of the **Institute of Internal Auditors (IIA)**.

The Sarbanes Oxley Act of 2002 helped to boost the profile of internal audit, and the IIA works to advocate the role that internal audit should play.

1.1.1 Technical pronouncements issued by the IIA

The International Professional Practices Framework (IPPF) is the conceptual framework that organises the guidance promoted by The Institute of Internal Auditors. The IIA provides internal auditors with guidance which is categorised as either **mandatory** or **strongly recommended**.

Mandatory Guidance

Conformance with the principles set forth in mandatory guidance is compulsory. The three mandatory elements of the IPPF are:

- Definition of Internal Auditing
- Code of Ethics
- International Standards for the Professional Practice of Internal Auditing (Standards)

The structure of the IIA standards is divided between **Attribute** and **Performance** standards. Attribute Standards address the attributes of organisations and individuals performing internal auditing. The Performance Standards describe the nature of internal auditing and provide quality criteria against which the performance of these services can be measured.

Attribute Standards

Number	Title
1000	Purpose, authority and responsibility
1100	Independence and objectivity
1130	Impairment to independence or objectivity
1200	Proficiency and due professional care
1300	Quality assurance and improvement program

Performance Standards

Number	Title
2000	Managing the internal audit activity
2100	Nature of work
2200	Engagement planning
2300	Performing the engagement
2400	Communicating results
2500	Monitoring progress
2600	Communicating the acceptance of risks

Strongly Recommended Guidance

The three strongly recommended elements of the IPPF are:

- Position Papers
- Practice Advisories
- Practice Guides

The IIA also issues Global Technology Audit Guides (GTAG) which address issues related to information technology (IT) management, risk, control, and security. The GTAG series serves as a resource for chief audit executives on different technology-associated risks and recommended practices.

1.2 The need for internal audit

The Turnbull Report in the UK stated that listed companies without an internal audit function should **annually review** the need to have one, and listed companies with an internal audit function should review annually its **scope, authority** and **resources**.

Turnbull states that the need for internal audit will depend on:

Scale, diversity and complexity of the company's operations	The more complex the operations, the more that can go wrong. Also the greater the need for an independent internal audit department to look at the system as a whole, to see if risk management and internal controls are appropriately focused. Also, where there is close scrutiny of the company's operations by regulators with the power to remove the company's licence to operate, the case for internal audit is much stronger.
Number of employees	Number of employees is generally used as a proxy for size. Investors would expect that the larger the company, the more formal the systems of internal control, including a separate internal audit department. A larger company may have complex reporting lines and it may have less shared culture between different locations.
Cost-benefit considerations	As with other controls, the costs of internal audit (salary, management time lost dealing with internal audit) should not outweigh the benefits. The benefits however may be difficult to quantify (how do you quantify the errors that internal audit has prevented?).

Changes in organisational structure	A simplification of the organisational structure may often lead to reduction of the internal audit department. However, a reduction should really mean the opposite. The removal of the checks and balances implied by a bureaucratic structure would seem to increase the need for an effective internal audit function.
Changes in key risks	If the business is developing in new areas, an internal audit assessment of how effectively it is handling consequent changes in risk can be very significant.
Problems with internal control systems	Internal audit assessment would help to determine how serious these problems are and what can be done to resolve them.
Increased number of unexplained or unacceptable events	This applies not just to events that cause problems with the accounting records, but also problems that delay production or result in inferior quality goods or services. The costs of internal audit may need to be weighed against the possibilities of lost sales.

Although there may be alternative means of carrying out the routine work of internal audit, those carrying out the work may be involved in operations and hence lack **objectivity**.

It seems likely that once the task of reviewing internal control and risk management systems becomes complex, a skilled and objective internal audit team will be needed to give the audit committee the evidence it needs about how systems are working.

CASE STUDY

The PWC report *Internal audit 2012* suggests ten imperatives for a high-performance internal audit function in the future:

- **Strategic stature within the organisation.** The chief audit executive should ensure priorities align with the wishes of the audit committee and management and should be a trusted adviser to key stakeholders.
- **Development and update of strategic plan aligned with objectives and stakeholder expectations.** The plan should indicate how internal audit will develop and be organised to deliver service, and suggest specific goals or strategic initiatives to bridge capability gaps.
- **Communication with key stakeholders.** In particular, there should be regular dialogue with the audit committee chairman and external auditors.

- **Align HR strategies with enterprise and stakeholder needs.** This means internal audit ensuring that skills gaps relating to new and emerging skills are bridged.
- **Focus continually on enterprise risks.** As well as testing controls, internal auditors ought to focus on the risks themselves, keeping management informed about risk exposures and conducting an annual enterprise-wide risk assessment, which feeds into the audit plan. Risk assessments need to be transparent, aligned with business units and involve external audit as well as internal management.
- **Integrated approach to IT audit.** There should be an annual IT risk assessment, which addresses risks within business processes and seeks to enhance IT audit capabilities. The IT audit plan needs to be aligned with organisational IT strategies and objectives.
- **Use of technology to improve efficiency, effectiveness and quality**. This includes automating tracking and reporting, testing populations automatically and using technology to conduct real-time reviews.
- **Development of knowledge management plan.** The aim of this plan should be to make available internal audit knowledge and expertise to other internal auditors and business unit and enterprise management.
- **Commitment to continuous quality assurance.** There should be a quality improvement programme, and external assessment of performance and benchmarking.
- **Link performance measures to strategic goals.** This means in particular using a balanced scorecard approach to track performance to the strategic plan.

1.3 Objectives of internal audit

The role of the internal auditor has expanded in recent years as internal auditors seek to monitor all aspects (not just accounting) of organisations, and add value to their employers. The work of the internal auditor is still prescribed by management, but it may cover the following broad areas.

(a) **Review of the accounting and internal control systems**. The establishment of adequate accounting and internal control systems is a responsibility of management and the directors. Internal audit is often assigned specific responsibility for the following tasks.

  (i) Reviewing the design of the systems

  (ii) Monitoring the effectiveness of the operation of the systems by risk assessment and detailed testing

(iii) Recommending cost effective improvements

Review will cover both financial and non-financial controls.

(b) **Examination of financial and operating information**. This may include review of the means used to identify, measure, classify and report such information and specific enquiry into individual items including detailed testing of transactions, balances and procedures.

(c) **Review of the economy, efficiency and effectiveness** of operations.

(d) **Review of compliance** with laws, regulations and other external requirements, with internal policies and directives, and with other requirements including appropriate authorisation of transactions.

