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Note: The section number (e.g. A1) refers to the Audit & Assurance syllabus published by ACCA

Introduction

There are different study materials and modes for you to prepare for ACCA professional exams.

You can prepare the exam through self-study mode by reading textbooks and practicing revision tests from Approved Content Providers

Or you can go directly to the classes offered by ACCA Approved Learning Partners and stick into their notes.

However, no matter you are choosing which modes of study or which textbook, you need to know the technical articles published by ACCA for each paper is one of the best materials to prepare for your exams that you cannot miss.

In general, the articles are published by ACCA exam team and the contents are updated on a regular basis.

They highlight the core concepts or important areas that a lot of students cannot do well in the past exams.

The most important part is technical articles are generally the guidance to which question to be seen in upcoming exam.

Here are June 2018 examiners comments on ACCA Paper P7 (Advanced Audit & Assurance):

Question Five

This was a reporting question and was in two sections. It was noted that this question was favoured by candidates who had obviously read the recently updated relevant article on the student website.

The second requirement was to critically appraise an extract from an auditor's report, which had been incorrectly prepared and needed amendment. As noted above it was clear that the candidates who selected this question had evidently read the relevant article and were able to identify that the sections were in the wrong order, contained inappropriate wording and that the key audit matters and emphasis of matters paragraphs had been incorrectly used. Good candidates were able to explain when an issue should be included as a key audit matter or if the issue would result in a qualification and hence needed to be part of the basis of opinion paragraph. Other candidates correctly commented that it would be inappropriate to include an emphasis of matter paragraph but that the report should include a section headed material uncertainty related to going concern.

Since it help thousands of students to prepare exam, I organized the articles published by ACCA and summarized them according to their topics and syllabus with relevant questions as Supplementary Notes for those who are interested to focus on the key or challenging areas.

Remember these articles are helping you to enhance your knowledge on particular subjects, and not a substitute of approved textbook.

Chapter 1 Audit risk

Executive Summary

This article outlines and explains the concept of audit risk, making reference to the key auditing standards which give guidance to auditors about risk assessment.

Identifying and assessing audit risk is a key part of the audit process, and ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*, gives extensive guidance to auditors about audit risk assessment.

The purpose of this article is to give summary guidance to FAU, AA (was F8) and AAA (was P7) students about the concept of audit risk.

All subsequent references in this article to the standard will be stated simply as ISA 315, although ISA 315 is a ‘redrafted’ standard, in accordance with the International Auditing and Assurance Standards Board (IAASB) Clarity Project.

This article outlines and explains the concept of audit risk, making reference to the key auditing standards which give guidance to auditors about risk assessment

Identifying and assessing audit risk is a key part of the audit process, and ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*, gives extensive guidance to auditors about audit risk assessment. The purpose of this article is to give summary guidance to FAU, F8 and P7 students about the concept of audit risk. All subsequent references in this article to the standard will be stated simply as ISA 315, although ISA 315 is a 'redrafted' standard, in accordance with the International Auditing and Assurance Standards Board (IAASB) Clarity Project. For further details on the IAASB Clarity Project, read the article 'The IAASB Clarity Project' (see 'Related links').

What is audit risk?

According to the IAASB Glossary of Terms (1), audit risk is defined as follows:

'The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of material misstatement and detection risk.'

Why is audit risk so important to auditors?

Audit risk is fundamental to the audit process because auditors cannot and do not attempt to check all transactions. Students should refer to any published accounts of large companies and think about the vast number of transactions in a statement of comprehensive income and a statement of financial position. It would be impossible to check all of these transactions, and no one would be prepared to pay for the auditors to do so, hence the importance of the risk-based approach toward auditing. Traditionally, auditors have used a risk-based approach in order to minimise the chance of giving an inappropriate audit opinion, and audits conducted in accordance with ISAs must follow the risk-based approach, which should also help to ensure that audit work is carried out efficiently, using the most effective tests based on the audit risk assessment. Auditors should direct audit work to the key risks (sometimes also described as significant risks), where it is more likely that errors in transactions and balances will lead to a material misstatement in the financial statements. It would be inefficient to address insignificant risks in a high level of detail, and whether a risk is classified as a key risk or not is a matter of judgment for the auditor.

Relevant ISAs

There are many references throughout the ISAs to audit risk, but perhaps the two most important audit risk-related ISAs are as follows:

ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs*
ISA 200 sets out the overall objectives of the auditor, and the standard explains the nature and scope of an audit designed to enable an auditor to meet those objectives. References to audit risk are frequently made by ISA 200, and the standard also requires that the auditor shall plan and perform an audit with professional scepticism, recognising that circumstances might exist that may cause the financial statements to be materially misstated. Professional scepticism is defined as an attitude that includes a questioning mind and a critical assessment of evidence.

ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*
ISA 315 deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through an understanding of the entity and its environment, including the entity's internal controls and risk assessment process. The first version of ISA 315 was originally published in 2003 after a joint audit risk project had been carried out between the IAASB, and the United States Auditing Standards Board. Changes in the audit risk standards have arguably been the single biggest change in auditing standards in recent years, so the significance of ISA 315, and the topic of audit risk, should not be underestimated by auditing students.

The requirements of ISA 315 are summarised in the following table.

(1). The auditor shall perform risk assessment procedures in order to provide a basis for the identification and assessment of the risks of material misstatement.
(2). The auditor is required to obtain an understanding of the entity and its environment, including the entity's internal control systems.
(3). The auditor shall identify and assess the risks of material misstatement, and determine whether any of the risks identified are, in the auditor's judgement, significant risks. This is in order to provide a basis for designing and performing further audit procedures.
(4). ISA 330 then deals with the required responses to assessed risks.

Let us consider each of these four stages in more detail.

1. Risk assessment procedures
ISA 315 gives an overview of the procedures that the auditor should follow in order to obtain an understanding sufficient to assess audit risks, and these risks must then be considered when designing the audit plan. ISA 315 goes on to require that the auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. ISA 315 goes on to identify the following three risk assessment procedures:

Making inquiries of management and others within the entity
Auditors must have discussions with the client's management about its objectives and expectations, and its plans for achieving those goals.

Analytical procedures
Analytical procedures performed as risk assessment procedures should help the auditor in identifying unusual transactions or positions. They may identify aspects of the entity of which the auditor was unaware, and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.

Observation and inspection
Observation and inspection may also provide information about the entity and its environment. Examples of such audit procedures can potentially cover a very broad area, including observation or inspection of the entity's operations, documents, and reports prepared by management, and also of the entity's premises and plant facilities.

ISA 315 requires that risk assessment procedures should, at a minimum, comprise a combination of the above three procedures, and the standard also requires that the engagement partner and other key engagement team members should discuss the susceptibility of the entity's financial statements to material misstatement. Key risks can be identified at any stage of the audit process, and ISA 315 requires that the engagement partner should also determine which matters are to be communicated to those engagement team members not involved in the discussion.

2. Understanding an entity
ISA 315 gives detailed guidance about the understanding required of the entity and its environment by auditors, including the entity's internal control systems. Understanding of the entity and its environment is important for the auditor in order to help identify the risks of material misstatement, to provide a basis for designing and implementing responses to assessed risk (see reference below to ISA 330, *The Auditor's Responses to Assessed Risks*), and to ensure that sufficient appropriate audit evidence is collected. Given that the focus of this article is audit risk, however, students should ensure that they also make themselves familiar with the concept of internal control, and the components of internal control systems.

3. Identification and assessment of significant risks and the risks of material misstatement
In exercising judgement as to which risks are significant risks, the auditor is required to consider the following:

- Whether the risk is a risk of fraud.
- Whether the risk is related to recent significant economic, accounting or other developments, and therefore requires specific attention.
- The complexity of transactions.
- Whether the risk involves significant transactions with related parties.

- The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty.
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

4. ISA 330 and responses to assessed risks
The requirements of ISA 330, *The Auditor's Responses to Assessed Risks*, will be covered in a future article, but essentially ISA 330 gives guidance about the nature and extent of the testing required, based on the risk assessment findings.

Audit risk and business risk

For the purposes of the F8 exam, it is important to make a distinction between audit risk and business risk (which is not examinable in F8), even though ISA 315 itself does not make such a distinction clear. ISA 315(2) defines business risk as follows:

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

Hence, business risk is a much broader concept than audit risk. Students are reminded that business risk is excluded from the FAU and F8 syllabus, although it is examinable in P7.

The audit risk model

Finally, it is important to make reference to the so called traditional audit risk model, which pre-dates ISA 315, but continues to remain important to the audit process. The audit risk model breaks audit risk down into the following three components:

Inherent risk
This is the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

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

Detection risk
This is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material,

either individually or when aggregated with other misstatements.

The interrelationship of the three components of audit risk is outside the scope of this current article. F8 students, however, will typically be expected to have a good understanding of the concept of audit risk, and to be able to apply this understanding to questions in order to identify and describe appropriate risk assessment procedures.

The UK and Ireland perspective

The UK Auditing Practices Board announced in March 2009 that it would update its auditing standards according to the clarified ISAs, and that these standards would apply for audits of accounting periods ending on or after 15 December 2010. UK and Irish students should note that there are no significant differences on audit risk between ISA 315 and the UK and Ireland version of the standard.

Conclusions

The concept of audit risk is of key importance to the audit process and F8 students are required to have a good understanding of what audit risk is, and why it is so important. For the purposes of the F8 exam, it is important to understand that audit risk is a very practical topic and is therefore examined in a very practical context. Any definition or explanation of the audit risk model itself will usually only be allocated a small number of marks, but many students still include such definitions in answers to case study and scenario questions which require a practical application of audit risk assessment procedures. Students must also be prepared to apply their understanding of audit risk to questions and come up with appropriate risk assessment procedures.

Written by a member of the F8 examining team

References

1. IAASB Handbook 2009, Glossary of Terms.
2. ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*, paragraph 4 (b).

Questions

What are the two elements of the risk of material misstatement at the assertion level?

A Inherent risk and detection risk
B Audit risk and detection risk
C Inherent risk and control risk
D Detection risk and control risk

Answer: C

The risk of material misstatement at the assertion level is made up of inherent risk and control risk.

Detection risk is the risk that the auditor's procedures will not detect a misstatement that exists in an assertion that could be material. Audit risk is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is made up of inherent risk, control risk and detection risk (AR = IR × CR × DR)

Chapter 2 ISA 330 and responses to assessed risks

Executive Summary

This article considers the requirements of ISA 330, ***The Auditor's Responses to Assessed Risks***.

The main objective of ISA 330 is to give guidance on how auditors should obtain sufficient appropriate evidence regarding the assessed risks of material misstatement by designing and implementing appropriate responses to those risks.

UK and Irish students should note that there are no significant differences between ISA 330 and the UK and Ireland version of this standard.

This article considers the requirements of ISA 330, *The Auditor's Responses to Assessed Risks*. The main objective of ISA 330 is to give guidance on how auditors should obtain sufficient appropriate evidence regarding the assessed risks of material misstatement by designing and implementing appropriate responses to those risks. UK and Irish students should note that there are no significant differences between ISA 330 and the UK and Ireland version of this standard.

Of central importance to both ISA 315 and ISA 330 is the recognition that assessing risk is at the core of the audit process, and these two ISAs specify that the auditor is required to obtain an understanding of the key risks (sometimes described as 'significant' risks) relevant to the financial statements. Paragraph 6 of ISA 330 requires that:

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

Definitions

ISA 330 requires that auditors should carry out tests of control and substantive procedures, and paragraph 4 of the ISA gives the definitions shown in **Table 1**.

Students often find it quite difficult to comprehend what tests of control and substantive procedures are, to explain the difference between them, and also to give examples of both. One important difference between them is that tests of control are usually short, quick tests which generate either a 'yes' or a 'no' answer, where 'yes' is favourable (confirming the operation of an internal control), and 'no' is unfavourable (indicating that an internal control is not operating satisfactorily). Substantive procedures, however, as the name suggests, are more substantive and time consuming, requiring more detailed audit work to be carried out. The following examples, in the context of a purchases system, should help.

Tests of control – examples for a purchases system

Consider when the auditor reviews a company's purchases system and internal controls, and the assertion of occurrence (that recorded purchases represent goods and services received and which pertain to the entity). An appropriate internal control would be that purchase orders are raised for each purchase and are authorised by appropriate senior personnel.

Table 1: ISA 330 tests of control and substantive procedures definitions

Test of control	Substantive procedure
An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.	An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise tests of details and substantive analytical procedures.

A test of control would be to examine a sample of purchase orders to ensure that they have been appropriately authorised, and a ‘yes’ answer is good, confirming that the internal control requiring authorisation of purchase orders is working, or alternatively a ‘no’ answer indicates that the internal control does not appear to be working, hence requiring further audit investigation.

Another example of a test of control for a purchases system would be to inspect a sample of goods received notes to confirm that stores inwards staff sign for goods received. Once again, a ‘yes’ answer is positive, confirming that staff have signed the goods received note, and a ‘no’ answer would be negative, requiring further audit work to be carried out to determine why the goods received note had not been signed. This test of control would also help to confirm the occurrence assertion.

Substantive procedures and tests of detail – overview

ISA 330 requires that the auditor shall always carry out substantive procedures on material items irrespective of the assessed risks of material misstatement, and that the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. According to the IAASB Glossary of Terms 1 , substantive procedures fall into two categories, ‘tests of details’ and ‘substantive analytical procedures’ (or simply ‘analytical procedures’, as they are usually described). ISA 330 says that auditors must decide when it is most appropriate to use which type of substantive procedure. Analytical procedures are outside the scope of this current article, and the examples given below are examples of tests of details.

Substantive procedures – examples of tests of detail for a purchases system

Substantive procedures will invariably tend to involve more work than tests of control. Consider once again the example of the purchases system for a manufacturing company and the assertion of existence for account balances in the statement of financial position. Typical tests of detail would involve some physical verification of year-end balances outstanding, which would require obtaining and reviewing the closing purchase ledger account balances for a sample of purchase ledger accounts with selected suppliers. Typically, this could include agreeing the closing balance figure to the supplier’s statement, or even possibly requesting third party confirmation by the supplier of the amount outstanding.

Cut-off testing would also be typically carried out on year-end purchase ledger balances, which would involve obtaining a sample of pre- and post - year-end goods received notes, and agreeing these to the matching pre- or post-year-end purchase invoices, to ensure that only goods received before the end of the accounting period were included. This test would also help to confirm the assertion of existence.

Timing

ISA 330 indicates that the auditor may perform tests of control or substantive procedures at an interim date or at the period end. The standard also indicates that, in general, the extent of audit procedures increases as the risk of material misstatement increases.

Overall responses

ISA 330 lists the following overall responses that may be used by auditors in order to address the assessed risks of material misstatement at the financial statement level:

- Emphasising to the audit team the need to maintain professional scepticism.
- Assigning more experienced staff, those with special skills, or using experts.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- Making general changes to the nature, timing or extent of audit procedures.

Summary

Assessing risk lies at the core of the audit process and this article has introduced and explained some of the terminology used by ISA 330, giving guidance to auditors on how to respond to assessed risks.

In general, tests of control are short, quick audit tests, whereas substantive procedures will require more detailed audit work. ISA 330 requires that, irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each class of transactions, account balance and disclosure.

Finally, students should try to identify tests of control and substantive procedures for the main accounting systems.

Reference

1 *IAASB Auditing Handbook 2010*, Glossary of Terms.

Questions

Is the following statement regarding the interim audit true or false?
The higher the risk of material misstatement the more likely it is that the auditor will decide to perform substantive procedures during the interim audit rather than at the period end.

A True
B False

Answer: B

In accordance with ISA 330 *The auditor's responses to assessed risks* the auditor is more likely to perform procedures at the period end where there is a high risk of material misstatement.

Chapter 3 ISA 315 (Revised) Identifying and assessing the risks of material

Executive Summary

One of the major revisions of ISA 315 relates to the inquiries made by external auditors of the internal audit function since internal auditors have better knowledge and understanding of the organisation and its internal control.

This article addresses and highlights the components of internal control.

As internal auditors have better understanding of the organisation and expertise in its risk and control, the proposed requirement for the external auditors to make enquiries of internal audit function in ISA 315 (Revised) will enhance the effectiveness and efficiency of audit engagements.

External auditors should pay attention to the components of internal control mentioned above in order to make effective and efficient enquiries.

An increase in the work of internal audit functions is also expected because of such proposed requirement.

One of the major revisions of ISA 315 relates to the inquiries made by external auditors of the internal audit function since internal auditors have better knowledge and understanding of the organisation and its internal control. This article addresses and highlights the components of internal control

The International Auditing and Assurance Standards Board (IAASB) issues International Standard on Auditing (ISA) for international use. From time to time, ISAs are revised to provide updated standards to auditors. In order to enhance the overall quality of audit, IAASB published a consultation draft on a proposed revision to ISA 315. The objective in revising ISA 315 is to enhance the performance of external auditors by applying the knowledge and findings of an entity's internal audit function in the risk assessment process, and to strengthen the framework for evaluating the use of internal auditors work to obtain audit evidence.

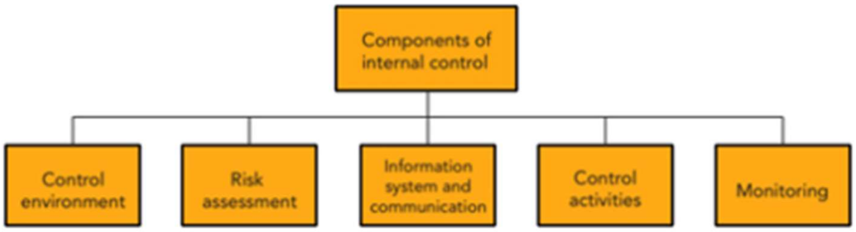
In March 2012, ISA 315 (Revised) was approved and released. One of the major revisions of ISA 315 relates to the inquiries made by external auditors of the internal audit function since internal auditors have better knowledge and understanding of the organisation and its internal control. This article addresses and highlights the components of internal control.

Objectives in establishing internal controls

Generally speaking, internal control systems are designed, implemented and maintained by the management and personnel in order to provide reasonable assurance to fulfil the objectives – that is, reliability of financial reporting, efficiency and effectiveness of operations, compliance with laws and regulations and risk assessment of material misstatement. The manner in which the internal control system is designed, implemented and maintained may vary with the entity's business nature, size and complexity, etc. Auditors focus on both the audit of financial statements and internal controls that relates to the three objectives that may materially affect financial reporting.

In order to identify the types of potential misstatements and to determine the nature, timing and extent of audit testing, auditors should obtain an understanding of relevant internal controls, evaluate the design of the controls, and ascertain whether the controls are implemented and maintained properly.

The major components of internal control include control environment, entity's risk assessment process, information system (including the related business processes, control activities relevant to the audit, relevant to financial reporting, and communication) and monitoring of controls.



Control environment

The control environment consists of the governance and management functions and the attitudes, awareness and actions of the management about the internal control. Auditors may obtain an understanding of the control environments through the following elements.

1. *Communication and enforcement of integrity and ethical values*
It is important for the management to create and maintain honest, legal and ethical culture, and to communicate the entity's ethical and behavioural standards to its employees through policy statements and codes of conduct, etc.

2. *Commitment to competence*
It is important that the management recruits competent staff who possess the required knowledge and skills at competent level to accomplish tasks.

3. *Participation by those charged with governance*
An entity's control consciousness is influenced significantly by those charged with governance; therefore, their independence from management, experience and stature, extent of their involvement, as well as the appropriateness of their actions are extremely important.

