

ACCA

PAPER AA

Audit and Assurance (AA)

FOR EXAM UNTIL Jun 2024

Introduction of AA

1. Aim 课程目标

The aim of ACCA Paper AA, Audit and Assurance, is to develop knowledge and understanding of the process of carrying out the assurance engagement and its application in the context of the professional regulatory framework.

2. Syllabus 课程大纲

- Part A Audit framework and regulation
- Part B Planning and risk assessment
- Part C Internal control
- Part D Audit evidence
- Part E Review and reporting
- Part F Employability and technology skills

3. Exam format 考试形式

- Time allowed: 3 hours (plus 10 minutes to read the pre-exam instructions)
- Predominantly computational

Section A- Scenario based OT question $5 \times 2 = 10$ marks (any area)

$10 \times 3 = 30$ marks

Section B- Constructive response (CR) question. The examination comprises one 30 mark and two 20 marks constructed response (long) questions. The questions in this section will focus on the following syllabus areas:

- Planning and risk assessment
- Internal control
- Audit evidence
- Reporting
- Corporate governance
- Ethic

Full specimen exam:

<https://www.accaglobal.com/africa/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/cbe-question-practice.html>

4. Pass rate 历年考试通过率

39%	38%	44%	39%	40%	44%	45%
Sep 2021	Dec 2021	Mar 2022	June 2022	Dec 2022	Mar 2023	June 2023

5. Key to success - Practice , practice, practice makes perfect!

Contents

Introduction.....	2
 Part A Audit framework and regulation	
Chapter 1 Audit and other assurance engagements	4
Chapter 2 Rules and regulation	11
Chapter 3 Corporate governance	17
Chapter 4 Professional ethics and accepting audit engagements	30
 Part B Planning and risk assessment	
Chapter 5 Audit planning, documentation and responsibility.....	49
Chapter 6 Risk assessment.....	62
 Part C Internal control	
Chapter 7 Internal control and test of control	80
 Part D Audit evidence	
Chapter 8 Audit evidence	118
Chapter 9 Audit procedure for specific items	135
 Part E Review and reporting	
Chapter 10 Review and finalisation.....	181
Chapter 11 Reports	198

Chapter 1 Audit and other assurance engagements

审计的工作内容是对财务会计报告进行审计，对企业资产负债表、损益表、现金流量表、会计报表附注及相关附表进行审计，是最常规的审计业务通常提供给公司的股东。通过学习本章节，你会了解到为什么需要审计，审计有多少种类以及审计的要素。

Learning outcomes

- Identify five elements of an assurance engagement.
- Discuss the concepts of accountability, stewardship and agency.
- Describe the types of assurance engagement.
- Explain the level of assurance provided by an external audit and other review engagements and the concept of true and fair presentation.



1. Assurance engagement

1.1. What is assurance engagement?

An assurance engagement is an engagement in which a practitioner evaluates and expresses an opinion on the subject matter so that third parties may place reliance upon it.

There are **five elements** of an assurance engagement (**CREST**):

- **Suitable Criteria.** The subject matter is compared to the criteria in order for it to be assessed and an opinion provided.
- **An assurance Report** which is a written report containing the practitioner's opinion given to the intended user and the responsible party
- **Evidence.** Appropriate evidence has to be obtained by the practitioner in order to give the required level of assurance.
- **Suitable subject matter.** The subject matter is the data that the responsible party has prepared and which requires verification.
- **A Three party relationship.**
 - The **intended user** who is the person who requires the assurance report
 - The **responsible party** which is the organisation responsible for preparing the subject matter to be reviewed.
 - The **practitioner** who is the professional who will review the subject matter and provide the assurance.

Exam focus point

five elements of an assurance engagement (CREST)

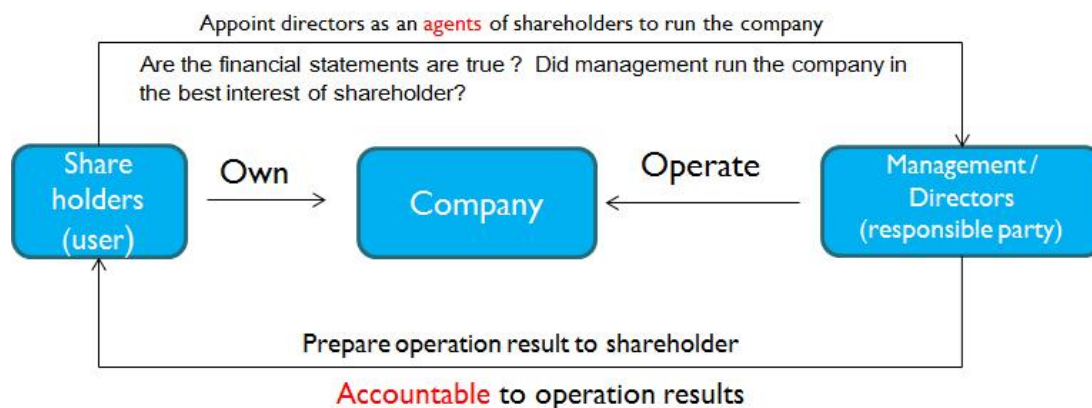
在历年考试的理论题中，考官多次考察 5 个 element 的定义，需要同学们要记忆这些定义。

1.2. Why is there a need for assurance engagement?

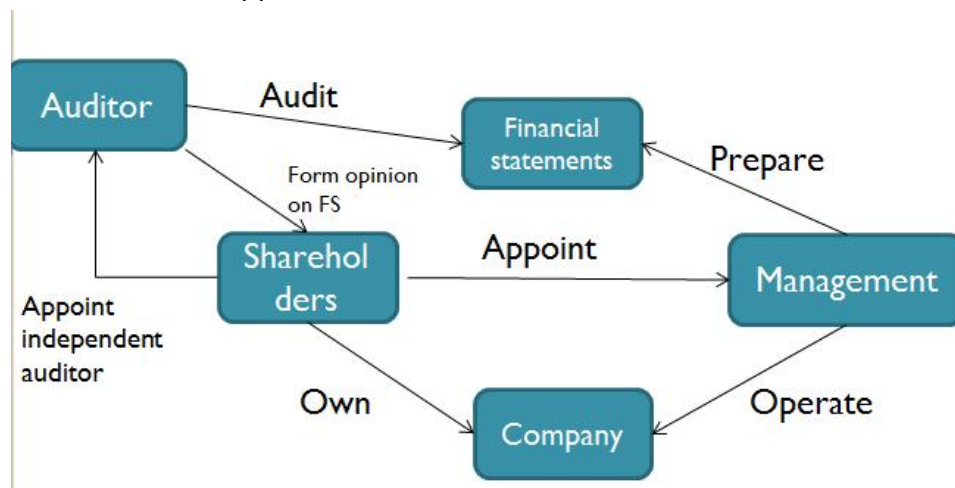
In a company, the agents (management) manage the company on behalf of the shareholders (principals). Shareholders seek to maximise their wealth through the increasing the profitability of the company. Management seeks to maximise their wealth through salary, bonuses and other employment benefits. This reduces company profitability.

Both of these parties may have their own aims which may potentially lead to conflicts of interest. Therefore, auditors are hired to verify the work performed by the management to ensure that they have the shareholder's best interests in mind

Before auditor was appointed:



When auditor is appointed



1.3. Accountability, agency and stewardship

Accountability means that people in a position of power can be held to account for their actions.

In the above graph, management should explain their decisions to shareholders and can be criticised or punished by shareholders if they have abused their position.

Agency occurs when one party, the principal, employs another party, the agent, to perform a task on their behalf. Shareholders employ management as agent to run the company on their behalf.

Stewardship is the responsibility to take good care of resources. In the above graph, management is responsible to take good care of resource for shareholders.

Exam focus point

Accountability, agency and stewardship 在历年考试的理论题中, 考官多次考察 3 个单词的定义, 需要同学们要记忆这些定义。

2. Level of assurance

The IAASB International Framework for Assurance Engagements permits two types of assurance engagement:

- reasonable
- limited.



2.1. Reasonable assurance engagements

Practitioner need to:

- Gives a **high level of assurance** (confidence)
- Gives a **positively worded** assurance opinion
- Gathers sufficient appropriate evidence to be able to **draw reasonable conclusions**
- **Performs very thorough procedures** to obtain sufficient appropriate evidence - tests of controls and substantive procedures

2.2. Limited assurance engagement

Practitioner need to:

- Gives a **lower level of assurance** than that of an audit.
- Gives a **negatively worded** assurance conclusion
- Gathers sufficient appropriate evidence to be able to draw limited conclusions.
- **Performs mainly enquiries and analytical procedures**

Reasonable assurance	Limited assurance
<p><i>Example</i></p> <p><i>In our opinion, <u>the financial statements give a true and fair view</u> of the financial position of ABC Company as at December 31 20X4, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.</i></p>	<p><i>Example</i></p> <p><i><u>Nothing has come to our attention</u> that causes us to believe that the financial statements of ABC Company as of 31 December 20X4 <u>are not prepared, in all material respects, in accordance with an applicable financial reporting framework.</u></i></p>

3. Types of assurance services

There are many types of assurance services: Audit of financial statements, review of financial statements, risk assessment reviews, verification of information and value for money audit in public sector organisations.

3.1. Review engagement

The objective of a **review engagement** is to obtain limited assurance about whether the subject matter information is free from material misstatement.

- A **review engagement is an example of a limited assurance** engagement.
- A **review engagement provides lower level assurance than an external audit.**
- The **procedures** will mainly focus on **analytical procedures** and **inquiries of management.**

3.2. External audit

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.

3.2.1. Objective of external audit

The **objective of an external audit** engagement 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

In general, auditor need to provide an opinion whether the financial statement give a **TRUE and FAIR view.**

- **True:** ① Information is **factual and conforms with reality.** ② The information

conforms with required standards and law. ③The financial statements have been correctly extracted from the books and records.

- **Fair:** ①Information is free from discrimination and bias and in compliance with expected standards and rules. ②The accounts should reflect the commercial substance of the company's underlying transactions

An **audit** of financial statements is an example of an **assurance engagement**.

Practise

An audit engagement provides higher/lower level assurance than a review engagement.

Summery

Type of engagement	Objective	Evidence-gathering procedures	Assurance report
Reasonable assurance (audit)	To obtain reasonable assurance about whether the financial statements present fairly in all material respects and are free of material misstatements.	Sufficient appropriate evidence is obtained engagement process includes: • Understanding of the engagement circumstances • Assessing risks • Responding to assessed risks • Performing detail audit procedure • Evaluating the evidence obtained	positive wording
Limited assurance (review)	To obtain limited assurance about whether the subject matter information is free from material misstatement	Review procedures are limited to analytical procedures and inquiries	negative wording

Exam focus point

在历年考试的选择題中，考官经常把 Reasonable assurance, Limited assurance, audit 和 review 结合在一起考，学生需要区分记住 Reasonable=audit, Limited=review 以及他们对应的 objective 和 report wording。

4. Limitations of audit

An external audit has a number of limitations which reduce its usefulness:

- Sampling – it is not practical for an auditor to test 100% of transactions and so they have to apply sampling methodologies in selecting balances/transactions to test. Therefore, there could be an error in an item not selected for testing by the auditor.
- Subjectivity – financial statements include judgemental and subjective areas, therefore the auditor is required to use their judgement in assessing whether the financial statements are true and fair. Auditor with may not able to identify misstate if he has limited experience.
- Inherent limitations of internal control systems – an internal control system is operated by by management of company and hence is liable to human error. Auditor relies on the internal control systems to provide audit evidences; there could be some error or mistake not be detected.
- Audit report format – the format of the opinion is determined by International Standards on Auditing. However, the terminology used is not usually understood by non-accountants. This means that users may not actually understand the audit opinion given.
- Historic information – the audit report is often issued some time after the year end, and so the financial information can be quite different to the current position. The audit opinion may no longer be relevant if companies' current financial positions.

以下内容可以帮助你进行本章复习及自测

1. 重点词汇

Assurance engagement

Suitable Criteria

Assurance Report

Evidence

Subject matter

Three party relationship

Accountability

Agency

Stewardship

Review engagement

External audit

true and fair view

2. 必做习题

PY question- 5 element of assurance,

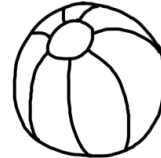
definition of Accountability, Agency, Stewardship

Chapter 2 Rules and regulation

审计是针对企业的财务信息进行审核，这样严肃的过程受到很多法律法律约束。通过本章节的学习，我们去了解企业聘用和辞去审计师有什么法律要求以及审计师在审计过程中有什么权利和义务。

Learning outcomes

- Describe the regulatory environment within which external audits take place
- Explain the statutory regulations governing the appointment, rights, removal and resignation of auditors.
- Explain the development and status of International Standards on Auditing (ISAs).
- Explain the relationship between International Standards on Auditing and national standards.



1. Regulation and auditors

Auditors are subject to regulation from a range of source

- National legislation
- Auditing Standards (national and international)
- Professional body (e.g. ACCA, CICPA)

1.1. The need for regulation

The role of the auditor has come under increased scrutiny over the last thirty years due to an increase in high profile audit failures. The most high profile case, and the catalyst for regulatory change, was the collapse of Enron and its auditor Arthur Andersen.

In order to try and regain trust in the auditing profession, national and international standard setters and regulators have tried to introduce regulation to monitor audit professional.

1.2. Who needs an audit and why

In most countries, companies are required by law to have an audit.

Small or owner-managed companies are often exempt. Reasons for exempting small companies from audit

- The owners and managers of the company are often the same people.
- The impact of misstatements in the accounts of small companies is unlikely to be material to the wider economy
- The audit fee and disruption of an audit are seen as too great a cost for any benefits the audit might bring

1.3. Who may act as auditor?

To be eligible to act as auditor, a person must be: a member of a Recognised Supervisory Body, e.g. ACCA, CPA

1.4. Who may not act as auditor?

For legal reason: individual or company involved with managing the company and those who have business or personal connections with company.

Example

- *Director or secretary of the company,*
- *employee of the company*
- *business partner of the company*

2. Appointment, removal and resignation of auditors

2.1. Who appoints the auditor?

- **Directors** - can appoint ①the first auditor or ②to fill a 'casual vacancy' this requires the members' approval at a members meeting.
- **Members (shareholders)** - Can appoint ①auditor by ordinary resolution or ②director fail to appoint auditor
- **Secretary of State** - if no auditors are appointed by the members or directors.

2.2. Resignation of auditors and removal of auditors

Procedure of remove auditor

1	Notice of removal	Company must either special notice (28days) or written resolution to terminate appointment Director must convene a meeting within reasonable time
2	representations	Auditor circulate representations stating why they should not be removed to members.
3	Resolution passed	Company must notify authority Auditor must deposit statement of circumstances at company's register office within 14 days.

Procedure of auditor resignation

1	Auditor must deposit written notice and statement of circumstances to member.
2	Company must notify authority.
3	Auditor send statement of circumstances to authority. All member of company entitle to get copy of statement of circumstances
4	Auditor can require directs call an extraordinary general meeting to discuss the resignation.
5	Hold the general meeting for auditor resignation. Auditor could speak at meeting on any matter which concern them as auditor.

3. Auditor's rights and duties

3.1. The auditor's rights

The auditors must have certain rights to enable them to carry out their duties effectively

- **Right of access** at all times to the company's **books, accounts** and vouchers.
- **Right to require** from an officer of the company for **information or explanations** related to audit.
- **Right to receive all written resolutions.**
- **Right to receive all notices** of, and other communications relating to, any general meeting which a member of the company is entitled to receive.
- **Right to attend any general meeting** of the company.
- **Right to be heard at any general meeting** which an auditor attends on any part of the business of the meeting which concerns them as auditor
- **Right to request a General Meeting** of the company to explain the circumstances of the **resignation**.

3.2. The auditor's duties

The auditor's primary statutory duty is to **audit the financial statements** and **provide an opinion on** whether **the financial statements**, as presented to the shareholders at the general meeting of the company give a true and fair view.

Other auditor's duties - report opinion on additional statutory requirement:

- Adhere to local law
- Maintain adequate records
- Ensure FS consistent with other info
- Ensure disclosure of director benefit

Exam focus point

在历年考试的理论题中，考官多次考察 auditors' rights and duties 审计师的权利和义务，需要同学们记忆相关知识

4. International Standards on Auditing

International Standards on Auditing (**ISAs**) are issued by the **International Auditing and Assurance Standards Board (IAASB)** and provide guidance on the performance of an audit.

ISAs only apply to the audit of historical financial information.

They are written in the context of an audit of financial statements by an independent auditor.

The basic principles and essential procedures of an ISA are to be applied in all cases. If in exceptional cases the auditor deems it necessary to depart from an ISA to achieve the overall aim of the audit, then this departure must be justified.



4.1. ISAs and national regulation

If ISAs conform with local regulations, the audit of financial information should comply ISA.

If **local regulations** differ from, or **conflict with, ISAs** on a particular subject, the **audit of financial information should comply with local regulations. Therefore, ISAs do not override the local regulations**

Exam focus point

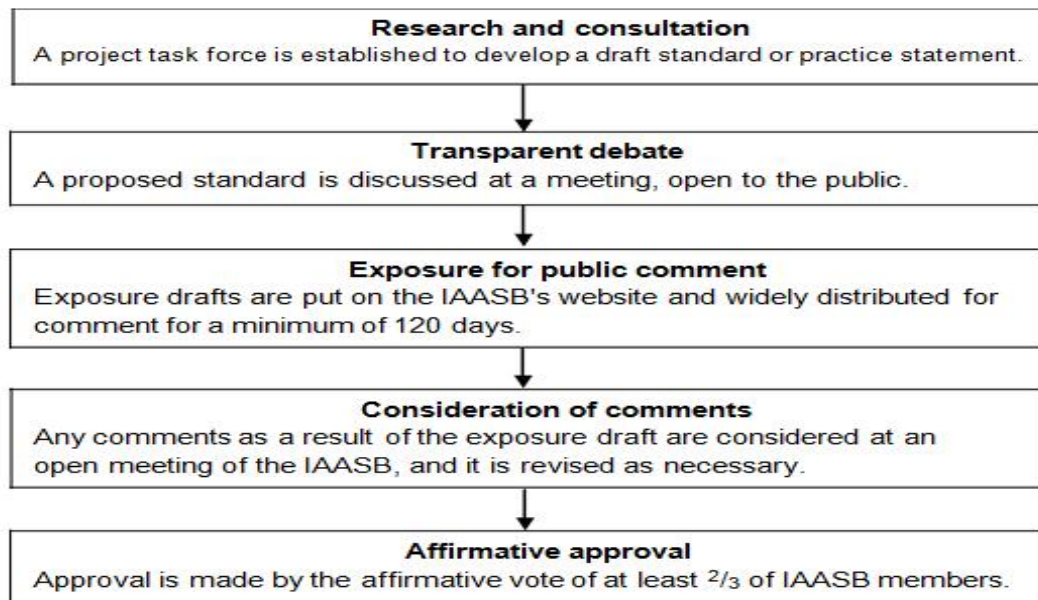
在历年考试的选择題和理論題中，考官多次给出国际审计准则 ISAs 和本土法律冲突的情景，需要学生牢记国际审计准则不能超越本土法律要求。

4.2. ISAs and other pronouncements

IAASB Pronouncements	
International Standards on Auditing (ISAs)	To be applied in the audit of historical financial information
International Standards on Review Engagements (ISREs)	To be applied in the review of historical financial information
International Standards on Assurance Engagements (ISAEs)	To be applied in assurance engagements dealing with subject matters other than

	historical financial information
International Standards on Related Services (ISRSs)	To be applied to compilation engagements, engagements to apply agreed-upon procedures to information and other related services engagements as specified by the IAASB
International Standards on Quality Control (ISQCs)	To be applied for all services falling under the IAASB's engagement standards (ISAs, ISREs, ISAEs, ISRSs)
International Auditing Practice Notes (IAPNs)	Provide practical explanations to auditors

4.3. Working procedures for ISA



以下内容可以帮助你进行本章复习及自测

1. 重点词汇

Resignation of auditors

removal of auditors

Standards on Auditing

2. 必做习题

PYQ

Auditor's rights and duty

ISA vs local legislation

Chapter 3 Corporate governance

Corporate governance 是公司治理，研究公司管理层是如何运作管理企业，被审计的公司运作管理是否规范会影响公司的平稳经营。通过本章节学习，我们要了解好的公司治理制度以及这些制度背后的考量。

Learning outcomes

- Discuss the objectives, relevance and importance of corporate governance.
- Discuss the provisions of international codes of corporate governance that are most relevant to auditors.
- Describe good corporate governance requirements relating to directors' responsibilities and the reporting responsibilities of auditors.
- Evaluate corporate governance deficiencies and provide recommendations to allow compliance with international codes of corporate governance.
- Analyse the structure and roles of audit committees and discuss their benefits and limitations.



1. Corporate Governance

Corporate governance refers to the system in which a company is directed and controlled.

1.1. Why is there a need for corporate governance?

The day to day running of a company is the responsibility of the directors. Although the company's results are submitted for shareholders' approval at the annual general meeting (AGM), shareholders only have an opportunity to raise their issues at the AGM.

Further, AGMs are often very poorly attended and there is the potential for conflicts of interest between management and shareholders

Corporate governance seeks to ensure that the company is managed in accordance with best practices (follow UK CG code) so that directors could manage the company in the best interest for the shareholders, employees and other parties.

2. OECD principle of Corporate Governance

The OECD (Organisation for Economic Co-operation and Development) Principles of Corporate Governance set out the rights of shareholders, the importance of disclosure and transparency and the responsibilities of the board of directors.

OECD develops a set of standards and guidelines on good corporate governance.

- a. To promote transparency, fair markets and efficient allocation of resources.
- b. To protect shareholders' rights and ensure all shareholders are treated fairly.
- c. To provide incentives relating to investment and to allow stock markets to function in a way that supports corporate governance.
- d. To recognise the rights of stakeholders and to encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of enterprises.
- e. To allow timely and accurate disclosure of material matters.
- f. To ensure companies are effectively guided and monitored.

3. The UK Corporate Governance Code

In the UK, All listed companies must follow to the principles in the UK Code of Corporate Governance (UK CG code). However, the company is ready to provide an explanation to the stakeholders if they did not follow UK CG code. This is known as “comply or explain”.

Principles of the UK Corporate Governance Code

CG code	Objective of CG code
Leadership	
<p>There should be a clear division of responsibilities at the head of the company between the running of the board (chairman) and the executive responsibility for the running of the company's business (CEO).</p> <p>历年考题常见违反 CG code 的情景 <i>chief executive officer, Daniel Brown, has recently taken on the role of chairman of the board</i></p>	<p>No individual should have unrestricted levels power in decision-making, as this to prevent abuse of power.</p>
<p>The board of directors will be collectively responsible for the long-term success of the</p>	<p>To ensure all directors would take into account the best</p>

company 历年考题常见违反 CG code 的情景 <i>only the finance director reviews the financial statements and budgets</i>	interest of the company.
CG code	Objective of CG code
Effectiveness	
The board should have the appropriate balance of skills; experience and knowledge of the company 历年考题常见违反 CG code 的情景 <i>All executive officers have many year sales experience</i>	To enable directors to discharge their respective duties and responsibilities effectively.
Appointment of directors should be made through a formal, transparent and rigorous process 历年考题常见违反 CG code 的情景 <i>CEO appoint his brother as finance director</i>	To ensure direct appointed carry with appropriate skills, experience and knowledge.
All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge. 历年考题常见违反 CG code 的情景 <i>A new sales director was appointed nine months ago. He has yet to undertake his board training.</i>	To enable directors to fully aware of their responsibilities and duties.
Non-executive directors (NEDs) NEDs are directors who do not have day-to-day responsibility for the company. NEDs may be independent NEDs (INEDs) or non-independent NEDs (NINEDs). INEDs do not have any interest in the company apart from their director's fee.	
Directors (especially NED) should allocate sufficient time to discharge their responsibilities 历年考题常见违反 CG code 的情景 <i>The non-executive director is very busy and always absent from board meeting.</i>	provide constructive challenge, strategic guidance, offer specialist advice and hold management to account
At least half of the board (excluding the Chairman) should comprise of INEDs 历年考题常见违反 CG code 的情景 <i>XX's board is comprised of six directors; there are four</i>	To ensure that the board makes the correct objective decisions and no individual or group of individuals

<i>executives and two non-executive directors</i>	dominates the board's decision-making.
Rotation	
<p>All directors should be submitted for re-election at regular intervals (within 1 years) subject to satisfactory performance.</p> <p>历年考题常见违反 CG code 的情景</p> <p><i>The directors have remained unchanged for 5 years and none have been subject to re-election by shareholders.</i></p>	<p>This acts as a disciplining mechanism and allows the shareholders a regular opportunity to vote non-performing directors out of office.</p>
Remuneration	
<p>There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding their own remuneration.</p> <p>历年考题常见违反 CG code 的情景</p> <p><i>The executive directors' remuneration is determined by the finance director.</i></p>	<p>To prevent excessive levels of pay being set.</p>
<p>Executive directors' remuneration should be designed to promote the long-term success of the company (salary + bonus + share option).</p> <p>历年考题常见违反 CG code 的情景</p> <p><i>Director remuneration is in the form of an annual bonus based on profits.</i></p>	<p>To motivate the EDs to focus on the long-term growth of the business rather than maximise short-term profit.</p>
<p>NEDs should be paid an annual fee (fixed director fees) for their services.</p> <p>历年考题常见违反 CG code 的情景</p> <p><i>Non-executive directors are paid annual fee and annual bonus based on 2% of profit.</i></p>	<p>To maintain independence of NEDs and encourage them to provide objective suggestion.</p>
Accountability	
<p>The board should present a balanced and understandable assessment of the company's position</p>	<p>To allow shareholders understand the operation of the entity and allow them to</p>

<p>历年考题常见违反 CG code 的情景</p> <p><i>Director remuneration is in the form of an annual bonus based on profits.</i></p>	<p>raise their concern.</p>
<p>The board should establish formal and transparent policy to ensure internal and external audit function</p> <p>历年考题常见违反 CG code 的情景</p> <p><i>Director remuneration is in the form of an annual bonus based on profits.</i></p>	
<p>The board should maintain sound risk management and internal control systems.</p> <p>历年考题常见违反 CG code 的情景</p> <p><i>to save costs, no internal audit function has been set up to monitor internal controls</i></p>	<p>To fulfill directors' responsibility – long-term success of the entity</p>
Audit committee (cover later)	
<p>The audit committee must be comprised of INEDs only (at least 3 INED)</p> <p>历年考题常见违反 CG code 的情景</p> <p><i>The chief executive officer set up the audit committee and he sits on this sub-committee along with the finance director</i></p>	<p>Audit committee is responsible to review internal control of the company and provide suggestion on the financial statements. This is to allow audit committee to provide independent opinion relate to FS.</p>
<p>The audit committee has primary responsibility to suggest the appointment and resignation of auditors and set their remuneration.</p> <p>历年考题常见违反 CG code 的情景</p> <p><i>the finance director and the chairman who make decisions on the appointment and remuneration of the external auditors.</i></p>	<p>To strengthen the independence of the external auditors. If EDs are responsible, the auditors may feel that if they do not provide an unmodified audit opinion then they could be removed.</p>
<p>At least one member of audit committee has recent and relevant financial experience</p> <p>历年考题常见违反 CG code 的情景</p> <p><i>All four members of the audit committee were previously involved in sales or production related roles.</i></p>	<p>To ensure audit committee could monitor integrity of financial statement</p>

Practice of prior year exam question D11Q4

Serena VDW Co has been trading for over 20 years and obtained a listing on a stock exchange five years ago. It provides specialist training in accounting and finance.

The listing rules of the stock exchange require compliance with corporate governance principles, and the directors are fairly confident that they are following best practice in relation to this. However, they have recently received an email from a significant shareholder, who is concerned that Serena VDW Co does not comply with corporate governance principles.

Serena VDW Co's board is comprised of six directors; there are four executives who originally set up the company and two non-executive directors who joined Serena VDW Co just prior to the listing. Each director has a specific area of responsibility and only the finance director reviews the financial statements and budgets.

The chief executive officer, Daniel Brown, set up the audit committee and he sits on this sub-committee along with the finance director and the non-executive directors. As the board is relatively small, and to save costs, Daniel Brown has recently taken on the role of chairman of the board. It is the finance director and the chairman who make decisions on the appointment and remuneration of the external auditors. Again, to save costs, no internal audit function has been set up to monitor internal controls.

The executive directors' remuneration is proposed by the finance director and approved by the chairman. They are paid an annual salary as well as a generous annual revenue related bonus.

Since the company listed, the directors have remained unchanged and none have been subject to re-election by shareholders.

Required

Describe SIX corporate governance weaknesses faced by Serena VDW Co and **provide recommendations** to address each weakness, to ensure compliance with corporate governance principles. (12 marks)

Exam focus point

在历年考试中，考官多次考察 CG 的应用题，面对这些题目学生需要注意分值，和作答技巧。一般情况下，一个 CG weakness 的作答可以获得 2 分，这需要学生写出以下 3 部分：

- 1 是描述题目中哪些地方不符合 CG code 的要求，这部分可以直接从题目摘抄，每找到一个 weakness 可以获得 0.5 分；
- 2 解释 weakness 对公司有什么影响，每解释一个 weakness 可以获得 0.5 分；
- 3 给公司提出建议，让公司达到 CG code 的要求，每个建议可以获得 1 分。

解答 CG 的应用题需要学生对于 CG code 非常熟悉，建议学生通过 CG code 的关键词来记忆。

在作答难度方面，解释 weakness 建议描述，建议学生优先在题目找出 weakness 和提供建议，时间充裕再写解释。

Solution		Identify weakness
	Weaknesses	Recommendations
1	<p>The board is comprised 4 executive directors (EDs) and 2 Non-executive directors (NEDs).</p> <p>(CG code – balance of NED and ED)</p> <p>There should be an appropriate balance of ED and NED to ensure the board makes correct decisions, which are in the best interest of shareholders, and to ensure no individual group dominate board decision making</p>	<p>At least half of the board should be comprise of NED. Hence, Serena VDW Co should recruit and appoint 2 more NEDs. (balance NED and ED means No of NED = No. of ED, current 4ED, should increase 2NED)</p> <div style="border: 1px solid black; padding: 5px; margin-top: 10px;"> <p>Explain benefit of following CG code</p> </div>

Board committee

The main board committees are:

- **Remuneration committee**— responsible for advising on executive remuneration policy and the specific package for each director
- **Risk committee** – responsible for overseeing the organisation's risk response and management strategies.
- **Nomination committee**— responsible for recommending the appointments of new directors to the board.
- **Audit committee** – responsible for financial reporting and internal control matters (see below)

4. Audit committee

An **audit committee** is a committee consisting of non-executive directors which is able to view a company's affairs in a detached and independent way and liaise effectively between the main board of directors and the external auditors.



4.1. Membership of audit committees

- The committee should have at least 3 non-executive directors (2 for smaller companies).
- At least one NED should have recent and relevant financial experience with an appropriate professional accountancy qualification.
- Committee members should be independent of operational management.

4.2. The objectives of the audit committee

- Increasing public confidence in the credibility and objectivity of published financial information
- Assisting executive directors in meeting their responsibilities in respect of financial reporting
- Strengthening the independent position of a company's external auditor by providing an additional channel of communication

4.3. Role and Responsibilities of the Audit Committee

- (a) To **monitor the integrity of the financial statements** of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting issues and judgements contained in them

- (b) To **review the company's internal financial controls** and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, the company's control and risk management systems
- (c) To **monitor and review** the effectiveness of the company's **internal audit** function
- (d) To make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the **appointment, reappointment and removal of the external auditor** and to **approve the remuneration** and terms of engagement of the **external auditors**
- (e) To **review and monitor the external auditor's independence and objectivity** and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements
- (f) To develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm, and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken

4.4. Advantages of having an audit committee

- (a) **Increase public confidence** in the credibility and objectivity of **financial statements**
- (b) **Improve the quality of financial reporting**, by reviewing the financial statements on behalf of the board
- (c) Create a climate of discipline and control which will **reduce the opportunity for fraud**
- (d) Allows executive directors to devote their attention to management as the audit committee can specialise in the problems of financial reporting
- (e) **Strengthen the position of the external auditor** by providing a channel of communication and forum for issues of concern
- (f) **Strengthen the position of the internal audit function**, by providing a greater degree of independence from management

4.5. Disadvantages of having an Audit Committee

- **Difficulties recruiting the right non-executive directors** who have relevant skills, experience and sufficient time to become effective members of the committee
- **The cost may be increased.** Non-executive directors are normally remunerated, and their fees can be quite expensive

Exam focus point

在历年考试中，考官多次考察 audit committee 作用和优缺点的理论题，需要学生通过关键词进行记忆。

5. Communication with those charged with governance

'Those charged with governance' (TCWG) is defined by ISA 260 as 'the person(s) or organisation(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity'.