(e) **Review of the safeguarding of assets**. Are valuable, portable items such as computers or cash secured, is authorisation needed for dealing in investments?

(f) **Review of the implementation of corporate objectives**. This includes review of the effectiveness of planning, the relevance of standards and policies, the organisation's corporate governance procedures and the operation of specific procedures such as communication of information.

(g) **Identification of significant business** and financial **risks, monitoring** the **organisation's overall risk management policy** to ensure it operates effectively, and **monitoring** the **risk management strategies** to ensure they continue to operate effectively.

(h) **Special investigations** into particular areas, for example suspected fraud.

It is inevitable that internal audit will focus on **operational controls**. In some companies however the problem may be a failure of strategic level controls, due to management override of controls or poor strategic decision making. However, internal audit's role in relation to strategic controls will be limited, at most checking procedures have been followed at board level. The board must ultimately be responsible for the operation of strategic controls.

1.4 Good practice for internal audit

CIMA has also published a guide on internal audit, *Internal audit – a guide to good practice for internal auditors and their customers (1999).* The guide stresses the importance of the internal audit function being properly resourced and supported by the highest levels of the organisation's management.

The guide states that the following conditions are needed for internal audit to function well:

- The **aims** of internal audit are **agreed** by the board.
- Internal audit **covers all areas** of controls, and not just accounting controls.
- Internal audit has whatever **access is necessary** to people and documents.
- The head of internal audit has **clear access to the chairman and chief executive** of the organisation, as well as to the chairman of the audit committee.
- The head of internal audit **reports** to a **senior director**.
- The internal audit department is **independent** of executive management.
- Internal audit fulfils the requirements of **auditing standards** and **best practice**.
- Internal audit is **consulted** if there are likely to be **significant changes** in the business or control systems.
- Internal auditors do **not** have **operational involvement** in areas outside internal audit.
- The results of internal audit's work are **clearly communicated**, and its recommendations acted upon by senior management.
- Internal audit's performance is **regularly assessed**.

1.5 Role of head of internal audit

As well as organising the internal audit function, and supervising staff, the head of internal audit will be responsible for determining **internal audit strategy** and preparing the **overall audit plan**, working with the audit committee. The head of internal audit will also be responsible for reporting the results of internal audit work to the audit committee.

Reporting to, and working with the audit committee, should help to ensure the independence of the head of internal audit and internal audit department from the finance director and the chief executive.

1.6 Audit charter

The purpose, authority, responsibility and position of internal audit within an organisation is set out in a formal document called the **audit charter**. This is also sometime referred to as the **terms of reference**.

The internal audit charter sets out the way in which internal audit (IA) will provide value to the organisation, the nature of the services it will provide and how it helps the organisation achieve its objectives. It also establishes:

- The position of IA within the organisation
- The reporting lines of the head of internal audit
- Authorisation for the IA team to access records, personnel and physical properties as required by specific engagements
- The scope of IA activities

The charter is therefore a reference point for measuring the effectiveness of internal audit.

1.6.1 Setting the audit charter

The audit charter will be drafted by the head of internal audit. The draft charter will then be discussed in detail with both senior management and the board to ensure it accurately reflects the agreed role and expectations of the team. Once finalised, the audit charter will be approved by the board, via the audit committee.

The charter should be reviewed periodically, again via discussions between the head of internal audit, senior management and the board, to ensure that it remains relevant to the needs of the organisation.

1.6.2 Contents of the audit charter

There is no standardised approach that must be taken in respect of the audit charter, however the IIA states that an audit charter will usually include the following:

- **Mission**: the overall purpose and function of internal audit within the organisation and how it will assist the organisation to achieve its objectives.
- **Objectives**: eg to provide assurance on the adequacy and effectiveness of risk management processes in reducing risk exposures to acceptable levels. The charter should also refer to the provision and nature of consulting activities.
- **Role and scope** of the work of internal audit.
- **Independence**: an explanation of the way independence is established and maintained.
- **Access**: the charter should set out the requirement of internal audit to have unrestricted access to all activities across the organisation (access to records, personnel and physical property).

- **Reporting**: the charter should set out the internal audit reporting lines, for example, that it reports regularly to the audit committee.
- **Responsibilities** of the head of internal audit as well as any relationship with other assurance providers.
- **Planning**: the charter should briefly explain internal audit's approach to risk-based internal audit planning, the resource plan and budget, including arrangements for approval of the plans, reporting, monitoring progress and providing updates.
- **Quality**: a description of the arrangements for developing an on-going programme of quality assessment and continuous improvement.
- **Approval**: the charter should state that formal approval and endorsement should be obtained from the head of internal audit and audit committee.
- **Other considerations:** the Mission of Internal Audit, the Core Principles for the Professional Practice of Internal Auditing, the Code of Ethics, the Standards and the Definition of Internal Auditing should be recognised in the internal audit charter, the details of which should be discussed with senior management and the board.

2 Internal audit and enterprise risk management

Internal auditors will be involved in **monitoring risk management systems** and feeding back suggestions for improvements.

2.1 Role of internal audit in risk management

Internal audit will play a significant part in the organisation's risk management processes, being required to assess and advise on how risks are countered. Internal audit's work will be influenced by the organisation's **appetite** for bearing risks. Internal audit will assess:

- The **adequacy of the risk management and response processes** for identifying, assessing, managing and reporting on risk
- The risk management and control **culture**
- The appropriateness of **internal controls** in operation to **limit risks**
- The **operation and effectiveness** of the **risk management processes**, including the internal controls

The areas auditors will concentrate on will depend on the **scope** and **priority** of the assignment and the **risks identified**. Where the risk management framework is insufficient, auditors will have to rely on their own **risk assessment** and will focus on **recommending an appropriate framework**. Where a framework for risk management and control is embedded in operations, auditors will aim to use **management assessment of risks** and concentrate on **auditing the risk management processes**.

A key part of internal audit's role in control systems is to provide feedback that influences the **design and operation** of **internal control systems.** Internal audit recommendations need to be seen in the context of the organisation's **strategic objectives** and **risk appetite.**

However, you should remember that internal audit has a primarily monitoring and review role.

Internal auditors should be **checking that day-to-day control procedures such as monitoring** of **transactions are being carried out**, rather than carrying out these control procedures themselves. If they had day-to-day responsibilities, they would be **part of the control system** rather than reviewers of it, and therefore be unable to give an independent opinion on its operation.

The risk management function will be responsible for **building a risk aware culture** throughout the organisation by **information provision and training**. Risk management will provide **guidelines on overall risk policy and coordinate the various functional activities that deal with risks**.