4. *Management's philosophy and operating style*
Management's philosophy and operating style consists of a broad range of characteristics, such as management's attitude to response to business risks, financial reporting, information processing, and accounting functions and personnel, etc. For example, does the targeted earning realistic? Does the management apply aggressive approach where alternative accounting principles or estimates are available? These management's philosophy and operating style provide a picture to auditors about the management's attitude about the internal control.

5. *Organisational structure*
The organisational structure provides the framework on how the entity's activities are planned, implemented, controlled and reviewed.

6. *Assignment of authority and responsibility*
With the established organisational structure or framework, key areas of authority and reporting lines should then be defined. The assignment of authority and responsibility

include the personnel that make appropriate policies and assign resources to staff to carry out the duties. Auditors may perceive the implementation of internal controls through the understanding of the organisational structure and the reporting relationships.

7. *Human resources policies and practices*
Human resources policies and practices generally refer to recruitment, orientation, training, evaluation, counselling, promotion, compensation and remedial actions. For example, an entity should establish policies to recruit individuals based on their educational background, previous work experience, and other relevant attributes. Next, classroom and on-the-job training should be provided to the newly recruited staff. Appropriate training is also available to existing staff to keep themselves updated. Performance evaluation should be conducted periodically to review the staff performance and provide comments and feedback to staff on how to improve themselves and further develop their potential and promote to the next level by accepting more responsibilities and, in turn, receiving competitive compensation and benefits.

With the ISA 315 (Revised), external auditors are now required to make inquiries of the internal audit function to identify and assess risks of material misstatement. Auditors may refer to the management's responses of the identified deficiencies of the internal controls and determine whether the management has taken appropriate actions to tackle the problems properly. Besides inquiries of the internal audit function, auditors may collect audit evidence of the control environment through observation on how the employees perform their duties, inspection of the documents, and analytical procedures. After obtaining the audit evidence of the control environment, auditors may then assess the risks of material misstatement.

Entity's risk assessment process

Auditors should assess whether the entity has a process to identify the business risks relevant to financial reporting objectives, estimate the significance of them, assess the likelihood of the risks occurrence, and decide actions to address the risks. If auditors have identified such risks, then auditors should evaluate the reasons why the risk assessment process failed to identify the risks, determine whether there is significant deficiency in internal controls in identifying the risks, and discuss with the management.

The Information system, including the relevant business processes, relevant to financial reporting and communication

Auditors should also obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:

- The classes of transactions in the entity's operations that are significant to the financial statements. The procedures that transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements.

- How the information system captures events and conditions that are significant to the financial statements.
- The financial reporting process used to prepare the entity's financial statements.
- Controls surrounding journal entries.
- Understand how the entity communicates financial reporting roles, responsibilities and significant matters to those charged with governance and external – regulatory authorities.

Control activities relevant to the audit

Auditors should obtain a sufficient understanding of control activities relevant to the audit in order to assess the risks of material misstatement at the assertion level, and to design further audit procedures to respond to those risks. Control activities, such as proper authorisation of transactions and activities, performance reviews, information processing, physical control over assets and records, and segregation of duties, are policies and procedures that address the risks to achieve the management directives are carried out.

Monitoring of controls

In addition, auditors should obtain an understanding of major types of activities that the entity uses to monitor internal controls relevant to financial reporting and how the entity initiates corrective actions to its controls. For instance, auditors should obtain an understanding of the sources and reliability of the information that the entity used in monitoring the activities. Sources of information include internal auditor report, and report from regulators.

Limitations of internal control systems

Effective internal control systems can only provide reasonable, not absolute, assurance to achieve the entity's financial reporting objective due to the inherent limitations of internal control – for example, management override of internal controls. Therefore, auditors should identify and assess the risks of material misstatement at the financial statement level and assertion level for classes of transactions, account balances and disclosures.

Conclusion

As internal auditors have better understanding of the organisation and expertise in its risk and control, the proposed requirement for the external auditors to make enquiries of internal audit function in ISA 315 (Revised) will enhance the effectiveness and efficiency of audit engagements. External auditors should pay attention to the components of internal control mentioned above in order to make effective and efficient enquiries. An increase in the work of internal audit functions is also expected because of such proposed requirement.

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Reference

ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*

Questions

Which of the following procedures must the auditor use to obtain an understanding of the entity and its environment in accordance with ISA 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment*?
(1) Analytical procedures
(2) Inquiry
(3) Confirmation
(4) Reperformance

A (1), (2) and (3)
B (1) and (2)
C (2), (3) and (4)
D (1) and (4)

Answer: B

ISA 315 requires auditors to use analytical procedures and inquiry when obtaining an understanding of the entity and its environment. In addition, they should also use observation and inspection.

Chapter 4 The audit of assertions

Executive Summary

This article focuses on assertions as identified by ISA 315 (Revised) and also provides useful guidance to candidates on how to tackle questions dealing with these.

Relevant to Foundations in Audit (FAU) and Audit and Assurance (AA)

This article will focus on assertions as identified by ISA 315 (Revised) and also provides useful guidance to candidates on how to tackle questions dealing with these.

Interim and final audit procedures

During the interim audit, the internal control system is documented and evaluated. This will determine the mix of tests of control and substantive procedures but both will tend to focus on transactions that have occurred so far in the period.

During the final audit, the focus is on the financial statements and the assertions about assets, liabilities and equity interests. At this stage the auditor will design substantive procedures to ensure that assurance has been gained over all relevant assertions.

Assertions

Transactions include sales, purchases, and wages paid during the accounting period. Account balances include all the asset, liabilities and equity interests included in the statement of financial position at the period end.

Obviously there is a link between the two because if the auditor performs tests to confirm the occurrence of sales this will also provide some assurance about the existence of receivables. Although the auditor may perform other tests specifically focussed on existence.

The assertions listed in ISA 315 (Revised) are as follows:

Assertions about classes of transactions and events and related disclosures for the period under audit
(i) Occurrence – the transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.
(ii) 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.
(iii) Accuracy – amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
(iv) Cut–off – transactions and events have been recorded in the correct accounting period.
(v) Classification – transactions and events have been recorded in the proper accounts.
(vi) Presentation – transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

Assertions about account balances and related disclosures at the period end
(i) Existence – assets, liabilities and equity interests exist.
(ii) Rights and obligations – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
(iii) 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.
(iv) Accuracy, valuation and allocation – assets, liabilities and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded and related disclosures have been appropriately measured and described.
(v) Classification – assets, liabilities and equity interests have been recorded in the proper accounts.
(vi) 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.

Interpretation of assertions and appropriate audit procedures

In many cases the meaning of the assertions is fairly obvious and in preparation for their FAU or AA exam candidates are reminded of the importance to learn and be able to apply the use of assertions in the course of the audit. Particularly, candidates need to be able to identify and explain the assertions, identify which assertion is being tested by a particular audit procedure and to describe audit procedures for relevant assertions in testing a specific transaction or balance, bearing in mind that the relevant disclosures should also be considered when deriving appropriate procedures.

Below is a summary of the assertions, a practical application of how the assertions are applied and some example audit procedures relevant to each.

Transaction assertions

Occurrence – this means that the transactions recorded or disclosed actually happened and relate to the entity. For example that a recorded sale represents goods which were ordered by valid customers and were despatched and invoiced in the period. An alternative way of putting this is that sales are genuine and are not overstated.

Relevant test – select a sample of entries from the sales account in the general ledger and trace to the appropriate sales invoice and supporting goods dispatched notes and customer orders.

Completeness – this means that transactions that should have been recorded and disclosed have not been omitted.

Relevant test – select a sample of customer orders and check to dispatch notes and sales invoices and the posting to the sales account in the general ledger.

Note the difference in the direction of the above test. In order to test completeness the procedure should start from the underlying documents and check to the entries in the relevant ledger to ensure none have been missed. To test for occurrence the procedures will go the other way and start with the entry in the ledger and check back to the supporting documentation to ensure the transaction actually happened.

Accuracy – this means that there have been no errors while preparing documents or in posting transactions to ledgers. The reference to disclosures being appropriately *measured and described* means that the figures and explanations are not misstated.

Relevant test – reperformance of calculations on invoices, payroll, etc, and the review of control account reconciliations are designed to provide assurance about accuracy.

Cut–off – that transactions are recorded in the correct accounting period.

Relevant test – recording last goods received notes and dispatch notes at the inventory count and tracing to purchase and sales invoices to ensure that goods received before the year end are recorded in purchases at the year end and that goods dispatched are recorded in sales.

Classification – transactions recorded in the appropriate accounts – for example, the purchase of raw materials has not been posted to repairs and maintenance.

Relevant test – check purchase invoices postings to general ledger accounts.

Presentation – this means that the descriptions and disclosures of transactions are relevant and easy to understand. There is a reference to transactions being appropriately aggregated or disaggregated. Aggregation is the adding together of individual items. Disaggregation is the separation of an item, or an aggregated group of items, into component parts. The notes to the financial statements are often used to disaggregate totals shown in the statement of profit or loss. Materiality needs to be considered when judgements are made about the level of aggregation and disaggregation.

Relevant test – confirm that the total employee benefits expense is analysed in the notes to the financial statements under separate headings– ie wages and salaries, pension costs, social security contributions and taxes, etc.

Account balance assertions

Existence – means that assets and liabilities really do exist and there has been no overstatement – for example, by the inclusion of fictitious receivables or inventory. This assertion is very closely related to the *occurrence* assertion for transactions.

Relevant tests – physical verification of non–current assets, circularisation of receivables, payables and the bank letter.

Rights and obligations – means that the entity has a legal title or controls the rights to an asset or has an obligation to repay a liability.

Relevant tests – in the case of property, deeds of title can be reviewed. Current assets are often agreed to purchase invoices although these are primarily used to confirm cost. Long term liabilities such as loans can be agreed to the relevant loan agreement.

Completeness – that there are no omissions and assets and liabilities that should be recorded and disclosed have been. In other words there has been no understatement of assets or liabilities.

Relevant tests – A review of the repairs and expenditure account can sometimes identify items that should have been capitalised and have been omitted from non–current assets. Reconciliation of payables ledger balances to suppliers' statements is primarily designed to confirm completeness although it also gives assurance about existence.

Accuracy, valuation and allocation – means that amounts at which assets, liabilities and equity interests are valued, recorded and disclosed are all appropriate. The reference to allocation refers to matters such as the inclusion of appropriate overhead amounts into inventory valuation.

Relevant tests – Vouching the cost of assets to purchase invoices and checking depreciation rates and calculations.

Classification – means that assets, liabilities and equity interests are recorded in the proper accounts.

Relevant tests – the test for transactions of checking purchase invoice postings to the appropriate accounts in the general ledger will be relevant again. Also that research expenditure is only classified as development expenditure if it meets the criteria specified in IAS® 38 Intangible Assets.

Presentation – this means that the descriptions and disclosures of assets and liabilities are relevant and easy to understand. The points made above regarding aggregation and disaggregation of transactions also apply to assets, liabilities and equity interests.

Relevant tests – auditors often use disclosure checklists to ensure that financial statement presentation complies with accounting standards and relevant legislation. These cover all items (transactions, assets, liabilities and equity interests) and would include for example confirming that disclosures relating to non–current assets include cost, additions, disposals, depreciation, etc.

Typical exam questions

Questions on assertions may often be included in the objective test questions (OTs) in the AA and FAU exams and may also appear in the constructed response questions where candidates may be required to demonstrate knowledge of the assertions and procedures that are linked to particular transaction or account balance assertions in more detail.

Below are some examples which provide an indication, but not an exhaustive list of how assertions can be tested at FAU and AA.

Which of the following substantive procedures provides evidence over the COMPLETENESS of non–current assets?

A. Select a sample of assets included in the non–current asset register and physically verify them at the client premises
B. Review the repairs and maintenance expense account to identify any items of a capital nature
C. For assets disposed of, agree the sale proceeds to supporting documentation and cash book
D. For a sample of non-current assets, recalculate the depreciation charge

In order to tackle a question like this, candidates are encouraged to work through each procedure and think about the objective of the auditor when they are testing for completeness and to consider whether the procedure as presented would satisfy that objective:

A. Confirms existence not completeness – the direction of the test is key here – had the test been the other way selecting sample of non–current assets in the factory and tracing to the non–current asset register that would have confirmed completeness.
B. Confirms completeness as the auditor may identify non–current assets that have not been capitalised and is therefore the correct answer.
C. Confirms the proceeds of sale so is more relevant to accuracy or valuation
D. Confirms depreciation so is also more relevant to accuracy or valuation

Candidates may be asked to identify and apply the assertions to a specified area of the financial statements in a constructed response question as follows:

Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to the VALUATION of X Co's inventory.

Candidates must be able to link relevant procedures to the specific assertion required. In this instance, for example procedures performed at the inventory count which provide evidence of existence and completeness of inventory would not be relevant.

Conclusion

Assertions have always been an important area of the syllabus for audit examinations.

Candidates should ensure that they know the assertions and can explain what they mean. Candidates should not simply memorise these tests but also ensure they understand the reasons why the test provides assurance about the particular assertion. In some instances, the direction of the test will be a key point to consider.

Written by a member of the Audit and Assurance examining team

Chapter 5 Exam technique article – answering audit risk questions

Executive Summary

This article aims to identify the most common mistakes made by candidates in answering audit risk questions as well as clarifying how such questions should be tackled in order to maximise marks.

Candidates studying Paper F8, *Audit and Assurance*, are required under the syllabus to: 'Explain the components of audit risk and explain the risks of material misstatement in the financial statements'.

This element of the syllabus has been examined in the last three sessions of Paper F8 – in June 2010, December 2010 and June 2011. However, the performance of candidates has on the whole been unsatisfactory. This article aims to identify the most common mistakes made by candidates as well as clarifying how audit risk questions should be tackled in order to maximise marks.

An example question requirement relating to audit risks is as follows:

Describe the audit risks and explain the auditor's response to each risk in planning the audit of XYZ Co.

Previously examined risk questions have carried a mark allocation of 10 marks. However, a significant majority of candidates have not passed this part of the question. Common mistakes made include:

- providing definitions of the audit risk model, even though this was not part of the question requirement
- a lack of understanding of what audit risk is and providing business risks instead
- not providing an adequate response to the risk. This needs to be from the perspective of the auditor and not from management's perspective
- a limited range of risks identified, often just focusing on one area such as going concern.

Audit risk definitions

Audit risk is defined as 'the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk'. Hence, audit risk is made up of two components – risks of material misstatement and detection risk.

Risk of material misstatement is defined as 'the risk that the financial statements are materially misstated prior to audit. This consists of two components... inherent risk ... control risk.'

Inherent risk is 'the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.'

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

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

Audit risk questions require candidates to identify risks of material misstatements, which include inherent and control risks as well as detection risks.

Audit risk model

In all three sessions a number of candidates have wasted valuable time by describing the audit risk model along with definitions of audit risk, inherent risk, control and detection risk. Unless the question requirement specifically asks for the 'components of audit risk' or 'a description of the audit risk model', candidates should not provide definitions of audit risk, inherent risk, control risk or detection risk as no marks are available.

Audit risk versus business risk

The main area where candidates continue to lose marks is that they do not actually understand what audit risk relates to. Hence, they frequently provide answers that consider the risks the business would face or 'business risks', which are outside the scope of the syllabus. There are no marks available for business risks.

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

Risks must be related to the risk arising in the audit of the financial statements and should include the financial statement assertion impacted. Therefore, audit risks should be related back to relevant assertions.

ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment* identifies the following assertions:

- Assertions about classes of transactions and events for the period under audit – occurrence completeness, accuracy, cut off and classification.

- Assertions about account balances at the period end – existence, rights and obligations completeness, and valuation and allocation.
- Assertions about presentation and disclosure – occurrence and rights and obligations, completeness, classification and understandability, and accuracy and valuation.

In addition, a risk can relate to a practical problem the audit team may face, such as attendance at inventory counts where the company has multiple sites holding simultaneous inventory counts, or if the company has had significant changes in their finance department and so the risk of fraud and error has increased.

The common mistake is for candidates to identify a relevant issue from the scenario and then consider the risk to the company rather than to the auditor, linking into the related assertion.

Therefore, using Question 3b from the June 2011 exam: 'The travel agents are given a 90-day credit period to pay Donald Co; however, due to difficult trading conditions, a number of the receivables are struggling to pay.' The audit risk related to this point is that if receivables are struggling to pay, then they may be overstated and, hence, valuation of receivables is the relevant risk.

The business faces the risk of slow cash flows and so there is a business risk related to the liquidity of Donald Co. While going concern is an audit risk, the above point from the scenario is not sufficient on its own to indicate going concern risk.

In addition, Question 1a from the June 2010 exam told candidates: 'Purchase orders for overseas paint are made six months in advance and goods can be in transit for up to two months.' The explanation of the audit risk would be to ascertain that the cut-off of inventory is appropriate at the year end. However, many candidates explained that the company may encounter problems with stock-outs of goods, which is focused more on operational business risk rather than on the risks to the financial statements.

Other examples of audit risks include:

- treatment of capital and revenue expenditure – the risk here could relate to existence of property plant and equipment if revenue expenditure has been capitalised rather than charged as an expense in the income statement
- valuation of inventory – when, for example, there are considerable levels of aged inventory
- completeness of liabilities – this could arise if provisions have been incorrectly treated as contingent liabilities
- completeness of revenue – this could be relevant where the entity being audited has significant cash sales.

Responses to audit risks

Having identified the audit risk candidates are often required to identify the relevant response to these risks. A common mistake made by candidates is to provide a response that management would adopt rather than the auditor.

From Question 3b June 2011, in relation to the risk of valuation of receivables, as Donald Co had a number of receivables who were struggling to pay, many candidates suggested that management needed to chase these outstanding customers. This is not a response that the auditor would adopt, as they would be focused on testing valuation through after date cash receipts or reviewing the aged receivables ledger.

Auditor’s responses should focus on how the team will obtain evidence to reduce the risks identified to an acceptable level. Their objective is confirming whether the financial statement assertions have been adhered to, and whether the financial statements are true and fair.

Responses are not as detailed as audit procedures; instead they relate to the approach the auditor will adopt to confirm whether the transactions or balances are materially misstated. Therefore, in relation to the risk of going concern, the response is to focus on performing additional going concern procedures, such as reviews of cash flow forecasts.

Also, auditor responses should not be too vague such as ‘increase substantive testing’ without making it clear how, or in what area, this would be addressed.

In addition, candidates’ must ensure that they do not provide impractical responses. A common example of this is to request directly from the company’s bank as to whether the bank will provide a loan or renew a bank overdraft. The bank is not going to provide this type of information to the auditor, especially if they have not yet informed the company, and therefore this response will not generate any marks.

Limited range of risks identified

In order to score well in risk questions it is advisable to aim to identify a breadth of points from the question scenario. If the question asks for a specific number of audit risks, such as five, then it is not sufficient to identify just one or two risks. In addition, a common mistake is to identify a risk such as going concern and then give this answer over and over again. In Question 3b of the June 2011 exam, there was only a maximum of one mark available for the description of going concern risk.

Each scenario will have a variety of audit risks and candidates should, as part of their planning, aim to identify as many as possible. They should then decide which of the identified risks they will explain/describe in their answer. If the question asks for five risks, candidates should aim to identify six or seven points during their initial reading of the question. Candidates should then review their list and pick the five risks and responses that they feel they can expand on the most when writing up their answer.

Conclusion

Audit risk is, and will continue to be, an important element of the Paper F8 syllabus. Candidates must understand the syllabus outcomes, understand what the question requirements involve and practise risk questions prior to the exam.

Written by a member of the Paper F8 examining team

Chapter 6 Laws and regulations

Executive Summary

It is important that candidates preparing for F8 have an understanding of how laws and regulations affect an audit, not only in terms of the work the auditor is required to do, but also to appreciate the responsibilities of both management and the auditor where laws and regulations are concerned.