5.1. Why need to communicate with TCWG

- It assists the auditor and those charged with governance to understand audit-related matters in context and allow them to develop a constructive working relationship.
- It allows the auditor to obtain information relevant to the audit.
- It assists those charged with governance to fulfill their responsibility to oversee the financial reporting process, thus reducing the risks of material misstatement in the financial statements.

5.2. What should be communicated?

- The auditor's responsibilities in relation to the financial statement audit
- Planned scope and timing of the audit
- Significant findings from the audit
 - Significant difficulties encountered during the audit
 - The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures
 - Significant matters arising from the audit that were subject to correspondence with management
- Auditor independence

5.3. When to communicate?

- Before the audit - engagement letter (auditor's responsibilities, scope and objective of the audit)
- Planning stage - planning meeting (discuss and plan the scope and timing of detailed audit work)
- Processing stage – ongoing communication (communication about significant qualitative aspects of the entity's accounting practices and the quality of the

related disclosures)

- Completion stage – written report (significant deficiencies in internal control discovered, the implications of the deficiencies and related recommendations)

以下内容可以帮助你进行本章复习及自测

1. 重点词汇

Corporate governance

Remuneration committee

Risk committee

Nomination committee

Audit committee

Those charged with governance

2. 必做习题

PYQ

Importance of CG

objectives of the audit committee

Role and Responsibilities of the Audit Committee

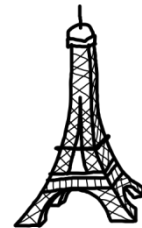
Advantages of having an audit committee

Chapter 4 Professional ethics and accepting audit engagements

审计师必须遵守专业道德守则，在审计过程中保持独立性和客观性，让审计师出具的审计报告被股东和企业外部人士认可。通过本章节的学习，我们要了解审计师需要遵守的道德守则以及有哪些行为会威胁审计师的独立性和客观性。

Learning outcomes

- Define and apply the fundamental principles of professional ethics
- Define and apply the self-interest, self-review, advocacy, familiarity, and intimidation threats.
- Describe the auditor's responsibility with regard to auditor independence, conflicts of interest and confidentiality.



1. The fundamental principles

ACCA members **must comply** with the fundamental principles set out in the Code of ethics and conduct.

The five fundamental principles are summarized as below (**PICOP**). **P**rofessional behaviour **I**ntegrity, **C**onfidentiality, **O**bjectivity, **P**rofessional competence and due care.

1.1. Integrity

Members shall be straightforward and honest in all professional and business relationships.

1.2. Objectivity

Members shall not allow bias, conflicts of interest or undue influence of others to override professional or business judgments.

1.3. Professional competence and due care

Members have a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques.

Members shall act diligently and in accordance with applicable technical and professional standards.

1.4. Confidentiality

Members shall 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. Confidential information acquired as a result of professional relationship should not be used for personal advantage.

Members can disclose confidential information for following situation:

1.4.1. Obligatory disclosure (must disclose to relevant authority without obtaining the client's permission)

- Infringement of law - If members know or suspect their **client committed money-laundering, treason, drug-trafficking or terrorist offences**, they are obliged to disclose all the information to public authority
- Legal proceeding - Members must make disclosure if compelled by the process of law, for example **under a court order** or summons, under which they are obliged to disclose information

1.4.2. Voluntary disclosure (could disclose confidential information without obtaining the client's permission)

- Public interest – An auditor may disclose information related to the 'public interest'. This would be perhaps if those charged with governance are involved in fraudulent activities
- Protect a member's interest – Members/auditors may disclose information to defend themselves against a negligence action, disciplinary proceedings or if suing for unpaid fees;
- Comply with quality review of professional body
- Response to investigation by authority.

Exam focus point

在历年考试中，考官多次在选择题和理论题考察 confidentiality 这个知识点，学生需要注意一般情况下审计师不能泄露客户资料给第三份或者用于谋取私利。在特殊的情况下，审计师可以披露客户资料，学生需要注意 Obligatory disclosure（毒恐叛洗钱是必须披露）和 Voluntary disclosure 的区分。

1.5. Professional behaviour

Members shall comply with relevant laws and regulations and avoid any action that discredits the profession.

Consequence of non-compliance of fundamental principles

Professional bodies like the ACCA therefore reserve the right to discipline members who fail to comply with the code of ethics through a process of:

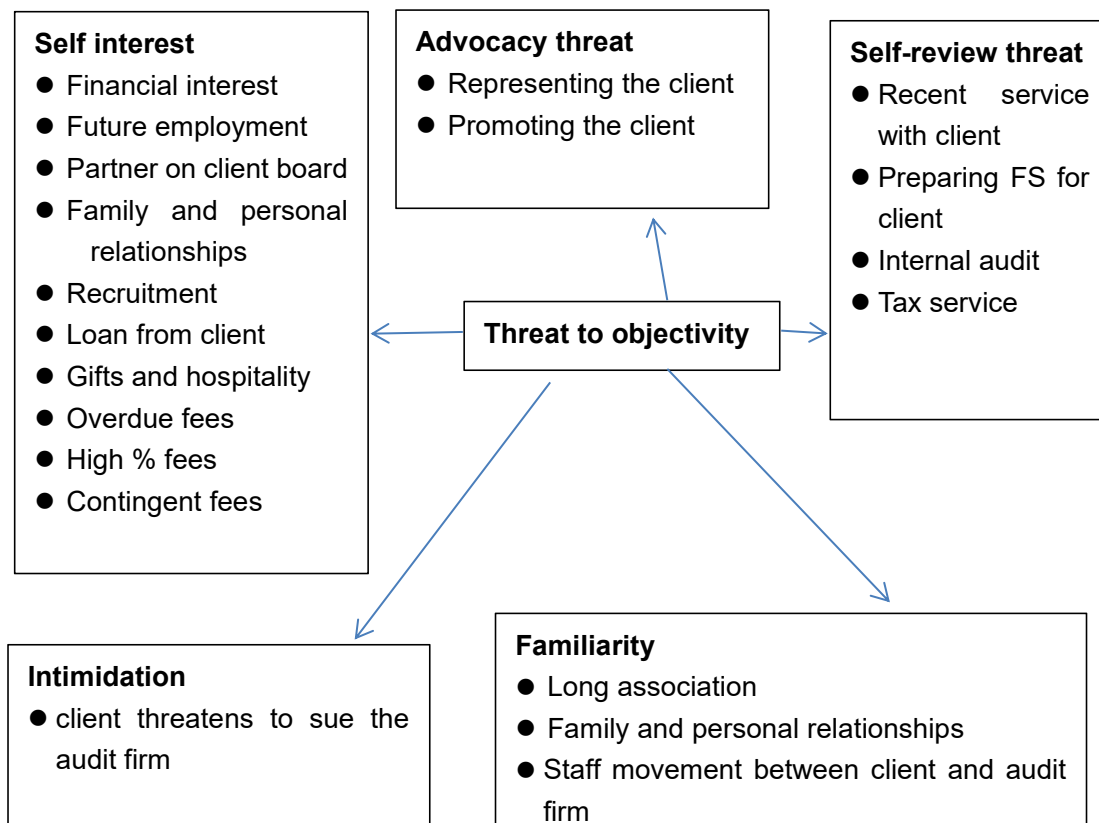
- Fines
- Suspension of membership
- Withdraw of membership

2. Threats to independence and objectivity

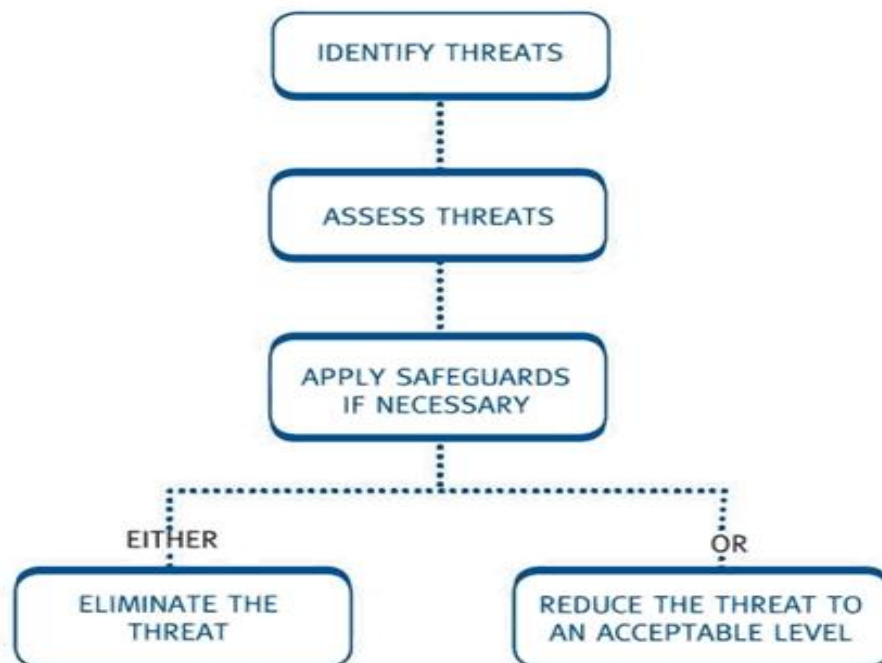
It is very important that **auditors are impartial and independent of management**, so that they can give an objective view on the financial statements of an entity. The independence of auditor could express in two ways:

- **Independence of mind** -The state of mind that allow auditor to enables the auditor to express an objective opinion.
- **Independence in appearance** - Auditors should be seen to be independent by 3rd parties.

Threats to independence and objectivity may arise in the form of **self-review, self-interest, advocacy, familiarity and intimidation threats**.



3. How to identify threat and relevant safeguard



3.1. Self-interest

A self-interest threat is the threat that a **financial or other interest will inappropriately influence the auditor's judgement or behavior.**

Type of threats	Why it is threat	Safeguards
Auditor or his family member owns shares in audit client. (Financial interest)	This may <u>deter auditor from issuing an unfavourable opinion</u> on the client's financial statements in <u>fear of reducing its share price</u> and thus, the auditor's personal wealth.	1. Selling off the shareholding 2. Replace with an engage partner with no financial interest in audit client.
历年考题出现情景- auditor partner's son work for client and he would receive share in client as part of his remuneration		
Auditor has a joint venture with an assurance client. (Financial interest)	Auditor may be reluctant to issue an unfavourable opinion on his partner's financial statements in <u>fear of offending them</u>	1. Selling off the shareholding 2. Replace the affected audit team member with the individual has sufficient experience.

Type of threats	Why it is threat	Safeguards
Audit team member will left audit firm to joint client's company (future employment)	Audit member might be <u>motivated by a desire to impress future possible employer. The member may unwilling to highlight issue during the audit.</u>	1. Replace the affected audit team member with the individual has sufficient experience. 2. Having an independent professional accountant review the work done by the member.
<i>历年考题出现情景- audit manager would left audit firm and become financial controller of audit client</i>		
Audit partner is to be asked to <u>act as NED</u> in the audit client's board meeting. (Partner on client board)	NED need to sit in board meeting and make decision for the company. If auditor act as NED, he may be perceived to perform management's role in the eye of external party. Independence of auditor and audit firm may perceive compromised.	If audit partner perform administrative role in an audit client company, there is no threat . Otherwise, audit partner should not accept the suggestion in audit client.
<i>历年考题出现情景- finance director request the review partner take role of NED temporarily</i>		
Audit team member has <u>family member in audit client.</u> (Family and personal relationships)	Note <i>When the audit team member and family member has high position and can influence the financial result, there would be a threat.</i> There is a risk that the <u>team member may place the family relationship above the needs of the users of the financial statements.</u> Objectivity of audit team may be compromised	1. Replace the affected audit team member with the individual has sufficient experience. 2. Having an independent professional accountant review the work done by the member. 3. Restructure team member responsibility , the team member does not deal with matter done by family member 4.
<i>历年考题出现情景- The finance director, who is the sister-in-law of the audit engagement partner</i>		

Type of threats	Why it is threat	Safeguards
Audit client <u>ask</u> <u>audit firm to</u> <u>recruit senior staff</u> (CFO / controller) (Recruitment)	Audit firm may intentionally choose someone who is 'friendly' to audit firm or friend of auditor. Auditor may not objectively audit the financial statement prepared by their friends	Audit firm is able to assist in reviewing a shortlist of candidates. However, they must ensure that they are not seen to undertake management decisions and so must not make the final decision on who is appointed.
历年考题出现情景- The finance director request engagement partner in recruiting finance controller		
Audit team <u>member received</u> <u>loan from audit</u> <u>client.</u> (Loan from client)	Only loan received for following situation will be a threat: <ul style="list-style-type: none"> ● Audit client is not a financial institution ● Interest rate is lower than commercial rate Audit team member may be <u>reluctant to highlight issue during the audit in fear of offending audit client</u> , as the client may withdraw the preferential term.	1. Audit firm should ascertain whether loans in preferential term. 2. Replace the affected audit team member with the individual has sufficient experience (if loan with preferential term)
历年考题出现情景- two team members have significant loans owing to client		
Client gives <u>discount on luxury</u> <u>good, or provides</u> <u>expensive gifts or</u> <u>hospitality.</u> (hospitality)	Auditor may <u>feel indebted to client and may not provide opinion objectively.</u>	Unless the value of the gift/hospitality is trivial and inconsequential, the firm should decline the gifts politely.
历年考题出现情景- finance director would like the audit team to attend an evening watching the national football team play a match followed by a luxury meal		
Prior year audit <u>fees have not yet</u> <u>paid</u> by client. (Overdue fees)	Auditor may <u>feel pressure to agree to certain accounting adjustments</u> in order to have the previous year and this year's	Auditor should discuss with those charged with governance the repayment schedule for

	audit fee paid	prior year audit fee. Current year audit would be only started when prior year fees were recovered.
历年考题出现情景- 20% of last year audit fee is still outstanding		
Type of threats	Why it is threat	Safeguards
Audit fees are based on % of profit before tax (% fees)	Auditor may ignore certain accounting adjustments which will reduce client's profit, in order to generate more audit fees income.	Auditor should not accept audit fees based on % of profit.
历年考题出现情景- finance director suggested that the audit fee should be at least 20% of the fee being based on the profit after tax of the company		
Audit firm receives total fees from listed company >15% total audit firm fee income more than 2 years (high % fees)	The audit firm could become overly reliant on audit client and auditor may not able to issue opinion objectively in fear of offending client.	For unlisted company <ul style="list-style-type: none"> ● Reducing the dependency on the client (resign from some non-audit works) ● External quality control reviews (if audit firm retain all work from client) ● Disclosed to those charged with governance
历年考题出现情景- total fee income from the company is substantial / The fee income derived from XX Co accounts for 16% of the firm's total fees		

3.2. Self-review threat

Self-review threats arises where a member from the audit firm performs work for the client and this work must later be reviewed by the same person,

Type of threats	Why it is threat	Safeguards
Audit team member has been seconded to audit client to perform work relate to financial statement (Recent service with client)	Audit team member may be tasked with reviewing the work in which he performed during his employment with the client. As such, he may lose professional scepticism in performing the audit.	1. Replace the affected audit team member with the individual has sufficient experience 2. Having an independent professional accountant review the work done by the member.
历年考题出现情景- The finance director has asked if a member of the audit team can be seconded to company for three months to act as the temporary financial controller.		
Audit firm prepares accounting records and financial statements for audit client. (Prepare FS for client)	Audit team member will review the financial statements prepared by them. As such, they may lose professional scepticism in performing the audit.	For unlisted company: Audit firm can assist the client with their preparation of the financial statements if 1. Using members other than audit team members to carry out work 2. using an independent partner to review the work performed For listed company: ● Audit firm cannot assist the client with their preparation of the financial statements.
历年考题出现情景- The finance director has asked if audit firm could prepare the financial statement on behalf.		
Audit firm provides internal audit service for audit client	Internal audit will review the internal control of audit client and this would affect the preparation of financial	For unlisted company: Audit firm can provide internal audit service if ● Using members other

	<p>statement.</p> <p>Audit team member will review internal control of audit client and they may lose professional scepticism in performing the audit.</p>	<p>than audit team members to carry out work</p> <ul style="list-style-type: none"> ● using an independent partner to review the work performed <p>For listed company:</p> <ul style="list-style-type: none"> ● Audit firm cannot provide internal audit service
<p>Audit firm <u>provides tax service</u> for audit client</p>	<p>If audit firm <u>prepare tax calculation</u> or <u>advise for audit client</u>, there would be threat.</p> <p>As audit team need to review the tax calculation which performed by them, they may lose professional scepticism in performing the audit.</p>	<p>Exception</p> <p>Audit firm just complete the tax return, there is no threat.</p> <p>Audit firm can provide tax service if</p> <ul style="list-style-type: none"> ● Using members other than audit team members to carry out work ● using an independent partner to review the work performed
<p><i>历年考题出现情景- The audit firm tax department provide tax planning/taxation calculation service to client.</i></p>		

Professional scepticism means that the auditor should approach the audit with an inquiring mind, being alert to conditions which may indicate possible misstatement due to error or fraud. Audit evidence obtained should also be critically assessed.

3.3. Advocacy threat

An advocacy threat occurs when the auditor is promoting the client's opinion or position to the point that 3rd party believe that he is not independent.

Type of threats	Why it is threat	Safeguards
<p>Auditor was asked to <u>attend meeting with</u></p>	<p>Audit firm may be <u>perceived as too close with audit client</u></p>	<p>Audit firm should decline the request form</p>

<p><u>potential investor</u></p> <p>Or</p> <p>Audit firm <u>represents the client in resolving disputes with authority.</u></p>	<p>and this threatens objectivity.</p>	<p>audit client politely.</p>
<p><i>历年考题出现情景- Audit firm represent client to resolve some outstanding issues with the taxation authorities.</i></p>		

3.4. Familiarity threat

If an auditor remains in position for a prolonged period of time, there is a possibility that he may develop a strong level of trust towards the client and begin losing professional skepticism.

Type of threats	Why it is threat	Safeguards
<p>Audit partner has been this position of Listed company for a long time. (Long association)</p>	<p>Audit partner has been involved in the audit for many years and hence may not maintain his/her professional scepticism and objectivity.</p>	<ul style="list-style-type: none"> ● If an individual is key audit partner (engagement / review partner) for 7 years, they must be rotated off <p>Other safeguard if <7 years:</p> <ul style="list-style-type: none"> ● Replace the affected audit partner with the individual has sufficient experience

历年考题出现情景- the finance direct and partner know each other many year / the engagement partner has audit client for 6 years.

Position	Roll off period	Cooling off period
Engagement partner	7 years	5 years
Quality review partner	7 years	3 years
Key audit partner	7 years	2 years

3.5. Intimidation threat

An intimidation threat arises when audit team member may be deterred from acting objectively by threats from audit client.

Type of threats	Why it is threat	Safeguards
Audit client threaten to <u>suit</u> auditor for previous work done.	Audit team as they may feel pressure to cut corners and not raise issues, and this could compromise the objectivity of the audit team.	Auditor need to inform client that audit work will follow relevant ISA and regulation and time spend would based on the actual work required.
Audit client <u>press audit team to perform audit quickly</u> (usually shorter than normal situation)		Auditor need to inform client that audit work will follow relevant ISA and regulation and time spend would based on the actual work required. If client insist shorter audit time, auditor should discuss with client the possibility to perform interim audit.
Audit client <u>imply offer new work to auditor, but auditor must minimize issue</u> during the audit (could be self-interest threat)	Auditor may unwilling to highlight issue in fear of losing future work. Independence of the audit team may be compromised.	Auditor need to inform client that audit work will follow relevant ISA and regulation. If the audit client continue, auditor should disclose to audit committee.
历年考题出现情景- Client has implied that in order to gain further work, auditor needs to complete the audit quickly and with minimal questions/issues.		

Prior year exam question for professional ethic

You are an audit manager of Pink Partners & Co (Pink) and are planning the audit of Golden Finance Co (Golden), a banking institution which provides a range of financial services including loans. Your firm has audited Golden for four years and the company's year-end is 30 September 2015.

At the end of August, Golden's financial controller left and the new replacement is not due to start until approximately two months after the year end. ①The finance director, who is the sister-in-law of the audit engagement partner, has asked if a member of the audit team can be seconded to Golden for three months to act as the temporary financial controller.

You are aware that a number of the audit team members currently bank with Golden and two team members have significant loans owing to the company. Pink's taxation department also provides services to Golden. They have been approached by Golden to represent them in negotiations to resolve some outstanding issues with the taxation authorities, for which the fees quoted are substantial.

The finance director has informed the audit engagement partner that when the audit is complete, she would like the whole team to attend an evening watching the national football team play a match followed by a luxury meal.

Required:

Using the information above:

(i) Identify and explain FIVE ethical threats which may affect the independence of Pink Partners & Co's audit of Golden Finance Co; and

(ii) For each threat, explain how it might be reduced to an acceptable level.

Note: The total marks will be split equally between each part. (10 marks)

Exam focus point

在历年考试中，考官多次考察 ethic threat 的应用题，面对这些题目学生需要注意分值，和作答技巧。一般情况下，一个 threat 的作答可以获得 2 分，这需要学生写出以下 3 部分：

1 是 identify, 描述题目中哪些地方可能产生 ethical threat，这部分可以直接从题目摘抄，每找到一个 threat 可以获得 0.5 分；

2 解释这个 threat 是 self interest, self review, advocacy, familiarity 和 intimidation threat 中的哪个，还需要解释这个 threat 怎么影响审计师的独立性和客观性 (independence and objectivity)，每解释一个 threat 可以获得 0.5 分；

3 给公司提出建议，降低 ethical threat 对公司的影响，每个建议可以获得 1 分。

解答 ethic threat 的应用题需要学生对于每种 threat 的情景非常熟悉，建议学生记忆讲义中总结的常见 threat 情景。

在作答难度方面，建议《解释 threat》描述，建议学生优先在题目找出 threat 和解释，时间充裕再写建议。

Solution (recommended using table to present your answer)

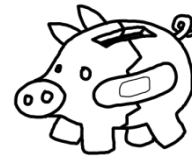
Ethical threats and managing these risks

	Ethical threat	Safeguards
①	<p>The finance director is the sister-in-law of the audit engagement partner and hence there is a family relationship.</p> <p>There is a familiarity threat as audit partner and the finance director both hold senior positions and they are in a position to influence the outcome of the audit. There is a concern that they may place their family relationship above the needs of the users of the financial statements. Auditor's objectivity may be compromised during the audit.</p>	<p>It would be advisable for the audit engagement partner to be removed and an alternative partner should be appointed</p>

4. Conflicts of interest

4.1. Conflicts between members' and clients' interests

This 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.



In this situation, audit team should **replace the affected team member** with another member without conflict of interest.

4.2. Conflicts between the interests of different clients

This situation frequently arises when the **audit clients are in direct competition (e.g. Pepsi and Coca-Cola) with each other**, and particularly when the auditors have access to particularly sensitive information.

Safeguards to be adopted to address the conflict of interest

Step 1 Notified both affected audit clients that audit firm would be acting as auditors for each company and obtain their consent to act

situation 1



situation 2



Step 2 Additional safeguards for situation 2

- Use of separate engagement teams, with different engagement partners worked on the audit of different client.
- Procedures to prevent access to information for example, strict physical separation of both teams, confidential and secure data filing.
- Use of confidentiality agreements signed by audit team member.
- Regular monitoring of safeguards by an independent senior individual.
- Advising one or both clients to seek additional independent advice

5. Accepting audit appointments

5.1. Advertising

Members are entitled to advertise their services and products. The advertising medium should not reflect adversely on the member, ACCA or the accountancy profession

5.2. Before accepting nomination

- Audit firm should consider any issues which might arise which could threaten compliance with ACCA's Code of Ethics and Conductor any local legislation
- The firm should consider whether they are competent to perform the work and whether they would have appropriate resources available, as well as any specialist skills or knowledge
- Obtain references of management of audit client if audit firm does not familiar with them .
- Communicate with present auditors (if there is an existing auditor)
 - Obtain permission from the client to contact the existing auditor; if this is not given then the engagement should be refused.
 - Communicate with the outgoing auditor to assess any ethical or professional reasons why outgoing audit should not accept appointment.
 - Existing auditor must obtain permission from the client to respond, if not given then the incoming auditor should refuse the engagement.
 - If given permission to respond, then the existing auditor should reply to the incoming auditor. Then carefully review the response for any issues that could affect acceptance.

和前任审计师沟通流程



5.3. After accepting nomination - client screening

- Audit firm should consider management integrity and assess whether any conflict of interest with existing clients would arise.
- Audit firm should assess the level of audit risk of the client and whether the

expected audit fee would be sufficient for the level of anticipated risk.

5.4. Accepting audit appointments

After perform the steps above, the audit firm can accept the appointment from audit client.



6. Preconditions for an audit

ISA 210 Agreeing the Terms of Audit Engagements provides guidance to auditors on the **steps they should take in accepting a new audit or continuing on an existing audit engagement.** It sets out a number of processes that the auditor should perform including agreeing whether the preconditions are present, agreement of audit terms in an engagement letter, recurring audits and changes in engagement terms.

Preconditions for accepting new audit or continuing exiting audit as follow:

- 6.1. Auditor must determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable. Auditor should assess the nature of the entity, the nature and purpose of the financial statements and whether any prescribed law or regulations need to be follow.
- 6.2. Auditor must obtain the agreement of management that it acknowledges and understands its responsibility for the following :
 - Preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
 - Maintain sound internal control to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
 - Provide the auditor with all relevant information for the preparation of the

financial statements, any information that the auditor may request from management and unrestricted access to persons within the entity to obtain audit evidence.

7. Purpose audit engagement letter

An **engagement letter** provides a written agreement of the audit engagement between the auditor and management. Confirming that there is a common understanding between the auditor and management of the terms of the audit engagement helps to avoid misunderstandings with respect to the audit.

On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

Content of the audit engagement letter

- The objective and scope of the audit;
- The responsibilities of the auditor;
- The responsibilities of management;
- The form of any other communication of results of the audit engagement;
- The expectation that management will provide written representations;
- The basis on which fees are computed and any billing arrangements;
- Any restriction on the auditor's liability;

Exam focus point

在历年考试中, Conflicts of interest (5分), Preconditions for an audit (3分), Content of the audit engagement letter (2-3分, 每个 content 0.5分) 是考官多次考察理论题的地方, 需要学生记忆。

Conflicts of interest 5个点: 1 通知客户获取认可; 客户都认可后-2 两个客户分开团队; 3 客户资料分开储存; 4 审计人员签署保密协议; 5 持续监督

Preconditions for an audit 3个点: 1 客户编制报表使用的准则符合要求; 被审计客户要 2 编制报表; 3 完善内控; 4 提供审计证据

以下内容可以帮助你进行本章复习及自测

1. 重点词汇

Professional behaviour

Integrity

Confidentiality

Objectivity

Professional competence and due care

Obligatory disclosure

Voluntary disclosure

Independence of mind

Independence in appearance

self-review threat

self-interest threat

advocacy threat

familiarity threat

Intimidation threat

Professional scepticism

Conflicts of interest

engagement letter

2. 必做习题

PYQ

5 fundamental principals

Step to due with conflict of interest

Step to prior to accepting audit appointment

Precondition of an audit

Contents of audit engagement letter

Chapter 5 Audit planning, documentation and responsibility

从本章节开始，我们要开始进入审计正式流程。审计最开始要做的是审计计划（audit planning），审计师通过审计计划安排期中审计和期末审计的任务，如何应对企业可能存在的欺诈和违反法律等问题，如何确保审计质量等问题。

Learning outcomes

- Describe the contents of the audit strategy and audit plan
- Describe and explain the nature, and purpose of, analytical procedures in planning
- Discuss the responsibilities of external auditors for the prevention and detection of fraud and error.
- Explain the difference between an interim and final audit.
- Explain the quality management procedures which should be in place over engagement resources, engagement performance, monitoring and remediation and compliance with ethical requirements
- Explain the need for, and the importance of, audit documentation
- Describe the form and contents of working papers and supporting documentation.



1. Audit planning process



2. Importance of audit planning (ISA300)

- Helping the auditor to devote appropriate attention to important areas of the audit.
- Helping the auditor to identify and resolve potential problems on a timely basis.
- Helping the auditor to properly organise and manage the audit engagement so that it is performed in an effective and efficient manner.
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks and the proper assignment of work to them.
- Facilitating the direction and supervision of engagement team members and the review of their work.
- To co-operate work done by expert and other auditors.

3. Audit strategy and audit plan

There are 2 main documents used in audit planning: audit strategy document and an audit plan.

3.1. Audit strategy document

The audit strategy refers to the general approach to the audit. It sets out the scope, timing and direction of the audit and helps the development of the audit plan. It should consider the following main areas.

Main areas in audit strategy	Detail info contained
characteristics of the engagement	<ul style="list-style-type: none"> ● Financial reporting framework being adopted. ● Availability of internal audit work ● Whether computer-assisted audit techniques will be used and the effect of IT on audit procedures. ● The availability of key personnel ● the scope of the audit
Reporting objectives, timing of the audit and nature of communications	<ul style="list-style-type: none"> ● Timetable for reporting ● Discussion and meetings with management and those charged with governance ● Expected communications with third parties

Significant factors, preliminary engagement activities, and knowledge gained on other engagements	<ul style="list-style-type: none"> ● Determination of materiality ● Areas identified with higher risk ● Results of previous audits ● Significant business developments
Nature, timing and extent of resources	<ul style="list-style-type: none"> ● The selection of the audit team with experience of this type of industry. ● Assignment of audit work to the team members. ● Setting the audit budget.

3.2. Audit plan

The audit plan converts the audit strategy into a more detailed plan. It includes the nature, timing and extent of audit procedures to be performed by engagement team members in order to obtain sufficient appropriate audit evidence.

The audit plan shall include the following:

- Nature, timing & extent of risk assessment procedures (ISA 315)
- Nature, timing & extent of further audit procedures at the assertion level (ISA 330)
- Nature, timing & extent of other audit procedures required by the other ISAs

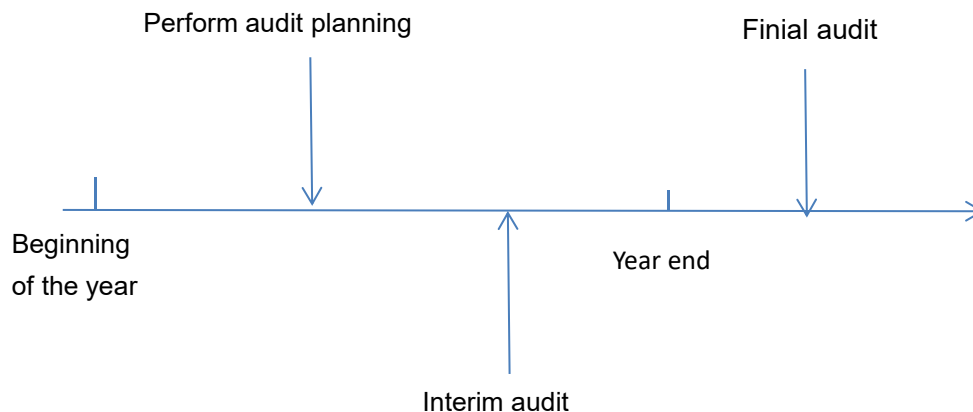
Examples of items included in the audit plan could be

- Timetable of planned audit work
- Allocation of work to audit team members
- Audit procedures for each major account area (eg inventory, receivables, cash)
- Materiality for the financial statements as a whole and performance materiality

Exam focus point

在历年考试的理论题中，考官多次考察 audit plan 和 audit strategy 的区别以及 audit strategy 包含什么东西。Audit strategic 是做审计的总体计划，包含审计范围，时间跨度以及怎么操作。Audit plan 是 audit strategic 细化后的详细计划，有具体的时间、人员和任务安排。

4. Interim and final audit



4.1. Comparison between interim and the final stage.

	Interim audit	Final audit
timing	Take place before the year end	Take place after the year end
purpose	Carry out procedures which would be difficult to perform at the year end because of time pressure. Work done focus on risk assessment and test internal control	Forming and expressing an opinion on the financial statements
Procedure undertake n	<ul style="list-style-type: none"> ● Recording entity's internal control systems ● Risk assessment and understand the entity ● Evaluating the internal controls ● Perform substantive procedures on profit and loss transactions for the year to date ● Identify issues may affect the final audit 	<ul style="list-style-type: none"> ● Performing test to ensure the conclusions formed at interim audit are valid. ● Obtaining third-party confirmations ● Subsequent events review ● Obtaining written representations ● Consideration of the going concern status of the entity

4.2. Benefit to perform interim audit

- Controls test done at the interim stage provided evidence on level of control risk, relevant substantive procedures can be determined at final stage. This makes final audit more efficiently.
- Substantive procedures were performed at the interim stage, fewer procedures

will be required at the final audit and workload of final audit would be reduced.

Exam focus point

在历年考试的理论题中，考官多次考察 interim audit 和 final audit 的区别以及两个阶段的审计内容有什么区别。Interim audit 主要是做审计前的准备工作（评估风险，评估内控，和做 PL 的审核），final audit 主要是做结尾工作和解决疑难问题（做 BS 的审核，拿函证和处理审计发现的问题）

5. Fraud and auditor

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.