Risk management will also be responsible for **designing risk analysis procedures and risk response processes**. They should ensure not only their **recommendations** for improvements, but the recommendations of the board, board committees and internal audit functions are **implemented**.

2.1.1 IIA Enterprise Risk Management Fan

The IIA states, in its position paper on ERM, that the role of internal audit in respect of ERM is to 'provide objective assurance to the board on the effectiveness of risk management.'

This position paper contains a visual guide, known as the ERM Fan, which presents a range of ERM activities and indicates which of these roles the internal audit function should and should not undertake.

Figure 5.1: The IIA's ERM Fan

The core activities, at the left of the diagram, are **assurance** activities. The IIA states that, in order to comply with the *International Standards for the Professional Practice of Internal Audit*, the internal audit activity should carry out **at least some** of these activities.

The roles shown on the right of the diagram are roles that form part of the control system itself. Internal auditors **should not** be involved in these tasks as to do so would compromise their independence as reviewers of the system.

The middle section represents consulting roles. Internal auditors can become involved in these areas, subject to establishing suitable safeguards.

Examples given in the position paper of consulting work that can be undertaken include the provision of advice, or facilitating workshops, on risk and control and supporting managers as they work to identify the best ways to mitigate a risk.

The key consideration of the internal audit activity when determining whether or not they can become involved in a consulting activity would relate to whether or not it would provide the internal auditor with management responsibility. The role can only be undertaken if it is determined that no management responsibility would be assumed as a result of the work.

To assist internal auditors with their work in these areas, the position paper sets out the following safeguarding conditions that must be met if the work is to be undertaken:

- It should be clear that management remains responsible for risk management.
- The nature of internal auditor's responsibilities should be documented in the internal audit charter and approved by the audit committee.
- Internal auditing should not manage any of the risks on behalf of management.
- Internal auditing should provide advice, challenge and support to management's decision making, as opposed to taking risk management decisions themselves.
- Internal auditing cannot also give objective assurance on any part of the ERM framework for which it is responsible. Such assurance should be provided by other suitably qualified parties.
- Any work beyond the assurance activities should be recognised as a consulting engagement and the implementation standards related to such engagements should be followed.

Within these constraints, ERM can help raise the profile and increase the effectiveness of internal auditing.

2.2 Risk auditing

Internal auditors will be concerned to see that managers have put in place **risk assessment processes that are capable of identifying risks on a timely basis,** and have **designed robust risk management processes and internal control systems**.

Auditors will attempt to confirm that these risk management processes and controls **operate to mitigate risks** and ensure that management **receives accurate information** about risks, particularly high consequences-likelihood risks, risks outside the organisation's risk appetite or risks that have materialised due to serious weaknesses in internal control**.** Risk audits are not compulsory for all organisations, although in some regulated industries (banking and financial services) a form of ongoing risk assessment and audit is compulsory in most jurisdictions.

Internal audit's work will be influenced by **business objectives**, the risks that may **prevent** the organisation **achieving its objectives** and the organisation's attitude towards risk (that is its degree of risk acceptance or risk aversion).

2.3 Internal audit and forensic auditing

Forensic auditing is a mix of traditional accounting, auditing and financial investigation. As company structures have become more complex, so have the opportunities for people with specialist knowledge of those structures and controls to bypass them. Internal audit has a large role to play in helping executives to identify such vulnerabilities in internal control systems by:

- Identifying and strengthening control mechanisms
- Undertaking regular and proactive investigations
- Ensuring regulatory compliance
- Resolving of disputes in areas such as insider dealing crimes
- Improving efficiency by identifying areas of waste
- Detecting potential conflicts of interest

3 Independence of internal audit

Internal audit should be **independent of operational management.**

3.1 Importance of independence

Auditors should be independent of the activities audited.

Although an internal audit department is part of an organisation, it should be **independent** of the **line management** whose sphere of authority it may audit.

3.1.1 Audit process

A lack of independence can mean that audits cannot be carried out to the extent and effectiveness desired. Internal auditors may not be able to examine all the areas they'd like to, or determine how the areas selected will be audited. They may feel inhibited from carrying out certain procedures for fear of upsetting powerful or vocal managers or staff.

In addition internal audit will be **trusted more by managers and staff**, and hence are more likely to have **sensitive information disclosed to them**, if they are felt to be independent.

3.1.2 Value of recommendations

Internal audit's recommendations will only be valuable if they are **influenced solely by what they find**, and not biased by other factors. Factors that can distort the judgements internal audit make include a willingness to take sides, motives of personal advantage or a desire to use the audit to confirm their own previous judgements (for example, dislikes of certain individuals).

3.1.3 Increased costs of internal audit

Clearly if internal audit produce recommendations that are flawed because they reflect the auditors' lack of independence, the **costs of their salaries** will be wasted. In addition, costs will increase if management uses internal audit's recommendations as the basis for decisions about risk management. Risks unnecessarily highlighted by internal audit may be **over-managed**, incurring excessive costs. Risks which are not highlighted by internal audit when they should have been may materialise, causing significant losses to the organisation.

3.1.4 Confidence in recommendations

Line managers will be less willing to implement internal audit recommendations if they believe that internal audit is biased against them.

CASE STUDY

Spencer Pickett in the *Internal Auditing Handbook* suggests that the concept of independence involves a number of key qualities:

Objectivity	Judgements are made in a state of detachment from the situation or decision
Impartiality	Not taking sides, in particular not being influenced by office politics in determining the work carried out and the reports given
Unbiased views	Avoiding the perception that internal audit is out to 'hit' certain individuals or departments
Valid opinion	The audit opinion should be based on all relevant factors, rather than being one that pleases everyone
No spying for management	Again internal audit should serve the whole organisation. Managers who want their staff targeted might be trying to cover up their own inadequacies
No no-go areas	Being kept away from certain areas will fatally undermine the usefulness of internal audit and mean that aggressive (incompetent?) managers are not checked
Sensitive areas audited	Internal audit must have the abilities and skills to audit complex areas effectively
Senior management audited	Internal audit must cover the management process and not just audit the detailed operational areas
No backing-off	Audit objectives must be pursued fully in a professional manner and auditors must not allow aggressive managers to deflect them from doing necessary work and issuing valid opinions

3.2 Threats to independence

3.2.1 Involvement in systems design

If internal audit has been involved in the design of systems, it is very doubtful that they can audit what they have recommended.