The auditing standard that is relevant to this article is ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*

The standard defines an act of 'non-compliance' as follows:

'Acts of omission or commission intentional or unintentional, committed by the entity, or by those charged with governance, by management or by other individuals working for or under the direction of the entity which are contrary to the prevailing laws or regulations. Non-compliance does not include personal misconduct unrelated to the business activities of the entity.'

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

It is important that candidates preparing for *Audit and Assurance* (AA) and *Advanced Audit and Assurance* (AAA) have an understanding of how laws and regulations affect an audit, not only in terms of the work the auditor is required to do, but also to appreciate the responsibilities of both management and the auditor where laws and regulations are concerned.

The auditing standard that is relevant to this article is ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, and the objectives of the auditor according to paragraph 11 in ISA 250 are:

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

The standard defines an act of 'non-compliance' as follows:

'Acts of omission or commission intentional or unintentional, committed by the entity, or by those charged with governance, by management or by other individuals working for or under the direction of the entity which are contrary to the prevailing laws or regulations. Non-compliance does not include personal misconduct unrelated to the business activities of the entity.'

Respective responsibilities of management and auditors

Candidates need to go into the exam with an understanding as to who is responsible for compliance with laws and regulations and who is responsible for the detection of non-compliance with laws and regulations.

It is the responsibility of management to ensure that an entity complies with relevant laws and regulations. It is ***not*** the responsibility of the auditor to either prevent or detect non-compliance.

Question 1(c) of the December 2011 F8 exam (now AA) for four marks required candidates to:

'Explain the responsibilities of management and auditors of Chuck Industries Co in relation to compliance with laws and regulations under ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements*.'*

The question itself was linked to a brief scenario where Chuck Industries Co had received a visit from the tax authority who had discovered incorrect levels of tax had been deducted from the payroll as tax rates had not been updated in the previous year and the finance director was questioning the audit firm as to why they had not identified this non-compliance with tax legislation.

To secure a pass in this part of the question, candidates would have had to:

- understand that it is role of the management of Chuck Industries Co to ensure the operations of the entity are conducted in accordance with laws and regulations (this applies to tax legislation also)
- appreciate that an auditor is not responsible for prevention of non-compliance with laws and regulations and is not expected to detect instances of non-compliance
- acknowledge in the answer that it is the auditor's responsibility to obtain reasonable assurance that the financial statements are free from material misstatement. To that end the auditor will take into account the legal and regulatory framework within which the entity operates
- make reference to the auditor's responsibility to consider those laws and regulations that have both a **direct** and an **indirect** effect on the determination of material amounts and disclosures in the financial statements.

Direct and indirect laws and regulations

There are many laws and regulations that a reporting entity may have to comply with in order to continue in business. For example, many entities will have to comply with strict health and safety legislation; a food manufacturer may have strict food hygiene legislation to comply with, and an accountancy firm will have a code of ethics to follow from its professional body. Such laws and regulations will have both a *direct* effect on the financial statements and an *indirect* effect.

For those laws and regulations that have a direct effect on the financial statements, the auditor will be concerned about gathering sufficient and appropriate audit evidence that the entity has complied with such laws and regulations. For example, when auditing the payroll the auditor will be concerned with gathering sufficient and appropriate audit evidence to ensure that tax legislation has been correctly applied by the entity because if it has not (as in Question 1(c) in the December 2011 F8 exam), there is risk that the entity could be fined for non-compliance and the fines could be material, either in isolation or when aggregated with other misstatements. In addition, amounts within the financial statements may also be misstated as a result of the non-compliance with laws and regulations.

For those laws and regulations that have an indirect effect on the financial statements, the auditor will undertake procedures with the objective of identifying *non-compliance* with such laws and regulations. ISA 250 gives examples in paragraph 6(b) of:

- compliance with the terms of an operating license
- compliance with regulatory solvency requirements, or
- compliance with environmental regulations.

When designing procedures to help to identify non-compliance with laws and regulations, ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* requires an auditor to obtain a general understanding of:

- the applicable legal and regulatory framework, and
- how the entity complies with that framework.

Identifying non-compliance with laws and regulations can be tricky for auditors, particularly where fraud and/or money laundering is concerned (see later in the article). It is for this reason that the auditor must maintain a degree of professional scepticism and remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention, and such procedures could include:

- reading minutes of board meetings
- enquiring of management and/or legal advisers concerning litigation or claims brought against the entity, and
- undertaking substantive tests on classes of transactions, account balances or disclosures.

Reporting identified or suspected non-compliance with laws and regulations

Where the auditor discovers non-compliance with laws and regulations, the auditor must notify those charged with governance. However, care must be taken by the auditor because if the auditor suspects that those charged with governance are involved, the auditor must then communicate with the next highest level of authority, which may include the audit committee. If a higher level of authority does not exist, the auditor will then consider the need to obtain legal advice.

The auditor must also consider whether the non-compliance has a material effect on the financial statements and, in turn, the impact the non-compliance will have on their report.

If the auditor identifies or suspects non-compliance, the auditor will need to consider whether law, regulation and ethical requirements either require the auditor to report to an appropriate authority outside the entity, or establish responsibilities under which this may be appropriate.

There may be occasions when the auditor's duty of confidentiality may be overridden by law or statute. This can be the case when the auditor discovers non-compliance with legislation such as drug trafficking or money laundering.

Money laundering

The *Study Guide* to AAA covers the issue of money laundering separately to that of laws and regulations in A2(a) to (g). ACCA's Code of Ethics and Conduct defines 'money laundering' as:

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

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

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

Money laundering offences can include:

- concealing criminal property
- acquiring, using or possessing criminal property
- becoming involved in arrangement which is known, or suspected, of facilitating the acquisition of criminal property.

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

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

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

Question 3(b) in the March/June 2016 P7 (Int) Sample Questions (now AAA) gave candidates a scenario where they were placed in the position of audit manager. The audit senior had noted as part of their review of the cash book, a receipt of $350,000 for which the source was unclear followed by a transfer of the same amount to a bank account held in another country. When questioned, the financial controller had referred the audit senior to the business owner. Documentary evidence had been requested but had not yet been received.

This particular question did not make reference to the term 'money laundering' in the scenario or in the question requirement; the question required the candidate to evaluate the implications for the completion of the audit, recommending any further actions which should be taken by the firm.

The fact that no mention of money laundering was made either in the scenario or in the question requirements is reflective of the fact that in real life those committing money laundering will not openly admit to committing such offences. Money laundering is therefore very similar (if not identical in many ways) to fraud and, therefore, auditors should set aside any beliefs concerning the integrity and honesty of the audit client and keep a sceptical mindset where such issues are concerned.

Tipping off

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

Conclusion

Candidates attempting AA and AAA are advised to gain a sound understanding of laws and regulations, not only in the context of the *Syllabus* and *Study Guide* but also in the context of real-life situations to allow for greater application of knowledge.

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

Questions

In accordance with ISA 250 Consideration of laws and regulations in an audit of financial statements what are the responsibilities of the external auditor?

A To obtain sufficient appropriate evidence regarding compliance with laws and regulations that have both a direct and indirect effect on the financial statements
B To obtain sufficient appropriate evidence regarding compliance with laws and regulations that have a direct effect on the financial statements only
C To obtain sufficient appropriate evidence regarding compliance with laws and regulations that have an indirect effect on the financial statements only
D To prevent and detect all non-compliance with laws and regulations which affect the business

Answer: B

ISA 250 distinguishes between laws and regulations which have a direct effect and those which have an indirect effect on the financial statements. The auditor must undertake specified audit procedures to help identify non-compliance with laws and regulations that may have a material effect on the financial statements.

Chapter 7 Audit working papers

Executive Summary

How working papers provide evidence that an effective, efficient, and economic audit has been carried out.

This article is about audit working papers.

Auditors should prepare and organise their working papers in a manner that helps the auditor carry out an appropriate audit service.

The auditor should avoid preparing or accumulating unnecessary working papers, and should therefore avoid making extensive copies of the client's accounting records.

It is worth noting at this stage that it is neither necessary nor practicable for the auditor to document every matter considered during the audit.

This article is about audit working papers. Auditors should prepare and organise their working papers in a manner that helps the auditor carry out an appropriate audit service. The auditor should avoid preparing or accumulating unnecessary working papers, and should therefore avoid making extensive copies of the client's accounting records. It is worth noting at this stage that it is neither necessary nor practicable for the auditor to document every matter considered during the audit.

Audit documentation needs to be understood for both *Audit and Assurance* (AA) and *Advanced Audit and Assurance* (AAA).

The auditing standards

ISA 230, *Audit Documentation* states that the objective (1) of the auditor is to prepare documentation that provides:

1. A sufficient and appropriate record of the basis for the auditor's report, and
2. Evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements.

The auditor should prepare the audit documentation on a timely basis and in such a way so as to enable an experienced auditor, having no previous connection with the audit, to understand:

1. The nature, timing, and extent of the audit procedures performed to comply with ISAs and applicable legal and regulatory requirements
2. The results of the audit procedures and the audit evidence obtained, and
3. Significant matters arising during the audit, the conclusions reached and significant judgments made in reaching those conclusions.

In documenting the nature, timing, and extent of audit procedures performed, the auditor should record the identifying characteristics of the specific items or matters being tested.

The auditor should document discussions of significant matters with management and others on a timely basis.

If the auditor has identified information that contradicts or is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor should document how the auditor addressed the contradictions or inconsistency in forming the final conclusion.

Where, in exceptional circumstances, the auditor judges it necessary to depart from a basic principle or an essential procedure that is relevant in the circumstances of the audit, the auditor should document how the alternative audit procedures performed achieve the objective of the audit, and, unless otherwise clear, the reasons for the departure.

In documenting the nature, timing, and extent of audit procedures performed, the auditor must record:

1. The identifying characteristics of the specific items or matters tested
2. Who performed the audit work and the date such work was completed, and
3. Who reviewed the audit work and the date and extent of such review (2).

The auditor should complete the assembly of the final audit file on a timely basis after the date of the auditor's report.

After the assembly of the final audit file has been completed, the auditor should not delete or discard audit documentation before the end of its retention period.

When the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final file has been completed, the auditor should, regardless of the nature of the modifications or additions, document:

1. The specific reasons for making them, and
2. When and by whom they were made and reviewed.

When exceptional circumstances arise after the date of the auditor's report that require the auditor to perform new or additional audit procedures, or that lead the auditor to reach new conclusions, the auditor should document:

1. The circumstances encountered
2. The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report
3. When and by whom the resulting changes to audit documentation were made, and (where applicable) reviewed.

The requirements of the ISA guide the auditor to produce audit documentation that is of an acceptable standard. Understanding and applying the requirements will protect the auditor from unwelcome and unnecessary litigation.

Importance of working papers

Working papers are important because they:

- are necessary for audit quality control purposes
- provide assurance that the work delegated by the audit partner has been properly completed
- provide evidence that an effective audit has been carried out
- increase the economy, efficiency, and effectiveness of the audit

- contain sufficiently detailed and
- up-to-date facts which justify the reasonableness of the auditor's conclusions
- retain a record of matters of continuing significance to future audits.

Avoiding unnecessary papers

Before deciding to prepare a particular audit working paper, the auditor should be satisfied that it is:

- necessary either because it will serve an essential or useful purpose in support of the auditor's report, or because it will provide information needed for tax or other client-related statutory/regulatory purposes
- not practicable for the client staff to prepare the working paper, or for the auditor to make copies of papers that the client staff (including internal auditors) have prepared as part of their normal regular duties.

Content

Typically each audit working paper must be headed with the following information:

- The name of the client
- The period covered by the audit
- The subject matter
- The file reference (3)
- The initials (signature) of the member of staff who prepared the working paper, and the date on which it was prepared
- In the case of audit papers prepared by client staff, the date the working papers were received, and the initials of the audit team member who carried out the audit work
- The initials of the member of staff who reviewed the working papers and the date on which the review was carried out
- Each audit paper should meet the characteristics of a good working paper, as detailed later in this article.

Papers prepared by client

Certain working papers required by the auditor may have already been prepared by client staff. The auditor should make arrangements, whenever possible, for copies of these to be made available to the audit team. If client staff prepare working papers which are to be retained by the auditor, the auditor should agree the form of the working papers with client staff at an early stage in the audit, and include this information in the audit timetable.

When arranging for working papers to be prepared, the auditor should take care to ensure that the working papers will give all the information required. All such working papers should normally be clearly identified as having been prepared by the client. The member of audit staff directly responsible for an audit area in which working papers prepared by client staff are included should sign those papers – this will show that they have been checked and that they can be reviewed by the manager and the partner, and by subsequent reviewers. The signature of the audit team member indicates that the working paper (prepared by client staff) has been ‘audited’.

Some characteristics of a good working paper

On the basis of the discussion above, a good working paper should meet the requirements of ISA 230 by displaying the following characteristics:

- It should state a clear audit objective, usually in terms of an audit assertion (for example, ‘to ensure the completeness of trade payables’).
- It should fully state the year/period end (eg 31 October 20X9), so that the working paper is not confused with documentation belonging to a different year/period.
- It should state the full extent of the test (ie how many items were tested and how this number was determined). This will enable the preparer, and any subsequent reviewers, to determine the sufficiency of the audit evidence provided by the working paper.
- Where there is necessary reference to another working paper, the full reference of that other working paper must be given. A statement that details of testing can be found on ‘another working paper’ is insufficient.
- The working paper should clearly and objectively state the results of the test, without bias, and based on the facts documented.
- The conclusions reached should be consistent with the results of the test and should be able to withstand independent scrutiny.
- The working paper should be clearly referenced so that it can be filed appropriately and found easily when required at a later date.
- It should be signed by the person who prepares it so that queries can be directed to the appropriate person.
- It should be signed and dated by any person who reviews it, in order to meet the quality control requirements of the review.

The reviewer of audit working papers should ensure that every paper has these characteristics. If any relevant characteristic is judged absent, then this should result in an audit review point (ie a comment by the reviewer directing the original preparer to rectify the fault on the working paper).

Conclusion

Working papers provide evidence that an effective, efficient, and economic audit has been carried out. They should therefore be prepared with care and skill. They should be sufficiently detailed and complete so that an auditor with no previous experience of that audit can understand the working papers in terms of the work completed, the conclusions reached, and the reasoning behind these conclusions.

Notes

1. ISA 230 paragraph 5.
2. Paragraph 17 of ISA 220 establishes the requirement for the engagement partner to be satisfied that sufficient appropriate audit evidence has been obtained through a review of the audit documentation (and discussion with the engagement team). This does not imply that each specific working paper must include evidence of review, however there must be documentation of what work was reviewed, who reviewed the work and when it was reviewed.
3. Each audit firm has its own file numbering and referencing system. Within each system, the best way of numbering working papers is to file them serially in each section and to cross-reference them. Where papers are intended to agree with or support items appearing in the financial statements, or in other working papers in the file, the auditor should normally prepare them so as to make such agreements obvious without the necessity of further investigation and reconciliation.

Questions

ISA 230 *Audit documentation* deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements.

Required
Explain **five** benefits of documenting audit work

Answer:

1. Evidence of conclusions
2. Evidence of compliance with ISAs
3. Helps team to plan and perform audit
4. Helps supervision
5. Team is accountable
6. Record of matters of continuing significance

Chapter 8 Examining evidence

Executive Summary

This article explains the importance of understanding audit evidence

Audit evidence is obtained by the auditor as a result of the audit procedure. For example, ‘performing a circularisation of receivables/debtors’ is an audit procedure, whereas ‘replies from customers’ is audit evidence. It is very important to be aware of the difference.

If a question asks for audit evidence and candidates state audit procedures, then the question hasn’t been answered, and gains no marks.

Questions in auditing exams on audit procedures are very common. This article considers the difference between audit procedures and audit evidence and techniques for deciding on relevant audit evidence in a variety of circumstances.

Audit procedures versus audit evidence

Audit procedures are actions that auditors carry out during the audit. Paper AA questions typically ask candidates to describe audit procedures, also known as 'audit tests' or 'audit work'.

Audit evidence is obtained by the auditor as a result of the audit procedure. For example, 'performing a circularisation of receivables/debtors' is an audit procedure, whereas 'replies from customers' is audit evidence. It is very important to be aware of the difference. If a question asks for audit evidence and candidates state audit procedures, then the question hasn't been answered, and gains no marks.

Which of the following are procedures and which are evidence?

1. Inspecting non-current/fixed assets for signs of obsolescence
2. An item of inventory/stock that is present at the inventory/stock count
3. A bank statement
4. Counting petty cash
5. A working paper showing a re-calculation of depreciation
6. A sales invoice
7. Attending a wages pay out.

Answer

Items 1, 4 and 7 are procedures (because procedures are actions, notice the use of verbs such as 'inspecting', 'counting', and 'attending'). The other items are evidence, as they are the result of audit procedures.

However, note that the phrasing is 'state the audit evidence that you should expect to find in undertaking your review of the audit working papers and financial statements'. Item 5 meets this criterion because it is a working paper, but items 3 and 6 are not necessarily included in audit working papers, so one would need to phrase the answer in such a way as to make this clear. For example, one could say 'a copy sales invoice' and 'a copy bank statement with the balance cross-referenced to the bank reconciliation'.

Item 2 is definitely not evidence normally seen in working papers, since it is an item of physical inventory/stock. This could be rephrased as 'a schedule showing items test-counted at the inventory/stock count' to make it into a correct answer.

Identifying appropriate audit evidence

Substantive testing questions can be quite tricky, as they can cover a range of accounting standards, and therefore are more varied than questions on topics such as inventory/stock, receivables/debtors, payables/creditors, or non-current/fixed assets.

Candidates need to be able to think on their feet and develop a 'sensible answer' approach to a wide variety of questions, even if they have never considered the subject previously. One way to do this is to use the financial statement assertions as a starting point.

The financial statement assertions are those assertions that are implicit or implied when the directors make an explicit statement that the financial statements give a true and fair view. In other words, they are attributes of the financial statements that must be true if the financial statements are to give a true and fair view.

Assertions include completeness (all assets, liabilities, transactions, and events are included) and valuation (assets and liabilities are included at an appropriate carrying value). Auditors design their audit programmes to ensure – as far as possible – that each of these assertions are true, in order to gain evidence that proves that the financial statements give a true and fair view.

Using the assertions as a starting point to answer a question can be useful if the question is general – for example 'describe how you would audit leases'. Candidates could consider what assertions are relevant to leases and then describe audit tests and/or evidence (depending on the question) to prove each of these assertions.

Example

You are the manager in charge of the audit of Yummy Mummy Co., a listed company with a European-wide chain of fashion stores for babies and expectant mothers. The audit for the year ended 30 September 2006 is nearing completion. The draft financial statements show a profit before tax of $50.6m (2005: $95.3m).

The audit senior has produced a schedule of 'Points for the attention of the audit manager' as follows:

(a) Due to the falling birth rate, the performance of the stores in Italy has been worse than expected. An impairment review was performed on 15 October 2006, treating the Italian stores as a single cash-generating unit, which indicated that the recoverable amount of the assets (based on value in use) was $23m lower than the carrying value. (6 marks)

(b) The company self-manufactures many of its clothing lines, and has a factory in Manchester, UK. Research has shown that the company could achieve substantial cost savings by outsourcing to south east Asia, and the factory in Manchester is to be closed. A provision of $3.2m to cover redundancy costs has been included in the 2006 draft financial statements. (7 marks)

(c) The company is planning to open 20 new stores in south east Asia in the next year. To assist in financing the expansion, the company sold a number of its properties on 28 September 2006 for $200m and leased them back under operating leases. (7 marks)

Required:

For each of the above points:
(i) Comment on the matters that you should consider; and
(ii) State the audit evidence that you should expect to find, in undertaking your review of the audit working papers and financial statements of Yummy Mummy Co. (20 marks)

The mark allocation is shown against each of the three points.