There are two types of fraud causing material misstatement in financial statements:

- **Fraudulent financial reporting** involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users.
- **Misappropriation of assets** involves the theft of an entity's assets.

Management' responsibilities

Management has primary responsibility for the prevention and detection of fraud.

They should implement an effective system of internal control and create a culture of honesty to reduce opportunities for fraud to take place.

External auditors' responsibilities

- ISA 240 stated that auditors are 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 identify and assess the risks of material misstatement due to fraud.
- The auditor will need to design and implement appropriate responses to fraud or suspected fraud identified during the audit.
 - Assign and supervise audit staff taking into account their knowledge, skill and ability
 - Evaluate whether the client's accounting policies may indicate fraudulent

financial reporting;

- Incorporate unpredictability in the selection of the nature, timing and extent of audit procedures
- Auditors need to maintain professional scepticism throughout the audit, considering the potential for management override of controls and recognise the fact that audit procedures that are effective in detecting error may not be effective in detecting fraud.
- Auditor need to discuss with audit team to ensure that the whole engagement team is aware of the risks and responsibilities for fraud and error.
- Auditor need to report any actual or suspected fraud to appropriate parties
 - If the auditor identifies fraud or suspect fraud may exist, the auditor shall report this on a timely basis to the appropriate level of management.
 - If the auditor identifies or suspects fraud involving management, employees with significant roles in internal control, they shall communicate this on a timely basis to those charged with governance.
 - The auditor also needs to consider whether there is a responsibility to report to the regulatory.

Exam focus point

在历年考试的理论题中，考官多次考察 fraud 和审计师。同学们需要注意审计师（auditor）和管理层（management）对 fraud 的责任是不一样的。

管理层要完善内控降低 fraud 的出现。

审计师判断 fraud 是否对报表产生影响，是否会导致的重大错误。如果发现 fraud 对报表有重大影响，需要做出审计措施去应对。

6. Law, regulations and auditor

Management' responsibilities

Management has a responsibility to ensure that the operations are conducted in accordance with the provisions of laws and regulations. This includes compliance with laws and regulations that determine amounts and disclosures in financial statements, including tax liabilities and charges.

External auditors' responsibilities

Under ISA 250, the auditor's responsibility is to obtain reasonable assurance that the financial statements are free from material misstatement whether due to fraud or error and, in this respect, the auditor must take into account the legal and regulatory framework within which the entity operates.

Auditor's responsibility differs in relation to the two different categories of laws and regulations identified below:

- Laws and regulations which have a **DIRECT effect on** the determination of **material amounts and disclosures in financial statements**. Auditor is responsible for obtaining sufficient appropriate audit evidence regarding compliance with those laws and regulations.
- Laws and regulations which **DO NOT HAVE A DIRECT EFFECT** on the determination of material amounts and disclosures in financial statements, but may be fundamental to operating, impact the entity's ability to continue to trade. Auditor's responsibility is limited to specified audit procedures to help identify non-compliance with those laws and regulations that **may have a material effect** on the financial statements. Specified audit procedures include:
 - Inquiring with management whether the entity is in compliance with such laws and regulations
 - Inspecting correspondence with relevant regulatory authorities.
 - Obtain written representations that the directors have disclosed all instances of known and possible non-compliance to the auditor.

Exam focus point

在历年考试的理论题中，考官多次考察 law 和审计师。同学们需要注意审计师（auditor）和管理层（management）对公司是否遵守 law 的责任是不一样的。

管理层要完善内控保证公司遵守相应的 law。

审计师要对 law 的影响进行分类：

对报表有直接重大影响-收集审计证据确保公司遵守相关法律；

对报表没有直接影响的- 询问管理层/律师公司有没有违反法律。

7. Misstatement and auditor

What is misstatement?

A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

Types of misstatements

There are three categories of misstatements:

- (i) **Factual misstatements** are misstatements about which there is no doubt.

(ii) **Judgemental misstatements** are differences arising from the judgements of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.

(iii) **Projected misstatements** are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn.

Auditor's responsibility

- The auditor has a responsibility to accumulate misstatements which arise over the audit unless they are very small amounts.
- The auditor should determine whether uncorrected misstatements are material in aggregate or individually.
- All misstatements should be communicated to those charged with governance on a timely basis and request that they make necessary amendments. If this request is refused, auditor should consider the potential impact on their audit report.
- A written representation should be requested from management to confirm that unadjusted misstatements are immaterial.

8. Quality control

ISA 220 requires firms to implement quality control procedures over individual audit engagements.

8.1. Quality control at firm level

Quality control at firm level encompass the following:

- Leadership - Firm and leadership is responsible for promoting a culture where quality is regarded as essential.
- Resource - Recruiting and retaining staff with the right capabilities, competence, and commitment to ethical principles to perform engagements in accordance with professional standards.
- Engagement performance - Implementing policies and procedures to ensure engagement are perform correctly. Good engagement performace involves:
 - Direction
 - Supervision
 - Review
 - Consultation

■ Resolution of dispute

Where 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 a quality reviewer.

Peer review: A review of the audit file carried out by another partner in the assurance firm.

Hot review/ Pre-issuance review: A peer review carried out before the auditor's report is signed. This is also known as an engagement quality review (EQR).

Cold review/ Post-issuance review: A peer review carried out after the auditor's report is signed.

● Monitoring - Evaluating quality control procedures to ensure that they remain relevant, adequate and effective.

■ **Ongoing evaluation:** Considering whether the firm has kept up to date with regulatory requirements

■ **Periodic inspection:** Inspecting the audit engagements of each engagement partner over an inspection cycle

8.2. Quality control on an individual audit work

The objective of the auditor is to implement quality control procedures for individual audit engagement :

- Ensure the audit complies with professional standards and applicable legal and regulatory requirements; and
- Ensure the auditor's report issued is appropriate in the circumstances

The **engagement partner** has overall responsibility for managing and achieving quality within an audit engagement. In order to achieve this, an engagement must manage quality in each of the following areas:

- **Leadership** - Audit engagement partner is required to set an example with regard to the importance of quality.
- **Ethical requirements** - The engagement partner must ensure that the audit team complies with applicable ethical requirements, including independence, throughout the course of the audit.
- **Acceptance and continuance of client relationships** - The partner is required to ensure that appropriate procedures in respect of accepting and continuing with the audit are followed
- **Engagement resources** -The engagement partner must ensure that sufficient and

appropriate resources are made available to the engagement team including human, technological, and intellectual resources.

- **Engagement performance** - The engagement partner is responsible for the **direction** and **supervision** of the member of the engagement team and the review of their work

The partner must ensure that direction, supervision and review is planned and performed in line with the firm's policies and with ISAs.

- **Direction** - The partner is required to hold a meeting with the audit team to discuss the risks associated with the audit.
- **Supervision** - The engagement supervises the overall audit, the audit senior staff supervise the junior staff. Matters need to be supervised:
 - ✚ Tracking the audit engagement progress .
 - ✚ Considering the capabilities and competence of audit team member, and whether they have sufficient time and understanding to carry out their work.
 - ✚ Addressing significant issues arising during the audit engagement.
- **Review** - The engagement partner need not review all audit documentation, but they should review critical areas of judgement and significant risks to ensure any significant matters are resolved on a timely basis and sufficient and appropriate evidence were collected.
- **Consultation** - The partner is also responsible for making sure there is appropriate consultation on the audit both within the audit team and outside it. If there are differences of opinion, then the partner is responsible for resolving them, using the firm's policies.
- **Engagement quality control review** - The audit engagement partner is responsible for appointing a reviewer and they are responsible for discussing significant matters. Audit report should not be issued until the engagement quality control review has been completed.

Exam focus point

Quality control 是 2020 年以来新增并不断强化的新考点。历年考题主要在理论题考核学生审计公司和具体的审计工作中是如何提升审计质量。

审计公司保证审计质量的方法：1 公司文化注重审计质量；2 聘请达标审计人员；3 公司要执行强化审计质量的措施并持续监控。

具体审计工作中需要：1 项目的 partner 要重视审计质量；2 保证遵守 ethical requirement；3 承接和继续审计工作符合准则要求；4 审计工作中，审计师要经常指导、监督并和审计员沟通。

9. Audit documentation

Audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (sometimes used as working papers)

All audit work must be documented, the working papers are the tangible evidence of the work done to support the audit opinion.

9.1. Benefits of documenting audit work

- Provides evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the audit.
- Provides evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements.
- Assists the engagement team to plan and perform the audit.
- Assists members of the engagement team responsible for supervision to direct, supervise and review the audit work.
- Enables the engagement team to be accountable for its work.
- Retains a record of matters of continuing significance to future audits.

9.2. Items that should be included on every working paper

- Name of client – identifies the client being audited.
- Year-end date – identifies the year end to which the audit working papers relate.
- Subject – identifies the area of the financial statements that is being audited.
- Preparer – identifies the name of the audit team member who prepared the working paper, so any queries can be directed to the relevant person.
- Date prepared – the date that the audit work was performed by the team member.
- Reviewer – the name of the audit team member who reviewed the working paper; this provides evidence that the audit work was reviewed by an appropriate member of the team.
- Date of review – the date the audit work was reviewed by the senior member of the team.
- Objective of work/test – the aim of the work being performed, this provides the context for why the audit procedure is being performed.
- Details of work performed – the audit tests performed along with sufficient detail of items selected for testing.
- Conclusion – the overall conclusion on the audit work performed, whether the area is true and fair.

9.3. Audit files

1. **Permanent audit files (PAF)** containing information of continuing importance to the audit. Example of document included in PAF

- Engagement letter
- Accounting system note and internal control questionnaires
- Detail of client's business

2. **Current audit files (CAF)** containing information of relevance to the current year's audit. Example of document included in PAF

- Current year FS
- Notes to board minutes
- Written representations
- Audit plan and strategy
- Working paper for each audit area

9.4. Safe custody and retention of working papers

Working papers are the property of the auditors and so the audit firm should establish policies and procedures designed to maintain the confidentiality, safe custody, for example:

- Passwords to restrict access to electronic documentation
- Back-up routines
- Confidential storage of hard copy documentation

The ACCA recommends **seven years** as a minimum period.

Audit working papers should not be made available to third parties without the permission of the entity unless the permission of the client is obtained

以下内容可以帮助你进行本章复习及自测

1. 重点词汇

audit planning

Audit strategy

audit plan

Interim and final audit

Fraud

Fraudulent financial reporting

Misappropriation of assets

Misstatement

Factual misstatements

Judgemental misstatements

Projected misstatements

Peer review

Hot review

Cold review

Ongoing evaluation

Periodic inspection

engagement partner

Direction

Supervision

Review

Consultation

Engagement quality control review

Permanent audit files (PAF)

Current audit files (CAF)

Audit documentation

2. 必做习题

PY question

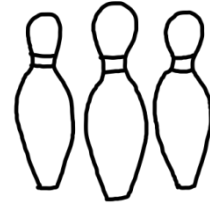
S19Q16a

Chapter 6 Risk assessment

审计师在完成审计计划后，下一步需要对企业进行风险评估（risk assessment）。通过本章节的学习，我们要了解在审计过程中有哪些风险，审计师是如何发现和评估企业的风险，审计师又是如何去应对这些风险的。

Learning outcomes

- Identify and explain the need for and importance of planning an audit.
- Identify the overall objectives of the auditor and the need to conduct an audit in accordance with ISAs.
- Explain how auditors obtain an initial understanding of the entity
- Explain the components of audit risk
- Describe the audit risks in the financial statements and explain the auditor's response to each risk
- Define and explain the concepts of materiality and performance materiality.



1. Importance of risk assessment

1.1. Objective of risk assessment

When conducting an audit of financial statements, the overall objectives of the auditor are:

To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, 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.

A risk assessment helps the auditor to ensure the key areas more susceptible to material misstatement are adequately investigated and tested during the audit.

1.2. Why auditor need to conduct audit in accordance with ISAs

- The ISAs also deal with the general responsibilities of the auditor. If the auditor does not conduct an audit in accordance with ISAs, important responsibilities may not be fulfilled.
- Confidence of users of the financial statements will be enhanced as the auditor refers to globally recognised standards in the audit report.
- Audits are conducted in accordance with ISAs also gives regulators of the audit

profession a framework against which to judge auditors.

1.3. Professional scepticism and professional judgement

Professional scepticism:

Professional scepticism: "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"

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 judgement

Professional judgement: "application of relevant training, knowledge and experience in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement"

1.4. Risk-based approach to audit

The ISAs require auditors to adopt a risk-based approach to auditing. This means the auditor must: Analyse the risk in the client's business, transactions and systems that could lead to material misstatement in the financial statements and Direct audit testing to risky areas.

2. Audit risk

Audit risk is the risk that the auditor expresses an inappropriate audit opinion on the financial statements. (E.g. true and fair audit opinion, but the FS actually contain misstatement)

Audit risk has two major components:

(a) One is dependent on the entity and is the risk of material misstatement arising in the financial statements (**inherent risk and control risk**)

(b) 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**)

The audit risk model is often mathematically represented as $AR = IR \times CR \times DR$

Inherent risk is the susceptibility of an assertion (detail refer to later chapter) about a class of transaction, account balance or disclosure to a misstatement which could be material, either individually or when aggregated with other misstatements, before

consideration of any related controls.

Inherent risk is the risk of a material misstatement because of the nature of the industry, entity or the nature of the item itself (e.g. complex accounting treatment).

Control risk is the risk that a misstatement which could occur in an assertion about a class of transaction, account balance or disclosure and which 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.

Control risk may be high if the internal control system has not been applied effectively

Inherent risk + control risk = risk of material misstatement. This is the risk that the financial statements are materially misstated **prior to the audit commencing.**

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 which exists and which could be material, either individually or when aggregated with other misstatements. **Detection risk is affected by sampling and non-sampling risk.**

Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion based on the entire population.

Non-sampling risk is the risk that the audit procedures adopted are unable to detect misstatements due to matters unrelated to sampling (e.g. the use of inappropriate audit procedures).

It is important to know that audit risk is focused on the financial statements of a company

Exam focus point

在历年考试中, 考官多次考察 audit risk, Inherent risk, control risk 和 detection risk 的定义。

Audit risk 是审计师出具错误的审计意见的风险。Inherent risk 是被审计事项容易出错。Control risk 是客户的内控系统没有及时发现错误。Detection risk 是审计师没有找出错误。

3. How to perform risk assessment flow chart

Step 1 Identify audit risk - Understanding the entity and its environment (ISA 315)



Step 2 Responding to the risk assessment

4. Understanding the entity and its environment

4.1. Why do we need to understand the entity and its environment?

- 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 response the risks.

4.2. What do we need need to understand the entity and its environment?

- 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 accounting policies
- Objectives and strategies and related business risks that might cause material misstatement in the financial statements
- Measurement of the entity's financial performance
- Internal control (we shall look at in detail in later chapter)

4.3. How do we gain an understanding the entity and its environment?

Documents	What info we could get
Prior year financial statements	Size of audit client
Discussions with the previous auditors	Key issues identified during the prior year audit
Prior year audit report to management	Internal control deficiencies noted last year

accounting systems notes	How each of the key accounting systems operates and this will be used to identify areas of potential control risk
board minutes	Any key issues which have arisen during the year

4.4. What audit procedure can be used?

- Analytical procedures
- Enquiries of management
- Observation and inspection

5. Analytical Procedures

Analytical procedures mean the analysis of relationships to identify inconsistencies and unexpected relationships.

The auditor must apply analytical procedures as risk assessment procedures for following reasons:

- To obtain an understanding of the entity and its environment.
- Indicate aspects which the auditor was unaware
- Assist in assessing the risks of material misstatement

Analytical procedures include the following types of comparisons:

- Actual vs Prior periods
- Actual vs Budgets
- Actual vs Predictive estimates
- Relationships between elements of financial information
- Relationships between financial and non-financial information
- Common ratios for use in analytical procedures include:

Ratio	Calculation
Profitability ratios	
Return on capital employed (ROCE)	$\frac{\text{Profit before interest and tax (PBIT)}}{\text{Share capital + reserves + Non-current liabilities}}$
Net profit margin	$\frac{\text{PBIT}}{\text{Revenue}}$
Asset turnover	$\frac{\text{Revenue}}{\text{Share capital + reserves + Non-current liabilities}}$
Gross profit margin	$\frac{\text{Gross profit}}{\text{Revenue}}$

Liquidity ratios	
Current ratio	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$
Quick ratio (acid test)	$\frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}}$
Inventory holding period	$\frac{\text{Inventories} \times 365 \text{ days}}{\text{Cost of sales}}$
Receivables collection period	$\frac{\text{Trade receivables} \times 365 \text{ days}}{\text{Credit sales}}$
Payables payment period	$\frac{\text{Trade payables} \times 365 \text{ days}}{\text{Credit purchases}}$

Gearing	
Debt/equity	$\frac{\text{Interest bearing debt}}{\text{Share capital and reserves}}$
Interest cover	$\frac{\text{PBIT}}{\text{Finance costs}}$

6. Materiality

It is not practical for auditor to test everything due to time limited. Hence, Auditor applies the concept of materiality in order to achieve greater audit efficiency. For **areas of high audit risk**, the auditor will set a **lower materiality level** (more items will be tested)

An item is deemed material if its misstatement or omission could affect the economic decisions of users taken on the basis of the financial statements

In assessing the level of materiality, auditor must consider both the amount (**quantity**) and the nature (**quality**) of any misstatements.

6.1. Quantitative characteristics

ISA 320 does not define materiality. Auditors usually use 5-10% of profit before tax, 0.5-1% of gross revenue and 1-2% of total assets as benchmark. These values are useful as a starting point for assessing materiality for the financial statements as a whole.

Further, numbers of errors each with a low value when aggregated amount is huge could represent material misstatement.

6.2. Qualitative characteristics

This refers to item with a low in value but due to its prominence could influence the user's decision, for example, **directors' transactions and relate party transactions**.

The assessment of what is material is ultimately a matter of the auditors' professional judgement, and it is affected by the auditor's perception of the financial information needs of users of the financial statements.

6.3. Performance materiality

Performance materiality is normally set at a level lower than materiality for financial statement as a whole. It is used for testing individual transactions, account balances and disclosures. The aim of performance materiality is to reduce the risk that the total of errors in balances, transactions and disclosures does not in total exceed overall materiality.

Example:

PPE	\$18m
cash	\$2m
Receivable	\$5m
Total assets	\$25m
Equity	\$25m
Materiality for FS = 1% total asset= 25m*1%=\$250k	
Materiality for PPE/cash/receivable (performance materiality)<Materiality for FS \$250k	

Exam focus point

在历年考试中, 考官多次考察 materiality 的判断方式以及和 materiality 和 Performance materiality 的区别。

Materiality 可以从金额 (quantitative) 和披露 (qualitative) 方面进行判断。

Materiality 一般分为两个层次: 1 是报表总层面的重要性 (5% PBT 或者 1% revenue); 2 是具体审计项目的重要性 (固定资产项目) performance materiality, 这个重要性金额比报表的低, 这样才能保证所有项目的错误不会大于报表的重要性。

7. Responding to the audit Risks

The ISA says that the auditor shall design and perform further audit procedures are responsive to the assessed risks of material misstatement. Audit procedures may be classified into 2 types: **tests of controls and substantive tests**.



7.1. Tests of Controls (TOCs)

TOCs are performed to assess the strength of the client's internal controls. If the client's internal controls are strong, the auditors may place greater reliance on the client's internal controls by reducing the level of audit testing.

When are TOCs performed?

- When the auditors perceive that the **client's internal controls are strong**.
- **When it is not be possible to obtain sufficient appropriate audit evidence from substantive procedures**. This might be the case if the entity conducts its business using IT systems which do not produce documentation of transactions.

7.2. Substantive procedures (SPs)

SPs are audit procedures designed to detect material misstatements at the assertion level (test specific accounting record correct or not). The auditor shall always carry out substantive procedures on material items.

Tests of details– trace individual transaction and balance back to original documents. Tests of detail may be appropriate to gain information about account balances; for example, inventory and trade receivables. This is a time-consuming method and it provides highly reliable evidence.

7.3. Overall responses to audit risk

Auditor will only use following method when the audit risk is relate to whole financial statement (such as management has intention to manipulate accounts, client's accounting system has internal control deficiencies).

- Emphasising to audit staff the need to maintain professional skepticism
- Assigning additional or more experienced staff to the audit team
- Incorporating more unpredictability into the audit procedures

Practice prior year question for audit risk

Minty Cola Co (Minty) manufactures fizzy drinks such as cola and lemonade as well as other soft drinks and its year end is 31 December 2013. You are the audit manager of Parsley & Co and are currently planning the audit of Minty. You attended the planning meeting with the engagement partner and finance director last week and recorded the minutes from the meeting shown below. You are reviewing these as part of the process of preparing the audit strategy.

Minutes of planning meeting for Minty

Minty's trading results have been strong this year and the company is forecasting revenue of \$85 million, which is an increase from the previous year. The company has invested significantly in the cola and fizzy drinks production process at the factory. ① This resulted in expenditure of \$5 million on updating, repairing and replacing a significant amount of the machinery used in the production process.

As the level of production has increased, the company has expanded the number of warehouses it uses to store inventory. It now utilises 15 warehouses; some are owned by Minty and some are rented from third parties. There will be inventory counts taking place at all 15 of these sites at the year end.

A new accounting general ledger has been introduced at the beginning of the year, with the old and new systems being run in parallel for a period of two months.

As a result of the increase in revenue, Minty has recently recruited a new credit controller to chase outstanding receivables. The finance director thinks it is not necessary to continue to maintain an allowance for receivables and so has released the opening allowance of \$1.5 million.

In addition, Minty has incurred expenditure of \$4.5 million on developing a new brand of fizzy soft drinks. The company started this process in January 2013 and is close to launching their new product into the market place.

The finance director stated that there was a problem in November in the mixing of raw materials within the production process which resulted in a large batch of cola products tasting different. A number of these products were sold; however, due to complaints by customers about the flavour, no further sales of these goods have been made. No adjustment has been made to the valuation of the damaged inventory, which will still be held at cost of \$1 million at the year end.

As in previous years, the management of Minty is due to be paid a significant annual bonus based on the value of year-end total assets.

Required:

(b) Using the minutes provided, identify and describe SIX audit risks, and explain the auditor's response to each risk, in planning the audit of Minty Cola Co. (12 marks)

Exam focus point

在历年考试中，考官每次必考 audit risk 的应用题，面对这些题目学生需要注意分值，和作答技巧。一般情况下，一个 threat 的作答可以获得 2 分，这需要学生写出以下 3 部分：

- 1 是 identify, 描述题目中哪些地方可能产生 audit risk, 这部分可以直接从题目摘抄，每找到一个 risk 可以获得 0.5 分；
- 2 是 explanation, 解释这个 risk 会影响报表项目的金额高估或者低估，导致报表的披露错误或者导致审计师无法检查除错误。每解释一个 risk 可以获得 0.5 分；
- 3 是 response, 针对风险提出的应对措施，每个应对措施可以获得 1 分。

解答 audit risk 的应用题需要学生对于 F3 和 F7 的会计准则非常熟悉，给审计师提出应对措施是实操经验，学生是无法通过讲义获得解答思路，建议学生多多刷往年历年考题，总结的常见 risk 的 responses。

在作答难度方面，《应对措施》解释 risk 描述，建议学生优先在题目找出 risk 和解释，时间充裕再写应对措施。

常见 audit risk 和 auditor response 和 IAS37 相关

Risk	Response
The client is facing potential law suit, no adjustment for lawsuit. 有 lawsuit 但是没有做任何会计分录或者披露，低估 provision 或者披露错误	The audit team should write to the company's lawyers to enquire of the existence and likelihood of success of any claim.
Client make insurance claim to insurance company, recognise as receivable 过早确认潜在收款，高估 receivable	Discuss with management whether any response has been received from the insurance company and review the related correspondence. If virtually certain, the treatment adopted is correct. If the receipt is probable, auditor should request management to remove it from profit and receivables and include a contingent asset disclosure note.
The client change product warranty policy. 更改 provision 的金额，导致 provision 低估	Review the level of the warranty provision to confirm completeness of the provision.
Client is closing its business and making the workforce redundant; 更改/少计 provision 的金额，导致 provision 低估	Discuss with management the status of the redundancy programme and review and recalculate the redundancy provision. Review the disclosure of redundancy provision in FS to ensure it comply with IAS37.

与 development cost 有关

Risk	Explanation	Response
------	-------------	----------

<p>The client has spent XX million on developing new products; these are at different stages and the total amount has been capitalised as an intangible asset.</p> <p>研 发 在 development 和 research cost 的区分不清晰，导致 IA 高估</p>	<p>There is a risk that some projects may not reach final development stage and hence should be expensed rather than capitalised. Intangible assets and profit could be overstated.</p>	<p>A breakdown of the development expenditure should be reviewed and tested in detail to ensure that only projects which meet the capitalisation criteria are included as an intangible asset, with the balance being expensed.</p>
---	---	---

和 bank loan 有关

Risk	Response
<p>The client has borrowed XX million from the bank and repaid over XX years.</p> <p>Loan 需要分期还钱，容易算错 CL 和 NCL</p>	<p>Audit team need to confirm loan finance was received.</p> <p>In addition, the split between current and non-current liabilities and the disclosures for this loan should be reviewed in detail to ensure compliance with relevant accounting standards.</p>
<p>Finance cost related to bank loan may omitted</p> <p>Loan 的利息容易漏</p>	<ul style="list-style-type: none"> ● Inspect the loan documentation to confirm interest rates. ● The finance costs should be recalculated to ensure accurate. ● Inspect cashbook and bank statements to confirm interest was paid and is not therefore a year-end payable.
<p>If the client breach loan covenants, they may not have sufficient cash flow to meet loan repayment This could be going concern implications.</p> <p>Loan 有违约条款，违约可能导致公司持续经营问题</p>	<p>The team should maintain their professional scepticism and be alert to the risk that profit has been overstated to ensure compliance with the covenant.</p>
<p>The client may pledge its fixed assets to secure the bank loan granted.</p> <p>Loan 有抵押品，披露可能漏了</p>	<p>The loan correspondence should be reviewed to ascertain whether any security has been given, and this bank should be circularised as part of the bank confirmation process.</p>

和销售应收有关

Risk	Response
<p>There has been a significant number of sales returns/refund made subsequent to the year end.</p> <p>年后有大量退货，需要冲减今年 sale，收入有高估风险</p>	<p>Review a sample of the post year-end sales returns and confirm if they relate to pre year-end sales, the revenue has been reversed and the inventory included in the year-end ledgers.</p>
<p>Sales-related bonus scheme (more sale, more bonus)</p>	<p>Increased sales cut-off testing will be performed along with a review of any post year-end cancellations of</p>

风险 1 销售人员的奖金和销售额挂钩，提前确认 sale，导致 sale 高估 风险 2，新顾客可能是虚构的，导致 AR 嘎咕	contracts as they may indicate cut-off errors. External confirmation of receivables to confirm that customers exist and represent valid amounts due.
The client a significant long outstanding amount due to customer. 顾客拖延还钱/有 dispute/AR 天数增加，AR 可能收不回，导致 AR 高估	Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation and the need for an allowance for receivables.
Client change provision policy (change from 5% to 1% of total AR) 公司调整 allowance 的金额，如果 AR 收不回，ar 会高估	Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation and the need for an allowance for receivables.

和存货有关

Risk	Response
During year-end inventory count there were movements of goods in and out. 存货盘点过程有货物移动，可能有漏点或者重复盘点，导致 inv misstate	During the final audit, the goods received notes and goods despatched notes received during the inventory count should be reviewed and followed through into the inventory count records.
The company decreased the selling price of products /provide significant discount /halt the sale for certain product/ inv days increase substantially. 产品价格下跌/暂停销售/inv 天数增加，inv 的 cost 可能高于 NRV，inv 高估。	The auditor should undertake detailed cost and NRV testing to assess whether inventory is overvalued and requires write down.
The client purchase inventory from overseas and it will take few weeks to receive goods. 存货在年底还在运输，存货，AP 和 COS 有 cut off 的问题，可能 misstate	The audit team should undertake detailed cut-off testing of goods in transit from the suppliers to ensure that the cut-off is complete and accurate.
The company undertakes continuous (perpetual) inventory counts. 公司使用 continuous count，年底不盘点，如果客户的存货内控不完善，导致 YE 的 misstate	The completeness of the continuous (perpetual) inventory counts should be reviewed. In addition, adjustments made to inventory should be considered to assess whether reliance on the inventory records at the year-end will be acceptable.
The client has many warehouse and auditor only attend a few warehouse stocktake. 客户有多个仓库，审计师只能盘点一部分，没有参加盘点仓库存货数量可能不完整	The auditor should assess which of the inventory sites they will attend the counts for. For those not visited, the auditor will need to review the level of exceptions noted during the count and discuss with management.

Client inventory held in third party warehouse. 客户的货物存放在第三方，存货的金额可能不完整	Additional procedures are required to ensure that inventory quantities have been confirmed for both third party and company.
The client use special inventory valuation policy. 客户使用 standard costing 或者其他方法给存货估值，导致 inv 高估	Testing should be undertaken to confirm cost and NRV of inventory are valued correctly. In addition, valuation testing should focus on comparing the cost of inventory to value under special method to confirm whether this method is actually a close approximation to cost.

和固定资产有关

Risk	Response
Disposal of fixed assets during the year. 风险 1 卖出资产没有从 register 移除，导致高估 PPE 风险 2，卖出资产的 gain or loss 没有正确计算，导致 profit 高估或者低估	Recalculate the profit or loss on disposal calculations and agree all items to supporting documentation. Review the non-current asset register to ensure that the asset has been removed.
Disposal of fixed assets with significant profit or loss. 资产出售有大额盈利或者亏损说明 depn 不恰当， depn 和 profit misstate	Discuss the depreciation policy for plant and equipment with the finance director to assess its reasonableness.
Client has a policy of revaluing its land and buildings , only revalue part of building. 风险 1 只对升值的 PPE 价值重估违反 IAS16 ，导致 PPE misstate 风险 2 revalue 需要披露，担心披露不充分	Discuss with management the process adopted for undertaking the valuation, including whether the whole class of assets was revalued. This process should be reviewed for compliance with IAS 16. Review the disclosures of the revaluation in the financial statements for compliance with IAS 16.
Client incurred significant amount on updating, repairing and replacing fixed assets. Repair 不能 capitalise ，否则高估 PPE	The auditor should review a breakdown of these costs to ascertain the split of capital and revenue expenditure, and ensure the classification in the financial statements is correct.
The client includes training cost in the cost of PPE Training cost 不能 capitalise ，否则高估 PPE	Obtain a breakdown of expenditure and undertake testing to confirm training costs had been exclude from cost of PPE
The client extended the useful lives of plant and machinery 延长折旧年限导致 depn 低估，利润高	Discuss with the directors the rationale for extending the useful lives. Also, the useful life should be compared to how

估	often these assets are replaced, as this provides evidence of the useful life of assets.
The client ordered fixed assets prior year end and received after year end. 有购买的 PPE 在年底还在运输中, 提前确认 PPE 导致 PPE 高估	Discuss with management as to whether the fixed assets have arrived, if so then physically verify a sample of these fixed assets to ensure existence.

和费用有关

Risk	Response
Significant fall in administration expenses 费用异常波动(行政费大幅减少, 销售费用减少但是销售额增加), exp 漏记	Discuss these with management and obtain supporting evidence to verify management explanations.
Increase in revenue but COS did not increase accordingly. Further, operating expenses increase significantly. COS 和 revenue 变化不匹配, 可能是 COS 错记为 exp	The classification of costs between cost of sales and operating expenses will be compared with the prior year to ensure consistency.

和 recon 有关

Risk	Response
Bank/AR/AP reconciliations no longer perform, or no recon for small balance 没有做 recon 或者小差异不做 recon, 导致不能及时发现 misstatement	Discuss this issue with the management and request that the reconciliation is fully reconciled. The reconciling items should be tested in detail and agreed to supporting documentation.

公司内控出现问题

Risk	Response
The new finance director was newly appointed and with no working experience in the related industry. 公司高层没有经验, FS 容易有 misstatement	Auditor should focus on any changes in accounting policies and any key judgemental decisions made by the finance director.
The client current does not have senior finance office to supervise accounting records. 管理层人手空缺, FS 的 misstatement 没有及时查出来	The audit team should maintain their professional scepticism and be alert to the risk of errors.
New accounting/IT system introduce during the year. 更换系统, 新系统的数据可能不完整, 导致 FS 有 misstatement	The auditor should undertake detailed testing to confirm that all opening balances have been correctly recorded in the new general ledger system.