3.2.2 Overfamiliarity

As a result of working for the same organisation, and being involved with the same issues, internal auditors may develop close professional or personal relationships with the managers and staff they are auditing. This may well make it very difficult to achieve independence. This particularly applies to staff who come into internal audit from operational departments. There may also be the risk of self-review – that they review work that they have previously done for operational departments.

An organisation's culture and informal networks of staff can have a big influence on individuals' attitudes to ethics.

3.2.3 Reporting relationships

The principle that internal audit should be **independent** of the **line management** whose sphere of authority it audits ideally should extend to internal audit being **independent of the finance director**.

The reason for this is best seen by thinking about what could happen if the internal audit department reported some kind of irregularity to a finance director without realising that the finance director was actually involved. The director would take the report and decide that it was all very interesting, but not worth pursuing. A very different line might be taken by another, independent director!

3.3 Dealing with threats to independence

Independence of internal auditors can be achieved by the following.

- The department should report to the **board** or to a special **audit committee** and not to the finance director.
- Management should ensure that staff recruited to internal audit internally **do not conduct audits** on departments in which they have worked.
- Where internal audit staff have also been involved in **designing** or **implementing new systems**, they should not **conduct post-implementation audits**.

- Internal auditors should have **appropriate scope** in carrying out their responsibilities, and unrestricted access to records, assets and personnel.
- **Rotation of staff** over specific departmental audits should be implemented.

3.3.1 Review and consultancy

Consultancy projects (one-off projects designed to address ad-hoc issues) are playing an **increasing role** in the work of **internal audit.** Taking on these projects enables internal auditors to extend their skills, and the organisation to draw on the knowledge of internal auditors. However, there are dangers in becoming too involved in consultancy projects.

(a) Internal audit staff may be diverted to consultancy projects, and the regular audit reviews may be **inadequately resourced**.

(b) By taking on consultancy projects, and suggesting **solutions** internal audit could be getting too involved in **operational concerns**. There is a serious potential lack of independence if internal audit has to review solutions that **internal audit** staff have provided.

(c) Management is relying on internal audit to **solve problems** instead of having operational staff and managers solve or preferably prevent them.

Certain steps therefore need to be taken in order to avoid these problems:

(a) The **terms of reference** of the internal audit department (the main responsibilities) should draw a clear distinction between **regular audit services** and **consultancy work**.

(b) **Enough resources** for **regular work** should be **guaranteed**. Consultancy work should be separately resourced and additional resources obtained if necessary.

(c) If managers are concerned about **improving controls**, reviewing these improvements can legitimately be included in the work of internal audit.

(d) **Regular audit reviews** and **consultancy projects** can be undertaken by different staff.

(e) If consultancy work **identifies serious control weaknesses**, these must be incorporated into **internal audit reviews** as **high risk areas**.

4 Management of internal audit

Internal audit standards should cover professional proficiency, scope of work, performance, management and independence.

An internal audit department should plan its work carefully through the preparation of **strategic**, **tactical** and **operational plans**.

Formal **quality control procedures** should be used to assess the work of internal audit, which should also consider the **value for money** provided by the internal audit function.

4.1 Management of internal audit

The chief internal auditor should manage the internal audit department properly. If the department is running well, it should have the following features.

- A statement of purpose, authority and responsibility
- Thorough planning
- Written policies and procedures
- A programme for personnel management and development
- Co-ordination with external auditors
- A quality assurance system

CASE STUDY

The PWC report *Internal audit 2012* suggests ten imperatives for a high-performance internal audit function:

- **Strategic stature within the organisation**. The chief audit executive should ensure that priorities align with the wishes of the audit committee and management and should be a trusted adviser to key stakeholders.
- **Development and update of strategic plan aligned with objectives and stakeholder expectations**. The plan should indicate how internal audit will develop and be organised to deliver service, and suggest specific goals or strategic initiatives to bridge capability gaps.
- **Communication with key stakeholders**. In particular there should be regular dialogue with the audit committee chairman and external auditors.
- **Align HR strategies with enterprise and stakeholder needs**. This means internal audit ensuring that skills gaps relating to new and emerging skills are bridged.
- **Focus continually on enterprise risks**. As well as testing controls, internal auditors ought to focus on the risks themselves, keeping management informed

about risk exposures and conducting an annual enterprise-wide risk assessment, which feeds into the audit plan. Risk assessments need to be transparent, aligned with business units and involve external audit as well as internal management.

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- **Development of knowledge management plan**. The aim of this plan should be to make available internal audit knowledge and expertise to other internal auditors and business unit and enterprise management.
- **Commitment to continuous quality assurance**. There should be a quality improvement programme, and external assessment of performance and benchmarking.
- **Link performance measures to strategic goals**. This means in particular using a balanced scorecard approach to track performance to the strategic plan.

CASE STUDY

SABMiller was, prior to its takeover in 2016, the biggest drinks company in the FTSE 100 Index and the second largest brewer in the world. It had a global internal audit team of 140 people. The group has operations in over 70 countries, and had internal auditors based in most of them. The group's chief internal auditor said that internal audit needs to engage with senior stakeholders at an early stage in any project, to explain why it should have a role in those projects, as well as to develop a good working relationship.

An early task for internal audit is to ensure that there are no gaps in coverage, that there is no duplication, and that assurance activities are delivered using a common language. The internal audit function conducts regular reviews of projects throughout their life-cycle. For example the team carries out health checks to re-examine project objectives and progress, and to see if management is in control.

The head of internal audit at SAB said that internal auditors need to have prior experience of working on projects to be able to perform their role effectively. This is confirmed by other internal audit chiefs.

'If you have done financial audits as the main part of your work for 20 years then you are not going to get asked to do much else,' says David Butler, head of internal audit at insurer Unum. 'However, if you form a closer relationship with your stakeholders, you will get invited to help in a wider range of work and you will also get a much clearer idea of what they want from you.'

Pulling together a summary showing the amount of resources that internal audit has allocated in recent years to particular risk areas – for example, financial controls, compliance, operational controls, and strategic risks – can help illustrate to management and the audit committee that there might be areas that require more attention.

In light of the comments from the case study, when planning an internal audit in an area at SABMiller, the internal audit team would need to take the following steps.

- Prepare a project scope (for example, if the audit is looking at procurement practices then prepare the project for review of all procurement procedures)
- Establish objectives
- Decide priorities
- Engage with senior stakeholders
- Appoint the internal audit team
- Finalise budget requirements
- Establish regular meetings with stakeholders
- Undergo audit
- Report on findings
- Follow up meetings (if relevant) on findings

4.2 Aims of audit planning

As with any other activity or enterprise, an internal audit department must plan its work carefully if it is to achieve the audit objectives efficiently and effectively. The aim of audit planning is:

(a) **Decide priorities** for audit work

(b) **Establish objectives** (and apply control measures to ensure that objectives are achieved)

(c) Ensure that audit resources are used **efficiently**, **effectively** and **cost-effectively**

4.3 Strategic audit planning

The strategic plan sets out audit objectives in broad terms, including areas to be covered, frequency of coverage and rough estimates of resource requirements.