Formulating an answer

Note the format of the question. There are three mini-case studies, and for each the candidate has to (i) comment on the matters that should be considered and (ii) state audit evidence. As this article is about audit evidence, we will only consider Part (ii) of the question. However, the examiner has given guidance on how she wants candidates to answer Part (i), and has said that matters to consider will normally include risk, materiality, and accounting treatment. In many answers, there is also a requirement to comment on the type of audit report that would be needed if the company refuses to amend an erroneous treatment.

Deciding on audit evidence

For each scenario:

1. Think about how the accountant would have calculated the numbers in the financial statements, the source documents used and the systems followed, and then write about the documents etc, that one would expect to see.
2. Think about how to verify the other relevant facts in each case.
3. Consider the accounting/disclosure requirements of each scenario, and say how one can check if they are being met.

Remember, as the question is about evidence, not procedures, I would advise candidates to begin their answers to each part with the words ‘I would expect to see’, and then list out the evidence as bullet points. This should stop candidates talking about procedures.

Here is an example answer – the bracketed text in italics is not part of the answer, but simply explanation where required.

(a) (Accounting issues in this scenario are subsequent events (adjusting) and impairment.)
I would expect to see:

- extracts from the management accounts showing the performance of the Italian stores compared to budget, and the most recent budget for 2007
- a copy of the board minutes detailing management's plans to improve performance or to sell the stores (if performance continues to be poor it could affect going concern, if stores are to be sold they may need to be re-categorised as assets held for sale)
- a schedule comparing the carrying value of the assets with the recoverable amount, annotated to show that carrying value has been agreed to the non-current/fixed assets register, and that any allocation of central assets and goodwill was reasonable
- a completed audit programme for non-current/fixed assets (as the appropriateness of the value of the assets has already been checked during the audit of non-current/fixed assets, there is no need to check it again)
- a calculation of value in use, annotated to show that the cash flows have been compared with budgets for 2007 and beyond, and with actual cash flows (to see if they are reasonable).

(b) (The obvious accounting issue is provisions, but issues which are not mentioned – but which are potentially relevant – include assets held for sale and discontinued operations.)
I would expect to see:

- a copy of the announcement of the restructuring (has to be before the year end in order for a provision to be made)
- a working paper detailing whether redundancy payments are being made in accordance with contractual, statutory, or constructive obligations, and how the constructive obligations, if any, have been derived (in some countries, companies are required under statute to pay certain levels of compensation to redundant employees)
- a schedule detailing the amount to be paid to each redundant employee. This schedule should be annotated to show that all relevant employees have been included and that the calculations have been checked for a sample of employees, including agreement of their pay/service to their contracts where relevant
- a point in the management representation letter as to any other costs to be provided for in closing the factory (eg penalties for cancellation of leases)
  a point in the management representation letter detailing whether the factory is to be sold or abandoned (if a decision is made to sell, then assets are valued as assets held for sale, but not if it is to be abandoned)
- a copy of the invitation to tender for the outsourcing contract, and notes of discussions with management as to how the manufacturer was selected and how quality is to be assured.

(c) (Candidates need to focus on checking whether the leaseback is really an operating lease rather than a finance lease.)
I would expect to see:

- a copy of the leasing contract
- a schedule comparing the present value of the minimum lease payments with the fair value of the leased assets
- a note comparing the length of the lease with the estimated useful life of the assets, and stating whether Yummy Mummy Co. is responsible for maintenance and insurance
- a schedule calculating the amounts that should appear in the financial statements, if the audit team believes this to be a finance lease
- an estimate of the carrying value of the assets at the date of sale, if the lease is an operating lease (if selling price is not fair value, it affects how profit on sale is recognised)
- a point in the management representation letter on the purchaser of these properties, and whether they are related to Yummy Mummy Co. and, if necessary, a draft of the related party disclosures that will appear in the financial statements.

This is just one possible answer – there are many other valid points that could be made. Notice that this sample answer reflects the three points mentioned above:

1. Evidence to show that the accountant has worked out the figures correctly (eg the calculation of the redundancy payment, the calculation of value in use).
2. Evidence to prove other relevant facts (eg performance in Italy, outsourcing contract, lease agreement).
3. Evidence to prove that accounting standards have been complied with (eg date of closure announcement, comparison of payments, fair value of leased assets).

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Chapter 9 The audit of financial statement assertions

Executive Summary

This article looks at the effect of revisions to ISA 315, Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and its Environment with respect to financial statement assertions.

ISA 315 (Revised) states: 'In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement and presentation of classes of transactions and events, account balances and disclosures'.

Consequently auditors use these assertions when considering the potential types of misstatements that may occur and when designing and performing appropriate audit procedures.

In July 2015 the International Auditing and Assurance Standards Board (IAASB) revised ISA 315, *Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and its Environment* with respect to financial statement assertions.

These changes were made as a result of the IAASB project entitled 'Addressing Disclosures in the Audit of Financial Statements – which resulted in a number of Revised ISA's and Related Conforming Amendments'.

This article will focus on financial statement assertions as identified by ISA 315 (Revised) and also provides useful guidance to candidates on how to tackle questions dealing with these.

ISA 315 revised

ISA 315 (Revised) states: 'In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement and presentation of classes of transactions and events, account balances and disclosures'.

Consequently auditors use these assertions when considering the potential types of misstatements that may occur and when designing and performing appropriate audit procedures.

Interim and final audit tests

During the interim audit, the internal control system is documented and evaluated. This will determine the mix of tests of control and substantive tests but both will tend to focus on transactions that have occurred so far in the period.

During the final audit, the focus is on the financial statements and the assertions about assets, liabilities and equity interests. At this stage the auditor will design substantive procedures to ensure that assurance has been gained over all relevant assertions.

Financial statement assertions

Transactions include sales, purchases, and wages paid during the accounting period. Account balances include all the asset, liabilities and equity interests included in the statement of financial position at the period end.

Obviously there is a link between the two because if the auditor performs tests to confirm the occurrence of sales this will also provide some assurance about the existence of receivables. Although the auditor may perform other tests specifically focussed on existence.

The assertions listed in ISA 315 (Revised) are as follows:

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

(i) Occurrence – the transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.

(ii) 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.

(iii) Accuracy – amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.

(iv) Cut–off – transactions and events have been recorded in the correct accounting period.

(v) Classification – transactions and events have been recorded in the proper accounts.

(vi) Presentation – transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

Assertions about account balances and related disclosures at the period end

(i) Existence – assets, liabilities and equity interests exist.

(ii) Rights and obligations – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

(iii) 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.

(iv) Accuracy, valuation and allocation – assets, liabilities and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded and related disclosures have been appropriately measured and described.

(v) Classification – assets, liabilities and equity interests have been recorded in the proper accounts.

(vi) 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.

Interpretation of assertions and appropriate audit tests

In many cases the meaning of the assertions is fairly obvious and in preparation for their FAU or AA exam candidates are reminded of the importance to learn and be able to apply the use of assertions in the course of the audit. Particularly, candidates need to be able to identify and explain the assertions, identify which assertion is being tested by a particular audit procedure and to describe audit procedures for relevant assertions in testing a specific transaction or balance, bearing in mind that the relevant disclosures should also be considered when deriving appropriate procedures.

Below is a summary of the assertions, a practical application of how the assertions are applied and some example audit procedures relevant to each.

Transaction assertions

Occurrence – this means that the transactions recorded or disclosed actually happened and relate to the entity. For example that a recorded sale represents goods which were ordered by valid customers and were despatched and invoiced in the period. An alternative way of putting this is that sales are genuine and are not overstated.

Relevant test – select a sample of entries from the sales account in the general ledger and trace to the appropriate sales invoice and supporting goods despatched notes and customer orders.

Completeness – this means that transactions that should have been recorded and disclosed have not been omitted.

Relevant test – select a sample of customer orders and check to despatch notes and sales invoices and the posting to the sales account in the general ledger.

Note the difference in the direction of the above test. In order to test completeness the procedure should start from the underlying documents and check to the entries in the relevant ledger to ensure none have been missed. To test for occurrence the procedures will go the other way and start with the entry in the ledger and check back to the supporting documentation to ensure the transaction actually happened.

Accuracy – this means that there have been no errors while preparing documents or in posting transactions to ledgers. The reference to disclosures being appropriately *measured and described* means that the figures and explanations are not misstated.

Relevant test – reperformance of calculations on invoices, payroll, etc, and the review of control account reconciliations are designed to provide assurance about accuracy.

Cut–off – that transactions are recorded in the correct accounting period.

Relevant test – recording last goods received notes and despatch notes at the inventory count and tracing to purchase and sales invoices to ensure that goods received before the year–end are recorded in purchases at the year end and that goods despatched are recorded in sales.

Classification – transactions recorded in the appropriate accounts – for example, the purchase of raw materials has not been posted to repairs and maintenance.

Relevant test – check purchase invoices postings to nominal ledger accounts.

Presentation – this means that the descriptions and disclosures of transactions are relevant and easy to understand. There is a reference to transactions being appropriately aggregated or disaggregated. Aggregation is the adding together of individual items. Disaggregation is the separation of an item, or an aggregated group of items, into component parts. The notes to the financial statements are often used to disaggregate totals shown in the statement of profit or loss. Materiality needs to be considered when judgements are made about the level of aggregation and disaggregation.

Relevant test – confirm that the total employee benefits expense is analysed in the notes to the financial statements under separate headings– ie wages and salaries, pension costs, social security contributions and taxes, etc.

Account balance assertions

Existence – means that assets and liabilities really do exist and there has been no overstatement – for example, by the inclusion of fictitious receivables or inventory. This assertion is very closely related to the *occurrence* assertion for transactions.

Relevant tests – physical verification of non–current assets, circularisation of receivables, payables and the bank letter.

Rights and obligations – means that the entity has a legal title or controls the rights to an asset or has an obligation to repay a liability.

Relevant tests – in the case of property, deeds of title can be reviewed. Current assets are often agreed to purchase invoices although these are primarily used to confirm cost. Long term liabilities such as loans can be agreed to the relevant loan agreement.

Completeness – that there are no omissions and assets and liabilities that should be recorded and disclosed have been. In other words there has been no understatement of assets or liabilities.

Relevant tests – A review of the repairs and expenditure account can sometimes identify items that should have been capitalised and have been omitted from non–current assets. Reconciliation of payables ledger balances to suppliers' statements is primarily designed to confirm completeness although it also gives assurance about existence.

Accuracy, valuation and allocation – means that amounts at which assets, liabilities and equity interests are valued, recorded and disclosed are all appropriate. The reference to allocation refers to matters such as the inclusion of appropriate overhead amounts into inventory valuation.

Relevant tests – Vouching the cost of assets to purchase invoices and checking depreciation rates and calculations.

Classification – means that assets, liabilities and equity interests are recorded in the proper accounts.

Relevant tests – the test for transactions of checking purchase invoice postings to the appropriate accounts in the general ledger will be relevant again. Also that research expenditure is only classified as development expenditure if it meets the criteria specified in IAS® 38 Intangible Assets.

Presentation – this means that the descriptions and disclosures of assets and liabilities are relevant and easy to understand. The points made above regarding aggregation and disaggregation of transactions also apply to assets, liabilities and equity interests.

Relevant tests – auditors often use disclosure checklists to ensure that financial statement presentation complies with accounting standards and relevant legislation. These cover all items (transactions, assets, liabilities and equity interests) and would include for example confirming that disclosures relating to non–current assets include cost, additions, disposals, depreciation, etc.

Typical exam questions

Questions on assertions may often be included in the objective test questions (OTs) in the AA and FAU exams and may also appear in the constructed response questions where candidates may be required to demonstrate knowledge of the assertions and procedures that are linked to particular transaction or account balance assertions in more detail.

Below are some examples which provide an indication, but not an exhaustive list of how assertions can be tested at FAU and AA.

Which of the following substantive procedures provides evidence over the COMPLETENESS of non–current assets?

A. Select a sample of assets included in the non–current asset register and physically verify them at the client premises

B. Review the repairs and maintenance expense account to identify any items of a capital nature

C. For assets disposed of, agree the sale proceeds to supporting documentation and cash book

D. For a sample of non-current assets, recalculate the depreciation charge

In order to tackle a question like this, candidates are encouraged to work through each procedure and think about the objective of the auditor when they are testing for completeness and to consider whether the procedure as presented would satisfy that objective:

A. Confirms existence not completeness – the direction of the test is key here – had the test been the other way selecting sample of non–current assets in the factory and tracing to the non–current asset register that would have confirmed completeness.

B. Confirms completeness as the auditor may identify non–current assets that have not been capitalised and is therefore the correct answer.

C. Confirms the proceeds of sale so is more relevant to accuracy or valuation

D. Confirms depreciation so is also more relevant to accuracy or valuation

Candidates may be asked to identify and apply the assertions to a specified area of the financial statements:

(i) Identify and explain FOUR financial statement assertions relevant to classes of transactions and events and related disclosures for the year under audit; and

(ii) For each identified assertion, describe a substantive procedure relevant to the audit of REVENUE.

In this type of question candidates should recall relevant assertions as specified by the ISA, and just as walked through above think about what procedures would satisfy the objective as set out by the assertion.

Conclusion

Financial statement assertions have always been an important area of the syllabus for audit examinations.

Candidates should ensure that they know the assertions and can explain what they mean. Audit manuals and texts explain the audit work required on each transaction cycle or account balance by linking the tests to the relevant assertions. Candidates should not simply memorise these tests but also ensure they understand the reasons why the test provides assurance about the particular assertion. In some instances, the direction of the test will be a key point to consider.

Written by a member of the FAU examining team

Questions

Which of the following assertions about classes of transactions and events for the period under audit is defined below: 'Amounts and other data relating to recorded transactions and events have been recorded appropriately'.

A Cut-off
B Accuracy
C Occurrence
D Classification

Answer: B

This is defined in ISA 315.

Chapter 10 The control environment of a company

Executive Summary

The purpose of this article is to provide candidates with a more detailed appreciation of matters pertinent to an auditor, focusing on the need for the auditor of a large limited liability company (in the UK – a limited company) to evaluate the effectiveness of the company's control environment.

The purpose of this article is to provide candidates with a more detailed appreciation of matters pertinent to an auditor, focusing on the need for the auditor of a large limited liability company (in the UK – a limited company) to evaluate the effectiveness of the company's control environment

ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, sets out the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment including the entity's internal control. One of the five components of internal control is the control environment and it is recognised that the control environment within small entities is likely to differ from larger entities. Many candidates have not yet had the opportunity of working in larger entities, or have chosen not to, so have not been exposed to working within the type of strong control environment often referred to in auditing texts. Consequently, they often have limited experience on which to draw when answering exam questions that require anything other than superficial knowledge of an entity's control environment.

This article aims to provide common examples of matters the auditor needs to consider when assessing an entity's control environment, and in making an assessment as to their impact on the risk of material misstatement in the financial statements. Reflecting the general trend of exam questions testing knowledge of this area, the article focuses on the need for the auditor of a large limited liability company (in the UK – a limited company) to evaluate the effectiveness of the company's control environment.

A company's control environment comprises seven elements each requiring careful consideration by the company's auditor, recognising that some elements may be more pertinent than others – depending on the subject company. Each one of these elements is identified below, along with an explanation of specific practical aspects that may be considered by the auditor when evaluating its effectiveness. Candidates should be aware that this process forms part of the auditor's assessment of the overall effectiveness of the company's internal control, relevant to the audit.

1 Communication and enforcement of integrity and ethical values

Many companies have high values and seek to promote honesty and integrity among their employees on a day-to-day basis. Clearly, if it is evident that such values do exist and are communicated effectively to employees and enforced, this will have the effect of increasing confidence in the design, administration and monitoring of controls – leading to a reduced risk of material misstatement in a company's financial statements. For example, where a company adopts comprehensive anti-bribery and corruption policies and procedures with regard to contract tendering, and has formal employee notification and checking practices in this regard, it follows that there is reduced risk of material misstatement due to the omission of provisions for fines for the non-compliance with relevant laws and regulations. Alternatively, the existence in a company of comprehensive and ethical procedures with regard to the granting of credit facilities to customers and the pursuance of payment of for goods and services supplied, together with regular supervisory control in this respect, is likely to lead to increased audit confidence in the trade receivables area. This is because the existence of a system allowing goods and services to be a supplied on credit to customers provides the opportunity for fraud to be perpetrated against the company by employees and customers, particularly if controls are deficient in terms of their design or implementation.

2 Commitment to competence
Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job. It is self-evident that if individual employees are tasked with carrying out duties that are beyond their competence levels, then desired objectives are unlikely to be met. For example, there is an increased probability that the objective of avoiding material misstatement in a set of complex financial statements will not be met if prepared by an inexperienced company accountant. This is simply due to the inexperience (translating to a lower competence level) of the accountant. From this, it follows that the auditor will have increased confidence in internal control relevant to the audit, where management have taken measures to ensure employees who participate in internal control are competent to carry out relevant tasks effectively. Measures taken by management in this regard can cover a range of activity including for example, rigorous technical and aptitude testing at the employee recruitment stage and in-house or external training courses and mentoring from more senior colleagues

3 Participation by those charged with governance
The directors of a limited liability/limited company are charged with the company's governance. As such, they are responsible for overseeing the strategic direction of the company and its obligations related to its accountability – for example, to governments, shareholders and to society in general. In particular, in most jurisdictions the company's directors are responsible for the preparation of its financial statements. Given the influence that the actions of directors have on a company's internal control, the extent of their day-to-day active involvement in the company's operations has a pervasive effect on the internal control of the company.

The extent to which directors do get involved will, to some extent, depend on legislation or codes of practice setting out guidance for best practice in given jurisdictions. For example, the UK Corporate Governance Code (with which companies listed on the London Stock Exchange should comply) sets out standards of good practice, including those pertaining to board leadership and effectiveness. Notwithstanding legislation and codes of practice, the extent of each director's participation is largely influenced by the nature of their professional discipline and their individual perspective about how they should carry out their respective roles. Some may see themselves as micromanagers, while others will trust subordinates to carry out defined duties with minimal interference. Frequently, directors will be very experienced and adopt an arms-length approach to getting involved in operational tasks. However, they may insist on monitoring activity by way of receipt of formal narrative reports. Other directors may adopt a more casual (but equally thorough!) 'working alongside subordinates' approach as a method of monitoring activities.

All of the variables mentioned above with regard to director involvement, should be important considerations of an auditor as part of the process of ascertaining the extent of internal control in the company and in assessing its effectiveness.

4 Management's philosophy and operating style
A company's board of directors will comprise of individuals each with a different mind – set as to philosophy and operating style, manifested in characteristics such as their:

- approach to taking and managing business risk
- attitudes and actions toward financial reporting
- attitudes toward information processing and accounting and functions personnel.

Each of the above characteristics underlie a company's control environment and it is crucial for an auditor to have an understanding of them. Dealing with each in turn:

Approach to taking and managing business risk. Business risk is the risk inherent in a company as a consequence of its day-to-day operations and it comprises several components. The first of these is financial risk – for example, the risk that the company may have insufficient cash flow to continue in operation. The second component is operational risk – for example, the risk that the company's product lines may decline in popularity leading to a sharp decline in sales and profitability. The final component of business risk is compliance risk – for example, the risk that the company may be in breach of health and safety regulations, leading to the possibility of hefty fines or even the closedown of operational activity.