审计师由于时间，经验不足导致无法查出风险

Risk	Response
New client for the audit firm. 新的客户，不了解客户，查不出 misstatement	Ensure a suitably experienced team for the audit. Allocated adequate time for team members to obtain an understanding of the company and the risks of material misstatement.
The director bonus is related to total profit/total asset and they disappoint with prior year result. 高层的薪酬和利润挂钩，高层有动力做假账	Throughout the audit the team will need to be alert to this risk. They will need to maintain professional scepticism and carefully review judgemental decisions and compare against prior years
Client request to reduce time for the audit. 客户要求压缩审计时间，时间不足导致 misstatement 查不出	The timetable should be confirmed with the client. If it is to be reduced, consideration should be given to performing an interim audit, this would reduce the pressure on the final audit.
Audit team may not be sufficiently qualified to assess the quantity and value of work in progress. 审计团队没有足够的经验，无法查出 misstatement	Consider whether an independent expert is required to value the work in progress. If so, this will need to be arranged with consent from the management and in time for the year-end count.

Solution

Part A please refer to above lecture note for audit risk.

Part B audit risk and auditor's response (recommend using table format)

	Audit risk	Auditor response
①	<p>Minty has incurred \$5m on updating, repairing and replacing a significant amount of the production process machinery.</p> <p>According to IAS 16, this expenditure should be capitalised as part of property, plant and equipment (PPE) if these expenses are capital in nature. If these expenses are related to repairs, they should be charged to income statement.</p> <p>If the expenditure is not correctly classified, profit and PPE could be under or overstated.</p>	<p>The auditor should review a breakdown of these costs to ascertain the split of capital and revenue expenditure to ensure that the classification in the financial statements is correct.</p>

以下内容可以帮助你进行本章复习及自测

1. 重点词汇

Audit risk

Inherent risk

control risk

Detection risk

Sampling risk

Non-sampling risk

Materiality

Performance materiality

Tests of Controls

Analytical procedures

Tests of details

2. 必做习题

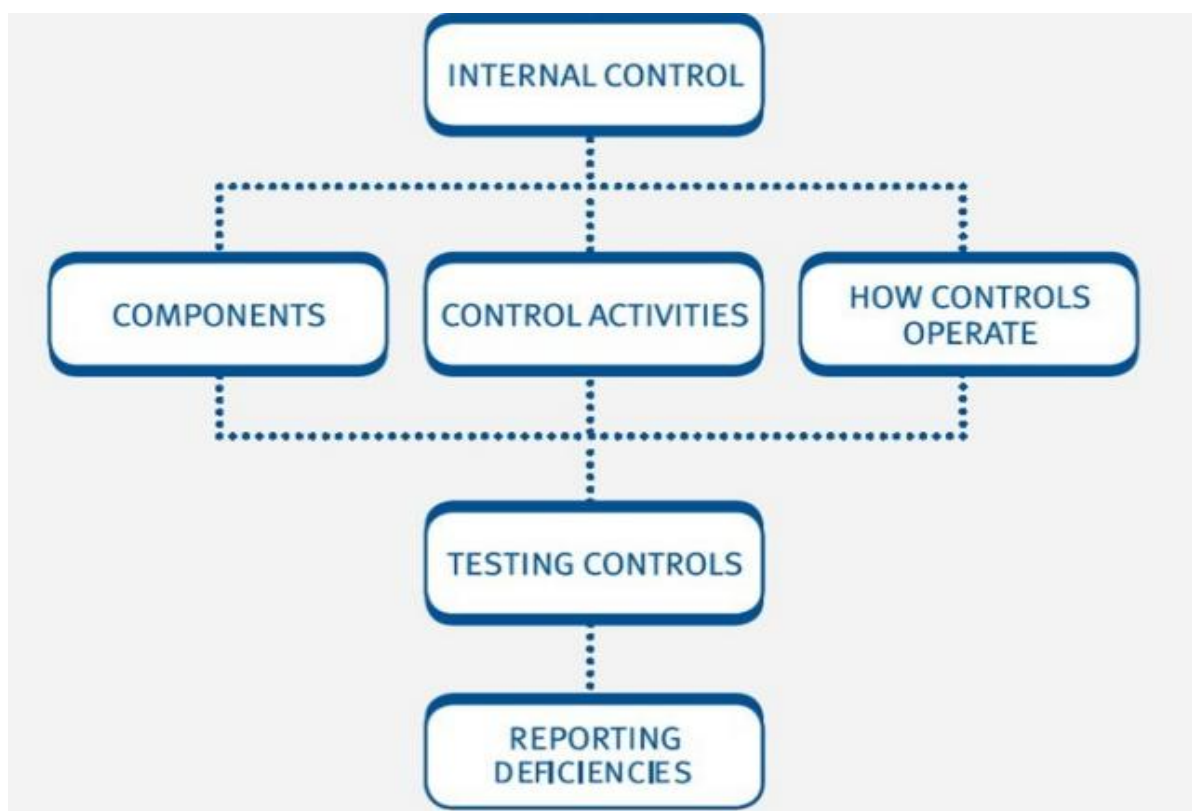
PY question S16Q17 S17Q17 S18Q16 M17Q16 M18Q17 M19Q17 M20Q16 M21Q17

Chapter 7 Internal control and test of control

Internal control 是企业的内部控制措施，这些措施能有效保证企业的营运效率以及报表数据的正确，审计师要通过评估企业的内控措施的完善程度来判断财务报表包含错误的概率。通过本章节的学习，我们要了解企业内控的组成部分以及审计师是如何判定企业的内控是否存在缺陷。

Learning outcomes

- Describe and explain the five components of a system of internal control
- Explain how auditors record systems of internal control
- Evaluate internal control deficiencies
- Describe control objectives, control procedures, control activities
- Describe how to report significant deficiencies in internal control are provided to management
- Discuss the need for auditors to communicate with those charged with governance.



1. Internal control systems

Internal control is the process designed, implemented and maintained by management to achieve reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

1.1. Why auditors need to understand internal control system?

An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement.

1.2. Five component of internal control (CRIME)

- **Control Environment** – includes the governance and management functions. It focuses on the attitudes, awareness and actions of those charged with governance and management.
- **Entity's Risk assessment process** –includes how management identifies business risks relevant to the preparation of financial statements in accordance with applicable financial reporting framework.
 - Identifying business risks relevant to financial reporting objectives
 - Estimating the significance of the risks
 - Assessing the likelihood of their occurrence
 - Deciding on actions to address those risks
- **Information system relevant to financial reporting** - accounting system consists of the procedures to initiate, record, process, and report entity transactions.
- **Control activities** - Control activities are the policies and procedures that help ensure that management directives are carried out. Example of control activity:
 - Authorisation - approval of transactions by a suitably responsible official to ensure transactions are genuine.
 - Performance reviews - comparison or review of the performance of the business with budget.
 - Arithmetical controls – controls which check the arithmetical accuracy of accounting records.
 - Physical controls - to prevent unauthorised access of assets
 - Segregation of duties - Assigning the responsibility for recording transactions, authorising transactions and maintaining assets to different employees to prevent the fraud.
 - Information processing - computer controls including general IT controls and application controls

✚ General IT controls covers a range of applications and support the overall IT environment. Examples are:

- ✧ Password protection
- ✧ Virus checks
- ✧ Back-up copies
- ✧ Disaster recovery procedures

✚ Application controls is to establish specific control procedures over the accounting applications

- ✧ **Control totals.** The system aggregates the total of the input document's gross value and this is compared to the control total. This helps to ensure completeness and accuracy of input.
- ✧ **Document counts.** The numbers of documents to be input are counted. At the end, the number of documents input is checked against the document count. This helps to ensure completeness of input.
- ✧ **One-for-one checking.** the documents entered into the system are manually agreed back one by one to the original documents
- ✧ **Check digits.** Mathematical calculations are performed by the system on a particular data field to ensure the data entered into the system is accurate
- ✧ **Existence checks.** The system is set up so that certain key data must be entered, such as supplier name, otherwise the invoice is rejected.
- ✧ **Range checks.** A pre-determined maximum amount is input into the system any amount keyed in is above the maximum amount, the system will reject the document.
- ✧ hash totals

- **Monitoring of controls** - 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.

Exam focus point

在历年考试中，考官的理论题经常考 internal control 的 5 components，需要学生熟悉这 CRIME 这 5 个内控组成部分的定义。

Control activity 的考核方式多出现在选择题上，考官通过会给出具体的内控措施，需要学生判断这是哪个类型的 control activity

1.3. Problem of internal control in small entity

In general, smaller companies tend to have relatively weaker internal controls. This may be due to:

- Weak segregation of duties due to having an insufficient number of staff
- Incomplete accounting records –smaller companies may not see the importance of maintaining proper accounting records

1.4. Limitations of accounting and control systems

- The costs of implementing internal controls may not outweigh their benefits
- The potential for human error may not be detected.
- The possibility of collusion between employees will undermine internal control system.
- The possibility of controls being bypassed or overridden by management
- For non-routine transactions, internal control may be useless.

2. Recording internal control systems

There are several techniques for recording the internal control system.

- **Narrative notes**
- **Flowcharts**
- **Questionnaires**

2.1. **Narrative Notes** – consist of a written description of the system. They detail what occurs in the system at each stage and include details of any controls which operate at each stage.

Advantage	Disadvantages
They are relatively simple to record and can facilitate understanding by all audit team members.	Narrative notes may prove to be too cumbersome, especially if the system is complex.
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.

2.2. **Flowchart** –Flowcharts are a diagrammatic illustration of the internal control system. Lines usually demonstrate the sequence of events and standard symbols are used to signify controls or documents.

Advantages	Disadvantages
Information is presented in a standard form, they are fairly easy to follow and review.	Difficult to amend, major amendments may require the whole flowchart to be redrawn.
Due to the use of standard symbols for controls, it can be effective in identifying missing controls	They are most suitable for describing standard systems. Procedures for dealing with unusual transactions will have to be recorded using narrative notes.

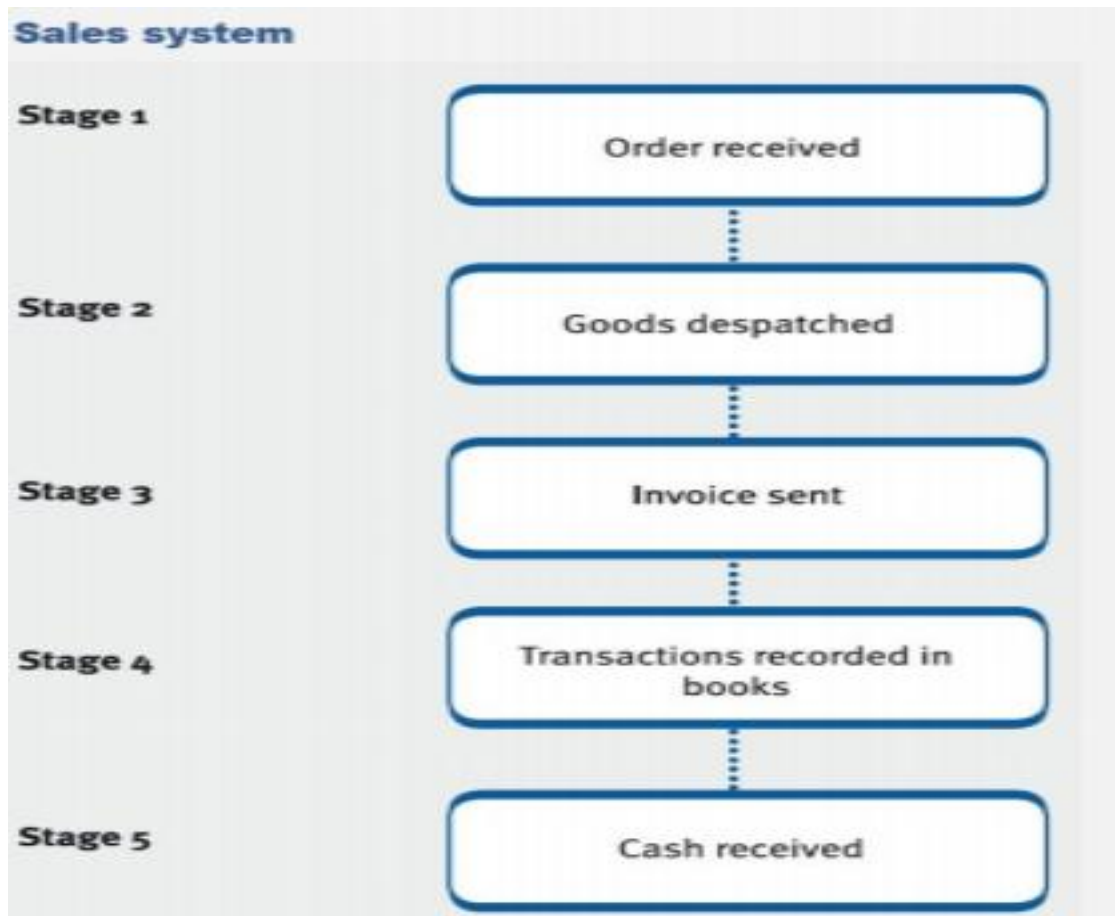
2.3. **Questionnaires** – includes internal control questionnaires (ICQs) or internal control evaluation questionnaires (ICEQs). **ICQs** is a list of control given to client to say whether or not the control existed. **ICEQs** is a list of questions given to client to assess the effectiveness of the controls in place.

Advantages	Disadvantages
Questionnaires are quick to prepare, which means they are a cost effective method for recording the system.	It can be easy for the client staff to overstate the level of the controls present as they are asked a series of questions relating to potential controls
They ensure that all controls present within the system are recorded; hence missing controls or deficiencies are clearly highlighted.	A standard list of questions may miss out unusual or more bespoke controls used by the company.

Exam focus point

在历年考试中，考官的理论题经常考记录内控系统的 3 中方法中两种，并且需要学生写出每种记录方法的优缺点，需要学生熟悉 Narrative notes, Flowcharts Questionnaires 的定义以及他们优缺点。

3. Internal control system - sales system



Stage	Control objective	Controls
Order receiving	To ensure that goods and services are only supplied to customers with good credit ratings.	<ul style="list-style-type: none"> ● All customers have a credit limit and each customer cannot purchase over its credit limit. ● Customers' credit limited will be reviewed by senior staff regularly. ● Prior accepting customers' order, there should be a check on inventory availability.
Goods despatched	Orders are despatched promptly and in full to correct customer	<ul style="list-style-type: none"> ● When the goods have been picked ready to be despatched, they should be cross checked back to the original order. They should check correct quantities and quality of goods being despatched.

		<ul style="list-style-type: none"> ● System should automatically highlighted sales orders not yet completed within normal despatch period. ● There should be a team of two staff to despatch goods; one member perform despatching and the other member should double check the detail of goods.
	All orders accepted should be processed in system.	<ul style="list-style-type: none"> ● Sales orders and goods despatched note (GDN) should be sequentially numbered. On a regular basis, a sequence check of orders should be undertaken to identify any missing orders.
Invoicing	To ensure that goods and services are provided accurately.	<ul style="list-style-type: none"> ● Sales staff should process sales invoice with price in master file. ● Only senior management could change the detail of master file and the master file should be review regularly.
	All despatched goods should be invoice	All sales invoices and GDN should be sequentially numbered. On a regular basis, a sequence check of sales invoices should be undertaken to identify any goods despatched not yet invoiced.
Recording	To ensure that recorded sales transactions represent goods or services provided.	<ul style="list-style-type: none"> ● Taking orders, recording sales and receiving payment are allocated to three different staff members. ● All sales invoices recorded in system should have valid GDN and sales order
	Revenue recorded in correct period	Sales invoices should record in system daily.

Payment received	Cash received is allocated against the correct customer to minimise dispute.	<ul style="list-style-type: none"> ● Monthly customer statements should be sent out promptly and they should be reviewed by relevant personnel. ● The sales ledger control account should be reconciled on a monthly basis to identify any errors. The reconciliations should be reviewed by a responsible official
------------------	--	---

How to test the internal control?

- Enquire the relevant personnel.
- Observing/testing the application of control.
- Trace a transaction through the system.
- Inspecting document.

Internal control	Test of control
Taking orders, recording sales and receiving payment are allocated to three different staff members	Enquire the sales staff whether he/she need to record sales transaction and receive payment from customer.
Prior accepting customers' order, there should be a check on inventory availability.	Auditor places an order for goods which did not have stock in warehouse. The system should reject this order.
Monthly customer statements should be sent out promptly	Inspect a sample of monthly statement to confirm they are performed and reviewed by relevant personnel.

Prior year exam question for sales system J12Q1

Pear International Co (Pear) is a manufacturer of electrical equipment. It has factories across the country and its customer base includes retailers as well as individuals, to whom direct sales are made through their website. The company's year-end is 30 September 2012. You are an audit supervisor of Apple & Co and are currently reviewing documentation of Pear's internal control in preparation for the interim audit.

Pear's website allows individuals to order goods directly, and full payment is taken in advance. ①Currently the website is not integrated into the inventory system and inventory levels are not checked at the time when orders are placed.

②Goods are despatched via local couriers; however, they do not always record customer signatures as proof that the customer has received the goods. ③Over the past 12 months there have been customer complaints about the delay between sales orders and receipt of goods. Pear has investigated these and found that, in each case, the sales order had been entered into the sales system correctly but was not forwarded to the despatch department for fulfilling.

④Pear's retail customers undergo credit checks prior to being accepted and credit limits are set accordingly by sales ledger clerks. ⑤These customers place their orders through one of the sales team, who decides on sales discount levels.

Raw materials used in the manufacturing process are purchased from a wide range of suppliers. As a result of staff changes in the purchase ledger department, supplier statement reconciliations are no longer performed. Additionally, changes to supplier details in the purchase ledger master file can be undertaken by purchase ledger clerks as well as supervisors.

In the past six months Pear has changed part of its manufacturing process and as a result some new equipment has been purchased, however, there are considerable levels of plant and equipment which are now surplus to requirement. Purchase requisitions for all new equipment have been authorised by production supervisors and little has been done to reduce the surplus of old equipment.

Required:

In respect of the internal control of Pear International Co:

- (i) **Identify** and **explain** FIVE deficiencies;
- (ii) **Recommend a control** to address each of these deficiencies; and
- (iii) **Describe a test of control** Apple & Co would perform to assess if each of these controls is operating effectively. (15 marks)

Exam focus point

在历年考试中，考官每次必考 internal control 的应用题，面对这些题目学生需要注意分值，和作答技巧。一般情况下，一个 control deficiency 的作答可以获得 2-3 分，这需要学生写出以下 3-4 部分：

1 是 identify, 描述题目中哪些地方可能产生 control deficiency，这部分可以直接从题目摘抄，每找到一个 control deficiency 可以获得 0.5 分；

2 是 explanation, 解释这个 control weakness 怎么影响报表项目的金额高估或者低估，或者导致公司的收入损失成本增加，或者导致公司失去顾客/供应商/员工的 goodwill。每解释一个 control deficiency 可以获得 0.5 分；

3 是 recommendation, 针对 control deficiency 提出的应对措施，每个应对措施可以获得 1 分。

4 是 test of control, 针对你提出的内控修改建议，如何去测试内控是否有效，每个 test of control 可以获得 1 分。

解答 control deficiency 的应用题需要学生对于公司的销售、采购、存货盘点、现金管理、薪酬支付等内控系统非常熟悉，给审计师提出应对措施是实操经验，学生是无法通过讲义获得解答思路，建议学生多多刷往年历年考题，总结的常见 control deficiency 的 responses 和 test of control

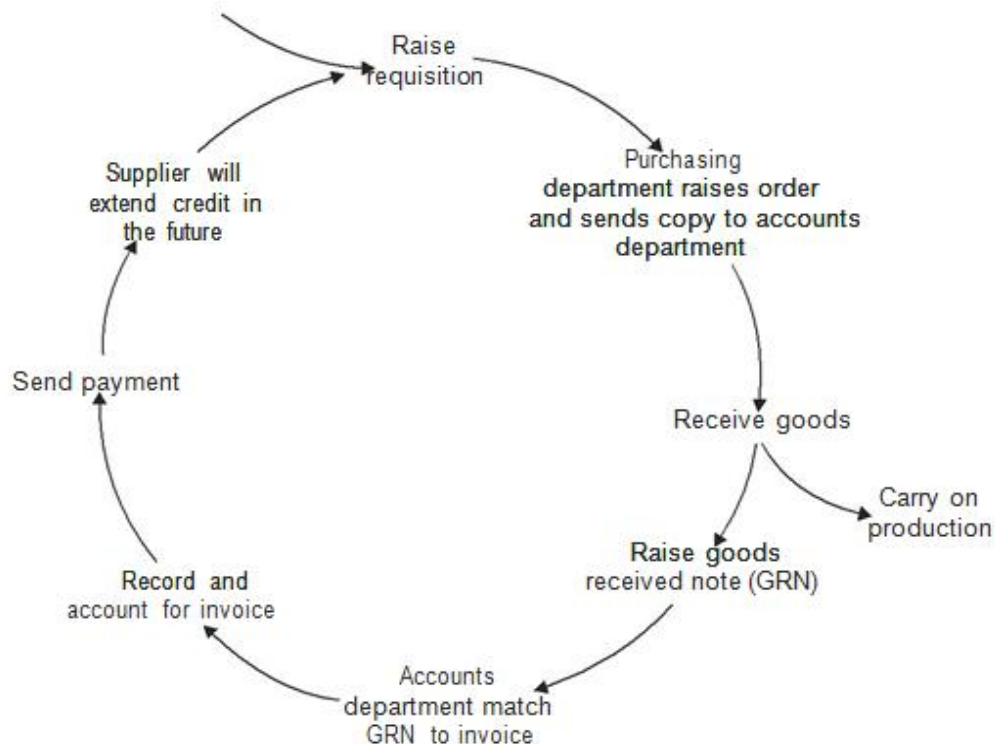
在作答难度方面，test of control》应对措施=解释 control deficiency》描述，建议学生优先在题目找出 control deficiency 和应对措施，时间充裕再写解释和 test of control。

① order received is not check with inventory → customer order goods without stock, loss of revenue → link order system with inventory system → place an order without stock to test whether control operate effectively

Solution

	deficiency	Recommended control	Test of control
①	<p>Currently the website is not integrated into inventory system.</p> <p>This can result in Pear accepting customer orders when they do not have the goods in inventory. This can cause them to lose sales and customer goodwill.</p>	<p>The website should be updated to link into the inventory system; this should check inventory levels and only process orders if adequate inventory is held.</p>	<p>Place an order via the website for items which are not currently held in inventory. The orders should be rejected by system</p>

4. Internal control system - Purchase system



Stage	Control objective	Controls
Raise purchase requisition /order	To ensure that goods and services need to be purchased are authorised	<ul style="list-style-type: none"> ● Requisition forms should be authorised by relevant ● Goods and services should be purchased from approved supplier. List of approved suppliers should be review regularly.
	To ensure that all purchase order are recorded	<ul style="list-style-type: none"> ● All purchase orders should be sequentially numbered and a sequence check of unfulfilled orders should be performed
Receive goods	To ensure that goods and services order by company are accepted.	<ul style="list-style-type: none"> ● Staff receiving goods checks them to the purchase order.
	To ensure goods received are recorded promptly	<ul style="list-style-type: none"> ● All goods received notes (GRN) forwarded to accounts payable department daily. ● All GRNs should be sequentially numbered and a sequence check of miss GRN should be performed

Receive purchase invoice	<ul style="list-style-type: none"> ● To ensure that invoices received relate to goods actually received ● To ensure that invoices received relate to correct quantity and price 	<ul style="list-style-type: none"> ● All purchase invoices should be matched to the related GRN. ● Placing the orders, recording the purchase order and making the payment is carried out by three different staff members.
Recording	Purchase recorded in correct period	<ul style="list-style-type: none"> ● Purchase invoices should record in system daily. ● Supplier statements should be reviewed and reconciled to trade payable records by a responsible officer.
Cash Payment	To ensure payment only make to goods received	There should be a review of the whole payments list and agree to supporting document prior to making payment.

Prior year exam question for purchase system J13Q1

Introduction

Fox Industries Co (Fox) manufactures engineering parts. It has one operating site and a customer base spread across Europe. The company's year end was 30 April 2013. Below is a description of the purchasing and payments system.

Purchasing system

Whenever production materials are required, the relevant department sends a requisition form to the ordering department. ①An order clerk raises a purchase order and contacts a number of suppliers to see which can dispatch the goods first. This supplier is then chosen. The order clerk sends out the purchase order. This is not sequentially numbered and only orders above \$5,000 require authorisation.

Purchase invoices are input daily by the purchase ledger clerk, who has been in the role for many years and, as an experienced team member, he does not apply any application controls over the input process. Every week the purchase day book automatically updates the purchase ledger, the purchase ledger is then posted manually to the general ledger by the purchase ledger clerk.

Payments system

Fox maintains a current account and a number of saving (deposit) accounts. The current account is reconciled weekly but the saving (deposit) accounts are only reconciled every two months. In order to maximise their cash and bank balance, Fox has a policy of delaying payments to all suppliers for as long as possible. Suppliers are paid by a bank transfer. The finance director is given the total amount of the payments list, which he authorises and then processes the bank payments.

As the external auditors of Fox Industries Co, write a report to management in respect of the purchasing and payments system described above which:

- (i) Identifies and explains FOUR deficiencies in the system; and**
- (ii) Explains the possible implication of each deficiency; and**
- (iii) Provides a recommendation to address each deficiency.**

A covering letter IS required.

(14 marks)

Solution

Board of directors
Fox Industries Co
15 ABC Street
DEF Town
G Country
6 June 2017

Dear Sirs,

Audit of Fox Industries Co (Fox) for the year ended 30 April 2013

Please find enclosed the report to management on deficiencies in internal controls identified during the audit for the year ended 30 April 2013. The appendix to this report considers deficiencies in the purchasing and payments system, the implications of those deficiencies and recommendations to address those deficiencies.

Please note that this report only addresses the deficiencies identified during the audit and if further testing had been performed, then more deficiencies may have been reported.

This report is solely for the use of management and if you have any further questions, then please do not hesitate to contact us.

Yours faithfully

An audit firm

	deficiency	Implication	Recommended control
①	When raising purchase orders, the clerks choose whichever supplier can despatch the goods the fastest.	This could result in Fox ordering goods at a much higher price than they would like.	An approved supplier list should be compiled and all orders should only be placed with suppliers on the approved list.

5. Internal control system - inventory system

There are two type of inventory system normally used by company: **Perpetual inventory system** and **Periodic Inventory System**

	Periodic Inventory System	Perpetual inventory system
Nature	Inventory is counted at a year-end count is not undertaken.	Inventory is counted continuously throughout the year (per month/quarter), and therefore a year-end count is not undertaken.
Feature	Did not know current stock level unless stock count. Control risk is high.	Current stock level is available but a stock system is required. If the inventory system with minimum adjustment, control risk is low.

Inventory control focus on inventory count as this would affect stock value in the financial statement. General inventory control on stock count as follow:

Objective	Control
To ensure the inventory in FS are physical exist.	<ul style="list-style-type: none"> ● Separate responsibilities for maintenance of records and custodianship. Warehouse staff should not take part in the stock count process. ● All inventory count sheets should be sequentially numbered to ensure completeness of inventory.
To ensure the inventory in FS are accurate.	<ul style="list-style-type: none"> ● Each stock count team should comprise two members and they should be assigned different task. One member counts and the second member checks that the inventory has been counted correctly ● Inventory counting sheets should be pre-printed with a description or item code of the goods, but the quantities per the records should not be pre-recorded. ● All completed inventory count sheets should be signed by team member
To ensure inventory is properly stated at the lower of cost and net realizable value.	<ul style="list-style-type: none"> ● Damaged goods should be move to a central location at the end of the count. A senior member of the finance team should then inspect these goods to assess the level of any write down or allowance ● A specialist should be utilised to assess both work-in-progress and the quantities of raw materials if the

	cost calculation is complicated.
General inventory control on stock keeping and movement	
<ul style="list-style-type: none">● Inventory should be kept in a warehouse with access restricted to warehouse staff by the use of swipe card or keypad access.● Inventory movements should be recorded in the system promptly from the GRNs and GDNs to ensure the inventory system is up to date.● Inventory count sheet should be completed by ink to prevent unauthorised amendment	

Prior year exam question for inventory count D07Q1

On the day of the inventory count, you attended depot nine at DinZee. You observed the following activities:

1. Pre-numbered count sheets were being issued to client's staff carrying out the count. ①The count sheets showed the inventory ledger balances for checking against physical inventory.
- 2.All count staff were drawn from the inventory warehouse and were counting in teams of two.
- 3.Three counting teams were allocated to each area of the stores to count, although the teams were allowed to decide which pair of staff counted which inventory within each area. Staff were warned that they had to remember which inventory had been counted.
4. Information was recorded on the count sheets in pencil so amendments could be made easily as required.
5. Any inventory not located on the pre-numbered inventory sheets was recorded on separate inventory sheets—which were numbered by staff as they were used.
6. At the end of the count, all count sheets were collected and the numeric sequence of the sheets checked; the sheets were not signed.

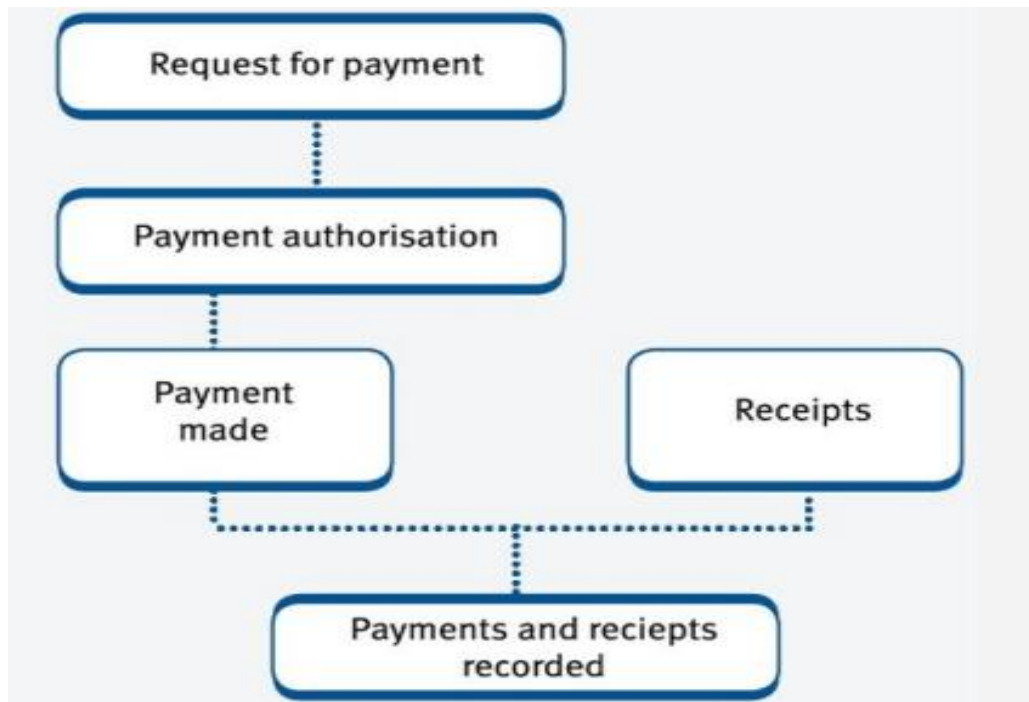
Required:

(i) List the weaknesses in the control system for counting inventory at depot nine. (3 marks)

(ii) For each weakness, explain why it is a weakness and state how that weakness can be overcome. (9 marks)

	Weakness	Recommendation
①	Inventory count sheets stated the quantity of items Count teams will stop counting when 'correct' number of items found. This would result in understatement of inventory.	Count sheets should not state the quantity of items.

6. Internal control system - cash and bank system



For cash payment	
Objective	Control
To ensure that only valid cash payments are made.	<ul style="list-style-type: none"> ● Recording, payment/receipt and reconciliation of cash should be performed by different staff. ● Supplier statements should be reviewed and reconciled to trade payable records regularly by a senior officer. ● Cash and cheques payments should only be made after supporting documents are reviewed and approved by senior officer.
To ensure that all cash payments that occurred are recorded.	<ul style="list-style-type: none"> ● Bank reconciliation should be performed monthly and reviewed by an independent officer. ● Use of pre-numbered cheques.
For cash received	
To ensure that all valid cash receipts are received and deposited.	<ul style="list-style-type: none"> ● Cash receipts should be processed by two members of staff. One open the envelop and one record cash in cash received. ● Cash and cheque received should be deposited regularly (usually every day). ● Cash and cheques should be stored in a lock safe with restricted access.

Prior year exam question for cash system J10Q3

Shiny Happy Windows Co (SHW) is a window cleaning company. Customers' windows are cleaned monthly, the window cleaner then posts a stamped addressed envelope for payment through the customer's front door.

SHW has a large number of receivable balances and these customers pay by cheque or cash, which is received in the stamped addressed envelopes in the post. The following procedures are applied to the cash received cycle:

1. ①A junior clerk from the accounts department opens the post and if any cheques or cash have been sent, she records the receipts in the cash received log and then places all the monies into the locked small cash box.
2. The contents of the cash box are counted each day and every few days these sums are banked by which ever member of the finance team is available.
3. The cashier records the details of the cash received log into the cash receipts day book and also updates the sales ledger.
4. Usually on a monthly basis the cashier performs a bank reconciliation, which he then files, if he misses a month then he catches this up in the following month's reconciliation.