Usually, the strategic plan covers a period of two to five years. It must be **regularly reviewed** and adjusted in the light of any changes of audit requirements or any information arising out of audit work.

4.3.1 Selecting areas for investigation

The internal auditors then have to consider what areas need to be investigated. Sometimes management will instruct them to look into a certain topic, but for the most part, the internal auditors need some yardstick which they can use to determine whether some segment of the company is important enough to merit investigation. By segment of the company we mean, for example, a specific function or business process, or a transactions flow, or even the work of a physical department located somewhere in the building.

Suppose the internal auditors are considering whether the work of a section which authorises invoices for payment is worth investigation. The criteria which they should bear in mind while making this judgement are as follows.

(a) **Financial**

The volume and size of income and expenditure transactions, or the value of assets

(b) **Internal control**

The existence or otherwise of controls

(c) **Probity**

Whether there is any evidence of past inaccuracies or fraud

(d) **Business goals**

Whether the organisation has laid down explicit objectives and policies against which its achievements can be measured

(e) **Business effects**

Whether the business generates any consequences, internal or external, which need to be investigated

(f) **Value for money**

Whether there is likely to be any waste which can be eliminated

(g) **Special investigations**

Whether management has requested the internal audit department to undertake any specific tasks

4.4 Tactical audit planning

Once the internal auditors have set out their strategic plan, and agreed it with management, it is necessary to prepare a **tactical plan.**

In many ways a tactical audit plan is the easiest type of audit plan to draw up. Basically, it takes the **areas of work** laid down in the strategic plan and matches them to audit resources and timetables. It covers a period of about six months to a year, and will include the following features.

- **Programme** of internal audits to be carried out
- Detailed definition of the **objectives** of each audit
- Detailed **allocation** of audit **resources**

4.5 Operational audit planning

An operational internal audit plan will be drawn up for each **individual audit**. It is based on the **objectives** as broadly indicated in the strategic plan, on resource and timetabling considerations within the tactical plan, on results of previous audits, and any other relevant data. When completed, it should show:

- **Detailed audit objectives**
- The **extent of coverage** and areas to be given emphasis
- **Target dates** for individual stages of the audit
- **Names of auditors** responsible for or involved in the completion of the audit

CASE STUDY

The PWC *Internal audit 2012* study suggests that in future internal audit will operate with a faster, more flexible, scheduling and planning model, having enough time throughout the year to address emerging issues on an as-needed basis. There will also be more continuous auditing through, for example, computer-assisted data extraction and analysis.

4.6 IIA Standards

Whatever the scope of internal audit, all staff should be aware of the standards to which they are working. The Institute of Internal Auditors has produced a series of standards covering all areas of internal auditing. The standards comprise five general standards supported by more specific standards with accompanying guidance.

4.7 Professional proficiency

Internal audits should be performed with **proficiency** and **due professional care**. There are specific standards on the following areas.

- Appropriate staffing
- Knowledge, skills and disciplines
- Supervision
- Compliance with professional standards
- Human relations and communications
- Continuing education
- Due professional care

4.8 Scope of work

The scope of internal audit's work should include **assessment** of the **adequacy** and **effectiveness** of the internal control system and quality of performance. The assessment should include consideration of whether the organisation has met the following objectives.

- Reliability and integrity of information
- Compliance with policies, plans, procedures, laws and regulations
- Safeguarding of assets
- Economical and efficient use of resources
- Accomplishment of established objectives and goals for operations and programmes

4.9 Performance of audit work

Performance should include the following stages.

- Planning the audit
- Examining and evaluating information
- Communicating results
- Follow up of work

4.10 Quality control and internal auditing

Whatever the criteria used to judge effectiveness, quality control procedures will be required to monitor the professional standards of internal audit. Internal audit departments should establish and monitor quality control policies and procedures designed to ensure that **all audits** are **conducted** in **accordance** with **internal**

standards. They should communicate those policies and procedures to their personnel in a manner designed to provide reasonable assurance that the policies and procedures are understood and implemented.

Quality control policies will vary depending on factors such as the following.

- The size and nature of the department
- Geographic dispersion
- Organisation
- Cost-benefit considerations

Policies and procedures and related documentation will therefore vary from company to company.

The Institute of Internal Auditors has suggested that a formal system of quality assurance should be implemented in the internal audit department. This should cover the department's compliance with appropriate standards, encompassing quality, independence, scope of work, performance of audit work and management of the internal audit department.

4.11 Annual review of internal audit

The board or audit committee should conduct an annual review of the internal auditors' work. The reviews should include the following areas.

4.11.1 Scope of work

The review will be particularly concerned with the work done to test:

- The **adequacy, effectiveness** and **value for money** of internal control
- **Risk assessment** and **management processes**
- **Compliance with laws, regulations** and **policies**
- **Safeguarding** of assets
- **Reliability** of information
- **Value for money**
- **Attainment** of organisation's **objectives** and **goals**

It should be possible to see from the plans that internal audit submits to the audit committee that internal audit's work forwards the organisation's aims and that internal audit is **responsive** to organisational change.

4.11.2 Authority

The review should cover the formal terms of reference and assess whether they are adequate.

It should consider whether there are senior personnel in the organisation who can ensure that the scope of internal audit's work is **sufficiently broad**, that there is **adequate consideration** of **audit reports** and **appropriate action** on audit findings and recommendations.

4.11.3 Independence

The review should consider carefully whether there are **adequate safeguards** in place to ensure the independence of internal audit. These include reporting by the head of internal audit to the audit committee, **dismissal of the head of internal audit** being the responsibility of the board or audit committee, internal auditors not assuming operational responsibilities and internal auditors being excluded from systems, design, installation and operation work.

4.11.4 Resources of internal audit

Again the review should consider the documentation provided by internal audit and confirm that resourcing plans indicate that there will be **sufficient resources** to review all areas. This should be assessed not just in terms of the hours set aside but also physical resources such as computers, and also of course the necessary **knowledge**, **skills and experience**.

QUESTION — **Reporting to board**

Explain the reasons why internal auditors should or should not report their findings on internal control to the board of directors.

ANSWER

A high level of independence is achieved by the internal auditors if they report directly to the Board. However, there may be problems with this approach.