Candidates should be aware that a risk-based approach to an audit requires the identification and assessment of inherent risk factors and then of the control risk pertaining to these, in order to determine the risk of material misstatement, prior to carrying out substantive procedures. By adopting a top-down approach to the audit and first identifying business risks, auditors should be able to identify the associated inherent risks arising. They can then progress through the audit using the audit risk model (audit risk = the risk of material misstatement x detection risk) to determine the amount of detailed testing required in each area of the financial statements. To illustrate this approach, referring to the compliance risk example above, an inherent risk arising from the risk of a breach of health and safety regulations. As a consequence, there is a risk that the company's liabilities may be understated due to the omission of a provision required in the financial statements, in respect of a fine for a non-compliance.

The directors' approach to taking and managing business risk has obvious ramifications on a company's financial statements, and the auditor should be aware of the various factors that influence directors in this area, and of applicable controls in place. It is often the case that a newly established company with young entrepreneurial directors and a flat management structure will have a more liberal approach to taking and managing business risk than a well-established company with more experienced directors, and a steep hierarchical management structure. Consequently, it is likely that there would be a lower level of a risk of material misstatement in the financial statements of the latter company.

Attitude and actions toward financial reporting. Financial Reporting Standards exist to help facilitate fairness, consistency and transparency of financial reporting. However, some determinants of profitability such as the measure of depreciation, the valuation of inventory or the amount of a provision remain open to the subjective judgment of management. Consequently, the auditor needs to gain an understanding of directors' attitudes and actions to financial reporting issues and then make a judgment as to the extent of reliance that can be placed upon these. It may be that a company that is struggling in a faltering economy, and in another driven by a culture to report increasing profits, there is a tendency to adopt aggressive (as opposed to conservative) accounting principles, in order to meet profit expectations. Clearly, on such audit engagements it is important for the auditor to remain resolute in exercising appropriate levels of professional scepticism throughout.

Attitude towards information processing and accounting functions and personnel. Properly financed and resourced with sufficient numbers of appropriately qualified staff and contemporary information and communications technology, the financial reporting (accounting) and information processing functions of a company are vital to a company's ongoing existence. They are key to the facilitation of compliance with laws and regulations, transactions with third parties, administration and control systems and in the provision of information for decision making. In most very large companies many aspects of the accounting function are inextricably intertwined with specific aspects of the company's information processing systems, and there is an ongoing programme of investment in these, to ensure that the accounting and information processing systems are contemporary and fit for purpose. This is reflective of a situation where directors recognise that business risk will be significantly reduced, if the company has effective information processing and accounting functions. However, this situation does not apply to all companies. In some, both functions may be seen by the directors merely as necessary functional overhead areas of the business and, as such, they become under-funded and inadequately resourced in terms of staffing and equipment. An auditor engaged on an audit in such a company should be aware that there is an increased risk of material misstatement in the financial statements.

5 Organisational structure

ISA 315 describes a company's organisational structure as being 'the framework within which an entity's activities for achieving its objectives are planned, executed, controlled and reviewed'. The appendix to the ISA then explains 'that the appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities'. It follows from this that an international consulting company with offices and operations in several countries has different priorities in terms of organisational structure to a national car sales company with several offices and a number of sales branches in a single country. Similarly, the organisational structure deemed suitable for such a car sales company would not be appropriate for a single site manufacturing company. Generally, an auditor may reasonably expect there to be a positive correlation between the level of inherent risk and the size and complexity of a company's operations. In assessing, the level of the risk of material misstatement the auditor should consider as to whether the company's organisational structure in terms of authority, responsibility and lines of reporting meet desired objectives.

6 Assignment of authority and responsibility

Normally, the larger a company's scale of operations, then the larger the size of the workforce and, inevitably, the larger the amount of assignment of authority and responsibility that is required. Consequently, companies need to deal not only with ensuring that appropriate levels of authority and responsibility are assigned to appropriately qualified and experienced individuals. They also need to ensure that adequate reporting relationships and authorisation hierarchies are in place. Additionally, individuals need to be properly resourced and made fully aware of their responsibilities and of how their actions interrelate with the actions of others and contribute to the objectives of the company. If a company is not successful in meeting each of these needs, then there is an increased probability of ineffective decisions, errors and oversights by employees leading to an increased risk of material misstatement in its financial statements. For example, where a wages clerk is authorised to process the wages payroll and is then assigned the (inappropriate!) authority to enter new employee details into the wages master file.

7 Human resources policies and practices

As explained in ISA 315, 'human resource policies and practices demonstrate important matters in relation to the control consciousness of an entity'. This implies that if human resources policies and practices are considered to be sound both in design and in implementation over a range of matters, then the risk of material misstatement will be reduced.

Examples of these matters include:

- Recruitment policies and procedures. These should ensure that only competent individuals with integrity are employed by the company. Interview procedures should ensure that only candidates meeting the company's criteria for recruitment are engaged.

- There should be adequate induction procedures for new employees, such that they can carry out their assigned responsibilities effectively and efficiently soon after being engaged by the company.

- Employees should be provided with ongoing training, support and mentoring as appropriate, such that they can continue to carry out their assigned responsibilities effectively and efficiently.

- There should be regular formal appraisal, at least annually of an employee's performance. Performance should be measured against standardised criteria authorised by senior management of the company, and there should be ongoing monitoring and feedback to employees about their performance and development needs.

- The company should employ comprehensive and transparent employment grievance procedures, such that employees can be confident that grievances will be dealt with openly and impartially.

- There should be open, transparent and equitable employee disciplinary procedures, such that employees can be confident they will not be treated unfairly by the company in the event that an action triggers its disciplinary process.

- Employment termination procedures should incorporate provision for an exit interview so that the reason for the termination can be confirmed or clarified, all emoluments due to the employee can be settled and arrangements can be made for the return of all company assets prior to the termination date.

While each of the above measures will have a positive impact on the internal control of a company, to some extent they all have the effect of reducing the risk of material misstatement in the financial statements. For example, the existence of fair and robust grievance and disciplinary procedures reduce the possibility of a successful claim against the company for constructive or unfair dismissal, and the absence of a material provision in this respect. Significantly, the existence of human resources policies and practices that are the same or similar to those above should leave a favourable impression with the auditor, as to the directors' attitude toward their company's workforce. It is likely that such an attitude would foster good working relationships with employees, leading to an increased likelihood that individuals would reciprocate by carrying out their tasks diligently with integrity in the best interests of the company – resulting in a reduced risk of material misstatement.

Summary

As indicated at the beginning of this article, the purpose of it is to provide candidates with a more detailed appreciation of matters pertinent to an auditor, when evaluating the control environment of a limited liability/limited company. When asked to explain what is meant by the term 'control environment', they typically comment that it is a component of a company's internal control and that it centres around how a company is operated by its management, reflecting such matters as their philosophy and operating style. While there is some merit in this answer, having now read the above commentary, candidates should be aware that the term has much more meaning than that.

Written by a member of the audit examining team

Question

ISA 315 Identifying and assessing the risks of material misstatement through understanding the entity and its environment sets out the five components of internal control.
Which of the following is not set out as a component of internal control within ISA 315?

A Control environment
B The information system relevant to financial reporting
C Human resource policies and practices

Answer: C

Human resource policies and practices is not a component of internal control in itself; it is an element of the control environment.

Chapter 11 Specific aspects of auditing in a computer-based environment

Executive Summary

The purpose of this article is to provide guidance on following aspects of auditing in a computer-based accounting environment:

- Application controls, comprising input, processing, output and master file controls established by an audit client, over its computer-based accounting system and
- Computer-assisted audit techniques (CAATs) that may be employed by auditors to test and conclude on the integrity of a client's computer-based accounting system.

Specific aspects of auditing in a computer-based environment

Information technology (IT) is integral to modern accounting and management information systems. It is, therefore, imperative that auditors should be fully aware of the impact of IT on the audit of a client's financial statements, both in the context of how it is used by a client to gather, process and report financial information in its financial statements, and how the auditor can use IT in the process of auditing the financial statements.

The purpose of this article is to provide guidance on following aspects of auditing in a computer-based accounting environment:

- Application controls, comprising input, processing, output and master file controls established by an audit client, over its computer-based accounting system and
- Computer-assisted audit techniques (CAATs) that may be employed by auditors to test and conclude on the integrity of a client's computer-based accounting system.

Exam questions on each of the aspects identified above are often answered to an inadequate standard by a significant number of students – hence the reason for this article.

Dealing with application controls and CAATs in turn:

Application controls

Application controls are those controls (manual and computerised) that relate to the transaction and standing data pertaining to a computer-based accounting system. They are specific to a given application and their objectives are to ensure the completeness and accuracy of the accounting records and the validity of entries made in those records. An effective computer-based system will ensure that there are adequate controls existing at the point of input, processing and output stages of the computer processing cycle and over standing data contained in master files. Application controls need to be ascertained, recorded and evaluated by the auditor as part of the process of determining the risk of material misstatement in the audit client's financial statements.

Input controls

Control activities designed to ensure that input is authorised, complete, accurate and timely are referred to as input controls. Dependent on the complexity of the application program in question, such controls will vary in terms of quantity and sophistication. Factors to be considered in determining these variables include cost considerations, and confidentiality requirements with regard to the data input. Input controls common to most effective application programs include on-screen prompt facilities (for example, a request for an authorised user to 'log-in') and a facility to produce an audit trail allowing a user to trace a transaction from its origin to disposition in the system.

Specific input validation checks may include:

Format checks
These ensure that information is input in the correct form. For example, the requirement that the date of a sales in voice be input in numeric format only – not numeric and alphanumeric.

Range checks
These ensure that information input is reasonable in line with expectations. For example, where an entity rarely, if ever, makes bulk-buy purchases with a value in excess of $50,000, a purchase invoice with an input value in excess of $50,000 is rejected for review and follow-up.

Compatibility checks
These ensure that data input from two or more fields is compatible. For example, a sales invoice value should be compatible with the amount of sales tax charged on the invoice.

Validity checks
These ensure that the data input is valid. For example, where an entity operates a job costing system – costs input to a previously completed job should be rejected as invalid.

Exception checks
These ensure that an exception report is produced highlighting unusual situations that have arisen following the input of a specific item. For example, the carry forward of a negative value for inventory held.

Sequence checks
These facilitate completeness of processing by ensuring that documents processed out of sequence are reject ed. For example, where pre-numbered goods received notes are issued to ac knowledge the receipt of goods into physical inventory, any input of notes out of sequence should be rejected.

Control totals
These also facilitate completeness of processing by ensure that pre-input, manually prepared control totals are compared to control totals input. For example, non-matching totals of a 'batch' of purchase invoices should result in an on-screen user prompt, or the production of an exception report for follow-up. The use of control totals in this way are also commonly referred to as output controls (see below).

Check digit verification
This process uses algorithms to ensure that data input is accurate. For example, internally generated valid supplier numerical reference codes, should be formatted in such a way that any purchase invoices input with an incorrect code will be automatically rejected.

Processing controls

Processing controls exist to ensure that all data input is processed correctly and that data files are appropriately updated accurately in a timely manner. The processing controls for a specified application program should be designed and then tested prior to 'live' running with real data. These may typically include the use of run-to-run controls, which ensure the integrity of cumulative totals contained in the accounting records is maintained from one data processing run to the next. For example, the balance carried forward on the bank account in a company's general (nominal) ledger. Other processing controls should include the subsequent processing of data rejected at the point of input, for example:

- A computer produced print-out of rejected items.
- Formal written instructions notifying data processing personnel of the procedures to follow with regard to rejected items.
- Appropriate investigation/follow up with regard to rejected items.
- Evidence that rejected errors have been corrected and re-input.

Output controls

Output controls exist to en sure that all data is processed and that output is distributed only to prescribed authorised users. While the degree of output controls will vary from one organisation to another (dependent on the confidentiality of the information and size of the organisation), common controls comprise:

- Use of batch control totals, as described above (see 'input controls').
- Appropriate review and follow up of exception report information to ensure that there are no permanently outstanding exception items.
- Careful scheduling of the processing of data to help facilitate the distribution of information to end users on a timely basis.
- Formal written instructions notifying data processing personnel of prescribed distribution procedures.
- Ongoing monitoring by a responsible official, of the distribution of output, to ensure it is distributed in accordance with authorised policy.

Master file controls

The purpose of master file controls is to ensure the ongoing integrity of the standing data contained in the master files. It is vitally important that stringent 'security' controls should be exercised over all master files.

These include:

- appropriate use of passwords, to restrict access to master file data

- the establishment of adequate procedures over the amendment of data, comprising appropriate segregation of duties, and authority to amend being restricted to appropriate responsible individuals
- regular checking of master file data to authorised data, by an independent responsible official
- processing controls over the updating of master files, including the use of record counts and control totals.

Computer Assisted Audit Techniques (CAATs)

The nature of computer-based accounting systems is such that auditors may use the audit client company's computer, or their own, as an audit tool, to assist them in their audit procedures. The extent to which an auditor may choose between using CAATs and manual techniques on a specific audit engagement depends on the following factors:

- the practicality of carrying out manual testing
- the cost effectiveness of using CAATs
- the availability of audit time
- the availability of the audit client's computer facility
- the level of audit experience and expertise in using a specified CAAT
- the level of CAATs carried out by the audit client's internal audit function and the extent to which the extern al auditor can rely on this work.

There are three classifications of CAATs – namely:

- Audit software
- Test data
- Other techniques

Dealing with each of the above in turn:

Audit software

Audit software is a generic term used to describe computer programs designed to carry out tests of control and/or substantive procedures. Such programs may be classified as:

Packaged programs
These consist of pre-prepared generalised programs used by auditors and are not 'client specific'. They may be used to carry out numerous audit tasks, for example, to select a

sample, either statistically or judgementally, during arithmetic calculations and checking for gaps in the processing of sequences.

Purpose written programs
These programs are usually ‘client specific ’ and may be used to carry out tests of control or substantive procedures. Audit software may be bought or developed, but in any event the audit firm’s audit plan should ensure that provision is made to ensure that specified programs are appropriate for a client’s system and the needs of the audit. Typically, they may be used to re-perform computerised control procedures (for example, cost of sales calculations) or perhaps to carry out an aged analysis of trade receivable (debtor) balances.

Enquiry programs
These programs are integral to the client’s accounting system; however they may be adapted for audit purposes. For example, where a system provides for the routine reporting on a ‘monthly’ basis of employee starters and leavers, this facility may be utilised by the auditor when auditing salaries and wages in the client’s financial statements. Similarly, a facility to report trade payable (creditor) long outstanding balances could be used by an auditor when verifying the reported value of creditors.

Test data

Audit test data
Audit test data is used to test the existence and effectiveness of controls built into an application program used by an audit client. As such, dummy transactions are processed through the client’s computerised system. The results of processing are then compared to the auditor’s expected results to determine whether controls are operating efficiently and systems’ objectiveness are being achieved. For example, two dummy bank payment transactions (one inside and one outside authorised parameters) may be processed with the expectation that only the transaction processed within the parameters is ‘accepted’ by the system. Clearly, if dummy transactions processed do not produce the expected results in output, the auditor will need to consider the need for increased substantive procedures in the area being reviewed.

Integrated test facilities
To avoid the risk of corrupting a client’s account system, by processing test data with the client’s other ‘live’ data, auditors may instigate special ‘test data only’ processing runs for audit test data. The major disadvantage of this is that the auditor does not have total assurance that the test data is being processed in a similar fashion to the client’s live data. To address this issue, the auditor may therefore seek permission from the client to establish an integrated test facility within the accounting system. This entails the establishment of a dummy unit, for example, a dummy supplier account against which the auditor’s test data is processed during normal processing runs.

Other techniques
This section contains useful background information to enhance your overall understanding.

Other CAATs include:

Embedded audit facilities (EAFs)
This technique requires the auditor's own program code to be embedded (incorporated) into the client's application software, such that verification procedures can be carried out as required on data being processed. For example, tests of control may include the reperformance of specific input validation checks (see input controls above) – selected transactions may be 'tagged' and followed through the system to ascertain whether stated controls and processes have been applied to those transactions by the computer system. The EAFs should ensure that the results of testing are recorded in a special secure file for subsequent review by the auditor, who should be able to conclude on the integrity of the processing controls generally, from the results of testing. A further EAF, of ten overlooked by students, is that of an analytical review program enabling concurrent performance of analytical review procedures on client data as it is being processed through the automated system.

Application program examination
When determining the extent to which they may rely on application controls, auditors need to consider the extent to which specified controls have been implemented correctly. For example, where system amendments have occurred during an accounting period, the auditor would need assurance as to the existence of necessary controls both before and after the amendment. The auditor may seek to obtain such assurance by using a software program to compare the controls in place prior to, and subsequent to, the amendment date.

Summary

The key objectives of an audit do not change irrespective of whether the audit engagement is carried out in a manual or a computer-based environment. The audit approach, planning considerations and techniques used to obtain sufficient appropriate audit evidence do of course change. Students are encouraged to read further to augment their knowledge of auditing in a computer-based environment and to practise their ability to answer exam questions on the topic by attempting questions set in previous ACCA exam papers.

Written by a member of the audit exam team

Chapter 12 Auditing in a computer-based environment

Executive Summary

The aim of this article is to help students improve their understanding of computer-assisted techniques by giving practical illustrations of computer-based controls and the way they may feature in exam questions.

References will be made throughout this article to the most recent guidance in standards:

- ISA 300 (Redrafted) Planning an Audit of Financial Statements
- ISA 315 (Redrafted) Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment
- ISA 330 (Redrafted) The Auditor's Responses to Assessed Risks.

The accounting systems of many companies, large and small, are computer-based; questions in all ACCA audit papers reflect this situation.

Students need to ensure they have a complete understanding of the controls in a computer-based environment, how these impact on the auditor's assessment of risk, and the subsequent audit procedures. These procedures will often involve the use of computer-assisted audit techniques (CAATs).

The aim of this article is to help students improve their understanding of this topic by giving practical illustrations of computer-based controls and computer-assisted techniques and the way they may feature in exam questions.

Relevant auditing standards
References will be made throughout this article to the most recent guidance in standards:

- ISA 300 (Redrafted) Planning an Audit of Financial Statements
- ISA 315 (Redrafted) Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment
- ISA 330 (Redrafted) The Auditor's Responses to Assessed Risks.

Internal controls in a computer environment
The two main categories are application controls and general controls.

Application controls
These are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records.

Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorised and are completely and accurately recorded and processed (ISA 315 (Redrafted)).

Application controls apply to data processing tasks such as sales, purchases and wages procedures and are normally divided into the following categories:

(i) Input controls
Examples include batch control totals and document counts, as well as manual scrutiny of documents to ensure they have been authorised. An example of the operation of batch controls using accounting software would be the checking of a manually produced figure for the total gross value of purchase invoices against that produced on screen when the batch-processing option is used to input the invoices. This total could also be printed out to confirm the totals agree.

The most common example of programmed controls over the accuracy and completeness of input are edit (data validation) checks when the software checks that data fields included on transactions by performing:

- reasonableness check, eg net wage to gross wage
- existence check, eg that a supplier account exists
- character check, eg that there are no alphabetical characters in a sales invoice number field
- range check, eg no employee's weekly wage is more than $2,000
- check digit, eg an extra character added to the account reference field on a purchase invoice to detect mistakes such as transposition errors during input.

When data is input via a keyboard, the software will often display a screen message if any of the above checks reveal an anomaly, eg 'Supplier account number does not exist'.

(ii) Processing controls
An example of a programmed control over processing is a run-to-run control. The totals from one processing run, plus the input totals from the second processing, should equal the result from the second processing run. For instance, the beginning balances on the receivables ledger plus the sales invoices (processing run 1) less the cheques received (processing run 2) should equal the closing balances on the receivable ledger.