Required:

For the cash cycle of SHW:

(i) Identify and explain THREE deficiencies in the system; (3 marks)

(ii) Suggest controls to address each of these deficiencies; and (3 marks)

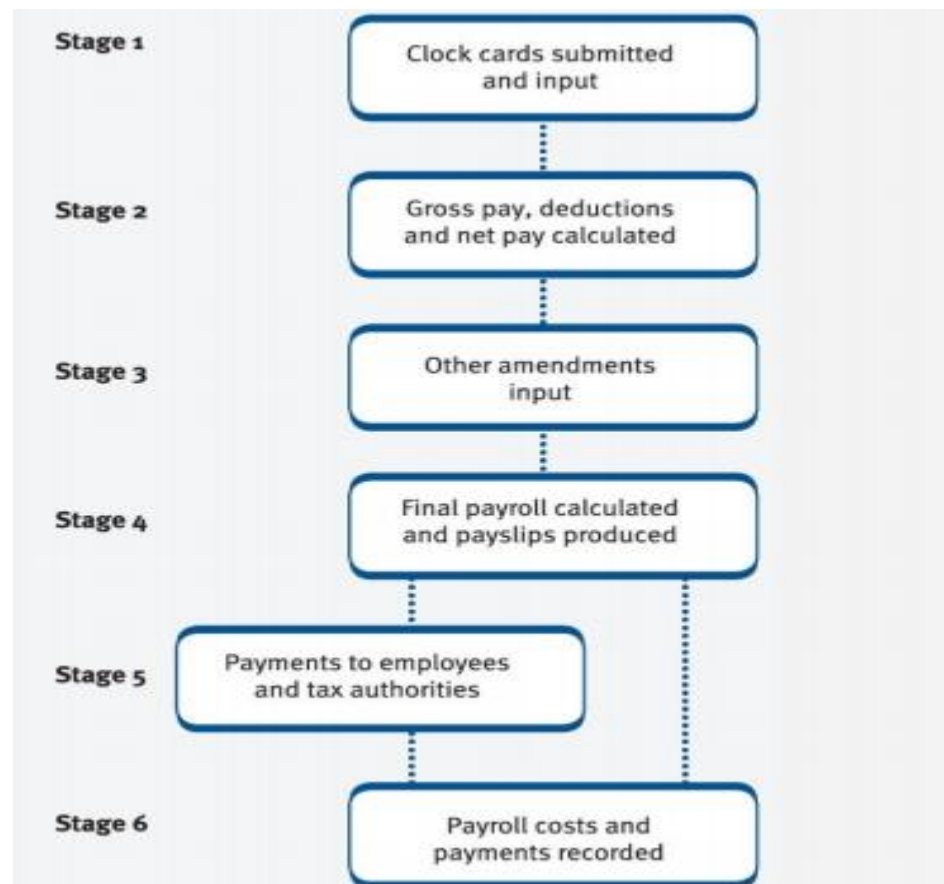
(iii) List tests of controls the auditor of SHW would perform to assess if the controls are operating effectively. (3 marks)

Solution

	Deficiency	Recommended control	Test of control
①	A junior clerk opens the post unsupervised. This could result in cash being misappropriated.	A staff independent of the accounts team should assist with the mail, one should open the post and the second should record cash received.	Observe the mail opening process, to assess if the control is operating effectively

--	--	--	--

7. Internal control system - payroll system



Stage	Control objective	Controls
Clock cards (or timesheets) submitted	Employees are only paid for work actually done.	<ul style="list-style-type: none"> ● All overtime hours worked should be authorised by the relevant department head. This should be evidenced by signature on the employees' overtime sheets. ● The clocking in and out process should be supervised by a responsible official to prevent one individual clocking in multiple employees.
Payroll calculation	Only genuine employees are paid.	Segregation of duties between HR, payroll functions (Payroll responsible calculation and recording payroll cost, HR recruits staff)
	Employees are paid at the correct rates of pay. Gross/net pay is	The gross to net pay for employees should be recalculated by senior member of payroll team. These calculations should be signed as approved before payments are

	calculated and recorded accurately.	made.
Standing data amendments	Access to standing data is restricted to prevent fraud or error occurring.	Changing standing data should be performed by a senior member of the payroll department.
Recording	All payroll amounts are recorded. Payroll amounts are recorded accurately.	<ul style="list-style-type: none"> ● Checks from payroll records to payment list and to confirm that payments are complete and only made to bona fide employees. Management should sign the payments list as evidence that he has undertaken these checks. ● All starters, leavers, changes to salaries and deductions are reported promptly to payroll department and changes are updated in the payroll master file promptly.
Payments to employees and tax authorities	Correct amounts are paid to the employees and taxation authorities.	<ul style="list-style-type: none"> ● There should be a review of the whole payments list and agree to supporting document prior to making payment. ● The payroll clerks should be informed that all cash wages can only be paid upon sight of the employee's clock card and photographic identification as this confirms proof of identity.

Prior year exam question for cash system J10Q3

Trombone Co (Trombone) operates a chain of hotels across the country. Trombone employs in excess of 250 permanent employees and its year end is 31 August 2014. You are the audit supervisor of Viola & Co and are currently reviewing the documentation of Trombone's payroll system, detailed below, in preparation for the interim audit.

Trombone's payroll system

Permanent employees work a standard number of hours per week as specified in their employment contract. However, when the hotels are busy, staff can be requested by management to work additional shifts as overtime. This can either be paid on a monthly basis or taken as days off.

Employees' record any overtime worked and days taken off on weekly overtime sheets which are sent to the payroll department. The standard hours per employee are automatically set up in the system and the overtime sheets are entered by clerks into the payroll package, which automatically calculates the gross and net pay along with relevant deductions. ① These calculations are not checked at all. Wages are increased by the rate of inflation each year and the clerks are responsible for updating the standing data in the payroll system.

Employees are paid on a monthly basis by bank transfer for their contracted weekly hours and for any overtime worked in the previous month. If employees choose to be paid for overtime, authorisation is required by department heads of any overtime in excess of 30% of standard hours. If employees choose instead to take days off, the payroll clerks should check back to the 'overtime worked' report; however, this report is not always checked.

The 'overtime worked' report, which details any overtime recorded by employees, is run by the payroll department weekly and emailed to department heads for authorisation. The payroll department asks department heads to only report if there are any errors recorded. Department heads are required to arrange for overtime sheets to be authorized by an alternative responsible official if they are away on annual leave; however, there are instances where this arrangement has not occurred.

The payroll package produces a list of payments per employee; this links into the bank system to produce a list of automatic payments. The finance director reviews the total list of bank transfers and compares this to the total amount to be paid per the payroll records; if any issues arise then the automatic bank transfer can be manually changed by the finance director.

Required:

(a) In respect of the payroll system of Trombone Co:

(i) Identify and explain FIVE deficiencies;

(ii) Recommend a control to address each of these deficiencies; and

(iii) Describe a test of control Viola & Co should perform to assess if each of these controls is operating effectively.

Note: The total marks will be split equally between each part. (15 marks)

Solution

	Deficiency	Recommended control	Test of control
①	<p>The wages calculations are generated by the payroll system and there are no checks performed.</p> <p>If system errors occur during the payroll processing, this would not be identified. This could result in wages being over or under calculated, leading to an additional payroll cost or loss of employee goodwill.</p>	<p>A senior member of the payroll team should recalculate the gross to net pay workings for a sample of employees and compare their results to the output from the payroll system. These calculations should be signed as approved before payments are made</p>	<p>Review a sample of the gross to net pay calculations for evidence that they are undertaken and signed as approved.</p>

--	--	--	--

8. Internal control system - fixed assets

Control objective	Controls
To ensure that expenditure is properly authorised.	All purchase orders for capital items are required to be authorised by appropriate level of management (small amount can be authorised by manger, high value need to be approved by capital committee)
To ensure that all non-current assets are correctly recorded in the accounting system.	Each asset is assigned a unique serial number and this is recorded on the asset and in the non-current assets register. Review of assets in the register and compares them to assets on site to confirm existence of the asset
To ensure that all non-current assets are properly safeguarded	Access to the non-current assets register is restricted through passwords.

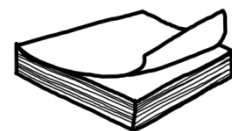
9. Communication of deficiencies in internal control

Deficiency in internal control means internal control is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis.

A significant deficiency in internal control is a deficiency in internal control that, in the auditor's professional judgment, is of sufficient importance to inform those charged with governance.

ISA 265 includes examples of matters to consider when determining whether a deficiency in internal control is a significant deficiency:

- Will the deficiency cause misstatements in the FS in the future?
- Is the related asset susceptible to loss or fraud?
- Is the estimation highly subjective and complex?
- How large is the amount involved?
- Is the deficiency related to other deficiencies?
- How frequent does the exceptions occur?
- How important are the controls to the financial reporting process?
- How large is the volume of activity which has occurred / could occur?



What should be communicated?

1. A description of the deficiencies and an explanation of their potential effects
2. The purpose of the audit was for the auditor to express an opinion on the financial statements, but not to express an opinion on the effectiveness of internal control.

10. Internal audit

Internal auditing function is 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.

10.1. Assessing the need for internal audit

UK requires all listed companies to establish an internal audit function. If do not have one, they should consider whether there is a need to set up an internal audit function based on the following factors:

- The cost of setting up an internal audit department versus the predicted benefit It will only be worth establishing an IA function if the benefits outweigh the costs.
- The complexity and scale of the organisation's activities and the systems supporting those activities The more complex the organisation is, the greater the benefit obtained from having an IA function as there is greater risk of things going wrong
- The ability of existing managers and employees to carry out internal audit assignments.
- Management's perceived need for assessing risk and internal control.
- The pressure from external stakeholders to establish an internal audit department. Some country may require company to set up internal audit department.
- Number of employees. The greater the number of employees the greater the risk of fraud.

10.2. Difference between internal and external audit

	Internal Audit	External Audit
Objectives	Designed to add value to and improve an organisation's operations.	An exercise to enable auditors to express an opinion on the financial statements.
Reporting	Reports to the board of directors, or TCWG. Reports are private and for the directors and	Reports to the shareholders or members of a company on the truth and fairness of the accounts.

	management of the company	Audit report is publicly available to the shareholders and other
Scope	Work relates to the operations of the organisation.	Work relates to the financial statements
Relationship with the company	Often employees of the organisation, although sometimes the function is outsourced.	Independent of the company and its management. Usually appointed by the shareholders.

11. Internal audit assignments

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.

11.1. Value for money audits

Value for money (VFM) audits examine the **economy, efficiency** and **effectiveness** of activities and processes. These are known as the three Es of VFM audits.



The three Es can be defined as follows.

- **Economy:** Attaining the **appropriate quantity and quality** of physical, human and financial resources (inputs) **at lowest cost**.
- **Efficiency:** This is the relationship between goods or services produced (outputs) and the resources used to produce them (inputs). 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.
- **Effectiveness:** This is concerned with how well an activity is achieving its policy objectives or other intended effects.

11.2. Operational audits

Operational audits are audits of the operational processes of the organisation. Their prime objective is the monitoring of management's performance, ensuring that company policy is adhered to.

11.3. IT system reviews.

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

11.4. Fraud investigations

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.

11.5. Compliance audits

There will be a number of regulations a company will need to comply with. Some will be specific to the industry the client operates in and some will apply to all companies operating in a region or country (eg tax laws and employee-related laws). Internal auditors may assist with or review compliance with these laws and regulations.

11.6. Customer service reviews (Mystery shopper visit)

Internal auditors may be asked to assess the level of customer service. They could do this by visiting stores/outlets and pretending to be customers to ensure that customer service is at the required level.

12. Limitations of the internal audit function

- Internal auditors may be employees of the company they are reporting on and therefore may not wish to raise issues in case they lose their job.
- If the internal audit staff have worked in the organisation for a long time, possibly in different departments, there may be a familiarity threat as they will be auditing the work of long standing colleagues and friends.
- Internal auditors are not required to be professionally qualified (as accountants are) and so there may be limitations in their knowledge and technical expertise.

13. Outsourcing the internal audit function

Advantage	Disadvantage
<ul style="list-style-type: none"> ● Cost saving in recruiting and training as the service provider has good quality and well trained staff. ● Outsourcing can provide an immediate internal audit department. ● The service provider has different 	<ul style="list-style-type: none"> ● There will be independence and objectivity issues if the company uses the same firm to provide both internal and external audit services. ● Company staff may oppose outsourcing if it results in redundancies. ● There may be hidden costs in

<p>specialist skills and can assess what management requires them to do.</p> <ul style="list-style-type: none">● The company may opt for a more flexible arrangement to cater to their needs. The service contract can be for the appropriate time scale (a two week project, a month, etc.)	<p>outsourcing internal audit. In particular, if the service provider provides bad quality services, the costs of monitoring the work of the service provider may be very high.</p>
--	---

以下内容可以帮助你进行本章复习及自测

1. 重点词汇

Internal control

Authorisation

Performance reviews

Arithmetical controls

Physical controls

Segregation of duties

Information processing

General IT controls

Application controls

Control totals

Document counts

One-for-one checking

Check digits

Existence checks

Range checks

Narrative Notes

Flowchart

internal control questionnaires

internal control evaluation questionnaires

Perpetual inventory system

Periodic Inventory System

Deficiency in internal control

Internal auditing

Value for money

Economy

Efficiency

Effectiveness

Operational audits

IT system reviews

Compliance audits

Customer service reviews

2. 必做习题

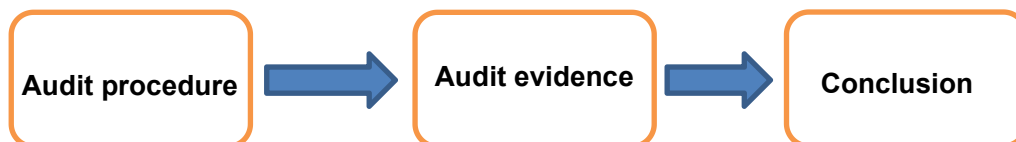
PY S21Q17 S20Q17 M21Q16 M20Q17

Chapter 8 Audit evidence

审计师在发现企业的风险和内控缺失后，需要通过特定方式收集审计证据（audit evidence）来给企业的财务报表作出审计意见。通过本章节的学习，我们会了解审计师需要什么类型的审计证据，他们通过什么方式来收集审计证据，如何选取审计证据以及是否可以通过第三方来收集审计证据。

Learning outcomes

- Explain the assertions contained in the financial statements
- Describe audit procedures to obtain audit evidence
- Discuss the quality and quantity of audit evidence.
- Define audit sampling and explain the need for sampling
- Identify and discuss the differences between statistical and non-statistical sampling
- Explain the use of automated tools and techniques in the context of an audit
- Discuss why auditors rely on the work of others.
- Discuss the extent to which external auditors are able to rely on the work of experts, internal audit and service organisation



1. Audit Evidence (ISA 500)

Audit evidence is all the information used by the auditor in arriving at the conclusions for the auditor's opinion

ISA 500 requires auditor to obtain sufficient and appropriate audit evidence in order to support the auditor's conclusions.

- **Sufficient** relates to the quantity of evidence. When determining whether there is enough evidence the auditor must consider:
 - risk of material misstatement
 - materiality of the item
 - nature of accounting and internal control systems
 - Source and reliability of information available

- **Appropriate** relates to the quality or **relevance** and **reliability** of evidence.
 - **Relevance** deals with the logical connection with the purpose of the audit procedure and the assertion under consideration
 - **Reliability** is influenced by the **source (where is the evidence obtained from?)** and **nature (what form is the evidence in?)** of the information.

The following may help in assessing the reliability of audit 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.
Written	Evidence in the form of written representations is more reliable than oral representations, since oral representations.
Originals	Original documents are more reliable than photocopies.
Internal controls	Evidence obtained from the entity with strong internal control system is more reliable

Exam focus point

在历年考试中，考官的选择题经常考审计证据的可靠度的问题，需要学生记住外部》内部，审计师》公司提供，写的》口述，原件》复印件，内控强》内控弱。

2. Financial statements assertions

Audit tests are designed to obtain evidence about the financial statement assertions relate to **classes of transactions and events and related disclosures (P/L items)**, and **account balances at the period end and related disclosures (B/S items)**.

Assertions about classes of transactions and events and related disclosures	<ul style="list-style-type: none"> ● Occurrence: Transactions and events 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
--	---

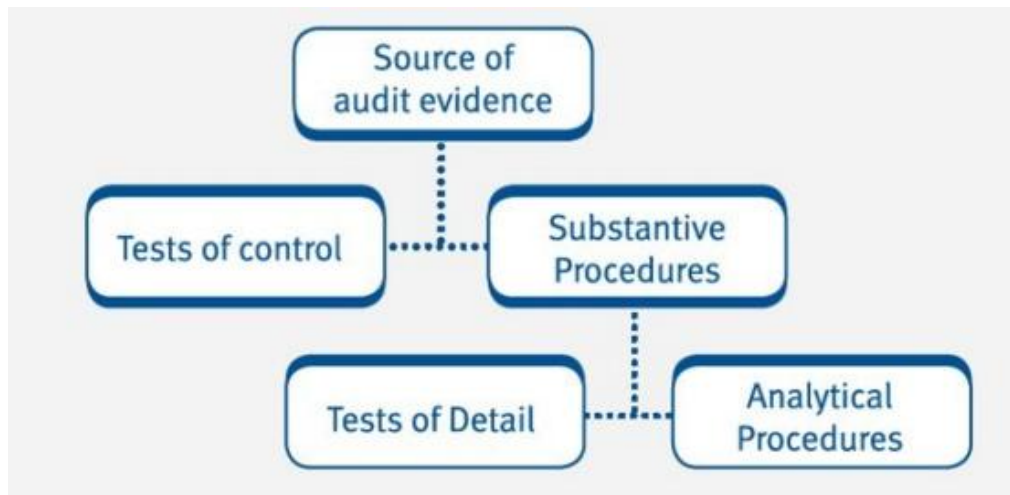
	<p>described</p> <ul style="list-style-type: none"> ● Cut-off: Transactions and events have been recorded in the correct reporting period ● Classification: Transactions and events have been recorded in the proper accounts ● Presentation: Transactions and events are appropriately aggregated or disaggregated and are clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.
<p>Assertions about account balances and related disclosures</p>	<ul style="list-style-type: none"> ● 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. ● Valuation: Assets, liabilities and equity interests have been included in the financial statements at appropriate amounts. ● 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.

Exam focus point

很多同学会纠结 Assertions 的翻译，这个审计术语单独翻译是很难和审计产生关系，不需要深究如何翻译。

但是同学们一定要记住 Occurrence，Completeness，Accuracy，Cut-off，Classification，Existence，Rights and obligations，Valuation 这几个单词的定义以及他们适用于资产负债表还是利润表，这个知识点会和下一章有紧密联系。

3. Source audit evidence



Tests of controls (TOC) are an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements.

The auditor makes the assumption that if controls are working effectively there is less risk of material misstatement in the financial statements. However, the test of control itself does not test the figure within the financial statements; this is the purpose of a substantive procedure.

Substantive procedures (SP) are audit procedures designed to detect material misstatements at the assertion level. Substantive procedures consist of: **Tests of detail** and **Substantive analytical procedures**.

Test of detail: verify individual transactions and balances. A test of detail looks at the supporting evidence for an individual transaction.

E.g. If there are 5000 purchase invoices recorded during the accounting period, test of detail would select sample of these invoice for inspection and only provided evidence for those transactions were selected.

Substantive analytical procedures (SAP): involve the evaluation of financial information through analysis of plausible relationship among both financial data and non-financial data. SAP would be used to assess the reasonableness of the figure in total.

E.g. If there are 5000 purchase invoices recorded during the accounting period, SAP would calculate the percentage change in purchases from last year and then compare this with the percentage change in revenue to see if they move in line

with each other as expected.

Suitability of analytical procedures

- Substantive analytical procedures are usually more suitable to large volumes of transactions that tend to be predictable over time.
- As analytical procedure would not detect misstatements in detail transactions, SAPs should only be used when the audit client's internal controls are strong.
- Analytical procedures are suitable for certain assertions. Analytical procedures are unsuitable for testing the existence of inventories. They are suitable for assessing the value of inventory in terms of the need for allowances by using the inventory holding period ratio (inventory holding period longer, more likely need to make allowance for inventory).

The auditor may rely on the following techniques to perform SAPs:

- Ratio analysis
- Trend analysis
- Reasonableness tests– a proof-in-total (auditor might create an expectation of payroll costs for the year by taking last year's cost and inflating for pay rises and changes in staff numbers. Then, compare the expected amount with actual result).

4. Types of audit procedures (AEIOURC)

ISA 500 identifies following types of procedures that the auditor can adopt to obtain audit evidence.

procedure	definition	TOC or SP
Analytical procedures	evaluations of financial information through analysis of plausible relationships among both financial and non-financial data, investigation of fluctuations that are inconsistent with other relevant information or differ from expected values by a significant amount	SP
Enquiry	seeking information from client staff or external sources	both
Inspection	examination of physical assets or documentation held by the company.	both
Observation	looking at a process or procedure being performed by others.	TOC

Recalculation	checking the mathematical accuracy of documents or records.	SP
Reperformance	auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.	TOC
Confirmation	This is the process of obtaining a representation of information or directly from a third party.	SP

Summary of TOC vs SP

	TOC	SP
objective	Confirm the completeness of payable	
focus	Auditor need to confirm the control over payable is in place and need to test the effectiveness of control	Auditor need to perform procedure on the number in FS Agree number in source document to FS
Procedure	Observation, reperformance, inspection	Analytical procedure, enquiry, inspection, confirmation, recalculation
outcome	Does the control operate efficiently? This will depend on the level of error in sample If the level is low, control is effective and low risk on completeness of payable If the level is high, control is weak and payable is highly incomplete, auditor need to perform SP	Is the balance complete? This will depend on the amount of errors in sample. Auditor need to project the error to estimate the total misstatement in payable

5. Audit sampling (selecting items for testing)

In accordance with ISA 500 Audit Evidence, the auditor has 3 options for selecting items to test:

- 1) **Select all items to test** (100%testing). This may be chosen where the population may be very small or area that is considered to be of significant risk of material misstatement.
- 2) **Selecting specific items for testing**. Items which have high value may be

chosen for testing, or item above certain amount (abnormal level)

3) **Audit sampling** (exam focus area).

5.1. What is 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. Auditor would test a smaller number of items and using the results to draw a conclusion about the whole balance or class of transactions.

Population is the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

5.2. The need for audit sampling

It is necessary for auditors to sample as it is impossible to select all items for testing as this would take the audit team too long and it would cost too much. In addition, auditors do not provide 100% assurance in their audit report about the financial statements, they only provide reasonable assurance and hence it is not necessary to test every item within a population.

6. Types of sampling

Audit sampling can be done using either **statistical sampling** or **non-statistical sampling** approach.

6.1. Statistical sampling

An approach of sampling which selects sample items randomly and use of probability theory to evaluate the sample results. It consists of following methods:

- **Random selection** - Ensures each item in a population has an equal chance of selection, for example, by using random number generators or tables.
- **Systematic sampling** - This involves having a constant sampling interval, such as every X item being selected, the starting point for testing is determined randomly.
- **Monetary unit sampling (MUS)** - This is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts

6.2. Non-statistical sampling

An approach to sampling that does not have these characteristics of statistical sampling.

- **Haphazard selection** - auditor selects the sample without following a structured technique. The auditor must ensure that no conscious bias or predictability arises.
- **Block selection** - This involves selection of a block(s) of contiguous items from within the population.

Example - Systematic Sampling

There are 19 customers with balances in the receivables ledger and 6 samples are required for testing. The sampling interval is therefore 3 (total number of balances and dividing it by the sample size 6). The first item is chosen randomly; in this case item 10. Every third item after that is then also selected for testing until 6 items have been chosen

Customer Ref	Customer Name	Balance \$	Item number	Sampling Item
A001	Anfield United Shop	176	1	
E002	The Beautiful Game	84	2	
B003	Beckham's	42	3	(5)
C001	Cheryl & Coleen Co	12	4	
D001	Dream Team	45	5	
E001	Escot Supermarket	235	6	(6)
G001	Golf is Us	211	7	
G002	Green Green Grass	61	8	
H001	HHA Sports	59	9	
J001	Jilberts	21	10	(1)
J002	James Smit Partnership	256	11	
J003	Jockeys	419	12	
O001	The Oval	92	13	(2)
P001	Pole Vaulters	76	14	
S001	Stayrose Supermarket	97	15	
T001	Trainers and More	93	16	(3)
W001	Wanderers	89	17	
W003	Walk Hike Run	4	18	
W004	Winners	31	19	(4)

Example - Monetary Unit Sampling

There are 19 customers with balances in the receivables ledger and 6 samples are required for testing. The sampling interval is therefore \$351 (total value of the ledger and dividing it by the sample size 6). The first item is chosen randomly; in this case item \$233. Each item after that is selected by adding the sampling interval, until six items have been selected.

Customer Ref	Customer Name	Balance	Cumulative	Sampling Item
A001	Anfield United Shop	176	176	
B002	The Beautiful Game	84	260	(1) \$233
B003	Beckham's	42	302	
C001	Cheryl & Coleen Co	12	314	
D001	Dream Team	45	359	
E001	Escot Supermarket	235	594	(2) \$584
G001	Golf is Us	211	805	
G002	Green Green Grass	61	866	
H001	HHA Sports	59	925	
J001	Jilberts	21	946	(3) \$935
J002	James Smit Partnership	256	1,202	
J003	Jockeys	419	1,621	(4) \$1,286
O001	The Oval	92	1,713	(5) \$1,637
P001	Pole Vaulters	76	1,789	
S001	Stayrose Supermarket	97	1,886	
T001	Trainers and More	93	1,979	
W001	Wanderers	89	2,068	(6) \$1,988
W003	Walk Hike Run	4	2,072	
W004	Winners	31	2,103	

6.3. Sampling risk and evaluating misstatements in a sample

Sampling risk is the risk that the auditor's conclusion, based on a sample, may be different from the conclusion if the entire population were subjected to the same audit procedure.

The auditor must determine a sample size that will reduce sampling risk to an acceptably low level. If the auditor judges that sampling risk is high then they will need to select a larger sample. Therefore there is a direct relationship between sampling risk and sample size.

Other factors which affect sample size include:

- Risk of material misstatement - high inherent risk and control risk need large sample size
- Expected error -expected error is high, larger sample size
- Tolerable error -lower level of tolerable error, larger sample size

6.4. Evaluating misstatements in a sample

There are two types of misstatement need to be considered:

- **Anomaly errors** are errors only occur on specific occasions. As such, they are not representative of the population

- **True errors** are representative of the population; they should be included in the error projection.

Where sampling has been used to perform tests of details, the auditor should project the monetary errors found in the sample to the population as a whole and compare this to the level of tolerable misstatement.

Where an error is an anomaly, it may be excluded when projecting sample errors to the population (but it still needs to be considered overall in addition to the projection of the non-anomalous errors).

Tolerable Misstatement is a monetary amount set by the auditor to obtain an appropriate level of assurance and this amount should not exceed the actual misstatement in the population.

Example

A sample of \$50,000 has been tested out of a population of \$800,000.

Misstatements of \$2,000 were found. Tolerable misstatement has been set at \$10,000.

*If the misstatements are **anomaly errors**, auditor should not project misstatement to whole population. Actual misstatement is \$2,000, less than tolerable misstatement. **Risk of material misstatement in the whole population is low and no further testing will be required.***

*If the misstatements are **true errors**, auditor should project misstatement to whole population. Actual misstatement is \$32,000 ($\$2k \times \$800k / \$50k$), greater than tolerable misstatement. **Risk of material misstatement in the whole population is high and further audit testing will be required.***

Exam focus point

在历年考试中，考官经常在理论题和选择题考核审计抽样方法的定义，学生需要记忆这些抽样方法的特征。

考官的选择题经常考通过抽样来判断某个具体审计项目的错误金额，学生必须要区分这些错误师重复性错误 true error 还是一次性错误 anomaly error。重复性错误需要放大到整体，一次性错误不需要放大。预计总错误=放大后的重复性错误+一次性错误

7. Automated tools and techniques

Automated tools and techniques are applications of auditing procedures using the computer.

Automated tools and techniques involve using a computer to perform audit work. Computers can be used to perform either substantive procedures or tests of controls. There are two particularly common types: **audit software** and **test data**.

7.1. Audit software (use for SP)

Audit software: consists of computer programs used by the auditor, 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 tests of controls.

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 arithmetic calculations on data, facilitating audit sampling and producing documents and reports.

Custom audit software: is written by auditors for specific tasks when generalised audit software cannot be used.

Examples of the use of audit software in the audit

- 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 search for large and unusual items
- Reperform calculations eg recalculate the total in sales ledger and ensure mathematical accuracy.
- Prepare documents and reports eg produce receivables' confirmation letters and monthly statements

7.2. Test data (use for TOC)

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.

There are two typical uses of test data:

- (a) Test data used to test specific controls in computer programs

Auditor could try to access data of the computer system which are password protected in order to determine whether the control is operating effectively.

(b) Test transactions

Auditor processes a series of transactions and monitors the output from the computer systems in order to determine whether the transactions have been processed correctly.

Test data can be conducted 'live' (when the computer systems are operational) or 'dead' (when the computer system is not in business use).

8. Audit data analytics (ADA)

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

The use of data analytics software will initially **involve significant costs** on the part of the auditor and **extensive training**, however it could offer auditors the ability to **examine all of an entity's data and test entire populations**. This in turn should **improve both audit efficiency and audit quality**.

Examples of how auditors might use data analytics include:

- Analyse patterns relating to revenue or costs per product or per customer
- Trace the matching of orders to goods despatched goods received documentation and to the invoice, in order to determine whether revenue and costs should be recognised
- Interrogate journals to determine whether there are any patterns (regarding who has processed certain journals) where fraud is suspected

9. Using the work of others

External auditors may make use of the work of an **auditor's expert**, **internal auditors** and **service organisations** when carrying out audit procedures.



9.1. Using the work of expert

	Expert	
	Management expert	Auditor' expert
Who are they?	Expert engaged by management is used to assist in preparation of FS. E.g. property valuer	Experts engaged by auditor to assist in obtaining audit evidence. Expert in valuation of inventory
What should auditor do BEFORE rely on they work done by expert	<ul style="list-style-type: none"> ● Before trust them, the external auditor must assess the expert's competence, capability and objectivity before asking the expert to perform work. ● Competence and capability can be achieved by enquiring of the expert's qualifications, experience, membership of a professional body, published work. ● Objectivity can be assessed enquiring whether there are any business or personal relationships between the expert and the client. 	
After we trust the expert, we need to assess the works performed by them	<ul style="list-style-type: none"> ● Does expert's work and consistency with other audit evidence? ● The relevance and reasonableness of assumptions and methods used ● The relevance, completeness and accuracy of any source data used 	

If the auditor concludes that the expert's work is not adequate, further work need to be done by the expert and additional audit procedures may be required by auditor.

Auditor is solely responsible for the audit opinion. It would be inappropriate to refer to the reliance on the work of expert, internal auditors and service organisations in the audit report.

9.2. Relay on internal audit (ISA610)

An internal audit function forms part of the client's system of internal control.

Auditors may be able to co-operate with a client's internal audit department and place reliance on their procedures in place of performing their own.

External auditor may wish to rely on internal audit department to perform test of control, risk assessment and fraud investigation.

<p>Before placing reliance on the internal audit department, the following factors should be considered</p>	<ul style="list-style-type: none"> ● Objectivity of internal audit function. Consider the status of the internal audit function, to whom it reports, any constraints or restrictions. ● Technical competence of internal audit function. Consider whether internal auditors are members of relevant professional bodies, have adequate technical training and proficiency, possess the required knowledge of financial reporting. ● Whether the internal audit function applies a systematic and disciplined approach. Consider whether internal audit activities include a systematic approach to planning, supervising, reviewing and documenting assignments, whether the function has appropriate quality control procedures.
<p>After we trust the internal audit department, we need to assess the work perform by them.</p>	<ul style="list-style-type: none"> ● whether the work was done by internal auditors having adequate technical training and proficiency ● Whether the work was properly planned, performed, supervised, reviewed and documented. ● Whether adequate audit evidence was obtained to draw reasonable conclusion. ● Whether the conclusions reached are appropriate and consistent with the audit evidence.

Using internal auditor to provide direct assistance

Direct assistance, external auditor can require internal auditor to provide direct assistance to collect audit evidence. 3 conditions are required:

- Direct assistance is not prohibited by law.
- The internal auditors are objectivity.
- The internal auditors are competence.

ISA 610 (Revised) **prohibits** the use of internal auditors to provide direct assistance to perform procedures **in following areas:**

- Involve making significant judgements in the audit
- Relate to areas with high risks of material misstatement
- Relate to work with which the internal auditors have been involved (self-review issue)

9.3. Using the work of service organizations (ISA 402)

A service organisation is a third-party organisation that provides services to audit client that are part of those entities' information systems relevant to financial reporting.