(1) The members of the Board may **not understand all the implications** of the internal audit reports when accounting or technical information is required.

(2) The Board may **not have enough time** to spend considering the reports in sufficient depth. Important recommendations might therefore remain unimplemented.

A way around these problems might be to delegate the review of internal audit reports to an **audit committee**, which would act as a kind of sub-committee to the main board. The audit committee should be made up largely of non-executive directors who have more time and more independence from the day-to-day running of the company, and who possess the necessary financial knowledge.

5 Internal audit engagements

Internal audit can be involved in many different assignments as directed by management. These can range from **value for money** projects to **operational** assignments looking at specific parts of the business.

In this section we will consider a number of the detailed assignments which an internal auditor could get involved in.

5.1 Value for money audits

5.1.1 Purpose

The purpose of a value for money (VFM) audit is to examine the **economy**, **efficiency** and **effectiveness** of activities and processes within a business. These are known as the **three Es** of VFM audits (National Audit Office, 2016).

5.1.2 Nature

The three Es which form the basis of the VFM audit are very important for assessing the performance of not-for-profit organisations, because their performance cannot be properly assessed using conventional accounting ratios. As a result, most not-for-profit organisations rely on measures that estimate the performance of the organisation in relation to the three Es. For example, in Singapore, the Auditor-General's Office carries out VFM audits on the economic, efficient and effective use of public resources.

The three Es can be defined as follows:

(a) **Economy**: Attaining the appropriate quantity and quality of physical, human and financial resources (**inputs**) at lowest cost. An activity would not be economical if, for example, there was overstaffing or failure to purchase materials of requisite quality at the lowest available price.

(b) **Efficiency**: This is the relationship between goods or services produced (**outputs**) and the resources used to produce them. An efficient operation produces the maximum output for any given set of resource inputs, or it has minimum inputs for any given quantity and quality of product or service provided.

(c) **Effectiveness**: This is concerned with how well an activity is achieving its policy objectives or other intended effects.

The internal auditors will **evaluate** these three factors for any given business system or operation in the company. Value for money can often only be judged by **comparison.** In searching for value for money, present methods of operation and uses of resources must be **compared with alternatives**.
The following list identifies areas of an organisation, process or activity where there might be scope for significant value for money improvements. Each of these should be reviewed within individual organisations:

- Service delivery (the actual provision of a public service)
- Management process
- Environment

An alternative approach is to look at areas of spending. A value for money assessment of economy, efficiency and effectiveness would look at whether:

- Too much money is being spent on certain items or activities, to achieve the targets or objectives of the overall operation.
- Money is being spent to no purpose, because the spending is not helping to achieve objectives.
- Changes could be made to improve performance.

An illustrative list is shown below of the sort of spending areas that might be looked at, and the aspects of spending where value for money might be improved:

- Employee expenses
- Premises expenses
- Suppliers and services
- Establishment expenses
- Capital expenditure

Problems with VFM auditing	
Measuring outputs	For example, the outputs of a fire brigade can be measured by the number of call-outs, but it is not satisfactory to compare a call-out to individuals stuck in a lift with a call-out to a small house fire or a major industrial fire or a road accident etc.
Defining objectives	In not-for-profit organisations the quality of the service provided will be a significant feature of their service. For example, a local authority has, among its various different objectives, the objective of providing a rubbish collection service. The effectiveness of this service can only be judged by establishing what standard or quality of service is required.

Problems with VFM auditing	
Sacrifice of quality	Economy and efficiency can be achieved by sacrificing quality. Neither outputs nor impacts are necessarily measured in terms of quality. For example, the cost of teaching can be reduced by increasing the pupil:teacher ratio in schools, but it is difficult to judge the consequences of such a change on teaching standards and quality.
Measuring effectiveness	For example, the effectiveness of the health service could be said to have improved if hospitals have greater success in treating various illnesses and other conditions, or if the life expectancy of the population has increased, but a consequence of these changes will be overcrowded hospitals and longer waiting lists.
Over-emphasis on cost control	There can be an emphasis with VFM audits on costs and cost control rather than on achieving more benefits and value, so that management might be pressurised into 'short-term' decisions, such as abandoning capital expenditure plans which would create future benefits in order to keep current spending levels within limits.
Measuring efficiency	In profit-making organisations, the efficiency of the organisation as a whole can be measured in terms of return on capital employed. Individual profit centres or operating units can also have efficiency measured by relating the quantity of output produced, which has a market value and therefore a quantifiable financial value, to the inputs (and their cost) required to make the output. In not-for-profit organisations, output does not usually have a market value, and it is therefore more difficult to measure efficiency. This difficulty is compounded by the fact that, since such organisations often have many different activities or operations, it is difficult to compare the efficiency of one operation with the efficiency of another. For example, with the police force, it might be difficult to compare the efficiency of a serious crime squad with the efficiency of the traffic police.

5.2 Information technology audits

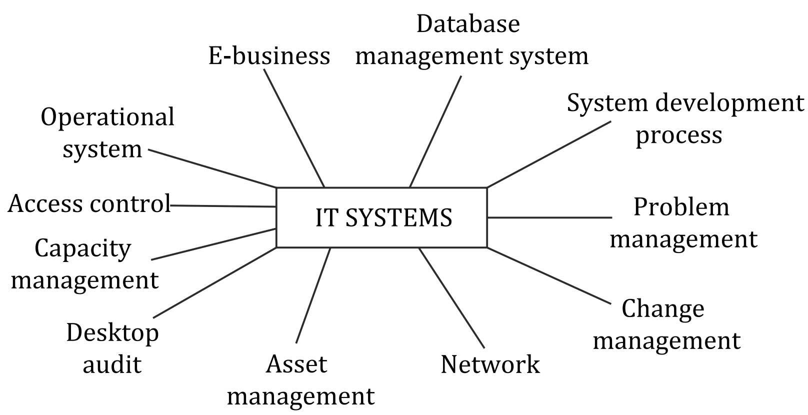
5.2.1 Purpose

An information technology (IT) audit is a test of controls in a specific area of the business, the computer systems. Increasingly in modern business, computers are vital to the functioning of the business, and therefore the controls over them are key to the business.

5.2.2 Nature

It is likely to be necessary to have an IT specialist in the internal audit team to undertake an audit of the controls, as some of them will be programmed into the computer system.

The diagram below shows the various areas of IT in the business which might be subject to a test of controls by the auditors.