(iii) Output controls
Batch processing matches input to output, and is therefore also a control over processing and output. Other examples of output controls include the controlled resubmission of rejected transactions, or the review of exception reports (eg the wages exception report showing employees being paid more than $1,000).

(iv) Master files and standing data controls
Examples include one-for-one checking of changes to master files, eg customer price changes are checked to an authorised list. A regular printout of master files such as the wages master file could be forwarded monthly to the personnel department to ensure employees listed have personnel records.

General controls
These are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, mini-frame and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

- data centre and network operations
- system software acquisition, change and maintenance
- program change
- access security

- application system acquisition, development, and maintenance (ISA 315 (Redrafted))

'End-user environment' refers to the situation in which the users of the computer systems are involved in all stages of the development of the system.

(i) Administrative controls
Controls over 'data centre and network operations' and 'access security' include those that:

- prevent or detect errors during program execution, eg procedure manuals, job scheduling, training and supervision; all these prevent errors such as using wrong data files or wrong versions of production programs
- prevent unauthorised amendments to data files, eg authorisation of jobs prior to processing, back up and physical protection of files and access controls such as passwords
- ensure the continuity of operations, eg testing of back - up procedures, protection against fire and floods.

(ii) System development controls
The other general controls referred to in ISA 315 cover the areas of system software acquisition development and maintenance; program change; and application system acquisition, development and maintenance.

'System software' refers to the operating system, database management systems and other software that increases the efficiency of processing. Application software refers to particular applications such as sales or wages. The controls over the development and maintenance of both types of software are similar and include:

- Controls over application development, such as good standards over the system design and program writing, good documentation, testing procedures (eg use of test data to identify program code errors, pilot running and parallel running of old and new systems), as well as segregation of duties so that operators are not involved in program development
- Controls over program changes – to ensure no unauthorised amendments and that changes are adequately tested, eg password protection of programs, comparison of production programs to controlled copies and approval of changes by users
- Controls over installation and maintenance of system software – many of the controls mentioned above are relevant, eg authorisation of changes, good documentation, access controls and segregation of duties.

Exam focus
Students often confuse application controls and general controls. In the June 2008 CAT Paper 8 exam, Question 2 asked candidates to provide examples of application controls over the input and processing of data. Many answers referred to passwords and physical access controls – which are examples of general controls – and thus failed to gain marks.

Computer-assisted audit techniques
Computer-assisted audit techniques (CAATs) are those featuring the 'application of auditing procedures using the computer as an audit tool' (Glossary of Terms). CAATs are normally placed in three main categories:

(i) Audit software
Computer programs used by the auditor to interrogate a client's computer files; used mainly for substantive testing. They can be further categorised into:

- Package programs (generalised audit software) – pre-prepared programs for which the auditor will specify detailed requirements; written to be used on different types of computer systems
- Purpose-written programs – perform specific functions of the auditor's choosing; the auditor may have no option but to have this software developed, since package programs cannot be adapted to the client's system (however, this can be costly)
- Enquiry programs – those that are part of the client's system, often used to sort and print data, and which can be adapted for audit purposes, eg accounting software may have search facilities on some modules, that could be used for audit purposes to search for all customers with credit balances (on the customers' module) or all inventory items exceeding a specified value (on the inventory module).

Using audit software, the auditor can scrutinise large volumes of data and present results that can then be investigated further. The software consists of program logic needed to perform most of the functions required by the auditor, such as:

- select a sample
- report exceptional items
- compare files
- analyse, summarise and stratify data.

The auditor needs to determine which of these functions they wish to use, and the selection criteria.

Exam focus
Sometimes, questions will present students with a scenario and ask how CAATs might be employed by the auditor. Question 4 in the December 2007 Paper F8 exam required students to explain how audit software could be used to audit receivables balances. To answer this type of question, you need to link the functions listed above to the normal audit work on receivables. Students should refer to the model answer to this question.

The following is an example of how this could be applied to the audit of wages:

- Select a random sample of employees from the payroll master file; the auditor could then trace the sample back to contracts of employment in the HR department to confirm existence
- Report all employees earning more than $1,000 per week
- Compare the wages master file at the start and end of the year to identify starters and leavers during the year; the auditor would then trace the items identified back to evidence, such as starters' and leavers' forms (in the HR department) to ensure they were valid employees and had been added or deleted from the payroll at the appropriate time (the auditor would need to request that the client retain a copy of the master file at the start of the year to perform this test)
- Check that the total of gross wages minus deductions equates to net pay.

(ii) Test data
Test data consists of data submitted by the auditor for processing by the client's computer system. The principle objective is to test the operation of application controls. For this reason, the auditor will arrange for dummy data to be processed that includes many error conditions, to ensure that the client's application controls can identify particular problems.

Examples of errors that might be included:

- supplier account codes that do not exist
- employees earning in excess of a certain limit
- sales invoices that contain addition errors
- submitting data with incorrect batch control totals.

Data without errors will also be included to ensure 'correct' transactions are processed properly.

Test data can be used 'live', ie during the client's normal production run. The obvious disadvantage with this choice is the danger of corrupting the client's master files. To avoid this, an integrated test facility will be used (see other techniques below). The alternative (dead test data) is to perform a special run outside normal processing, using copies of the client's master files. In this case, the danger of corrupting the client's files is avoided – but there is less assurance that the normal production programs have been used.

(iii) Other techniques
There are increasing numbers of other techniques that can be used; the main two are:

- Integrated test facility – used when test data is run live; involves the establishment of dummy records, such as departments or customer accounts to which the dummy data can be processed. They can then be ignored when client records are printed out, and reversed out later.

- Embedded audit facilities (embedded audit monitor) – also known as resident audit software; requires the auditor's own program code to be embedded into the client's application software. The embedded code is designed to perform audit functions and can be switched on at selected times or activated each time the application program is used. Embedded facilities can be used to:
  – Gather and store information relating to transactions at the time of processing for subsequent audit review; the selected transactions are written to audit files for subsequent examination, often called system control and review file (SCARF)
  – Spot and record (for subsequent audit attention) any items that are unusual; the transactions are marked by the audit code when selection conditions (specified by the auditor) are satisfied. This technique is also referred to as tagging.

The attraction of embedded audit facilities is obvious, as it equates to having a perpetual audit of transactions. However, the set-up is costly and may require the auditor to have an input at the system development stage. Embedded audit facilities are often used in real time and database environments.

Impact of computer-based systems on the audit approach
The fact that systems are computer-based does not alter the key stages of the audit process; this explains why references to the audit of computer-based systems have been subsumed into ISAs 300, 315 and 330.

(i) Planning
The Appendix to ISA 300 (Redrafted) states 'the effect of information technology on the audit procedures, including the availability of data and the expected use of computer - assisted audit techniques' as one of the characteristics of the audit that needs to be considered in developing the overall audit strategy.

(ii) Risk assessment
'The auditor shall obtain an understanding of the internal control relevant to the audit.' (ISA 315 (Redrafted))

The application notes to ISA 315 identify the information system as one of the five components of internal control. It requires the auditor to obtain an understanding of the information system, including the procedures within both IT and manual systems. In other words, if the auditor relies on internal control in assessing risk at an assertion level, s/he needs to understand and test the controls, whether they are manual or automated. Auditors often use internal control evaluation (ICE) questions to identify strengths and weaknesses in internal control. These questions remain the same – but in answering them, the auditor considers both manual and automated controls.

For instance, when answering the ICE question, 'Can liabilities be incurred but not recorded?', the auditor needs to consider manual controls, such as matching goods received notes to purchase invoices – but will also consider application controls, such as programmed sequence checks on purchase invoices. The operation of batch control totals, whether programmed or performed manually, would also be relevant to this question.

(iii) Testing

'The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.' (ISA 330 (Redrafted))

This statement holds true irrespective of the accounting system, and the auditor will design compliance and substantive tests that reflect the strengths and weaknesses of the system. When testing a computer information system, the auditor is likely to use a mix of manual and computer-assisted audit tests.

'Round the machine (computer)' v 'through the machine (computer)' approaches to testing

Many students will have no experience of the use of CAATs, as auditors of clients using small computer systems will often audit 'round the machine'. This means that the auditor reconciles input to output and hopes that the processing of transactions was error-free. The reason for the popularity of this approach used to be the lack of audit software that was suitable for use on smaller computers. However, this is no longer true, and audit software is available that enables the auditor to interrogate copies of client files that have been downloaded on to a PC or laptop. However, cost considerations still appear to be a stumbling block.

In the 'through the machine' approach, the auditor uses CAATs to ensure that computer - based application controls are operating satisfactorily.

Conclusion

The key objectives of an audit do not change in a computer environment. The auditor still needs to obtain an understanding of the system in order to assess control risk and plan audit work to minimise detection risk. The level of audit testing will depend on the assessment of key controls. If these are programmed controls, the auditor will need to 'audit through the computer' and use CAATs to ensure controls are operating effectively.

In small computer-based systems, 'auditing round the computer' may suffice if sufficient audit evidence can be obtained by testing input and output.

Written by a member of the Paper F8 examining team

Questions

Computer assisted audit techniques include test data and audit software.
In respect of which of the following activities would the use of audit software be most relevant?

A Tests of online passwords
B Testing of computerised in-put controls on sales invoices
C Totalling of the purchase ledger
D Testing controls over computerised credit-limits

Answer: C

A, B and D relate to activities which would use test data. Test data is used for tests of controls.

Chapter 13 The audit of wages

Executive Summary

The most common payroll frauds can affect even those companies that appear to have good internal controls.

This article sets out to help F8/FAU candidates better identify significant deficiencies in internal control, explain the implications of the deficiencies and recommend appropriate controls.

It considers the different stages in a typical wages system – for example, what tasks should be undertaken during both the interim audit and final audit stages – as well as the link between control objectives, controls and audit tests.

This article focuses on the audit of wages but many of the points made also apply to salaries (the term payroll covers both). The distinction between the two is that wages are normally paid weekly in cash to employees working in departments such as production. Salaries, on the other hand, are paid monthly to employees normally working in administrative departments, via electronic transfers to their bank accounts. Changes in technology and less reliance on cash have blurred this traditional distinction and many hourly paid employees are now paid via bank transfer. However, in some small companies or in parts of the world where few people have bank accounts, employees are still paid in cash based on hours in attendance or work completed.

The auditor is required to plan and perform their work in order to form an opinion on the financial statements and in doing so to obtain reasonable assurance that the financial statements are free from material misstatement, whether due to fraud or error. As such this article will consider some of the key considerations that the auditor should make when planning and performing work on payroll, including the nature, timing and extent of procedures that should be carried out. The article will also consider the potential for fraud within the payroll function and some of the fraud risk factors that the auditor should be alert to when planning and performing their work.

Audit work on wages – timing

Much of the audit work on the wages system may be performed during the interim audit, through detailed controls testing, as due to the nature and volume of payroll transactions the auditor is likely to wish to place some reliance on the company's control system. However, some substantive procedures to confirm payroll costs and wage accruals will form part of the final audit.

Interim audit work on wages should involve the normal stages of recording, evaluating and testing internal controls.

Wages control objectives

In order to evaluate the control system the auditor will firstly consider the objectives which the control activities should be designed to achieve. Typical control objectives for wages include the following:

1. To ensure that employees are only paid for work done.
2. To ensure that wages are only paid to valid employees.
3. To ensure that all wages are authorised.
4. To ensure that wages are paid at the correct rates of pay.
5. To ensure that wages are correctly calculated.
6. To ensure all wages transactions are correctly recorded in the books of account.

7. To ensure that all payroll deductions are paid over to appropriate third parties (for example, tax authorities)

Evaluation of the internal control system

The evaluation should be performed by considering if controls exist to ensure specified control objectives are met.

Auditors often complete questionnaires to assist in system evaluation. Internal Control Questionnaires (ICQs) ask specific questions about controls relevant to each control objective. The alternative is an Internal Control Evaluation Questionnaire (ICEQs), sometimes referred to as key or control questions which focus on risks rather than objectives. They cover the same areas as control objectives and typical examples include:

- Can employees be paid for work not done?
- Can wages be paid to fictitious employees?
- Can unauthorised wages be paid?
- Can errors occur in wage calculations?
- Can wage costs be incorrectly recorded?

If the evaluation indicates that controls exist a *test of controls* will be performed but if controls are weak or absent then a *substantive procedure* will be appropriate, to determine if material misstatement has occurred.

Stages in a wages system

Five stages are shown below and typical controls identified are linked to relevant control objectives.

(i) Setting up master file data
Robust recruitment procedures are required before new employees are entered on the wages master file. Interviews should be undertaken involving senior staff to ensure the new employee has the required skills. New starters' forms should be completed in the human resources (HR) department and copies retained along with contracts of employment. Changes to standing data on the master file should be performed by staff who are independent of processing payroll. The wages master file contains all the standing data about employees, such as name, address, date of birth, date of starting employment, employee number, rate of pay and tax code.

Relevant controls

- Changes to master file data such as rates of pay and new starters/leavers should be supported by forms approved by a senior responsible official. (Control objectives 2 and 4)

- Access to the master file should require a responsible official's password and a log of standing data amendments should be produced and reviewed. (Control objectives 2, 3 and 4)
- An independent check should be performed of standing data amendments log to supporting documentation. (Control objectives 2, 3 and 4)

(ii) Recording wages due
Clock cards are often used to record the hours that employees enter and leave the premises. Modern equivalents would include employee ID cards which are swiped by an electronic card reader. In this scenario employees are paid based on hours worked. If employees are paid in accordance with work completed job cards may take the place of clock cards.

Relevant controls

- Supervision of clocking on points and control over blank clock cards (or employee ID cards) are essential. (Control objective 1)
- Clock cards should be authorised by a responsible official before they are sent to the payroll departments. (Control objectives 1 and 3)
- HR department should keep blank clock cards or ID cards, which are only issued for new employees with contracts of employment. (Control objective 2)

(iii) Calculation of wages
Hours worked should be converted to a gross wage by reference to the employee's hourly rate of pay and deductions such as payroll taxes are made to calculate net pay. Software is normally used to produce the weekly payroll and calculation errors are less likely than with manual systems. Gross wages should be based on a standard working week (for example, 40 hours) and if overtime has been worked this should be picked up from the clock card. However, in some systems, authorised lists of overtime worked during the week are entered so that the revised gross wage can be calculated.

Relevant controls

- Overtime forms/ listings should be reviewed and authorised by responsible managers before input to the system. (Control objectives 1 and 3)
- Software controls should include data validation (edit) checks on the data fields included on transactions, and include reasonableness, existence, range and character checks. Error reports should be produced which list rejected items– for example, employee numbers entered that do not exist. Also exception reports should list transactions that have been processed but which exceed certain pre-determined limits– for example, employees earning more than $2,000 per week or those who worked more than 30 hours of overtime. It is very important that both reports are investigated closely and if necessary data corrected and re-input. (Control objectives 2 and 4).
- A sample of payroll calculations should be checked by senior responsible official and the payroll initialled. (Control objective 5)

(iv) Payment of wages
As indicated earlier employees should either be paid in cash or by bank transfer. In the case of cash a cheque should be signed, preferably by two senior responsible officials (normally directors in small companies). Once collected from the bank the cash should be included in pay packets with payroll slips for subsequent distribution to employees.

Relevant controls

- The payroll should be reviewed by a senior responsible official before the payroll cheque is signed. If employees are paid by bank transfer, the list should be authorised before being sent to the bank. (Control objectives 2 and 3)
- Two individuals independent of the processing of wages should be involved in the make up of pay packets and during the wages pay-out. (Control objective 2)
- Employees' signatures should be required when wages are collected, as evidence of receipt. If employees are absent their wage packets should be entered in an uncollected wages book and returned to a safe under the control of an independent responsible official (eg the cashier). There should be a requirement for formal identification procedures to be carried out on the subsequent collection of wage packets. (Control objective 2)

(v) Accounting for wage costs and deductions
Payroll software should automatically transfer total wage costs and deductions such as tax and pension contributions to the appropriate accounts in the general (nominal) ledger. Outstanding wages owed to employees or deductions not yet paid over to the relevant third parties should be accrued and disclosed as 'other payables'.

Relevant controls

- Monthly comparison of actual and budgeted payroll costs and investigation of significant variances. (Control objective 6)
- Independent reconciliation of total pay and deductions between one payroll and the next. (Control objective 6)
- Annual completion of tax returns and reconciliation to total tax deducted. (Control objective 7)

The above comparisons and reconciliations should be performed by senior responsible officials who are independent of the payroll department – for example, management or financial accounting staff.

Assessing the risk of material misstatement due to fraud

The risk of fraud should be considered by the auditor when planning the work which is to be performed on payroll. Even companies that appear to have good internal controls can suffer from instances of fraud. The most common payroll frauds include:

1. *The inclusion of fictitious (ghost) employees on the payroll* – this can happen in circumstances where blank clock-cards are kept by factory supervisors who also distribute wage packets to employees. There is also a risk of this type of fraud if staff who update the master file for changes are also involved in the preparation or distribution of wage packets.

2. Deliberate timing errors – a variation on the above fraud is to include new employees on the payroll before they actually commence work or to leave them on the payroll after they have left.

3. Requesting a cheque for net wages in excess of the required amount. This type of fraud is generally easier to perpetrate in manual wages systems. Alternatively, if employees are paid by bank transfer a lack of controls could provide staff with the opportunity to make changes to the list before it is sent to the bank.

4. Payment of unauthorised/invalid overtime – this can happen in circumstances where the authorisation of overtime is not properly controlled or details of overtime input during the preparation of the payroll are not independently reconciled to authorised totals for the week.

The common feature that often facilitates these frauds is inadequate segregation of duties. Frauds can be difficult to prevent where there is collusion among staff. Historically organisations have lost significant sums when large numbers of staff came to expect the routine inclusion of unauthorised overtime in their pay. While it is not the responsibility of the auditor to prevent or detect fraud, the auditor must identify and assess the risk of misstatement due to fraud and respond appropriately in order to obtain sufficient appropriate evidence regarding these risks.

Typical tests of control and substantive procedures

Interim audit
The type of test performed will depend on the particular features of the wages system and the auditor's evaluation of controls. Typical tests for each control objective are listed below. However, this list is not exhaustive and some of the substantive procedures may be carried out during the final audit.

1. *To ensure that employees are only paid for work done.*
   Test of control – observe clocking on procedures and the level of supervision.
   Substantive procedure – select a sample of employees from the payroll and agree hours paid to individual clock cards.

2. To ensure that wages are only paid to valid employees.
   Test of control – attend the wages pay out.
   Substantive procedure – select a sample of employees from the payroll and vouch to individual contracts of employment in HR department.

3. To ensure that overtime paid is for additional hours required by the business.
   Test of control – review overtime forms/lists for authorised signatures.
   Substantive procedure – compare overtime costs each month with the prior year and

investigate significant variances.

4. To ensure wages are paid at the correct rates of pay.
   Test of control – review log of amendments to master file for evidence of independent review.
   Substantive procedure – obtain printout of employee wage rates and compare to HR records.

5. To ensure that errors do not occur in payroll calculations.
   Test of control – review payrolls for signatures as evidence of independent calculation checks.
   Substantive procedure – select a sample of employees and reperform calculations of gross and net pay.

Final audit

Tests to ensure the accuracy and completeness of balances in respect of wage costs and payroll deductions (Control objectives 5, 6 and 7) are normally substantive in nature and conducted as part the final audit.

A substantive audit programme should include:

- Agree total wages and deductions per selected payrolls to the amounts recorded in the individual general (nominal) ledger accounts
- Perform analytical procedures such as proof in total by using number of employees and average wage. Investigate any significant fluctuations.
- Carry out month-by-month comparisons of total wages with prior year/budgets and investigate differences.
- Agree sundry payables for tax outstanding at the year end to the payroll records and check subsequent payment to cash book.