As the data provided by service organisations would be included in financial statement, auditor need to obtain an understanding of the service organisation sufficient to identify and assess the risks of material misstatement.

Auditor can obtain an understanding of the service organisation through following procedures:

1. Obtaining a report from a service organisation's auditor, if available.
2. Contacting the service organisation through the user entity and Visiting the service organisation and performing necessary procedures.
3. Using another auditor to perform necessary procedures

Exam focus point

在历年考试中，考官的理论题经常考依赖审计专家和公司内审部门收集证据需要做的步骤，学生需要记住要依赖第三方收集证据要做两个评估，1 是第三方的能力和独立性；2 是第三方的收集证据的方法是否达到审计师的要求。

以下内容可以帮助你进行本章复习及自测

1. 重点词汇

Audit evidence

Sufficient

Appropriate

Relevance

Reliability

Occurrence

Completeness

Accuracy

Cut-off

Classification

Presentation

Existence

Rights and obligations

Valuation

Substantive procedures

Test of detail

Analytical procedures

Enquiry

Inspection

Observation

Recalculation

Reperformance

Confirmation

Audit sampling

Population

Statistical sampling

Random selection

Systematic sampling

Monetary unit sampling

Non-statistical sampling

Haphazard selection

Block selection

Sampling risk

Anomaly errors

True errors

Tolerable Misstatement

Audit software
Generalised audit software
Custom audit software
Test data
Test transactions
Data analytics
Management expert
Auditor' expert

2. 必做习题
PY S17Q17a

Chapter 9 Audit procedure for specific items

在审计师评估企业的风险以及内控缺失后，审计师需要结合上一章的审计手法去收集具体的审计证据。通过本章学习，我们要了解审计师是如何对资产负债表和利润表项目进行审计证据的收集。

Learning outcomes

Explain the audit objectives and the audit procedures to obtain sufficient, appropriate evidence in relation

- direct confirmation of accounts receivable
- other evidence in relation to receivables and prepayments
- completeness and occurrence of revenue
- inventory counting procedures in relation to year-end and continuous inventory systems
- inventory cut-off testing, valuation
- auditor's attendance at inventory counting
- supplier statement reconciliations and direct confirmation of accounts payable
- purchases and other expenses, including payroll
- bank confirmation reports used in obtaining evidence in relation to bank and cash
- evidence in relation to Tangible and intangible non-current assets depreciation and profit/loss on disposal
- evidence in relation to non-current liabilities and provisions and contingencies
- evidence in relation to share capital, reserves and directors' emoluments



In this chapter, you will learn how to apply audit procedure in specific scenario.

Audit procedures must be designed to respond to the specific risks of material misstatement identified for each individual client. In the exam, you should make your answers specific to the scenario. It is highly likely the scenario focuses on a specific risk such as valuation of inventory, recoverability of receivables, etc.

1. Non-current assets

	Note	2015 \$	2014 \$
ASSETS			
Non-current assets			
Property, plant and equipment	3	3,197,186	3,018,086

3. Property, plant and equipment

2015	Freehold property \$	Furniture & fittings \$	Machinery & equipment \$	Motor vehicles \$	Office equipment \$	Total \$
Cost / Valuation						
At beginning of the year	3,000,000	46,790	5,645	247,224	31,762	3,331,421
Additions	-	-	-	355,777	-	355,777
Disposal	-	-	-	(83,365)	-	(83,365)
At 31 December 2015	<u>3,000,000</u>	<u>46,790</u>	<u>5,645</u>	<u>519,636</u>	<u>31,762</u>	<u>3,603,833</u>
Accumulated depreciation and impairment losses						
At beginning of the year	-	46,790	4,597	233,329	28,619	313,335
Depreciation for the year	100,000	-	1,048	59,297	2,438	162,783
Disposal	-	-	-	(69,471)	-	(69,471)
At 31 December 2015	<u>100,000</u>	<u>46,790</u>	<u>5,645</u>	<u>223,155</u>	<u>31,057</u>	<u>406,647</u>
Carrying amount						
At 31 December 2015	<u>2,900,000</u>	<u>-</u>	<u>-</u>	<u>296,481</u>	<u>705</u>	<u>3,197,186</u>

3. Property, plant and equipment (cont'd)

Freehold property with a carrying amount of \$2,900,000 (2014: \$3,000,000) is pledged to a bank to secure the Company's bank loan.

Freehold property of the Company was revalued on 31 December 2014 by ECG Consultancy Pte Ltd, a firm of independent professional valuers that has appropriate recognised professional qualifications and recent experience in the location and category of the properties being valued. The valuation is determined based on the property's highest and best use basis, using the Direct Sale Comparison Approach. Sales prices of comparable properties in close proximity are adjusted for differences in key attributes such as floor area/level, orientation, design, standard of finishes, date of sale, condition and prevailing market condition. The revaluation surplus amounting to \$2,076,124 have been transferred to the revaluation reserves of the Company.

The carrying amount of freehold property of the Company would have been \$671,381 (2014: \$693,359) had the freehold property been carried at cost less accumulated depreciation and impairment losses.

For the year ended 31 December 2015, the Company's freehold property has been valued at director's valuation based on the highest and best use basis.

Disclosure notes

For audit of fixed assets, we need to focus on following situations: ①addition and disposal of PPE, ②revaluation of PPE and ③depreciation of PPE

The financial statement assertions relating to non-current assets are 'RECCVP' - **Rights and obligations, Existence, Completeness, Classification, valuation and presentation.**

Situation 1 addition and disposal of PPE

In this situation, auditor need to focus on the completeness, rights and obligation, existence, valuation assertion of PPE.

1.1. Completeness

Here, auditor needs to focus on following:

- Newly purchased assets should be included in register and accounts.
- Disposed assets should be removed from register and accounts.
- Amount in FS and register represents all fixed assets used by the entity.

For disposal/addition, audit client would prepare a breakdown (listing) which contains details of fixed assets purchased/disposed during the year. Auditor can compare the breakdown and fixed asset register to identify any assets omitted.

Substantive procedures

Obtain the breakdown of disposal and agree to non-current assets register to confirm they are removed from non-current asset register properly.

Obtain the breakdown of addition and agree to non-current assets register to confirm they are included non-current asset register properly.

Exam focus

This is an audit procedure and it includes three parts: **action**, **what** and **why**.

Exam focus point

在历年考试中，考官的必考 substantive procedures (SP)。学生一定要记住一个完整的 SP 包含一个动词+目标+SP 的目的，简单来说就是审计师做了什么，为什么这样做。SP 的历年考题通常师小情景应用题，每个题 3-6 分，总分达到 25 分，学生一定要记牢 SP 使用的情景和审计项目。

In order to confirm no PPE is omitted in fixed register, auditor can perform test from assets to book (fixed asset register) to:

Substantive procedures

Select a sample fixed assets used by the entity and trace back to non-current asset register to confirm they are all included in fixed assets register.

If all expenses in repair and maintenance account are not capital in nature, this means no fixed asset wrongly recognised as expense.

Substantive procedures

Review the repairs and maintenance expenses account in the income statement for items of a capital nature to confirm no non-current asset wrongly recognized as expenses.

1.2. Rights and obligations

We need to consider what kinds of document can indicate the ownership.

Purchase invoices	All PPE
Title deed	Land, building, warehouse
Registration document	Motor vehicle

Therefore, auditor could inspect these documents to verify the ownership.

Substantive procedures

Inspect a sample of purchase invoices of motor vehicles to ensure they are in the name of client.

Inspect title deed of newly purchased warehouse to ensure they are in the name of client.

1.3. Existence

In order to verify the existence of fixed assets, auditor needs to know the detail information of fixed assets first. All fixed assets detail would record in **fixed assets register**. Then, auditor can physical verify in the entity's premise (test from book to asset)

Substantive procedures

Select a sample of assets in the non-current asset register and physically inspect these assets in the client's premise to confirm existence.

1.4. Valuation

Auditor need to confirm whether the cost of PPE stated correctly.

Substantive procedures

Vouch the cost of non-current asset additions in the supplier's invoice to confirm the valuation.

1.5. Classification / Presentation

Here, auditor need to confirm the disclosures relating to cost, additions and disposals, depreciation policies, useful lives are adequate and in accordance with accounting standards (IAS 16). Auditor usually will review relevant disclosure in draft financial statement.

Substantive procedures

Review the disclosure of additions/disposals in the financial statements to ensure that they are in line with IAS 16.

Situation 2 revaluation of PPE

1.6. Revaluation of fixed asset

When the entity revalue its land and property, following areas will be affected:

- ① Cost of asset needs to be adjusted to revalued amount (provided by valuer)
- ② There will be a revaluation surplus and this amount needs to be calculated correctly.
- ③ Depreciation for revalued asset will be based on the revalued amount.
- ④ Revaluation needs to be disclosed in FS properly.

Substantive procedures

- ① Agree the revalued amount to valuation report provided by valuer to confirm valuation of the asset stated correctly.
- ① Consider the valuer's experience, independence, scope of work and assumptions used to assess the reasonableness of the valuation.
- ② Recalculate the revaluation surplus to confirm the arithmetical accuracy of the revaluation adjustment
- ③ Recalculate the depreciation charged for revalued asset to ensure the depreciation calculated based on revalued amount.
- ④ Review the financial statements for the disclosures of revaluation to ensure they comply with IAS 16

Situation 3 depreciation of PPE

Auditor should focus on the **reasonableness and accuracy of depreciation**.

Audit procedure for **reasonableness of depreciation**:

- Compare the depreciation policy used by the company to industry practices / the entity's replacement policy to assess the reasonableness of depreciation policy.
- Review profits or losses on non-current asset disposed during the year to assess the reasonableness of the depreciation policies. (if depreciation policies are reasonable, there should not be a significant profit or loss)

Audit procedure for **accuracy of depreciation**:

- Recalculate the depreciation charge for a sample of non-current assets to confirm

arithmetical accuracy of depreciation.

- Perform a proof in total calculation for the depreciation charged for each category of assets, discuss with management if significant fluctuations arise. (If machinery with cost of \$8m and depreciate in 4 years with no scarp value. Depn should be \$2m (assume no additions/disposal). If actual Depn is \$3m, this may indicate Depn calculation incorrect)

2. Intangible non-current assets

Substantive procedures for intangible non-current assets are the same as for non-current assets except for the existence test (because you cannot inspect IA physically).

However, auditors need to perform special audit procedure for development expenses (IAS38) due to its special characteristic:

- ① **Probable future economic benefit**
- ② **Intention to complete the IA**
- ③ **Resources to complete the IA**
- ④ **Ability to sell the IA**
- ⑤ **Technical feasibility of completing IA**
- ⑥ **Expenditure for IA can be measured reliably**

Special Substantive procedures (special for development expenses)

SP 的目的	SP
Ability to sell the IA	Review the market research report, budget or forecast to assess the probability of future economic benefits and ability to sell or use the asset
Technical feasibility of completing IA	Discuss with the company's engineers, technical staffs and management to assess technical feasibility of completing the asset
Resources to complete the IA	Review the cash flow forecast to ensure the company has adequate resource to complete the assets
Intention to complete the IA	Obtain written representation from management to confirm the company intends to complete and use the asset.
Expenditure for IA can be measured reliably	For those expensed as research, agree the costs incurred to invoices and supporting documentation and to inclusion in profit or loss. For those capitalised as development, agree costs incurred to invoices

Other procedure relate to completeness and amortisation

- Obtain and cast a schedule of intangible assets, agree the closing balances to the general ledger, trial balance and draft financial statements.
- Discuss with the management the rationale for the XX-year useful life and consider its reasonableness

- Recalculate the amortisation charge for a sample of intangible assets which have commenced production and confirm that it is in line with the amortisation policy of straight line over XX years and that amortisation only commenced from the point of production.

Practice of prior year exam question

In the exam, there are two types of audit procedure questions you will face:

1. Describe TWO substantive procedures the external auditor should adopt to verify EACH of the following assertions in relation to an entity's property, plant and equipment;
 - 1) Valuation;
 - 2) Completeness; and
 - 3) Rights and obligations(6marks)

This type question examiner will require you to provide audit procedure for specific assertion. You can provide any audit procedure relate to the assertion. This type question normally is 2 - 5 marks from Sep 16.

Example for rights and obligations

Inspect a sample of purchase invoices of motor vehicles to ensure they are in the name of client.

Inspect title deed of land and building to ensure they are in the name of client.

2. Kyanite Pizzas Co (Kyanite) operates a large chain of fast food restaurants. You are an audit supervisor of Jasper & Co and are currently preparing the audit programmes for the audit of Kyanite's financial statements for the year ended 31 March 2016. You are reviewing the notes of last week's meeting between the audit manager and finance director.

(i) Property, plant and equipment

In the past Kyanite has received negative press reports over the condition of its fast food restaurants, with comments suggesting they are old fashioned and tired looking. Therefore during the year the company undertook a full review of all its assets and carried out extensive refurbishments to the majority of its restaurants. This review resulted in a significant amount of ageing fixtures and fittings being disposed of and a significant amount of capital expenditure was invested in all remaining restaurants. (6 marks)

Describe substantive procedures you should perform to obtain sufficient and

appropriate audit evidence in relation to the above matter

This is a scenario base question and you will need to read the whole scenario to understand which assertion you need to perform audit procedure. This type question normally is 15-18 marks from Sep 16.

After reading this scenario, you should know that Kyanite disposed and purchased a significant amount of fixed assets during the year. Therefore, you should perform substantive procedure relate to additions and disposal.

What assertions are related?

Completeness – (1) did all additions are included in fixed asset register and (2) all disposals are removed?

- (3) Confirm additions of assets were not wrongly recognised in expense account

Valuation – (4) Did the cost of additions state correctly?

- (5) Did the gain or loss on disposal calculate correctly?

Rights – (6) Did the additions of fixed assets were own by the entity?

Presentation – (7) disclosure of additions and disposals correctly?

The approach to this type question are ① read the scenario to identify assertion related ② ask your-self what kinds of problem would occur ③ Then provide an audit procedure to solve the problem you come out.

This question is 6 marks which you need to provide 6 audit procedures for additions and disposal (composition should be 3:3 or 4:2)

Solution

Practice

Vieri Motor Cars Co (Vieri) manufactures a range of motor cars and its year end is 30 June 20X5. You are the audit supervisor of Rossi & Co and are currently preparing the audit programmes for the year-end audit of Vieri. You have had a meeting with your audit manager and he has notified you of the following issues identified during the audit risk assessment process:

Land and buildings

Vieri has a policy of revaluing land and buildings, this is undertaken on a rolling basis over a five-year period. During the year Vieri requested an external independent valuer to revalue a number of properties, including a warehouse purchased in January 20X5. Depreciation is charged on a pro rata basis.

Describe the substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to the revaluation of land and buildings and the recently purchased warehouse (6 marks)

For revaluation (confirm ① no posing error ② depreciation base revalue amount ③ revaluation reserve calculation is correct ④proper disclosure)

For newly purchased warehouse (confirm ①cost state correctly ②ownership ③depreciation follow company policy (only depreciate 6 months))

3. Inventory

In the exam, audit procedures for inventory focus on two main timings: **stock count stage** and **final audit stage**.

Management - Responsible to ensure the inventory in FS exists and is owned by the company and organize a physical inventory count to determine the valuation of inventory.

Auditor - Responsible to attend the physical inventory count to obtain audit evidence on inventory.

3.1. When to attend stock count?

At the year-end - this is the best method as it does not require any adjustments to be made to counted balance

Before/after the year-end - If stock count performed before or after year-end.

Stock quantity at YE = quantity at stock count date + stock movement between count date and year-end.

The reliability of the stock quantity at year-end will be affected by following factors:

- The length of time between the physical inventory count and the year-end.
- Audit client internal control system.
- The quality of the inventory movement record.

3.2. Perpetual inventory and audit procedure

Perpetual inventory is management has a programme of inventory counting throughout the year. Therefore, there is no need to perform a year-end inventory count.

Example for perpetual inventory

	1.1.2016	Stock movement	30.6.2015 Stock count	Adjustment	Stock movement	30.11.2016 Stock count	Stock movement	31.12.2016 (year-end)
Material A	1,000	3,000	4,100	100	-2,000	2,100	1,050	3,150
Material B	1,500	3,000	4,500	0	-1,000	3,500	1,000	4,500

If client did not perform year end stock count, generate year end inventory though perpetual inventory system. Auditor need to perform following procedures to assess the reliability of inventory system:

- Attend at least one of the continuous inventory counts to ensure the controls over the inventory count are adequate.
- Review the adjustments made to the inventory records on a monthly basis to gain an understanding of the level of differences.
- If significant differences consistently arise, discuss with management any procedure they will implement to ensure the year-end inventory will not be misstated.

3.3. Stock count stage – before the count

Auditors should ensure the inventory count is appropriate and client's count instructions have been reviewed. Auditor should perform following procedures:

- Obtain a copy of the inventory count instructions to understand how the count will be conducted and assess the effectiveness of the count process.
- Inspect prior year working papers to understand the inventory count process and identify any issues that would need to be taken into account this year.
- Discuss with management to ascertain whether any inventory is held by third parties and determine how to gather sufficient appropriate evidence
- Discuss the valuation method of inventory with management to consider the need for using an expert to assist in valuing the inventory being counted

3.4. Stock count stage – during the count

Auditors need to perform to **test of control** and **substantive procedure** .

Test of control (ensure count instruction are being followed)

- Observe the inventory counts performed by count team to confirm inventory count instructions are being followed correctly.
- Observe the inventory count to ensure the procedures for identifying damaged, obsolete and slow-moving inventory operate properly.
- Observe the inventory count to ensure no movements of inventory during the count.

Substantive procedure (confirm **completeness, existence and rights**)

- Select a sample of items from the inventory count sheets and physically inspect the items in the warehouse to confirm existence.

- Select a sample of items from the warehouse and trace to the inventory count sheets to ensure that they are recorded accurately.
- Enquire of management whether goods held on behalf of third parties are segregated and recorded separately to ensure inventory is not overstated.
- Identify and make a note of the last goods received notes and goods delivery notes at year-end date in order to perform cut-off procedures in final audit.
- Obtain copies of inventory count sheets at the end of the inventory count for follow up testing on the final audit.

3.5. Stocks held by a third party

If auditors find out some of client's stocks were **held by a third party (stocks owned by client but they are not stored at client's warehouse)**, auditor should perform following **audit procedure**:

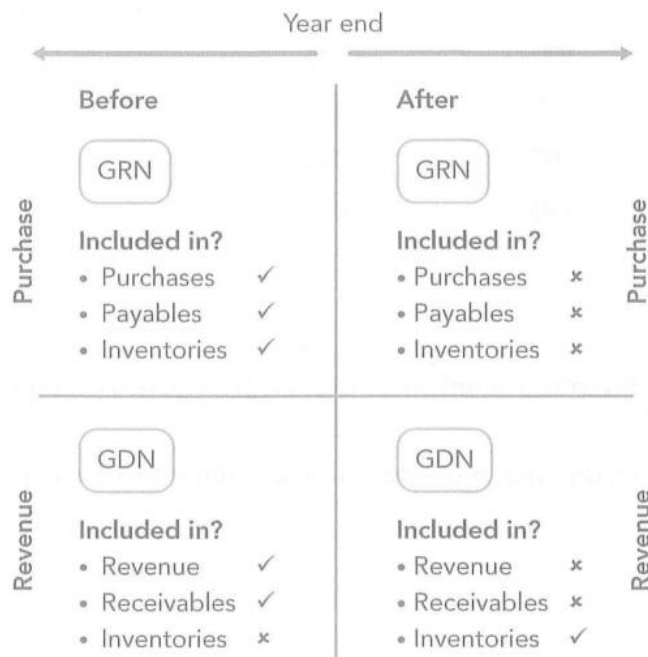
- Perform a direct confirmation of inventory balances held by the third party at year-end to confirm quantities and condition of inventory held by them.
- Obtain any reports produced by the auditors of the third party in relation to the adequacy of controls over inventory to assess the reliability of information confirmed by the third party. (if third party reply our confirmation)
- Attend the inventory count at the third party warehouses to review the controls in operation to ensure the completeness and existence of inventory. (if third party did not reply or auditor conclude that the info provide by third party is not reliable)

3.6. Stocks Cut-off

When goods received by company should be recognised as inventory. When goods delivered to customers should not recognised as inventory but treated as cost of good sold. The KEY documents for cut off are goods delivery note (goods deliver to customer) and goods receive note (goods received by company)

Audit procedure

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.



3.7. Final audit stage (after stock count)

The auditors should check that final inventory sheets (value would be showed in the FS) have been properly compiled from count records and that book inventory has been appropriately adjusted. Following substantive audit procedures would be performed by auditors:

- Trace the items counted during the inventory count to the final inventory list to ensure it is the same as the one used at the year-end and to ensure that any errors identified during counting procedures have been rectified. (completeness)
- Cast the list (*if inventory categorised between finished goods, WIP and raw materials*) to ensure arithmetical accuracy and agree totals to financial statement. (completeness)
- Inspect purchase invoices for a sample of inventory items and agree their cost to confirm valuation.
- Inspect purchase invoices for the name of the client to confirm the ownership of inventory.

3.8. Important area – valuation of inventory

IAS 2 Inventories requires inventory to be stated at the lower of cost and net realisable value.

Cost of inventory comprise all costs of purchase and other costs incurred in bringing inventory to its present location and condition.

There are three categories of inventory: **raw material, work-in-progress and finished goods.**

3.8.1. Valuation of raw material purchased goods = Quantity X Unit cost

Quantity was confirmed through stock count .

Unit cost is the cost of material purchased from supplier.

Substantive procedure

agree the cost of a sample of goods in the records to recent purchase invoices to confirm cost is correctly stated.

3.8.2. Valuation of finished goods = Quantity X Unit Cost

Unit Cost includes cost of material and labour cost.

Substantive procedure for inventory labour cost

inspect the labour cost of a sample of goods in the records to time sheet to confirm cost is correctly stated'.

3.8.3. Valuation of finished goods using standard cost.

Some company would value its finished goods based on standard cost (set by management). Auditor need to perform following audit procedures to assess the reasonableness of standard cost:

- Discuss with management regarding the basis of the standard costs applied to the inventory valuation, and how often these are reviewed and updated to assess the reasonableness of the client's inventory valuation.
- Obtain a breakdown of the standard costs and agree a sample of these costs to purchase invoices or payroll records to assess their reasonableness
- Review the level of variances between standard and actual costs and discuss with management how these are treated to assess the reasonableness of the client's inventory valuation.

3.8.4. Valuation of work-in-progress = Quantity X percentage of completion X Unit Cost

Work-in-progress (WIP) means inventory not yet completed. Management needs to estimate the percentage of completion in order to calculate the value of WIP. Auditor need to perform following audit procedures to assess the reasonableness of percentage of completion:

- Discuss with management how the percentage completions are attributed to the WIP to obtain an understanding and assess the reasonableness of the valuation policy
- Observe the procedures carried out by management in assessing the level of WIP to evaluate the reasonableness of the assumptions used.
- Review sample of percentage of completions assessed during the count to

evaluate whether the valuation policy is complied correctly.

3.8.5. Damaged/obsoleted inventory

According to IAS2, inventory should be valued at lower of net realizable value (NRV) or cost. If client has some inventories were damaged or obsoleted, auditor should perform audit procedures to confirm following:

- ① **Cost of damaged inventory**
- ② **NRV of damaged inventory**
- ③ **accuracy of inventory written down**
- ④ **disclosure of inventory written down**

Substantive procedure

- ① Agree the cost of XXX to supporting documentation confirm the raw material costs and labour costs are correctly stated
- ② Discuss with management to understand why they believe XXX have a net realisable value of \$\$
- ② If any XXX has been sold post year end, review sales invoices issued after the year-end to confirm the NRV
- ③ Calculate the level of adjustment \$\$ (cost – NRV) for XXX and discuss with management if this adjustment has been made to ensure inventory is valued appropriately
- ④ Review the financial statement for the disclosure relating to inventory to ensure it comply with IAS2 inventories

Exam focus point

在历年考试中, 存货的 SP 考题主要是考核存货跌价的情景和存货盘点前、中、后 3 个情景中的其中一个。

Past year exam question S16Q17a

Your firm attended the year-end inventory count for Elounda Co and ascertained that the process for recording work in progress (WIP) and finished goods was acceptable. Both WIP and finished goods are material to the financial statements and the quantity and stage of completion of all ongoing production was recorded accurately during the count.

During the inventory count, the count supervisor noted that a consignment of finished goods, compound E243, with a value of \$720,000, was defective in that the chemical mix was incorrect. The finance director believes that compound E243 can still be sold at a discounted sum of \$400,000. (6 marks)

Analysis

Due to the defective finished goods, inventory should be written down to NRV \$400,000. Auditor need to perform audit procedure to confirm following ① How NRV \$400k generate? ② cost of \$720k is correct? ③ reasonableness of NRV ④ whether adjustment for E243 had been made? ⑤ disclosure made correctly?

Solutions

Past year exam question

Andromeda's raw materials and finished goods inventory are stored in 12 warehouses across the country. Each of these warehouses is expected to contain material levels of inventory at the year end. It is expected that there will be no significant work in progress held at any of the sites. Each count will be supervised by a member of Andromeda's internal audit department and the counts will all take place on 31 December, when all movements of goods in and out of the warehouses will cease.

Describe audit procedures you would perform during the audit of Andromeda Industries Co:

(i) BEFORE and DURING the inventory counts; and (8 marks)

Analysis

Although this question provides you some background information, you do not need to apply the info in the background in your answer; this is a question you need to memorise procedure for before the count and during the count.

Detail answer refers to test above.

Receivable and Revenue

Relationship between revenue and receivables

Customer	Sales for the year (\$)	Payment received (\$)	YE balance (\$)
A	500,000	500,000	nil
B	750,000	725,000	25,000
C	200,000	90,000	110,000
D	550,000	555,000	-5,000
Total	2,000,000	1,870,000	130,000

Revenue amount shows in income statement

Receivable balance shows in balance sheet

4. Audit procedures for revenue

As revenues are classified under class of transactions, auditors need to ascertain **completeness, occurrence, cut-off, accuracy** these 4 main assertions.

4.1. Completeness

Auditor need to confirm whether revenue for the year are completely recorded (no under/overstatement). Two types of substantive procedures could be applied: **analytical procedure and test of detail**.

- **Analytical procedure** – auditor could **compare** current year result with prior year or budgeted figure to find out any significant variance, if management cannot explain the variance with valid reason, this may indicate revenue were misstated.
- **Test of detail**. Revenue in income statement was the total of individual sales made during the year. Auditor can trace **source document (invoice, GDN)** to **ledger** to identity any sales invoices were omitted by the client.

Substantive procedure - Analytical procedure

Compare the **current year revenue** on a month-by-month basis **to the prior year** and **investigate any significant differences** to assess the completeness of revenue. Calculate the gross profit margin and compare this to the prior year and investigate any significant fluctuations to assess the completeness of revenue.

Substantive procedure - test of detail

Trace sample of sales invoices and GDN raised during the year to the sales ledger to confirm they are all included.

Agree the total sales amount in sales ledger to trial balance and financial statement to ensure all balances are the same.

4.2. Occurrence

Auditors need to confirm the sale transactions recorded in sales ledger have occurred.

Audit procedure

Auditor should trace a sample of sales transactions in ledger to back to sales order and good delivery note to ensure occurrence of these sales transactions.

4.3. Cut-off

Auditors need to confirm the sale transactions recorded in current year sales accounts occurred in current year. (usually the YE transaction could be misplaced - such as next year sales recorded in current year's account) .

Audit procedure

- Trace a sample of pre and post year-end GDNs through to sales invoices and sales ledger to ensure they are recorded in the correct accounting period.
- Review the post year-end sales return to ensure sales return related to pre year-end sales has been correctly removed from sales.
- Calculate and compare the sales return to sales for current year and prior to identify any significant variance and investigate them

4.4. Accuracy

First, auditors need to confirm no calculation errors in the source documents (such as sales invoice).

Audit procedure

Recalculate a sample of sales invoices for larger customers to confirm the arithmetical accuracy.

Recalculate a sample of sales invoices with discount granted to confirm the discount has been properly applied.

Further, auditor needs to confirm data transfer from sales invoice to sales ledger correctly.

Audit procedure

Select a sample of sales invoices and agree the amount stated in the invoices to the amount stated in sales ledger to confirm the amounts are correctly stated

Exam focus point

在历年考试中，收入的考核的 SP 情景是收入的完整性和 cut off

5. Audit procedures for receivables

5.1. Confirmation (Receivables Circularisation)

One of the major procedures performed by the auditor in auditing receivables will be external confirmations (circularization). This involves directly contact with customers regarding the amount they owe to the audit client.

Confirmation of receivables (*if customers reply the confirmation*) provides audit evidence to satisfy the objective of testing whether customers exist and owe bona fide amounts to the company (**existence** and **rights and obligations** assertion).

5.2. Types of circularisation Requests

There are 2 types of circularisation requests:

- **Positive confirmation request** - The confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request. *The positive method is generally preferable.*
- **Negative confirmation request** - The confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. *The negative method is generally used in following situation:*
 - Risk of material misstatement is low.
 - Client has strong internal control.
 - Large number of small, homogeneous account balances.
 - Very low exception rate.

Example of Circularisation Requests

MANUFACTURING CO LIMITED ← Name of audit client
15 South Street
London

Messrs C Co ← Name of customer

In accordance with the request of our auditors, BDO LLP, we ask that you kindly confirm to them directly your indebtedness to us at 31 December 2015 which, according to our records, amounted to \$110,000 as shown by the enclosed statement. ← Client' YE

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,

Director of audit client

Xyz Director
Date:
For Manufacturing Co Limited

.....
(Tear-off slip)

The amount shown above is/is not* in agreement with our records as at _____.

Account No Signature

Date Title or position

Notes

- A copy of the customer statement is attached.
- The reply is sent **directly to the auditor** in a prepaid envelope.

5.3. What if the client does not allow the auditor to perform the circularisation?

Auditors should inquiry management whether there are valid reasons to deny permission:

- **Valid reasons** (customer is overseas or customer is government body) - Auditor should perform alternative procedure.
- **Invalid reasons** - Auditor needs to consider a limitation on the scope of the audit (inability to obtain audit evidence) and the audit opinion will be modified accordingly (this will cover in later chapter).

5.4. Steps for preparing direct confirmation of receivables

1. Obtain a list of receivables balances, cast and agree the balance to the total in receivables control account at the end of the year to ensure accuracy.
2. Select the balances to be tested, with specific consideration to the **material balances** (more than 10% of total receivable), **negative balances** (may indicate error) and **old unpaid balance** (may indicate amount cannot be recovered).
3. Extract details of each receivable selected from the ledger and prepare circularisation letters.
4. Ask the chief accountant/CFO/financial controller of the audit client to sign the letters.
5. The auditor posts, faxes or emails the letters to the individual customer.

5.5. Auditor's responses with different situations

After auditor sent out circularisation letters, 3 situations would come to the world:

Situations	Auditors' responses
Customers agree with the balances	Auditor can confirm existence and rights of the balance, no further work done (<i>auditor still need to test the valuation and presentation, this will be discussed later</i>).
Customers disagree with the balances	<p>There are normally 4 reasons for disagreement of balance:</p> <ul style="list-style-type: none"> ● There is a dispute between the client and the customer. <i>Auditor should discuss the disputed balance with management to assess whether a write down is necessary.</i> ● Goods returned by the customer are not recorded. <i>Auditor should review a sample of post year-end credit notes that relate to pre-year-end transactions to ensure they have not been included in receivables.</i> ● Differences due to cash-in-transit (customer transfer money to client bank account before YE, cash received after

	<p>YE). Auditor should agree differences due to cash-in-transit to post year-end cash receipts in the cash book to verify the existence the amount.</p> <ul style="list-style-type: none"> ● Errors in clients' ledger. Auditor should review the receivables ledger carefully to identify any possible errors in the records.
<p>Customers did not reply circularisation letters</p>	<p>The audit team should arrange to send a follow up circularisation with the client's permission.</p> <p>If customer still did not reply circularisation letters, auditors need to perform alternative procedure:</p> <ul style="list-style-type: none"> ● Calculate average receivable days and compare this to prior year, and investigate any significant variance to assess the reasonableness of receivables. (completeness) ● Obtain receivable listing and agree to trail balance, aged receivable listing and amount statement in financial statement to ensure all balances are correct. (completeness) ● Trace a sample of goods delivery notes issue during the year end to the sale invoices and inspect sales ledger and receivable account to ensure they are recorded in the correct accounting period.(completeness) ● Agree a sample of year-end receivable balances back to GDN and sales order to confirm existence of receivable balances (existence +rights). ● Review post year-end cash receipts for a sample of receivables at year end to confirm existence of receivable balances (existence+rights). ● Trace a sample of GDN before and just after the year end to the sales ledger to ensure they are recorded in the correct accounting period to confirm proper cut-off procedure. ● Review the aged receivable ledger to identify any slow moving balances and discuss these balances with the management to assess whether allowance for receivable is required (slow moving may indicate amount cannot be recovered).