5.3 Best value audits

5.3.1 Purpose

'Best value' is a performance framework introduced into local authorities by the UK Government (Department of Communities and Local Government, 2011). They are required to publish annual best value performance plans and review all their functions over a five-year period.

As part of best value, authorities are required to strive for continuous improvement by implementing the '4 Cs':

(a) **Challenge.** How and why is a service provided?

(b) **Compare**. Make comparisons with other local authorities and the private sector.

(c) **Consult**. Talk to local taxpayers and services users and the wider business community in setting performance targets.

(d) **Compete.** Embrace fair competition as a means of securing efficient and effective services.

The purpose of the best value audit is to measure the organisations performance against the established criteria.

5.3.2 Nature

One of internal audit's standard roles in a company is to provide assurance that internal control systems are adequate to promote the effective use of resources and that risks are being managed properly.

This role can be extended to ensure that the local authority has arrangements in place to achieve best value, that the risks and impacts of best value are incorporated into normal audit testing and that the authority keeps abreast of best value developments.

As best value depends on assessing current services and setting strategies for development, internal audit can take part in the 'position audit', as they should have a good understanding of how services are currently organised and relate to each other.

As assurance providers, internal audit will play a key part in giving management assurance that its objectives and strategies in relation to best value are being met.

5.4 Financial audits

5.4.1 Purpose

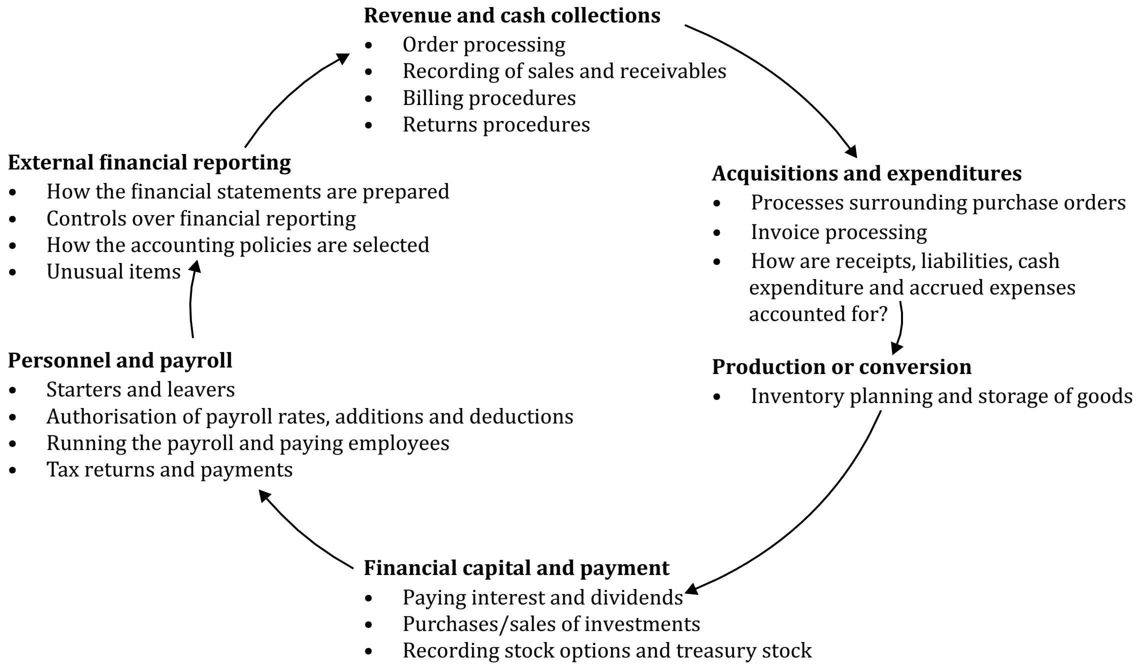
The financial audit is internal audit's traditional role. Its purpose is to evaluate the operating effectiveness of the key business processes which relate to the financial statements.

5.4.2 Nature

It involves reviewing all the available evidence to substantiate information in management and financial reporting. The substantive procedures and tests of controls employed by external audit are also used by internal audit.

The importance of controls in preventing financial reporting errors means that it is necessary to review certain areas regularly to ensure the relevant controls continue to be in place. Many internal audit functions will therefore adopt a **cycle approach** to financial internal audit engagements to ensure each area is reviewed on a regular basis.

The below diagram shows a cycle that could be followed, along with some examples of areas that may be considered as part of the reviews of those areas.



This role in many ways echoes that of the external auditor, and is one in which the value the internal auditors can add to the business is limited. Therefore, the range of assignments internal auditors have undertaken has increased, as organisations seek to apply their skills in areas which will add most value to the business.

5.5 Regulatory compliance audit

5.5.1 Purpose

The regulation which affects companies will vary depending on the nature of the organisation. **Some regulations** will be **specific to the industry** the client operates in (eg regulations over disposing of hazardous waste in the nuclear industry) and **some will apply to all companies** operating in a region or country (eg tax laws and employee-related laws). The purpose of the compliance audit is to **assess the effectiveness** of the business' systems and processes that are designed to ensure that the company complies with the relevant laws and regulations.

5.5.2 Nature

The compliance audit will review the following key matters:

- The effectiveness of systems in identifying which regulations the company has to comply with
- The effectiveness of systems in ensuring that those regulations are complied with
- The extent to which regulations are complied with
- The effectiveness of systems in identifying non-compliance

5.6 Fraud investigations

5.6.1 Purpose

The purpose of a fraud investigation may vary but one will normally be performed:

- To determine whether fraud risk management **controls are adequate** to ensure that fraud is prevented and/or detected and to make recommendations if they are not
- To determine **whether a fraud has actually occurred** based on information which has come to light.

5.6.2 Nature

When evaluating the effectiveness of fraud risk management controls the internal auditor will:

- Evaluate the **risk of fraud** in the organisation
- Evaluate the **potential for fraud** to take place
- Assess whether **fraud controls are sufficient** and if not, make recommendations for improvements
- Assess whether **fraud controls are operating effectively** and if not investigate the reasons why
- Consider the **effectiveness of reporting suspicions** of fraud eg support provided to 'whistle blowers' (employees who raise concerns about their employer outside of normal employment channels due to their scepticism that anything will be done – often, this is done anonymously as the employee may feel threatened by the employer for raising these concerns in the first place)

- Provide a **report of findings and recommendations** to the board and management

If investigating a potential fraud the process would typically include the following:

- Confirmation of the facts obtained to date
- Conduct an investigation
- Analyse the evidence and form a conclusion
- Report conclusions and make recommendations for improvements to controls if a fraud has taken place

5.7 Customer experience audit

5.7.1 Purpose

The purpose of a customer experience audit is to help a business understand **how it manages its customer relationships** and to **maximise the potential value of its customers.** This will involve evaluating the existing 'customer journey' in order to identify any improvements which can be made and the systems which need to be in place.