Computer assisted audit techniques
Use the computer as an audit tool and the most common examples are test data and audit software. These could be employed during the interim and final audit of wages.

Test data consists of data submitted by the auditor to test the operation of application controls such as data-validation (edit) checks. Test data should be input using valid and invalid transactions to check the operation of these controls. Examples include:

- Input employee numbers that do not exist or are in an incorrect format – to ensure these items are rejected and included on an error report.
- Input a gross weekly pay exceeding $2,000 – to ensure these employees are included on an exception report.

- Input overtime hours exceeding 30 hours per week – to ensure these employees are also included on an exception report.

Audit software is normally used by the auditor for substantive testing and can interrogate a client's computer files, re-perform calculations or extract items for further investigation. Examples include:

- Re-perform calculations of gross wage, deductions and casts on selected payrolls.
- Compare the payroll file at the beginning and end of the period to identify starters and leavers, which could then be checked to appropriate documentation.
- Comparing employee records on payroll file and HR files

Summary

Knowledge of the stages in a typical wages system and the link between control objectives, controls and audit tests should help students distinguish between these terms. It is also important that, for a given wages system, candidates can identify significant deficiencies in internal control, explain the implications of the deficiencies and recommend appropriate controls.

Written by a member of the FAU examining team

Questions

Which of the following controls helps to ensure that payroll payments are only made to bona fide employees?
(1) Personnel records maintained for all employees
(2) Comparison of bank transfer listing with payroll
(3) Segregation of duties between staff involved in human resources and payroll functions
(4) Reperformance of the calculation of a sample of payroll deductions

A (1) and (2)
B (1) and (3)
C (2) and (4)
D (3) and (4)

Answer: B

Personnel records are documentary evidence of the existence of an employee. Segregation of duties between staff involved in HR and payroll helps to prevent the creation of bogus employees with subsequent payroll payments being made.

Chapter 14 Audit sampling

Executive Summary

Paper AA, Audit and Assurance, requires students to gain an understanding of audit sampling.

While you won't be expected to pick a sample, you must have an understanding of how the various sampling methods work.

This article will consider the various sampling methods in the context of Paper AA.

This subject is dealt with in ISA 530, Audit Sampling. The definition of audit sampling is:

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

Paper F8, *Audit and Assurance* and Paper FAU, *Foundations in Audit* require students to gain an understanding of audit sampling. While you won't be expected to pick a sample, you must have an understanding of how the various sampling methods work. This article will consider the various sampling methods in the context of Paper F8 and Paper FAU.

This subject is dealt with in ISA 530, *Audit Sampling*. The definition of audit sampling is:

'The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.' (1)

In other words, the standard recognises that auditors will not ordinarily test all the information available to them because this would be impractical as well as uneconomical. Instead, the auditor will use sampling as an audit technique in order to form their conclusions. It is important at the outset to understand that some procedures that the auditor may adopt do not involve audit sampling, 100% testing of items within a population, for example. Auditors may deem 100% testing appropriate where there are a small number of high value items that make up a population, or when there is a significant risk of material misstatement and other audit procedures will not provide sufficient appropriate audit evidence. However, candidates must appreciate that 100% examination is highly unlikely in the case of tests of controls; such sampling is more common for tests of detail (ie substantive testing).

The use of sampling is widely adopted in auditing because it offers the opportunity for the auditor to obtain the minimum amount of audit evidence, which is both sufficient and appropriate, in order to form valid conclusions on the population. Audit sampling is also widely known to reduce the risk of 'over-auditing' in certain areas, and enables a much more efficient review of the working papers at the review stage of the audit.

In devising their samples, auditors must ensure that the sample selected is representative of the population. If the sample is not representative of the population, the auditor will be unable to form a conclusion on the entire population. For example, if the auditor tests only 20% of trade receivables for existence at the reporting date by confirming after-date cash, this is hardly representative of the population, whereas, say, 75% would be much more representative.

Sampling risk

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

ISA 530 recognises that sampling risk can lead to two types of erroneous conclusion:

1. The auditor concludes that controls are operating effectively, when in fact they are not. Insofar as substantive testing is concerned (which is primarily used to test for material misstatement), the auditor may conclude that a material misstatement does not exist, when in fact it does. These erroneous conclusions will more than likely lead to an incorrect opinion being formed by the auditor.
2. The auditor concludes that controls are not operating effectively, when in fact they are. In terms of substantive testing, the auditor may conclude that a material misstatement exists when, in fact, it does not. In contrast to leading to an incorrect opinion, these errors of conclusion will lead to additional work, which would otherwise be unnecessary leading to audit inefficiency.

Non-sampling risk is the risk that the auditor forms the wrong conclusion, which is unrelated to sampling risk. An example of such a situation would be where the auditor adopts inappropriate audit procedures, or does not recognise a control deviation.

Methods of sampling

ISA 530 recognises that there are many methods of selecting a sample, but it considers five principal methods of audit sampling as follows:

- random selection
- systematic selection
- monetary unit sampling
- haphazard selection, and
- block selection.

Random selection
This method of sampling ensures that all items within a population stand an equal chance of selection by the use of random number tables or random number generators. The sampling units could be physical items, such as sales invoices or monetary units.

Systematic selection
The method divides the number of sampling units within a population into the sample size to generate a sampling interval. The starting point for the sample can be generated randomly, but ISA 530 recognises that it is more likely to be 'truly' random if the use of random number generators or random number tables are used. Consider the following example:

Example 1
You are the auditor of Jones Co and are undertaking substantive testing on the sales for

the year ended 31 December 2010. You have established that the 'source' documentation that initiates a sales transaction is the goods dispatch note and you have obtained details of the first and last goods dispatched notes raised in the year to 31 December 2010, which are numbered 10,000 to 15,000 respectively.

The random number generator has suggested a start of 42 and the sample size is 50. You will therefore start from goods dispatch note number (10,000 + 42) 10,042 and then sample every 100th goods dispatch note thereafter until your sample size reaches 50.

Monetary unit sampling
The method of sampling is a value-weighted selection whereby sample size, selection and evaluation will result in a conclusion in monetary amounts. The objective of monetary unit sampling (MUS) is to determine the accuracy of financial accounts. The steps involved in monetary unit sampling are to:

- determine a sample size
- select the sample
- perform the audit procedures
- evaluate the results and arriving at a conclusion about the population.

MUS is based on attribute sampling techniques and is often used in tests of controls and appropriate when each sample can be placed into one of two classifications – 'exception' or 'no exception'. It turns monetary amounts into units – for example, a receivable balance of $50 contains 50 sampling units. Monetary balances can also be subject to varying degrees of exception – for example, a payables balance of $7,000 can be understated by $7, $70, $700 or $7,000 and the auditor will clearly be interested in the larger misstatement.

Haphazard sampling
When the auditor uses this method of sampling, he does so without following a structured technique. ISA 530 also recognises that this method of sampling is not appropriate when using statistical sampling (see further in the article). Care must be taken by the auditor when adopting haphazard sampling to avoid any conscious bias or predictability. The objective of audit sampling is to ensure that all items that make up a population stand an equal chance of selection. This objective cannot be achieved if the auditor deliberately avoids items that are difficult to locate or deliberately avoids certain items.

Block selection
This method of sampling involves selecting a block (or blocks) of contiguous items from within a population. Block selection is rarely used in modern auditing merely because valid references cannot be made beyond the period or block examined. In situations when the auditor uses block selection as a sampling technique, many blocks should be selected to help minimise sampling risk.

An example of block selection is where the auditor may examine all the remittances from customers in the month of January. Similarly, the auditor may only examine remittance advices that are numbered 300 to 340.

Statistical versus non-statistical sampling

Paper F8 students need to be able to differentiate between 'statistical' and 'non-statistical' sampling techniques. ISA 530 provides the definition of 'statistical' sampling as follows:

'An approach to sampling that has the following characteristics:
i. Random selection of the sample items, and
ii. The use of probability theory to evaluate sample results, including measurement of sampling risk.' (2)

The ISA goes on to specify that a sampling approach that does not possess the characteristics in (i) and (ii) above is considered non-statistical sampling.

The above sampling methods can be summarised into statistical and non-statistical sampling as follows:

Statistical sampling	Non-statistical sampling
Random sampling	Haphazard sampling
Systematic sampling	Block selection
Monetary unit sampling	

Statistical sampling allows each sampling unit to stand an equal chance of selection. The use of non-statistical sampling in audit sampling essentially removes this probability theory and is wholly dependent on the auditor's judgment. Keeping the objective of sampling in mind, which is to provide a reasonable basis for the auditor to draw valid conclusions and ensuring that all samples are representative of their population, will avoid bias.

Conclusion

Paper F8 and FAU students must ensure they fully understand the various sampling methods available to auditors. In reality there are a number of ways in which sampling can be applied that ISA 530 recognises – however, the standard itself covers the principal methods.

Students must ensure they can discuss the results of audit sampling and form a conclusion as to whether additional work would need to be undertaken to reduce the risk of material misstatement.

Written by a member of the F8 examining team

References

(1). ISA 530, paragraph 5 (a)
(2). ISA 530, paragraph 5 (g)

Questions

Is the following statement regarding audit sampling true or false?
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.

A True
B False

Answer: A

As set out in ISA 530 *Audit sampling*.

Chapter 15 Using the work of internal auditors

Executive Summary

This article focuses on the provision of direct assistance by the internal auditors, which – to date – has been a very controversial issue.

Although internal auditors are the employees of the entity, which could result in threats to independence (either in fact or perceived) if direct assistance is provided by the internal auditors, there are benefits relating to this provision which cannot be ignored.

International Standard on Auditing (ISA) 610, *Using the Work of Internal Auditors* was revised and published in 2013. This standard focuses on whether the external auditor can use the work of the internal audit function for purposes of audit, and the revised version of the standard, clarified whether the internal auditors could be used to provide direct assistance to the external auditor.

Candidates taking AA and AAA should familiarise themselves with this aspect of the standard as they are expected to be able to discuss the extent to which external auditors are able to rely on the work of internal auditors (section D6 of the AA *Study Guide*) and to assess the appropriateness and sufficiency of the work of internal auditors as well as the extent to which reliance can be placed on it (section D4) of the AAA *Study Guide*).

External and internal auditors

Much of the work performed by a company's internal audit function can overlap with the work conducted by the external auditor, specifically in areas dealing with the assessment of control processes. It is likely that in carrying out detailed work evaluating and reviewing the company's internal control framework internal audit perform procedures on financial controls relevant to the external audit. As such, the external auditor, rather than duplicating these procedures, may be able to place reliance on the work carried out by the internal auditor.
This article focuses on the provision of direct assistance by the internal auditors, which historically has been a very controversial issue. Internal auditors are the **employees of the entity,** which could result in **threats to independence** (either in fact or perceived) if direct assistance is provided by the internal auditors. On the other hand, the following benefits relating to provision of direct assistance by the internal auditors cannot be ignored:

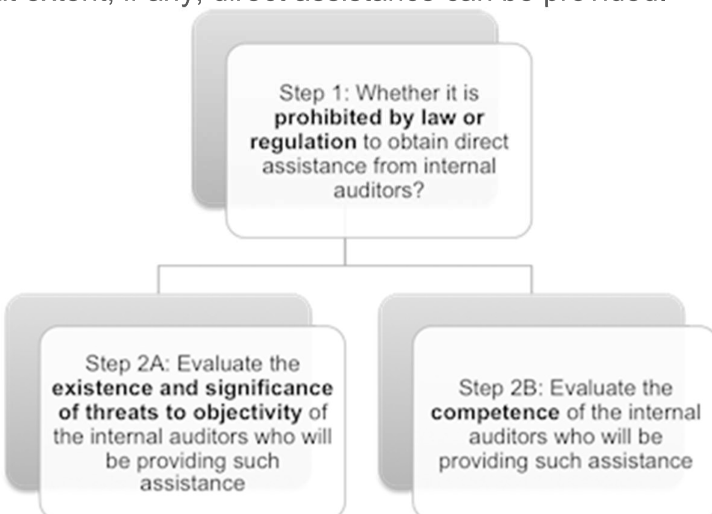
- There will be a **strengthened relationship** between the external and internal auditors through a more effective dialogue
- With the **knowledge** of the internal auditors, the external auditor can gain additional insights into the entity
- The external auditor can use internal auditors who may have relevant **expertise** in particular areas, and
- The external audit team can focus on the **more significant audit issues**.

Where such use is not prohibited by law or regulation, the ISA provides a robust framework to ensure that direct assistance is obtained only in appropriate circumstances, that the external auditor considers the relevant limitations and safeguards, and that the auditor's responsibilities are clearly set out.

Guidance on determining if it is appropriate for internal auditors to provide direct assistance

When can internal auditors be used to provide direct assistance?

The external auditor, in the course of discharging their responsibilities must decide if it is appropriate in the circumstances to use internal audit to provide direct assistance. The ISA identifies a number of steps that the external auditor should work through when determining to what extent, if any, direct assistance can be provided.



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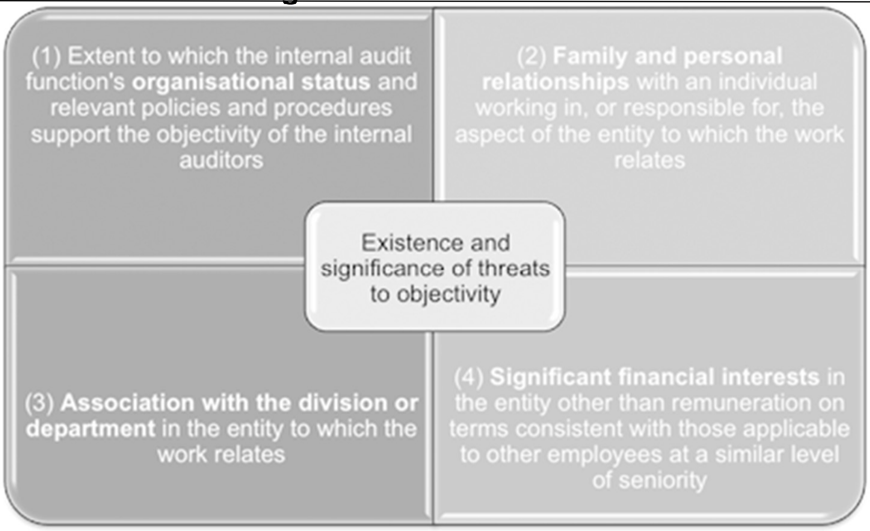
Step 1: Prohibition by law or regulation
The external auditor **may be prohibited** by law or regulation from obtaining direct assistance from internal auditors; therefore, the first task is to understand the law or regulation of the jurisdiction in which the auditor is operating. In the United Kingdom for example, the Financial Reporting Council (FRC) prohibits external auditors from using internal auditors as 'direct assistance' members of the audit team in order to enhance the principle of auditor independence. Consequently the guidelines in relation to direct assistance are irrelevant to audits conducted in accordance with ISAs (UK).

Step 2A: Evaluation of the existence and significance of threats to objectivity of the internal auditors
This is considered as an important element in the external auditor's judgment as to whether internal auditors can provide direct assistance. Objectivity is regarded as the ability to perform the tasks without allowing bias, conflict of interest or undue influence of others to override professional judgment. The following factors are relevant to the external auditor's evaluation of objectivity:



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It should be noted that the main purpose here is to evaluate **threats to objectivity**. Take the first factor as an example – if evidence shows that the internal audit function's organisational status supports the objectivity of the internal auditors, the external auditor will feel more comfortable using direct assistance from the internal auditors. The following situations are likely to support the objectivity of the internal auditors:

- The internal audit function reports to those charged with governance (eg the audit committee) rather than solely to management (eg the chief finance officer)
- The internal audit function does not have managerial or operational duties that are outside of the internal audit function
- The internal auditors are members of relevant professional bodies obligating their compliance with relevant professional standards relating to objectivity.

Step 2B: Evaluation of the level of competence of the internal auditors
Competence of the internal audit function is likely to be deemed satisfactory where it can be evidenced that the function as a whole operates at the level required to (i) enable assigned tasks to be performed diligently and (ii) in accordance with applicable professional standards. To make such evaluation, the external auditor can take into consideration the following factors:

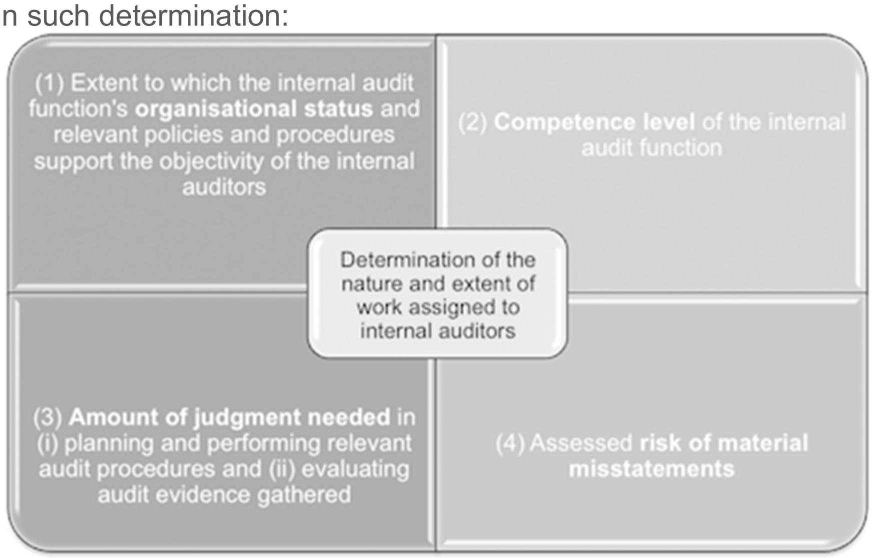
- Whether there are established policies for **hiring**, **training** and **assigning** internal auditors to internal audit engagements
- Whether the internal auditors have adequate technical training and proficiency in auditing (eg with relevant professional designation and experience)
- Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework
- Whether the internal audit function possesses the necessary skills (for example, industry-specific knowledge) to perform work related to the entity's financial statements.

Points to note in the evaluation
The above evaluation regarding the internal auditors' objectivity and competence should not be new to candidates as it forms the basis for any assessment by the external auditor when determining if reliance can be placed on the work of internal auditors. The external auditor should bear in mind that the assessment of competence and objectivity are of equal importance, and should be assessed individually and in aggregate. For example if the internal auditors are deemed appropriately competent but the external auditor identifies significant threats to objectivity it is unlikely that the external auditor will be able to use the internal auditors to provide direct assistance and vice versa.

What can be assigned to internal auditors providing direct assistance?

Following the above detailed evaluation, if the external auditor determines that internal auditors, can be used to provide direct assistance for purposes of the audit, the next decision to be made by the external auditor is to determine the **nature and extent of work** that can be assigned to internal auditors.

This is a matter that requires the auditor to exercise professional judgment, due to the fact that extensive use of direct assistance could affect perceptions of the independence of external auditors. ISA 610 (Revised 2013) limits the circumstances in which direct assistance can be provided. The external auditor is advised to consider the following factors in such determination:



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The external auditor should have performed the assessment of the first two factors when determining whether the internal auditors can provide direct assistance in the first instance. The less persuasive the evidence regarding the internal auditors' objectivity and competency, the more restrictive the nature and extent of work that can be assigned.