Other substantive audit procedure for receivables

As above, receivables circularization could verify existence and rights and obligation of receivables. Auditors need to perform further substantive procedure to verify **valuation and presentation** of receivables.

5.6. Valuation

Trade receivables

Trade receivables are non-interest bearing and are generally on 30 to 60 days' terms. They are recognised at their original invoice amounts which represent their fair values on initial recognition.

	2011 \$	2010 \$
Trade receivables due from related parties	120,000	140,000
Less: Provision for doubtful receivables	(1,500)	(5,000)
	<u>111,500</u>	<u>135,000</u>

Above is a sample of receivable disclosure in the FSs. The amounts \$111,500 and \$135,000 show in FSs as receivables value at FY2011 and FY2010. Therefore, auditors need to verify the **original value of receivables** and the **sufficiency of allowance of receivables** (major issue for receivable).

Substantive procedure (original value)

- Agree some individual receivables balances back to sales invoices to ensure the amount stated correctly.

Substantive procedure (sufficiency of allowance)

- Review cash book for any post-year end cash receipt for slow moving / old balance receivable to assess whether an allowance or write down is necessary.
- Review the aged receivables listing to identify any slow moving or old receivables balances, discuss the status of these balances with the management to assess whether they are likely to pay.
- Review customers correspondence to identify any balance which are in dispute or unlikely to paid.
- Review board minutes to identify whether there are any material disputed receivables discuss these with management to assess whether an allowance or write down is necessary.
- Recalculate the allowance for receivables and compare to the potentially irrecoverable balances to assess if the allowance is adequate.

5.7. Presentation

- Inspect the detail in receivable schedule for any credit balances and discuss with management whether these should be reclassified as payables and ensure disclosure of receivable are comply with relevant accounting standard (*credit balance in AR may due to error or overpayment, overpayment should be treat as payables*)

6. Audit procedures for other receivables (prepayment)

Audit procedure for prepayment

- Compare the level of prepayments to the previous year to ensure the figure is reasonable and complete ·
- Obtain the prepayment listing and recalculate the amount prepaid to ensure arithmetic accuracy
- Review the cash book/bank statement/invoice to confirm existence of prepayment

Exam focus point

在历年考试中，receivable 是 SP 的考核重点，考官经常考核 confirmation 准备的 procedure，不使用 confirmation 的还有哪些 SP 可以使用，还有最热门的 receivable allowance 的情景，学生需要熟悉这几个情景的 SP

Practice of prior year question Dec16

You are an audit manager of Snail & Co and you are in charge of two audits which are due to commence shortly. Insects4U Co is a registered charity which promotes insect conservation and has been an audit client for several years. Spider Spirals Co, also an existing audit client, manufactures stationery products and its draft total liabilities are \$8.1m. Both clients' financial year ended on 31 October 20X6. The following matters have been brought to your attention for each company.

Insects4U Co

Completeness of income

Insects4U Co is a not-for-profit organisation which generates income in a number of ways. It receives monthly donations from its many subscribers and these are paid by bank transfer to the charity. In addition, a large number of donations are sent through the post to the charity. Insects4U Co also sells tickets for their three charity events held annually. During the audit planning, completeness of income was flagged as a key risk. (4marks)

Spider Spirals Co

Trade receivables

Spider Spirals Co has a large number of small customers; the normal credit terms offered to them is 30 days. However, the finance director has informed you that the average trade receivables days have increased quite significantly this year from 34 days to 55 days. This is partly due to difficult trading conditions and also because for six months of the year the role of credit controller was vacant. The company has historically maintained on average an allowance for trade receivables of 1.5% of gross trade receivables. (5marks)

Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to the matter identified.

Analysis

Revenue

What is the issue here? This charity collects donation in 3 ways: bank transfer, post and ticket sales. Auditor is afraid the money already received but accountant forget to book in cash book.

For completeness assertion, auditors normally use analytical procedure (compare...) and trace supporting documents to record to confirm completeness

AR

What is the issue here?

The company's credit term is 30days and AR days increase from 34 days to 55days. This means company needs more time to recover the amount owed by customer which means some amount may not recovered. Because the company already made an allowance for receivable, we need to assess the **sufficiency of receivable**.

Solution

Substantive procedures for Insects4U Co income

Substantive procedures for Spider Spirals Co trade receivables

Bank and cash

The financial statement assertions relating to bank are **completeness, existence, rights and obligation, valuation and presentation.**

7. Audit procedure for bank

The most important documents in auditing bank account are **bank confirmation** (letter from client's banker confirming assets, liabilities held by client) and **bank reconciliation** (document reconcile variance between bank balance and cash book balance).

7.1. How to get bank confirmation?

1. Obtain letters of authority from a director of audit client for the bank to disclose information to the auditor.
2. Prepare a standard bank request letter in the format agreed with banks. *Request letter can require bank to disclose following items:*
 - Balances due to or from the client entity on **current, deposit and loan accounts**
 - **Contingent liabilities**, such as guarantees
 - **Securities** hold by bank on behalf of audit client
3. The auditor must refer to the client's letter of authority and the date thereof in the bank request letter.
4. The auditor sends the request letter directly to bank with a request to send the reply directly back to the auditor.
5. The request letter should reach the bank branch manager before the client's year-end
6. The auditors should themselves check that the bank response covers all the information

When the bank confirmation received, **bank balance per statement agrees to balance per client's bank record, no bank reconciliation** required.

If bank **balance per statement did not agree** to balance per client's bank **record**, auditor must **obtain bank reconciliation report and perform audit procedure to verify it.**

7.2. Bank reconciliation (usually perform at month end to reconcile the difference between bank record and company's record)

ABC CO			
① BANK RECONCILIATION 31 DECEMBER 20X1			
		\$	\$
Balance per bank statement 31 December 20X1			35,111.91 ②
Add: outstanding lodgements ③			
30 December (ref 1122)	10,222.00		
31 December (ref 1123)	<u>25,000.00</u>	<u>35,222.00</u>	
			70,333.91
Less: outstanding cheques ④ ⑤			
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	<u>1,255.65</u>	<u>26,833.55</u>	
Balance per bank in the general ledger 31 December 20X1			43,500.36 ⑥

Substantive audit procedures for bank reconciliation

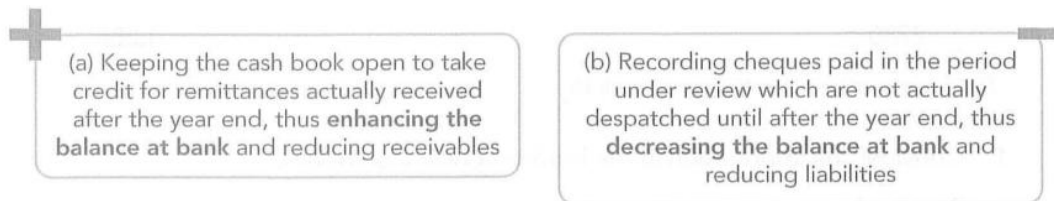
- ① Obtain bank account reconciliation and cast to check the additions to ensure arithmetical accuracy
- ② Agree the balance per bank statement on bank reconciliation to the bank confirmation ensure the balance stated correctly
- ③ Trace all the outstanding lodgements to the pre year-end cash book and post year-end bank statement to ensure they were paid in prior to the YE and cleared quickly after the year end.
- ④ Trace the outstanding cheques on the bank reconciliation through to a pre year-end cash book and post year-end bank statement to ensure they issue prior year-end and cleared quickly after year-end. Obtain explanations from management for any unusual amounts or significant delays.
- ⑤ Examine any old outstanding cheques to assess if they need to be written back into the purchase ledger as they are no longer valid to be presented.
- ⑥ Agree the balance per the cash book on bank reconciliation to the year-end cash book ensure the balance stated correctly.

7.3. Audit procedure relate to presentation of bank balance

- Review the bank confirmation letter for details of any security provided by the company to ensure this has been properly disclosed in the financial statement.
- Review the cash book and bank statements for any unusual items or large transfers around the year end to assess any possible window dressing.

7.4. Window dressing and cut-off test

Window dressing in this context is usually manifested as an attempt to overstate the liquidity of the company. When auditing cash balances, care must be taken to ensure that there is no window dressing, by auditing cut-off carefully.



As regards (a) above, 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 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.

8. Cash

Some company may maintain cash at year-end.

Audit procedure - Petty cash amount is significant

Perform cash count at year end and agree the amount count to petty cash record to ensure petty cash stated correctly.

Audit procedure - Petty cash amount is insignificant

Obtain certificates of cash-in-hand from management and agree the amount stated in certificate to petty cash records.

Exam focus point

在历年考试中，考官经常考核 bank recon 情景的 SP，学生需要熟悉 bank recon 最常用的 5-6 个 procedure。

Practice of prior year exam question

Airsoft Co is a listed company which manufactures stationery products. The company's profit before tax for the year ended 31 December 20X6 is \$16.3m and total assets as at that date are \$66.8m. You are an audit supervisor of Biathlon & Co and you are currently finalising the audit programmes for the year-end audit of your existing client Airsoft Co. You attended a meeting with your audit manager where the following matters were discussed:

Bank overdraft and savings accounts

Airsoft Co's draft financial statements include a bank overdraft of \$2.6m, which relates to the company's main current account. In addition Airsoft Co maintains a number of savings accounts. The savings account balances are classified as cash and cash equivalents and are included in current assets. All accounts have been reconciled at the year end.

Required

Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to Airsoft Co's year-end bank balances. (5 marks)

Analysis

5 marks = 5 audit procedure

For bank balance, auditors need to obtain bank confirmation and perform audit procedures for bank reconciliation. Further, this company has \$2.6m overdraft at year end. Auditor should consider the audit procedure for presentation of bank balance.

Solution

Payable, liabilities and expenses

9. Non-current liabilities

Non-current liabilities comprise **loans and debentures repayable more than one year** after the year end. Further, there are interest charges on the loans debenture borrowed.

Bank	ICBC	ABC	BOC	total
Opening ①	500,000	1,100,000	700,000	2,300,000
Addition ②	500,000	-	-	500,000
Repayment ③	-	(500,000)	(100,000)	(600,000)
Balance at YE ④	1,000,000	600,000	600,000	2,200,000

A loan of \$1,000,000 is repayable over a period of 10 years at monthly installments of \$6,667. The loan bears interest at 6% per annum. The loan is secured by a legal mortgage on the Company's leasehold property with carrying amount of \$2,000,000. ⑤

The key assertion for non-current liabilities is completeness and presentation.

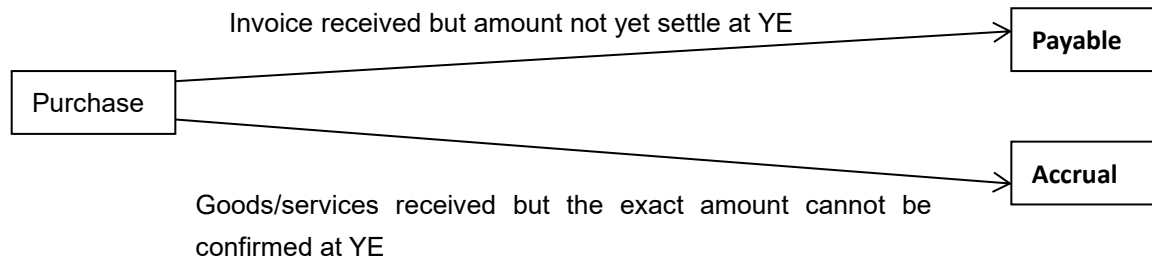
Substantive audit procedure

- ① Obtain schedule of loans outstanding at the year-end and compare opening balances to previous year's financial statements to ensure no loan is omitted.
- ② Review board minutes and cash book to confirm any new loans obtained during the year.
- ③ Review cash book or correspondence from lender/bank to confirm any loan repayment made during the year.
- ④ Obtain direct confirmation from lenders/banks of the loan amounts outstanding and any security provided, agree the amounts to loan schedule and financial statements to ensure they are stated correctly.
- ⑤ Inspect financial statements for disclosure of interest rate, and the split of loan between current and non-current liabilities to ensure they comply with relevant accounting standard.

Recalculate the interest charged and any interest accrual in accordance with term within loan agreement to ensure mathematical accuracy of loan interest.

Trade payable, accrual and purchase

Relationship between payable, accrual and purchase



10. Purchase

Similar to audit procedure of revenue, auditors need to ascertain **completeness, occurrence, cut-off, accuracy** these 4 main assertions for purchase.

10.1. Completeness

Auditor need to confirm whether purchase for the year are completely recorded (no under/overstatement). Two types of substantive procedures could be applied: **analytical procedure and test of detail.**

- **Analytical procedure** – auditor will **compare** current year result with prior year or budgeted figure to find out any significant variance, if management cannot explain the variance with valid reason, this may indicate revenue were misstated.

Audit procedure

Compare the current year purchase on a month-by-month basis to the prior year and investigate any significant differences to assess the completeness of purchase. Calculate the gross profit margin and compare this to the prior year and investigate any significant fluctuations to assess the completeness of purchase.

- **Test of detail.** Auditor can trace **source document (invoice, GRN)** to **ledger** to identity any sales invoices were omitted by the client.

Audit procedure

Trace sample of purchase invoices and GRN raised during the year to the purchase ledger to confirm they are all included.

10.2. Occurrence

Auditors need confirm the purchase transactions recorded in purchase ledger have occurred.

Audit procedure

Trace a sample of **transactions in ledger** back to **purchase order / good received note** to confirm occurrence of these purchase transactions

10.3. Cut-off

Purchase should be recognized when risk and reward transfer from supplier to client. In practice, purchase should be recognized when goods received (when GRN issue) not the date purchase invoices received.

Audit procedure

Trace a sample of pre and post year-end GRNs through to purchase invoices recorded in the correct accounting period to ensure that cut-off has been correctly applied.

10.4. Accuracy

First, auditors should ensure no calculation errors in the source documents.

Audit procedure

recalculate a sample of purchase invoices for larger suppliers to confirm the arithmetical accuracy

Further, auditor should ensure no posting error from invoice to ledger.

Audit procedure

select a sample of purchase invoices and agree the amounts stated in the invoices to the purchase ledger to confirm the amounts are stated correctly

11. Payable and accrual

Similar to trade receivables, auditor can perform **trade payable circularisation** to confirm existence, completeness valuation, rights and obligation of payables. In practice, .suppliers normally sent out monthly statement to the audit client to chase outstanding balance. Therefore, auditors can perform **audit procedure on suppliers' statements** to confirm valuation, existence, obligation and completeness of payables.

Substantive audit procedures

Completeness (most important assertion)

- Obtain supplier statements and reconcile these to the purchase ledger balances, and investigate any reconciling items to ensure payable balance correctly stated at year-end. *(also can confirm existence and obligation)*

- Calculate trade payable days and compare to prior year, investigate any significant variance to assess reasonableness of payables at year-end. (*payable days should be stable compare to prior year, significant change may due to errors*)
- Select a sample of payable balances and perform trade payables' circularization, follow up any non-replies and reconciling items between payable balance and the amount confirmed. (*also can confirm existence and obligation*)
- Select a sample of goods received notes before the year-end and follow through to inclusion in the year-end payable balance to ensure these amounts completely recorded.
- Inspect payments after year-end and trace those payments related to current year back to accrual listing to ensure they recorded in correct accounting period.
- Compare current year **accruals** to prior year to identify any missing item or unusually fluctuation

Existence, right and obligation

- Perform trade payables' circularization (refer to above)
- Obtain supplier statements and reconcile (refer to above)

Accuracy

Cast the trade payables schedule / accrual listing and agree to total to the financial statements to ensure mathematical accuracy.

Valuation of accrual (accrual at YE base on estimation)

Vouched to a sample of invoice received after year-end to confirm actual amount for accrual and assess whether the accrual is reasonable.

Exam focus point

在历年考试中，考官经常考核 payable 和 accrual 的 completeness 的情景

12. Payroll expense and director remuneration

In modern business, manpower costs are the major cost to the business. Manpower cost normally split into 2 parts: **salaries & wages** (Paid to employee, consist of basic pay and overtime) and **director remuneration** (Paid to directors, consists of basic pay, bonus and others).

12.1. Audit procedures for salaries and wages

Completeness

- Perform a proof in total of total wages and salaries, incorporating joiners and leavers and the pay increase. Compare estimated wages and salaries to the actual in the financial statements and investigate any significant differences to assess the reasonableness of payroll cost. (analytical procedure)
- Compare monthly payroll cost to the prior year and budgets and discuss with management any significant variances to assess the any omission of payroll cost (analytical procedure).
- Agree the total wages and salaries expenses per payroll system to general ledger and financial statements to ensure payroll expenses in system correctly stated in financial statements.

Accuracy

- Cast the payroll listing to ensure mathematical accuracy of payroll expenses (for the total amount).
- Select a sample of employee from payroll and recalculate their gross and net pay to ensure mathematical accuracy
- Agree the individual wages and salaries per payroll record to personnel records and record of hours worked per clock card to confirm occurrence and accuracy of payroll expenses (agree record in ledger to document).

Occurrence

- Agree to total net pay per payroll record to bank statements and to cash book to confirm salaries and wages did paid to employees (some company may accrue salaries at year end to postpone profit to next year, money transfer out can proof this is a 'real' expenses to client).

12.2. Audit procedures for director remuneration

- Obtain a schedule of the directors' remuneration and recalculate the schedule to ensure arithmetical accurate.
- Review the board minutes to confirm whether any bonus payments relating to this year have been approved (director's bonus need to be approved by shareholder).
- Inspect bank statements to confirm director remunerations actually paid to directors (confirm occurrence).
- Obtain a written representation from management that they have disclosed all director remuneration to auditor. This is to ensure all directors' remuneration haven been included in financial statements (director may receive non-cash remuneration and this need to be confirmed by director).
- Review disclosures related to director remuneration to ensure these are in compliance with local legislation and relevant accounting standards.

12.3. Audit procedure for share capital

With no share issue during the year

- Agree the authorised share capital with statutory documents governing the company's constitution

New share issue during the year

- Review board minutes to confirm the issue of additional share capital had been approved by shareholders.
- Inspect the cash book and bank statements for evidence of cash receipts from share issue and ensure the amounts not yet received are correctly disclosed as call-up share capital in the financial statements.
- Recalculate the split of proceeds between the nominal value of shares and share premium and agree to the record in share capital and share premium account to confirm the mathematical accuracy.
- Review the disclosure of the share issue in the draft financial statements to ensure it is in line with relevant accounting standards and local legislation.

Dividend paid during the year

- Agree dividends paid and declared pre-year-end to board minute to confirm dividend its authorised by shareholder
- Review the cash book for dividend paid during the year to confirm dividend did paid to shareholder.

Exam focus point

在历年考试中，payroll 和 director remuneration 的 SP 是学生经常搞混的地方，payroll 是对应一般员工的薪酬，director remuneration 是针对公司 director 的。Director remuneration 的情景进本都会出现需要披露符合本地的法律要求。

Payroll 和 director remuneration 常考的是 completeness 和 accuracy。

13. Provisions

According to IAS 37, three conditions need to be met in order for a provision to be recognised:

- There **must be an obligation** (this can be legal or constructive in nature)
- The **outflow** must be **probable** (there is a > 50% chance)
- A **reliable estimate** can be made on economic outflow

If these conditions are not met, **disclosure as a contingent liability** may be necessary.

13.1. Audit procedure for provision – assess whether a provision should be made

- Discuss with management the nature of the event to obtain a full understanding of the issue and to confirm that a present obligation exists at year end.
- Obtain confirmation from client's lawyer about the likely outcome and chance of payment to assess whether the probability of cash outflow.
- Review board minutes to ascertain whether the directors believe that the claim will be successful or not.
- Review any correspondence from the counter party to assess whether a reliable estimate of payments can be made.

13.2. Audit procedure for provision – confirm completeness, valuation and presentation

- Obtain a breakdown of provision, cast it and agree the figure to financial statements to ensure the amount stated correctly.
- Review the post year-end cash book and bank statement to identify whether any payments for provisions have been made, compare actual payments to the amounts provided to assess whether the provision is reasonable.
- Obtain a written representation from management that they believe the provision is valued appropriately and is complete.
- Review the disclosure of the provision to ensure compliance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

Exam focus point

在历年考试中，provision 是一个相对困难的地方，因为需要学生了解 IAS37 并针对 IAS37 的 requirement 写出有针对性的 SP。

14. Accounting estimates

An **accounting estimate** is an approximation of a monetary amount in the absence of a precise means of measurement.

There are many accounting estimates in the financial statements, e.g. allowances for receivables, expected life of PPE etc.

14.1. Problem with auditing accounting estimate

Some financial statement items cannot be measured precisely, only estimated. Management use their discretion when arriving at accounting estimate. Balances and transactions related to accounting estimates are therefore more susceptible to management bias.

Unless the actual outcome of an issue that has given rise to an accounting estimate is known at the time of the audit, it is often difficult for auditors to obtain conclusive evidence over the reliability of estimates.

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 that they are better placed to make estimates due to their ongoing involvement with the business and its environment.

14.2. What should auditors do with accounting estimates

- **Obtain an understanding** of how managements identify those transactions, events or conditions that give rise to the need for an estimate.
- Enquire of management **how the accounting estimate is made** and the **data** on which it is based to assess.
- Review the method of measurement used and **assess the reasonableness of assumptions** made
- Develop an expectation of the possible estimate to **evaluate reasonableness** of management's **estimate**.
- Review the judgments and decisions made by management in the making of accounting estimates to **identify** whether there are any indicators of **management bias**.
- **Obtain written representations** from management whether they believe significant assumptions used in making accounting estimates are reasonable.

- Obtain sufficient appropriate audit evidence about **whether the disclosures** in the financial statements related to accounting estimates and estimation uncertainty are **reasonable**

Practice prior year exam question Mar 17

Airsoft Co is a listed company which manufactures stationery products. The company's profit before tax for the year ended 31 December 20X6 is \$16.3m and total assets as at that date are \$66.8m. You are an audit supervisor of Biathlon & Co and you are currently finalising the audit programmes for the year-end audit of your existing client Airsoft Co. You attended a meeting with your audit manager where the following matters were discussed:

Trade payables and accruals

Airsoft Co purchases its raw materials from a large number of suppliers. The company's policy is to close the purchase ledger just after the year end and the financial controller is responsible for identifying goods which were received pre year-end but for which no invoice has yet been received. An accrual is calculated for goods received but not yet invoiced (GRNI) and is included within trade payables and accruals. The audit strategy has identified a risk over the completeness of trade payables and accruals. The audit team will utilise computer assisted audit techniques (CAATs), in the form of audit software while auditing trade payables and accruals.

Directors' remuneration

Airsoft Co's board is comprised of eight directors. Their overall remuneration consists of two elements: an annual salary, paid monthly; and a significant annual discretionary bonus, which is paid in a separate payment run on 20 December. All remuneration paid to directors is included within wages and salaries. Local legislation requires disclosure of the overall total of directors' remuneration broken down by element and by director.

(a) Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to the COMPLETENESS of Airsoft Co's trade payables and accruals. (4 marks)

(b) Describe substantive procedures the auditor should perform to confirm the directors' remuneration included in the financial statements at the year end. (3 marks)

Analysis

COMPLETENESS of trade payables and accruals

Auditor can perform analytical procedure (compare data current year with prior year) or

Perform cut-off test to ensure proper cut-off (indirectly confirm completeness) or

Reconcile supplier statement

Director remuneration

Auditors should confirm **completeness** of payroll cost by using analytical procedure

Auditors need to confirm occurrence of bonus payment and disclosure requirement by local legislation.

Solution

Completeness of purchase and accrual

directors' remuneration

以下内容可以帮助你进行本章复习及自测

1. 重点词汇

Revaluation

Perpetual inventory

Stock count

Stocks held by a third party

Positive confirmation request

Negative confirmation request

aged receivables listing

cash-in-transit

receivables circularization

bank confirmation

bank reconciliation

outstanding lodgements

cheques

Window dressing

Petty cash

purchase order

good received note

Payroll expense

director remuneration

Provisions

accounting estimate

2. 必做习题

PY S21Q18 S20Q18 S19Q18 M21Q18 M20Q18 M19Q18

Chapter 10 Review and finalisation

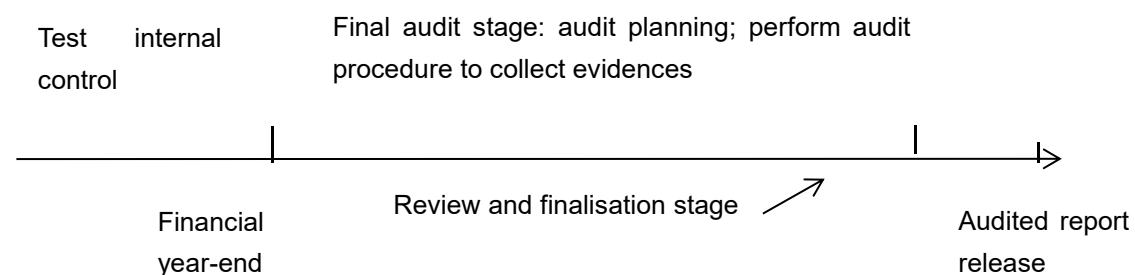
审计师通过对报表项目进行审计手法收集证据后，开始进入撰写审计报告前的最后一个阶段。审计师在这个阶段需要审核日后事项（subsequent event），客户的持续经营（going concern），获取管理层声明（director representation）和对收集的证据进行复核。通过本章的学习我们将要了解审计师为什么要做这些事情以及怎么去做。

Learning outcomes

- Explain the responsibilities of auditors regarding subsequent events
- Discuss the procedures to be undertaken in performing a subsequent events review
- Define and discuss the significance of the concept of going concern..
- Identify and explain potential indicators that an entity is not a going concern
- Discuss the procedures to be applied in performing going concern reviews.
- Discuss the reporting implications of the findings of going concern reviews.
- Explain the purpose of and procedure for obtaining written representations
- Discuss the quality and reliability of written representations as audit evidence
- Discuss the importance of the overall review
- Describe procedures an auditor should perform in overall review of financial statements.



1. Time frame for audit



The review stage of the audit is very important and auditors need to focus on 4 matters which may affect audit opinion in the audited report.

4 main matters in this chapter:

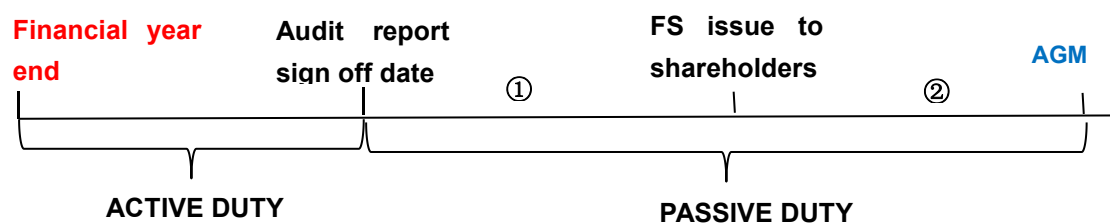
- Subsequent event (consider the impact of event occurred between YE to date audit report)
- Going concern (consider whether audit client could continue operation for next period)
- Written representation (director of audit client should provide statement relate to

audit, if this is not provide by director, impact to financial statement)

- Review and assess misstatement identified during the final audit (consider the impact to audit opinion)

2. Subsequent events

Subsequent events are events that occur between the financial year end date and the date on which the financial statements are authorised for issue.



Auditors are **required to perform audit procedures to identify subsequent events** and request the management to account for them appropriately.

Audit procedure to **identify** subsequent event

- **Inquire with the management** regarding the occurrence of any subsequent events.
- **Inquire with the entity's lawyers** for any occurrence of any litigations & claims
- **Obtain written representation** that all events occurring subsequent to the period end which need adjustment or disclosure have been adjusted or disclosed.
- **Read board minutes** to identify the occurrence of any subsequent events.

Auditors **do not need to perform procedures to identify subsequent events**.

If they become aware of a fact which would cause them to issue a modified report, they must take action –

The auditor should discuss the matter with management and consider if the financial statements require amendment.

If Management amend FS - Undertake necessary audit procedures on the changes made & issue a new audit report on the amended FS.

If Management did not amend FS

① Report has **not yet been provided to audit client** – auditor should modify the opinion in the auditor report.

② Report has **been provided to audit client** – auditor should notify management not to issue FS to shareholder before amendments are made

② Report has **been issued to shareholders** the auditor shall take action to prevent reliance on the auditor's report

2.1. Application of subsequent event in the exam

① Determine adjusting event or non-adjusting event

Adjusting events: those that provide evidence of **conditions that existed at the year-end date.**

Example

- Receivable balance due to a customer has cash flow problem after YE.
- Law suit before YE but case settle after YE.
- Defective inventory discovered after YE

Non-adjusting events: those are indicative of **conditions that arose after the year-end date.**

Example

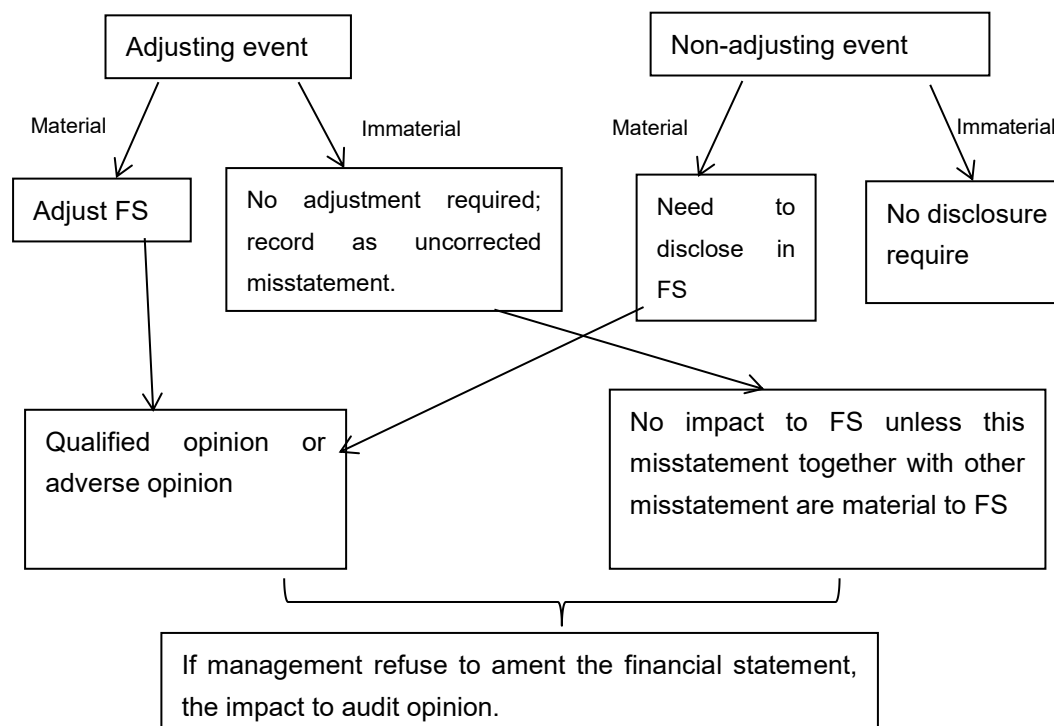
- Accident like fire, flood, explosion (did not affect company going concern status)
- Law suit or offence regulation after YE
- Dividends declared after the year-end

② Determine materiality of the event:

	Material	Immaterial
Event amount /revenue	>1%	<1%
Event amount /PBT	>5%	<5%

③ **Perform audit procedure** to confirm the loss of the event or disclosure in the FS (detail refer to previous chapter).

④ Determine the impact to financial statement and audit report



Practice prior year exam question

(a) Describe the auditor's responsibility for subsequent events occurring between:

(i) The year-end date and the date the auditor's report is signed; and

(ii) The date the auditor's report is signed and the date the financial statements are issued. (5 marks)

(b)

Humphries Co operates a chain of food wholesalers across the country and its year end was 30 September 2011. The final audit is nearly complete and it is proposed that the financial statements and audit report will be signed on 13 December. Revenue for the year is \$78 million and profit before taxation is \$7.5 million. The following events have occurred subsequent to the year end.

Receivable

A customer of Humphries Co has been experiencing cash flow problems and its year-end balance is \$0.3 million. The company has just become aware that its customer is experiencing significant going concern difficulties. Humphries believe that as the company has been trading for many years, they will receive some, if not full, payment from the customer; hence they have not adjusted the receivable balance.

Lawsuit

A key supplier of Humphries Co is suing them for breach of contract. The lawsuit was filed prior to the year end, and the sum claimed by them is \$1 million. This has been disclosed as a contingent liability in the notes to the financial statements; however correspondence has just arrived from the supplier indicating that they are willing to settle the case for a payment by Humphries Co of \$0.6 million. It is likely that the company will agree to this.

Warehouse

Humphries Co has three warehouses; following extensive rain on 20 November significant rain and river water flooded the warehouse located in Bass. All of the inventory was damaged and has been disposed of. The insurance company has already been contacted. No amendments or disclosures have been made in the financial statements.