5.7.2 Nature

The precise nature of the audit will depend on the type of business involved and the nature of the customer relationships. Typically, however, the internal auditor will consider the following issues:

- The **types of customers** from which the business generates the most revenue
- **What the customer values most** about the company's goods/services
- The extent to which the company **retains customers**
- The rate at which **customer interest is converted in to sales**
- Key areas of **customer dissatisfaction**

5.8 Governance and culture audits

5.8.1 Purpose

The purpose of governance and culture audits is to help a business understand **the impact of its corporate culture and leadership** on the organisation and to **identify potential issues** before they turn into problems that could destroy the business. This is important, because robust governance and a good organisational culture play key roles in ensuring the appropriate structures, policies, controls, beliefs and attitudes are in place for corporate success.

Poor organisational culture has been identified as a root cause of ethical failures and other poor corporate behaviour. In addition, the organisation's approach to risk management and the risk appetite will be heavily influenced by its systems of governance and culture.

Internal audit reviews in these areas could therefore add significant value for the organisation.

5.8.2 Nature

The precise nature of the audit will depend on the type of business involved and the systems by which it is governed.

Audits in these areas will involve looking at the overall way that the organisation is managed and controlled, the process though which policies and procedures are set, communicated, monitored and reviewed. Typically, however, the internal auditor will consider the following issues:

- The overall way that the organisation is managed and controlled
- The process through which policies and procedures are set, communicated, monitored and reviewed
- The constitution of the board and its various committees
- The work carried out by the board and the various committees, and the way that they interact together

The primary focus will be on observation, surveys and discussions with staff. Experts, such as organisational psychologists, could be brought in to assist in understanding the culture of the organisation and the behaviours within it.

5.9 Operational audits

Operational audits are audits of the operational processes of the organisation. They are also known as management or efficiency audits. Their prime objective is the monitoring of management's performance, ensuring that company policy is adhered to.

5.9.1 Approaching operational internal audit assignments

There are two aspects of an operational assignment:

(a) Ensure policies are adequate

(b) Ensure policies work effectively

In terms of adequacy, the internal auditor will have to review the policies of a particular department by:

(a) Reading them
(b) Discussion with members of the department

Then the auditor will have to assess whether the policies are adequate, and possibly advise the board of any areas which need improvement.

The auditor will then have to examine the effectiveness of the controls by:

(a) Observing them in operation
(b) Testing them

This will be done on similar lines to the testing of controls by external auditors which is discussed in Section D of this Study Text, even though the controls being tested may differ.

5.9.2 Procurement audits

Procurement is the process of **purchasing** for the business. A procurement audit will therefore concentrate on the **systems** of the purchasing department(s). The internal auditor will be checking that the system achieves key objectives and that it operates according to company guidelines.

5.10 Examples of internal audit assignments

The assignments internal auditors will carry out will depend on the particular circumstances of the company involved and its objectives. However, the following are examples of the sorts of assignment internal auditors may be asked to carry out by management:

(a) **Testing operational or financial controls**: This may include testing controls operating centrally (at head office) or at branches. One example is the testing of controls over inventory counting or cash counting. This would include observation of controls in operation at warehouses or retail stores during attendance at counts.

(b) **IT system reviews**: We mentioned IT audits earlier. Internal auditors may be asked to look specifically at controls over the accounting system, or, instead, over other computer systems that supply data to the accounting system. For example, a travel company's reservation system will usually link to the accounting system and is an important element in determining when the revenue on a flight or holiday is recorded. Or for companies with retail stores, assignments may include reviewing controls over computer systems linking tills to head office.

(c) **Value for money reviews**: As stated earlier, these are often common in not-for-profit entities. However, they are carried out by internal auditors in profit-making entities too. This could be in the context of whether the company is obtaining from its assets or its suppliers, as well as whether the company is providing value for money for its customers.

(d) **Fraud investigations**: Fraud can range from theft of assets to fraudulent financial reporting. Internal audit may be asked to investigate specific instances of suspected fraud or, more generally, to review and test controls to prevent or detect fraud.

(e) **Review of compliance with laws and regulations**: As we saw in Section 4.5 above, internal auditors may assist with or review compliance with laws and regulations. For example, if a company has an overseas branch, the internal audit department may review compliance with laws/regulations specific to that country (such as filing adequate financial or non-financial returns).

(f) **Customer service reviews**: Internal auditors may be asked to assess the level of customer service. They could do this by phoning in or visiting stores/outlets and pretending to be customers. Alternatively they could review and analyse the results of customer surveys.

The list of examples above is not exhaustive and those charged with governance could ask internal audit to review and report on any business area where feedback could be useful in improving the company's position and performance.

CHAPTER ROUNDUP

- The role of internal audit will **vary** according to the **organisation's objectives** but is likely to include review **of internal control systems, risk management, legal compliance** and **value for money**.
- Internal auditors will be involved in **monitoring risk management systems** and feeding back suggestions for improvements.
- Internal audit should be **independent of operational management.**
- Internal audit standards should cover **professional proficiency, scope of work, performance, management** and **independence**.

  An internal audit department should plan its work carefully through the preparation of **strategic**, **tactical** and **operational plans**.

  Formal **quality control procedures** should be used to assess the work of internal audit, which should also consider the **value for money** provided by the internal audit function.
- Internal audit can be involved in many different types of assignments, as directed by management. These can range from **value for money** projects to **operational** assignments looking at specific parts of the business.

PROGRESS TEST

1 What criteria should the internal auditors bear in mind when deciding which areas should be covered in a strategic audit plan?

2 What are the main elements of internal audit's review of the accounting and control systems?

3 Which of the following is not a measure designed to enhance the independence of internal audit?

(a) Internal audit should have unrestricted access to records, assets and personnel.

(b) Internal audit should report ultimately to the finance director.

(c) Internal auditors should not audit systems that they have designed.

(d) The terms of reference of the internal audit department should draw a clear distinction between regular audit services and consultancy work.

ANSWERS TO PROGRESS TEST

1
- Financial
- Internal control
- Probity
- Business goals
- Business effects
- Value for money
- Special investigations

2
- Reviewing the design of systems
- Monitoring the operation of systems by risk assessment and detailed testing
- Recommending cost effective improvements

3 B Internal audit should ultimately report to the audit committee.

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