Required:

For each of the three events above:

(i) discuss whether the financial statements require amendment;

(ii) describe audit procedures that should be performed in order to form a conclusion on the amendment; and

(iii) explain the impact on the audit report should the issue remain unresolved. (15 marks)

Note: The total marks will be split equally between each event.

Solution

A

	Responsibility
between YE date to audit report sign off	The auditor shall perform audit procedures to obtain sufficient appropriate evidence that all events occurring between year-end date and the auditor's report is signed had been adjusted and disclosure in financial statements properly.
between auditor report signed off to FSs are issued	<ul style="list-style-type: none"> ● Auditor has no obligation to perform any audit procedure regarding the financial statements after the date the auditor's report is signed. ● Management needs to inform the auditor regarding the occurrence of the subsequent events. Audit should discuss the matter with management and determine whether the financial statements need to be amended ● If the management amends the financial statements, the auditor shall perform necessary audit procedure to ascertain the event and provide a new auditor's report for the amended financial statements ● If the managements refuse to amend the financial, the auditor shall consider the needs to amend audit opinions for the financial statements.

B

Exam focus point

在历年考试中，考官经常在应用题考 subsequent event 的题目，分值在 4-5 分。这类题目的得分点有 4 个：1 描述事件并说明事件是否 adjusting event；2 评估受影响金额 materiality；3 针对事件写出审计师应该执行的 SP(难度最高)；4 根据是否 adjusting event 来判断对审计报告的影响。4 个得分点中 SP 的难度最高，建议学生在作答中优先判断事件是否是 adjusting event 和评估 materiality。

Solution

Receivables

I

- A customer owing 0.3million at YE, is experience a going concern issue. This information was received after YE but provide evidence that the recoverability of receivables at YE. This is an adjusting event.
- Receivable balance is overstated \$0.3million and this is not material as it represent 4% (0.3/7.5) of PBT and 0.4% (0.3/78) of revenue. Therefore, no adjustment is required for the financial statement for this event. However, \$0.3 million should be should be

summarised in unadjusted errors.

II Audit procedure for subsequent event (focus on valuation of receivable)

- Review the post year-end cash book and bank statement for any payment received from this customer to assess the need for receivable written-down.
- Review the correspondence with the customer to assess whether there is a likelihood of payment and ascertain the need for receivable written-down.

III impact to audit report

As the overstatement of receivable is not material, no amendment to audit opinion is required for this matter.

Law suit

Warehouse

3. Going concern

Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. Foreseeable future is not defined in ISA 570 Going Concern. This period is a minimum of 12 months after the year end under IAS1.



3.1. IAS 1 requirement – Management responsibility of going concern

IAS 1 requires management to assess whether the entity is a going concern and prepare financial statements on a going concern basis unless they believe that the company will soon cease trading.

Directors should prepare forecasts to help assess whether the company is able to continue trading for the next 12 months as minimum.

If management has significant **concerns about the entity's ability to continue as a going concern**, the uncertainties must be **disclosed**.

If management concludes that the entity is **not a going concern**, the financial should **be prepared on a break-up basis** (assets and liabilities are recorded at realizable value)

Example of going concern impact

	Going concern	Break-up basis
Property plant and equipment	Stated at cost less depreciation and present as non-current asset in FS	Stated at realisable value and present at current assets in FS

3.2. Auditor's responsibilities in respect of going concern

- To obtain sufficient appropriate evidence regarding the appropriateness of management's use of going concern basis of accounting in the preparation of financial statements.
- To consider whether there are material uncertainties which affects the entity's going concern status.
- To consider whether the **period of management's going concern assessment is adequate**. The assessment needs to cover a period of no less than 12 months from the date of the financial statements.

3.3. Going concern indicator

Indicator	Why could impact going concern
Trading	
① Significant decline in demand for its products	There will be significant loss of future revenues and profit and <u>not able to generate sufficient operating cash flows to cover its cash outflow</u> leading to going concern difficulties.
① A major customer ceased trading	
① Revenue generated from single product, and this market has now become very competitive.	As the market is very competitive and sales generate from the product may decrease leading to it may face <u>difficulties in meeting all expenses</u> .
② Supplier request cash on delivery.	This puts <u>additional pressure on the company's cash flow</u> as the company has to pay for goods in advance but it may not receive cash from its receivables until sometime later.
③ Main supplier stop trading	There is a <u>risk that the company may not be able to obtain these products from other suppliers</u> which would impact on their ability to trade.
Finance	
The company raise finance for future investment; this was rejected by shareholder or lender.	The <u>shareholders/lender may feel it is to be too risky to invest in further</u> as they may be concerned that the company <u>may not be able to offer them a suitable return</u> on their investment or to repay the amount.
④ The overdraft facility has increased substantially and is repayable in short-term.	If the bank does <u>not renew the overdraft</u> and the company is unable to obtain alternative finance then it may <u>not be able to continue to trade</u> .
⑤ Breach the loan covenant and the loan amount is now all repayable	If the company is unable to obtain alternative finance then it may not be able to continue to trade.
⑤ Current assets are not sufficient to pay the current liabilities.	

⑥The cash flow forecast has shown a significantly worsening position.	The cash outflows are greater than the inflows and this position may indicate there are difficulties in funding its operating activities.
⑥Continuing negative monthly cash flows	
Others	
Lack of investment in future product development	If current products reach the end of their life-cycle they cannot generate cash inflows. <u>Without new products to generate future income operating cash flows will be strained.</u>
⑦Law suit	If the company loss the case, there may be a significant cash outflow due to the settlement.

Audit procedures to ascertain whether an entity is a going concern

- ①Review the company's post year-end sales day book whether the level of sales from its existing customers has increased or if any new customers have been obtained.
- ②Review post year-end correspondence with suppliers to identify if any further restrictions in credit have arisen, and if so ensure that the cash flow forecast reflects an immediate payment for trade payables.
- ③Discuss with the directors whether they have contacted any alternative suppliers to assess whether they have any other plan to continue trading.
- ④Review any bank correspondence to assess the likelihood of the bank renewing the overdraft facility.
- ④⑤Discuss with the directors whether they have contacted any alternative banks for finance to assess their contingency plans in relation to repayment of overdraft/loan.
- ⑥Obtain the company's cash flow forecast and review the cash in and out flows to assess the reasonableness of cash flow forecast understand whether the company will have sufficient cash flows in the next 12 months.
- ⑥Obtain a copy of latest post year-end interim financial statement of the company to assess the reasonableness of cash flow forecast.
- ⑦Inquire of the lawyers of the company to confirm the existence of litigation and claims, if any exist then consider their materiality and impact on the going concern basis.

Perform audit tests in relation to subsequent events to identify any items might indicate the risk of going concern not being appropriate.

Review the post year-end board minutes to identify any other issues which might indicate further financial difficulties for the company.

Obtain a written representation confirming the directors' view that the company is a going concern.

Impact on auditor's report of going concern

	Scenario	Impact on auditor's report
1	<u>Going concern assumption appropriate</u> but material uncertainty which is <u>adequately disclosed</u>	<u>Unmodified opinion</u> A paragraph titled ' <u>Material Uncertainty Related to Going Concern</u> ' should be included in FS to stated that a material uncertainty exists and to draw attention to the relevant disclosure note in the f/s
2	<u>Going concern assumption appropriate</u> but material uncertainty which is <u>not adequately disclosed</u>	<u>Qualified opinion</u> as this is material to FS or <u>Adverse opinion</u> if it is material and persuasive to FS
3	Use of <u>going concern assumption inappropriate</u>	<u>Adverse opinion</u> - FS should change from going concern basis to break-up basis, material and persuasive to FS.
4	Management <u>unwilling to make its assessment.</u>	<u>Qualified or disclaimer</u> of opinion as auditor unable to obtain sufficient appropriate audit evidence.

Exam focus point

在历年考试中，going concern 对报表的影响一般在选择题出现，学生需要熟悉 going concern 对审计意见的影响。

going concern 的应用题一般是考核评估客户是否 going concern 的审计措施（SP），这类题目历年考题出现了几次，每次的 SP 基本一样，学生只需要背讲义列出来的 SP 就可以。

Practice prior year exam question D15Q3

Mercury Motoring Co (Mercury) specialises in manufacturing engine parts for motor cars and the company has a diverse customer base but seven significant customers. The company's year end was 30 September 2015.

During the year, a number of the company's significant customers have experienced a fall in sales, and consequently they have purchased fewer items from Mercury. As a result, Mercury has paid a number of its suppliers later than usual and some of them have withdrawn credit terms meaning the company must pay cash on delivery. One of Mercury's main suppliers is threatening legal action to recover the sums owing. As a result of the increased level of payables, the company's current ratio has fallen below 1 to 0.9 for the first time.

Mercury has produced a cash flow forecast to 30 June 2016 and this shows net cash outflows until May 2016. Mercury has a loan of \$2.3 million which is due for repayment in full by 30 September 2016.

The finance director has just informed the audit manager that there is a possible change in legislation which will result in one of Mercury's top product lines becoming obsolete as it will not comply with the proposed law. The prepared cash flow forecasts do not reflect this possible event.

Required:

- (a) Explain FIVE potential indicators that Mercury Motoring Co is NOT a going concern. (5 marks)
- (b) Describe the audit procedures which you should perform in assessing whether or not Mercury Motoring Co is a going concern. (5 marks)

Solution

	Indicator	Audit procedure
1	During the year, number of customer reduces purchases from Mercury. (Identify indicator) There is a risk that customers of Mercury continue to reduce purchase from the company and this will reduce the company future cash inflow (explain the impact to cash flow or continue trading).	Discuss with the finance director whether the level of sale from existing customer has increase or any new customer have been obtained (audit procedure must relevant to going concern indicator).
2	Mercury has paid some of its suppliers later than usual and suppliers withdraw credit term. Company has to pay cash on delivery. This puts additional pressure on company's cash flow as it has to pay cash on goods	Review post YE correspondence with suppliers to identify any further restrictions in credit have arisen and ensure the cash flow forecast reflect an immediate payment for payable.

	received but it could only collect cash from customer sometime later. If company could not maintain sufficient cash for its operation, it may not continue to trade.	
3	<p>Mercury's main supplier is threatening legal action to recover the sum owing.</p> <p>Mercury would incur significant amount of legal cost for the legal action. In addition, Mercury may need to pay large amount of back to supplier if it lose the case. This would put pressure on company's cash flow.</p>	<p>Enquire the lawyer of Mercury to confirm the existence of litigation and the likely amount to be paid.</p> <p>or</p> <p>Review company's cash flow forecast to assess whether it has sufficient fund to cover this amount.</p>
4	<p>Mercury's current ratio has fallen below 1 to 0.9 for the first time. In addition, company's payable increased a significant amount.</p> <p>If current ratio is less than 1, this would indicate company's current assets could not cover its current liabilities. If this situation continue, company's liquidity situation may even worse and could not continue to trade.</p>	<p>Obtain cash flow forecast for the next 12 months to assess whether company has sufficient cash for the next 12 months.</p>
5	<p>Mercury has a loan of \$2.3m to be fully repaid by 30 Sep 2016 and company forecast net cash outflow until May 2016.</p> <p>With continue net cash outflow and falling level of sales, it is difficult to see how Mercury will be able to raise \$2.3m to pay the loan. If Mercury unable to obtain alternative finance, it may not able to pay this amount back and has to stop trading.</p>	<p>Discuss with director of Mercury whether they have obtain alternative bank for finance or shareholder would pump in extra funds to assess whether company is able to pay this loan.</p>

4. Written representations

A **written representation** is: a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence.

Example of written representation to support other audit evidence

- Appropriateness of accounting policies
- Valuation of provision and completeness of contingent liabilities
- Disclosed all information in relation to allegations of fraud by employees
- All subsequent events requiring adjustment or disclosure

Written representations should only be sought to support other audit evidence. It cannot substitute for more reliable evidence (E.g. auditor cannot just obtain written representation from director and not to perform receivable circularization).

4.1. The purpose of obtaining written representations

- i. To obtain evidence that management, and those charged with governance, have fulfilled their responsibility (as agreed and acknowledged in the terms of the audit engagement) for the preparation of the financial statements, including:
 - Preparing the financial statements in accordance with an applicable financial reporting framework
 - Providing the auditor with all relevant information and access to records.
- ii. To support other audit evidence relevant to the financial statements if determined necessary by the auditor or required by ISAs

4.2. Characteristics of written representation

- The **auditor will often draft** the written representations letter but it **must be printed on client headed paper** and signed by the client.
- The letter must be signed by an appropriate senior member of client management (CEO and CFO).
- The **date of the written representation** letter should be the **same as the date the financial statements are authorised**.

4.3. Reliability of written representations

If **written representations are inconsistent with other audit evidence**, the auditor shall perform other audit procedures to try to resolve the matter reassess the competence, integrity and ethical values of management.

4.4. If management does not provide written representations, the auditor shall:

- 1) Discuss the matter with management to understand why they are refusing
- 2) Consider the reliability of other representations or other documents provided by management
- 3) Consider the implication for the audit report, the auditor must issue a disclaimer of opinion.

Exam focus point

在历年考试中, written representation 基本只是在选择题出现, 考核 written rep 的特征以及是否可以替代别的审计证据, 审计师如果能获取比 written rep 更可靠的证据的时候, 不能使用 written rep 替代其他证据 (譬如不能拿 written rep 替代 confirmation)

5. Overall review and evaluation of misstatement

5.1. What happen in overall review of financial statement?

The overall review should be carried out by engagement partner who has ultimate responsibility for the audit (the one signing auditor's report)

Following audit procedures should be performed during overall review of financial statement:

- Review the financial statements to ensure **compliance with accounting standards and local legislation disclosure**
- Review the disclosure of the **accounting policies** to ensure that they are in accordance with accounting standards, **properly disclosed, consistently applied** and appropriate to the entity
- **Perform analytical procedures** to assist in forming an overall conclusion as to whether the **financial statements are consistent with the auditor's understanding** of the entity
- Review the financial statements to ensure they are consistent with the auditor's knowledge of the business and the results of their audit work.
- **Review the aggregate of uncorrected misstatements** to assess whether a material misstatement arises; if so discuss with management with regards to a potential adjustment.

5.2. What happen in overall review of audit evidence?

The auditor should assess whether the audit evidence gathered by the team is sufficient and appropriate to support the audit opinion.

5.3. Evaluation of misstatement

ISA 450 requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial.

ISA 450 requires the auditor to communicate all misstatements accumulated during the audit with the appropriate level of management on a timely basis and to request management to correct those misstatements.

If misstatements are material and management refuses to correct them, auditor should consider modifying audit report accordingly (qualified opinion or adverse opinion)

以下内容可以帮助你进行本章复习及自测

1. 重点词汇

Subsequent events

ACTIVE DUTY

PASSIVE DUTY

adjusting event

non-adjusting event

Going concern

Written representations

2. 必做习题

Hut Ch20: Crighton Co Ch31 Mulberry Co PY S16Q11-15 M17Q6-10

Chapter 11 Reports

通过本章节的学习，我们要了解审计师在审计完成阶段如何撰写审计报告（audit report），审计报告的组成部分有什么，还有审计师要怎么结合已收集到的审计证据给出恰当的审计意见（audit opinion）。

Learning outcomes

- Explain unmodified audit opinions in the auditor's report
- Explain the circumstances in which a modified audit opinion may be issued in the auditor's report
- Explain the impact on the auditor's report when a modified opinion is issued
- Describe the format and content of key audit matters, emphasis of matter and other matter paragraphs



1. Basic elements of the unmodified auditor's report

1.1. Element of audit report

Elements	Explanation
Title	The auditor's report must have a title that clearly indicates that it is the report of the independent auditor.
Addressee	The addressee will be determined by law or regulation. In most situation, the auditor's report is addressed to the members of the company or the shareholder
Opinion paragraph	Opinion paragraph should include following: <ul style="list-style-type: none"> ● Identify which entity being audited ● State that the financial statements have been audited ● identify the title of each statement that comprises the FS, accounting policies and other explanatory notes being audited ● Specify the date period covered by each statement comprising the FS.
Basis for Opinion	this paragraph should: <ul style="list-style-type: none"> ● State that the audit was conducted with ISAs and refer to the section of the auditor's report that describes the auditor's responsibilities ● State that the auditor is independent and has fulfilled the relevant applicable ethical requirements

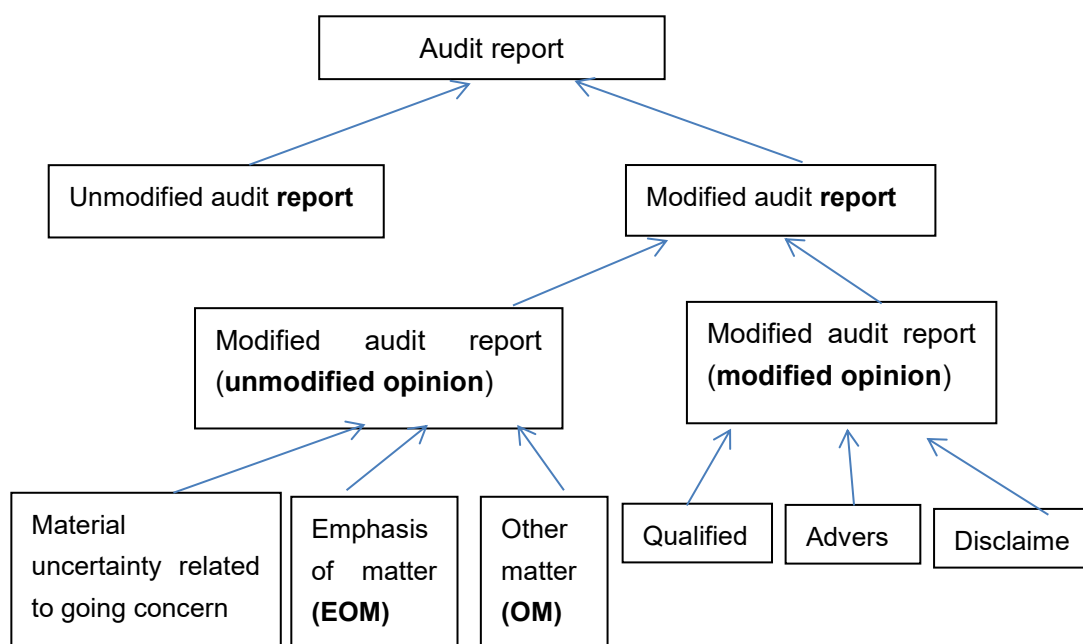
	<ul style="list-style-type: none"> ● State whether the auditor believes that the evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.
Key audit matters (KAM)	For the listed entities or required by law or regulation, the auditor should include a 'Key audit matters' section to describes the matters are most significant to the audit.
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.
Management's Responsibilities	<p>This part of the report describes the responsibilities of those who are responsible for the preparation of the financial statements. Management's responsibility including the following:</p> <ul style="list-style-type: none"> ● Preparing the financial statements in accordance with IAS ● Maintaining internal control as are necessary to enable the preparation of financial statements that are free from material misstatement, whether due to error or fraud. ● Assessing the entity's ability to continue as a going concern & disclosing matters relating to going concern.
Auditor's responsibilities	<p>This part of the report describes the responsibilities of auditor. The auditor's responsibilities include</p> <ul style="list-style-type: none"> ● To obtain reasonable assurance whether the financial statements as a whole are free from material misstatement ● Consider the client's internal controls as part of the auditor's risk assessment to design appropriate audit procedures. ● Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates.
Other reporting responsibilities	If the auditor is required by law to report on any other matters, this must be done in an additional paragraph titled 'Report on other legal and regulatory requirements' or otherwise as appropriate.
Name of the engagement partner	
Auditor's signature	The audit report may be signed in the auditor's own name or the audit firm's name
Auditor's	The location where the auditor practises must be included.

address	
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.

Exam focus point

在历年考试中，审计报告每个部分的定义是每次选择题的热门题目，学生需要记忆。

2. Audit opinion



2.1. Unmodified opinion（没有重大错误）

ISA 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.

Example of 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 International Financial Reporting Standards.

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 the independent auditor's report.

2.2. Modified report with unmodified opinion（没有重大错误，但有强调的事项）

Auditors are required to make additional communications in the audit report even though the financial statements show a true and fair view.

- **Material uncertainties related to going concern** stated that material uncertainties exist and the directors have adequately disclosed in the financial statements. This draws the attention of the user to the client's disclosure note.
- 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, is of such importance that it is fundamental to users' understanding of the financial statements
- An other matter paragraph is a paragraph refers to a matter is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

It is important to note that these do not impact the wording of the opinion and do not constitute either a qualified, adverse or disclaimer of opinion.

2.3. Modified report with modified opinion（有重大错误）

There are 3 types of possible modifications to the audit opinion:

- **A qualified opinion** - ① **Misstatements are material, but not pervasive** to the FS.
- ② Auditor **cannot obtain sufficient appropriate audit evidence** on which to base the opinion but concludes that the possible effects of **undetected misstatements could be material but not pervasive**.
- **An adverse opinion** - the auditor **obtained sufficient appropriate audit evidence**, concludes that misstatements are both material and pervasive to the financial statements.

Situation for adverse opinion

- Preparation of FS on wrong basis (company is going to liquidate but prepare on going concern basis)
- Non-consolidation of a subsidiary
- Misstatement in the FS would has significant impact to assets or profit

(change a profit to loss)

- **A disclaimer of opinion** - Auditor cannot obtain sufficient appropriate audit evidence on which to base the opinion and concludes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive.

Situation for disclaimer of opinion

- Client failure to keep adequate accounting records.
- Director refuse to provide written representation

	Material but NOT pervasive	Material and pervasive
Financial statements are materially misstated	Qualified opinion Except for Basis for qualified opinion	Adverse opinion FS do not give a true and fair view Basis for adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion Except for Basis for qualified opinion	Disclaimer of opinion Do not express an opinion Basis for disclaimer of opinion

Exam focus point

在历年考试中，审计意见是必考题，考官可能在选择题或者应用题考核。学生需要注意 4 中审计意见对应的情景和他们特殊的审计用语

3. How to determine materiality and pervasiveness

Material - >1% of total revenue/assets or >5% profit before tax

3.1. Pervasive

Pervasiveness is a term used to describe the effects or possible effects on the financial statements of misstatements or undetected misstatements. There are three types of pervasive effect:

- Those that are not confined to specific elements, accounts or items in the financial statements.

E.g. a machine wrongly recognised as inventory. PPE, inventory, depreciation, COS

and PBT may be affected.

- 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.

E.g. More than 50% revenue is generated from a fictitious customer. Hence, a significant portion of revenue is unable to be ascertained.

- Those that relate to disclosures which are fundamental to users' understanding of the financial statements.

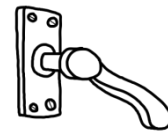
E.g. Use of going concern assumption inappropriate.

4. Key audit matters (KAM)

Key audit matters are matters 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.

4.1. Purpose of KAM

The purpose of including key audit matters in the auditor's report is to **help users in understanding the entity**, and to provide a basis for the users to discuss with management and those charged with governance about matters relating to the entity and the financial statements. KAMs are **part of every listed company auditor's report**.



4.2. How are KAMs determined?

ISA 701 suggests that in determining key audit matters the auditor should take the following into account:

- Areas of higher risk of material misstatement or significant risks. (fraud risk)
- Significant judgements in relation to areas where management made judgements (appropriateness of accounting policy applied by management).
- Significant events or transactions occurred during the period (breach of loan covenants)

4.3. How KAM present in auditor's report?

KAMs are communicated in a separate subsection of the auditor's report. The description of **each KAM says two main things**:

- Why the matter was considered to be one of most significance in the audit
- How the matter was addressed in the audit

4.4. Relationship with the auditor's opinion, EOM and OM

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**. If auditor disclaims an opinion on the financial statements, a Key Audit Matters section must not be included in the auditor's report.

Example: If PPE is material misstated, Vqualified or adverse opinion on PPE

×KAM on PPE

If auditor disclaim PPE, NO KAM section in auditor's report.

KAMs do not modify the report.

Exam focus point

KAM 自从 2019 年加入大纲后一直都是考官的理论题和选择题的热门考点，学生需要了解什么是 KAM，KAM 的存在的目的以及审计师是如何判定，还有 KAM 对审计意见的影响。

5. Material uncertainties related to going concern paragraphs

Material uncertainties related to going concern stated that material uncertainties exist and the directors have adequately disclosed in the financial statements. This draws the attention of the user to the client's disclosure note

Material uncertainties related to going concern paragraph modifies audit report but NOT modify audit opinion.

Example

Material uncertainties related to going concern

We draw attention to Note X in the financial statements, which indicates that the company incurred a net loss of \$Z during the year ended 31 December 20X1, . As stated in Note X, these events or conditions, along with other matters as described in Note X, indicate that a material uncertainty exists that may cast significant doubt on the company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Material uncertainties related to going concern paragraph should be titled as 'Material uncertainties related to going concern' and included immediately after the "Basis for Opinion" paragraph

6. Emphasis of matter paragraphs (EOM)

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, is of such importance that it is fundamental to users' understanding of the financial statements.

EOM modifies audit report but NOT modify audit opinion.

Example

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.

EOM paragraph should be titled as 'Emphasis of matter' and included immediately after the "Basis for Opinion" paragraph

Examples of situations where an auditor might include an EOM paragraph:

- An uncertainty relating to the future outcome of legal action.
- A significant subsequent event
- Early application of a new accounting standard that has a material effect on the financial statements.
- A major catastrophe that has had a significant effect on the entity's financial position

7. Other Matter Paragraphs (OM)

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.

Example

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.

OM paragraph should be titled as 'Other Matter' and included immediately after the "Emphasis of Matter" paragraph.

Example of situations where an auditor might include an OM paragraph may include:

- **Relevant to users' understanding of the audit**—such as planning and scope of audit.
- **Relevant to users' understanding of the auditor's responsibilities.**
- **Reporting on more than one set of financial statements** – E.g. ABC Co. listed in Shanghai and Hong Kong stock exchange, it prepares one set FS follow China accounting rule and one set FS follow Hong Kong accounting rules.

8. Other information in documents containing audited financial statements

Other information is financial and non-financial information (other than the financial statements and the auditor's report thereon) included in an entity's annual report.

Examples of other information:

- A report by management or those charged with governance on operations
- Financial summaries or highlights
- Financial ratios
- Names of officers and directors

8.1. Auditor's Responsibilities Relating to Other Information

- To consider whether there is a material inconsistency between the other information and the FS.
- To consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained during the course of the audit.
- To respond appropriately when the auditor identifies such inconsistencies

Auditor shall read the other information to **identity material inconsistencies with the audited financial statements** as this may undermine the auditor's 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 **include an other information section** in the auditor's report that describes the material inconsistency.

9. Expectations gap

Expectations gap is the term used to describe the difference between the general public's expectation regarding the auditor's responsibilities and the auditor's actual responsibilities.

Example

Auditors do not have a responsibility to perform procedures to material misstatement in the financial statement. However, the users of the financial statements may presume auditor can detect all misstatement in the financial statements.

9.1. How to we close the expectations gap?

- **Educate the public**– this involves making clear the auditor's responsibilities in the audit report. It may have the undesired effect of reducing the value of the audit
- **Extend the auditor's responsibilities**– this brings the auditor's responsibilities in line with the public's perception. It may increase the cost of conducting an audit. Furthermore, not much of a difference may be made.

Practice past year exam question J11Q5

The following additional issues have arisen during the course of the audit of Minnie Co. Profit before tax is \$10m.

(i) Depreciation has been calculated on the total of land and buildings. In previous years it has only been charged on buildings. Total depreciation is \$2.5m and the element charged to land only is \$0.7m. (4 marks)

(ii) Minnie Co's computerised wages program is backed up daily, however for a period of two months the wages records and the back-ups have been corrupted, and therefore cannot be accessed. Wages and salaries for these two months are \$1.1m. (4 marks)

(iii) Minnie Co's main competitor has filed a lawsuit for \$5m against them alleging a breach of copyright; this case is ongoing and will not be resolved prior to the audit report being signed. The matter is correctly disclosed as a contingent liability. (4 marks)

Required:

Discuss each of these issues and describe the impact on the audit report if the above issues remain unresolved.

Analysis

Discuss the issue = 2 marks of each issue (1 mark for stating what happen to company and the impact to the audit, 1 mark for assessing the materiality and the correct accounting treatment- 1% of total revenue or 5% of PBT)

Describe the impact on audit report = 2 marks of each issue (1 mark for whether the report need to be modified – could be include EOM or modify audit opinion, 1 marks for how to modify the report – what paragraph should be included and the reason for it)

Solution

Depreciation of PPE

- According to IAS 16 Property, Plant and Equipment no depreciation should be charged on land. Depreciation charged on land would result to PPE and profit understated.
- The error is material as it represents 7% of profit before tax (0.7m/10m) and hence management should remove this from the financial statements.
- If management refuse to amend this error then the audit report will need to be modified. As management has not complied with IAS 16 and the error is material but not pervasive then a qualified opinion would be necessary.
- A basis for qualified opinion paragraph would need to be included explaining the material misstatement in relation to the depreciation on land and the effect on the financial statements. The opinion paragraph would be 'except for' – due to material misstatement

of depreciation.

Wage system

Lawsuit

The company is being sued by a competitor for breach of copyright. This

以下内容可以帮助你进行本章复习及自测

1. 重点词汇

Title

Addressee

Date of the report

unmodified opinion

qualified opinion

adverse opinion

disclaimer of opinion

Pervasiveness

Key audit matters

An emphasis of matter paragraph

other matter paragraph

Other Information

expectations gap

2. 必做习题

PY S16Q11-15 M17Q6-10 Hut Ch29 Panda Co Ch29 Strawberry Co

附件 1 4 种意见的审计报告

Example1 unmodified audit report (标准无保留)

INDEPENDENT AUDITOR'S REPORT Title

To the Shareholders of ABC Company Addressee

Report on the Audit of the Financial Statements

Opinion Opinion paragraph Identify which entity being audited Components of FS

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 International Financial Reporting Standards (IFRSs).

Basis for Opinion Audit was conducted with ISAs Auditor is independent and has fulfilled the ethical requirements

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) together with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters Evidence obtained is sufficient and appropriate

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.

Accounting for investments in REITs
 (Refer to Note 6 to the financial statements)

Risk: Reference to the related disclosures in the financial statements

The Group holds differing levels of equity stakes in these REITs. The accounting treatment for the investments in REITs is dependent on the Group's relationship with the REITs. The determination of the Group's relationship with these REITs is the result of a critical accounting judgement on many factors principally, the extent of its voting stakeholding, the relationship with other stakeholders, the constitutional arrangements for the trust, its manager and its trustee, and the extent to which the Group's equity stake increases when management fees

Why the matter is considered a KAM

are paid in additional trust units. REITs that are determined to be subsidiaries are consolidated into the Group's financial statements, whereas REITs that are determined to be associates are equity-accounted for. An inappropriate classification can have a material effect on the financial statements.

Our response:

We assessed the Group's processes for the review and the determination of the accounting for its investments in REITs. We examined the legal documents and business arrangements relating to the constitution of the REITs, decision-making over their activities and operations of the manager. We also considered the economic stakes of the Group held through ownership interests in the REITs and the management fee arrangements; and the disclosure of the assessment of the relationships with the REITs.

Our findings:

How the matter was addressed in the audit

The Group has processes in place to periodically review and re-assess its relationship with the REITs it manages and whether previously-applied accounting treatments remain appropriate. The judgements exercised by the Group in these processes reflect realistic assessments of its relationship with the REITs. The disclosures on the basis of accounting for the Group's interests in these REITs are appropriate.

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 IFRSs, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

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

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

Auditor's Responsibilities for the Audit of the Financial Statements

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

Report on Other Legal and Regulatory Requirements

Other reporting responsibilities

In our opinion, the accounting and other records required by the Act to be kept by the

Company have been properly kept in accordance with the provisions of the Act.

EDF & Associates →

Name of the engagement partner

**Public Accountants and
Certified Public Accountants**

SINGAPORE →

Auditor's address

XX January 2012 →

Date of the report

Example2 **Qualified opinion** （审计师发现部分有重大错误）

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 paragraph, the financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of ABC Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Audit opinion 'except for'

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 International Financial Reporting 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 International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Basis for qualified opinion paragraph must state **reason for qualification** and the **impact to FS**

Example3 **Adverse opinion** due to material misstatement with a pervasive effect （有很多重大错误）

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 paragraph, the **financial statements do not present fairly** (or do not give a true and fair view of) the financial position of ABC Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Adverse audit opinion-FS do not present fairly

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 IFRSs, 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 International Standards on Auditing (ISAs). 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 ethical requirements that are relevant to our audit of the consolidated financial statements in [jurisdiction], 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.

Basis for adverse opinion paragraph must state **reason for adverse** and the **impact to FS**

Example4 **Disclaimer of opinion** due to inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements （审计师无法获得审计证据并且错误广泛）

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.

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. **Accordingly, we do not express an opinion on the financial statements.**

Basis for disclaimer of opinion

Disclaimer of opinion – auditors do not express an opinion on the FS

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 audit 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.

Basis for disclaimer of opinion paragraph must state **reason for disclaimer** and the **impact to FS**