As a starting point the external auditor should consider the amount of judgment needed in (i) planning and performing relevant audit procedures and (ii) evaluating audit evidence gathered. The **greater the level of judgment** required, the **narrower the scope** of work that can be assigned to internal auditors. The following activities are deemed to involve significant judgment and therefore are not expected to be assigned to internal auditors providing direct assistance:

- Assessing risks of material misstatements
- Evaluating the sufficiency of tests performed
- Evaluating significant accounting estimates, and
- Evaluating the adequacy of disclosures in the financial statements and other matters affecting the auditor's report.

For any particular account balance, class of transaction or disclosure, the external auditor has to take into consideration the assessed risk of material misstatement when determining the nature and extent of work that they propose to assign to internal auditors. The **higher the assessed risk**, the **more restricted the nature and extent** of work that should be assigned to internal auditors. If the risk of material misstatement is considered to be anything other than low, the more judgment that has to be involved and the more persuasive the audit evidence required. Therefore, in these circumstances, in order to reduce audit risk to an acceptably low level it is expected that the external auditor has to perform more procedures directly and place less reliance on assistance provided by internal auditors when collecting sufficient appropriate evidence. The ISA provides some specific examples of areas where reliance should be restricted.

ISA 610 (Revised 2013) states that internal auditors cannot carry out procedures when providing direct assistance that:

- Involve making *significant* judgment in the audit
- Relate to higher assessed risks of material misstatements where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathering is *more than limited*
- Relate to decisions the external auditor makes in accordance with ISA 610 (Revised 2013) regarding the internal audit function and the use of its work or direct assistance
- Relate to work with which the internal auditors have been involved and which has already been or will be reported to management (or those charged with governance) by the internal audit function. This restriction intends to minimise self-review threats.

ISA 610 (Revised 2013) also states that the following should not be assigned to or involve internal auditors providing direct assistance:

(i) discussion of fraud risks
(ii) determination of unannounced (or unpredictable) audit procedures as addressed in ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements, and
(iii) maintaining control over external confirmation requests and evaluation of results of external confirmation procedures.

Responsibilities of the external auditor using internal auditors to provide direct assistance

The external auditor should note the following responsibilities at different stages of the audit when using internal auditors to provide direct assistance:

(1) After determining the use of internal auditors to provide direct assistance
The external auditor has to:

- Communicate the nature and extent of the planned use of internal auditors with those charged with governance (in accordance with ISA 260, *Communication with Those Charged with Governance*) so as to reach a mutual understanding that **such use is not excessive** in the circumstances of the engagement. This communication not only dispels any perception that the external auditor's independence might be compromised by the use of direct assistance but also facilitates appropriate dialogue with those charged with governance.
- Evaluate whether the external auditor is still sufficiently involved in the audit.

(2) Prior to the use of internal auditors to provide direct assistance
The external auditor has to **obtain written agreement** from two parties:

- From an **authorised representative** of the entity stating that: (i) the internal auditors will be allowed to follow the external auditor's instructions, and (ii) the entity will not intervene in the work the internal auditor performs for the external auditors.
- From **internal auditors** stating that they will: (i) keep confidential specific matters as instructed by the external auditor and (ii) inform the external auditor of any threat to their objectivity.

(3) During the audit
The external auditor has to:

- Direct, supervise and review the work performed by internal auditors on the engagement, bearing in mind that the **internal auditors are not independent** of the entity. It is therefore expected that such supervision and review will be of a different nature and more extensive than if members of the audit engagement team perform the work.

- Remind the internal auditors to bring accounting and auditing issues identified during the audit to the attention of the external auditors.
- Check back to the underlying audit evidence for some of the work performed by the internal auditors.
- Make sure the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work.

(4) Documenting the audit evidence
The documentation requirements evidencing the application of the important safeguards in ISA 610 (Revised 2013) have been expanded when the external auditor uses the internal auditors to provide direct assistance. The external auditor should document the following in the working papers:

- **Evaluation** of the existence and significance of the **threats to the objectivity** of the internal auditors and the level of **competence** of the internal auditors used to provide direct assistance
- The **basis** for the decision regarding the nature and extent of the work performed by the internal auditors
- Who **reviewed the work performed** and the date and extent of that review in accordance with ISA 230, *Audit Documentation*
- The **written agreements** obtained from an authorised representative of the entity and the internal auditors
- The **working papers** prepared by the internal auditors providing direct assistance on the audit engagement.

Conclusion

The external auditor has to exercise professional judgment when determining whether the internal auditors, subject to law and regulation, can be used to provide direct assistance in the financial statement audit of an entity. Candidates are expected to understand (i) how the external auditor makes such evaluations and (ii) for which processes or tasks the internal auditors can provide direct assistance to the external auditor. The most important principle is, in any circumstances, the external auditor should be **sufficiently involved** in the audit as the external auditor has the **sole responsibility** for the audit opinion expressed.

Eric YW Leung, CUHK Business School, The Chinese University of Hong Kong, FCCA

Reference
ISA 610 (Revised 2013), *Using the Work of Internal Auditors, together with its Basis for Conclusions*

Questions

Which type of risk is the internal auditor normally responsible for monitoring?
A Audit risk
B Business risk
C Audit risk and business risk
D Neither audit risk nor business risk

Answer: B

The internal auditor plays a key role in organisational risk management, an important aspect of corporate governance. The internal auditor ensures that there are strategies in place to manage business risk and that they are effective. Audit risk is relevant to the external audit.

Chapter 16 Analytical procedures

Executive Summary

To obtain audit evidence, the auditor performs one – or a combination – of the following procedures:

- inspection
- observation
- external confirmation
- inquiry
- reperformance
- recalculation
- analytical procedures.

It is mandatory that the auditor should perform risk assessment for the identification and assessment of risks of material misstatement at the financial statement and assertion level, and the risk assessment procedures should include analytical procedures (ISA 315).

It is also mandatory that the auditor should perform analytical procedures near the end of the audit that assess whether the financial statements are consistent with the auditor's understanding of the entity (ISA 520).

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Analytical procedures are also commonly used in non-audit and assurance engagements, such as reviews of prospective financial information, and non-audit reviews of historical financial information. While the use of analytical procedures in such engagements is not covered in the ISAs, the principals regarding their use are relevant.

Definition of analytical procedures

Analytical procedures consist of 'evaluations of financial information through analysis of plausible relationships among both financial and non-financial data'. They also encompass 'such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount' (ISA 520). A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of conditions to the contrary.

Purposes of analytical procedures

Analytical procedures are used throughout the audit process and are conducted for three primary purposes:

1. Preliminary analytical review – risk assessment (required by ISA 315)
   Preliminary analytical reviews are performed to obtain an understanding of the business

and its environment (eg financial performance relative to prior years and relevant industry and comparison groups), to help assess the risk of material misstatement in order to determine the nature, timing and extent of audit procedures, ie to help the auditor develop the audit strategy and programme.

2. Substantive analytical procedures
Analytical procedures are used as substantive procedures when the auditor considers that the use of analytical procedures can be more effective or efficient than tests of details in reducing the risk of material misstatements at the assertion level to an acceptably low level.

3. Final analytical review (required by ISA 520)
Analytical procedures are performed as an overall review of the financial statements at the end of the audit to assess whether they are consistent with the auditor's understanding of the entity. Final analytical procedures are not conducted to obtain additional substantive assurance. If irregularities are found, risk assessment should be performed again to consider any additional audit procedures are necessary.

Use of substantive analytical procedures

One of the objectives of ISA 520 is that relevant and reliable audit evidence is obtained when using substantive analytical procedures. The primary purpose of substantive analytical procedures is to obtain assurance, in combination with other audit testing (such as tests of controls and substantive tests of details), with respect to financial statement assertions for one or more audit areas. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be more predictable over time.

The application of substantive analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and occurrence of transactions. Due to their nature, substantive analytical procedures can often provide evidence for multiple assertions, identify audit issues that may not be apparent from more detailed work, and direct the auditor's attention to areas requiring further investigation. Furthermore, the auditor may identify risks or deficiencies in internal control that had not previously been identified, which may cause the auditor to re-evaluate his planned audit approach and require the auditor to obtain more assurance from other substantive testing than originally planned.

To derive the most benefit from substantive analytical procedures, the auditor should perform substantive analytical procedures before other substantive tests because results of substantive analytical procedures often impact the nature and extent of detailed testing. Substantive analytical procedures might direct attention to areas of increased risk, and the assurance obtained from effective substantive analytical procedures will reduce the amount of assurance needed from other tests.

There are four elements that comprise distinct steps that are inherent in the process to using substantial analytical procedures:

STEP 1: Develop an independent expectation

The development of an appropriately precise, objective expectation is the most important step in effectively using substantive analytical procedures. An expectation is a prediction of a recorded amount or ratio. The prediction can be a specific number, a percentage, a direction or an approximation, depending on the desired precision.

The auditor should have an independent expectation whenever s/he uses substantive analytical procedures (ISA 520). The auditor develops expectations by identifying plausible relationships (eg between store square footage and retail sales, market trends and client revenues) that are reasonably expected to exist based on his knowledge of the business, industry, trends, or other accounts.

STEP 2: Define a significant difference (or threshold)

While designing and performing substantive analytical procedures the auditor should consider the amount of difference from the expectation that can be accepted without further investigation (ISA 520). The maximum acceptable difference is commonly called the 'threshold'.

Thresholds may be defined either as numerical values or as percentages of the items being tested. Establishing an appropriate threshold is particularly critical to the effective use of substantive analytical procedures. To prevent bias in judgment, the auditor should determine the threshold while planning the substantive analytical procedures, ie before Step 3, in which the difference between the expectation and the recorded amount are computed.

The threshold is the acceptable amount of potential misstatement and therefore should not exceed planning materiality and must be sufficiently small to enable the auditor to identify misstatements that could be material either individually or when aggregated with misstatements in other disaggregated portions of the account balance or in other account balances.

STEP 3: Compute difference

The third step is the comparison of the expected value with the recorded amounts and the identification of significant differences, if any. This should be simply a mechanical calculation.

It is important to note that the computation of differences should be done after the consideration of an expectation and threshold. In applying substantive analytical procedures, it is not appropriate to first compute differences from prior-period balances and then let the results influence the 'expected' difference and the acceptable threshold.

STEP 4: Investigate significant differences and draw conclusions

The fourth step is the investigation of significant differences and formation of conclusions (ISA 520). Differences indicate an increased likelihood of misstatements; the greater the degree of precision, the greater the likelihood that the difference is a misstatement.

Explanations should be sought for the full amount of the difference, not just the part that exceeds the threshold. There is a chance that the unexplained difference may indicate an increased risk of material misstatement. The auditor should consider whether the differences were caused by factors previously overlooked when developing the expectation in Step 1, such as unexpected changes in the business or changes in accounting treatments.

If the difference is caused by factors previously overlooked, it is important to verify the new data, to show what impact this would have on the original expectations as if this data had been considered in the first place, and to understand any accounting or auditing ramifications of the new data.

Key factors affecting the precision of analytical procedures

There are four key factors that affect the precision of analytical procedures:

1 Disaggregation
The more detailed the level at which analytical procedures are performed, the greater the potential precision of the procedures. Analytical procedures performed at a high level may mask significant, but offsetting, differences that are more likely to come to the auditor's attention when procedures are performed on disaggregated data.

The objective of the audit procedure will determine whether data for an analytical procedure should be disaggregated and to what degree it should be disaggregated. Disaggregated analytical procedures can be best thought of as looking at the composition of a balance(s) based on time (eg by month or by week) and the source(s) (eg by geographic region or by product) of the underlying data elements. The reliability of the data is also influenced by the comparability of the information available and the relevance of the information available.

2 Data reliability
The more reliable the data is, the more precise the expectation. The data used to form an expectation in an analytical procedure may consist of external industry and economic data gathered through independent research. The source of the information available is particularly important. Internal data produced from systems and records that are covered by the audit, or that are not subject to manipulation by persons in a position to influence accounting activities, are generally considered more reliable.

3 Predictability
There is a direct correlation between the predictability of the data and the quality of the expectation derived from the data. Generally, the more precise an expectation is for an analytical procedure, the greater will be the potential reliability of that procedure. The use of non-financial data (eg number of employees, occupancy rates, units produced) in developing an expectation may increase the auditor's ability to predict account relationships. However, the information is subject to data reliability considerations mentioned above.

4 Type of analytical procedures
There are several types of analytical procedures commonly used as substantive procedures and will influence the precision of the expectation. The auditor chooses among these procedures based on his objectives for the procedures (ie purpose of the test, desired level of assurance).

1. Trend analysis – the analysis of changes in an account over time.
2. Ratio analysis – the comparison, across time or to a benchmark, of relationships between financial statement accounts and between an account and non-financial data.
3. Reasonableness testing – the analysis of accounts, or changes in accounts between accounting periods, that involves the development of a model to form an expectation based on financial data, non - financial data, or both.

Each of the types uses a different method to form an expectation. They are ranked from lowest to highest in order of their inherent precision. Scanning analytics are different from the other types of analytical procedures in that scanning analytics search within accounts or other entity data to identify anomalous individual items, while the other types use aggregated financial information.

If the auditor needs a high level of assurance from a substantive analytical procedure, s/he should develop a relatively precise expectation by selecting an appropriate analytical procedure (eg a reasonableness test instead of a simple trend or 'flux' analysis). Thus, determining which type of substantive analytical procedure to use is a matter of professional judgment.

In summary, there is a direct correlation between the type of analytical procedure selected and the precision it can provide. Generally, the more precision inherent in an analytical procedure used, the greater the potential reliability of that procedure.

Key messages:

- Substantive analytical procedures play an important part in a risk-based audit approach.
- Properly designed and executed analytical procedures can allow the auditor to achieve audit objectives more efficiently by reducing or replacing other detailed audit testing.
- The effectiveness of analytical procedures depends on the auditor's understanding of the entity and its environment and the use of professional judgment; therefore, analytical procedures should be performed or reviewed by senior members of the engagement team.
- It is vital that the analytical procedures be sufficiently documented to enable an experienced auditor, having no previous connection with the audit, to understand the work done (ISA 230).

Questions

Which of the following statements is/are true with respect to analytical procedures?
(1) Analytical procedures can be used throughout the audit.
(2) Analytical procedures must be used as risk assessment procedures.

A (1) only
B (2) only
C (1) and (2)
D Neither (1) nor (2)

Answer: C

Analytical procedures can be used throughout the audit but must be used as risk assessment procedures and at the review stage of the audit.

Chapter 17 Going concern

Executive Summary

It is essential that candidates preparing for the AA exam understand the respective responsibilities of auditors and management regarding going concern.

This article discusses these responsibilities, as well as the indicators that could highlight where an entity may not be a going concern, and the reporting aspects relating to going concern.

It is essential that candidates preparing for the Paper F8 exam understand the respective responsibilities of auditors and management regarding going concern. This article discusses these responsibilities, as well as the indicators that could highlight where an entity may not be a going concern, and the reporting aspects relating to going concern

Candidates attempting Paper F8, *Audit and Assurance* will need to have a sound understanding of the concept of going concern. Among other syllabus requirements, candidates must ensure they are aware of the respective responsibilities of auditors and management regarding going concern. The provisions in ISA 570, Going Concern deal with the auditor's responsibilities in relation to management's use of the going concern assumption in the preparation of the financial statements.

The concept of going concern

An entity prepares financial statements on a going concern basis when, under the going concern assumption, the entity is viewed as continuing in business for the foreseeable future. The term 'foreseeable future' is not defined within ISA 570, but IAS 1, *Presentation of Financial Statements* deems the foreseeable future to be a period of 12 months from the entity's reporting date.

The concept of going concern is an underlying assumption in the preparation of financial statements, hence it is assumed that the entity has neither the intention, nor the need, to liquidate or curtail materially the scale of its operations. If management conclude that the entity has no alternative but to liquidate or curtail materially the scale of its operations, the going concern basis cannot be used and the financial statements must be prepared on a different basis (such as the 'break-up' basis).

Management's responsibility

The concept of going concern is particularly relevant in times of economic difficulties and in some situations management may determine that a profitable company may not be a going concern, for example because of significant cash flow difficulties. It is important that candidates understand that it is the responsibility of management to make an assessment of whether the going concern presumption is appropriate, or not, when they are preparing the financial statements. In order to conclude as to whether, or not, an entity is able to continue in business for the foreseeable future, management will have to make judgments on various uncertain future outcomes of events or conditions. ISA 570 outlines three factors that are relevant and which management must take into consideration when determining whether, or not, an entity can prepare the financial statements on the going concern basis:

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.

- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.

- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made. (1)

Question 5(b) in the June 2010 exam (Medimade Co), for eight marks, required candidates to: 'Identify any potential indicators that the company is not a going concern and describe why these could impact upon the ability of the company to continue trading on a going concern basis.'

The scenario presented to candidates gave an abundance of warning signals that management's assessment of going concern may not be appropriate in the circumstances. These warnings signals were:

- a growth in the level of competition Medimade Co faces

- a significant decline in demand for its products

- failing to re-invest in new product development

- difficulties in recruiting suitably trained scientific staff

- an inability to agree suitable financing terms with the bank

- investing $2m in new plant and machinery using an overdraft (a short-term borrowing facility which carries higher rates of interest)

- delayed payments to suppliers with some suppliers withdrawing credit and insisting on cash on delivery, which further impacts the overdrawn balance at the bank

- cash flow forecast showing a significantly worsening position within the next 12 months.

In the Paper F8 exam, candidates must be able to identify factors that may have an impact on an entity's ability to continue as a going concern. The factors present in Question 5 of the June 2010 exam are not exhaustive and there are many other indicators that an entity may not be a going concern, such as:

- inability to pay dividends to shareholders
- major losses or cash flow difficulties that have arisen since the reporting date
- adverse key financial ratios
- indications of withdrawal of financial support from the bank or other financial institutions
- negative operating cash flows
- major debt repayments falling due which the entity will not be able to meet
- pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied

If there are any material uncertainties relating to the going concern assumption, then management must make adequate going concern disclosures in the financial statements.

Auditor's responsibilities

As mentioned earlier, it is not the auditor's responsibility to determine whether, or not, an entity can prepare its financial statements under the going concern presumption; this is the responsibility of management. The auditor's responsibility under ISA 570 is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements, and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern.

In the June 2010 exam, question 5(c) required candidates to: 'Explain the audit procedures that the auditor of Medimade should perform in assessing whether or not the company is a going concern.'

When faced with such a requirement, candidates must be careful not to produce a list of generic audit procedures, but instead identify and highlight the factors from the scenario that may call into question the entity's ability to continue as a going concern. Once these factors have been identified, candidates should then be able to think about the procedures the auditor may adopt to establish whether the factors mean the going concern presumption is appropriate in the circumstances, or not.

In Question 5(c) of the June 2010 exam, if candidates simply wrote 'Obtain confirmation from the bank that the overdraft facility will be renewed' this will generate no marks for two reasons:

- The scenario clearly says that Medimade's bankers will not make a decision on the overdraft facility until AFTER the audit report is completed.
- A bank, or other financial institution, is not going to give this sort of information directly to the auditor.

Candidates should generate the audit procedures specifically from information contained in the scenario to demonstrate application skills, and candidates should refer to the model answer in the June 2010 exam to make sure the procedures they have generated are specific to the scenario.

Many candidates fall into the trap of relying on 'discussions with management/directors' and 'obtaining a written representation'. Candidates must appreciate that while discussion/inquiry is a valid audit procedure under ISA 500, *Audit Evidence*, such a procedure is always used in addition to other procedures – in other words, inquiry on its own will not generate sufficient appropriate audit evidence. Similarly ISA 580, *Written Representations* recognises that while written representations do provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.

Other procedures that the auditor may adopt to establish whether the use of the going concern presumption is appropriate in an entity's particular circumstances could be:

- Reading minutes of shareholders' meetings to identify any current, or potential, cash flow difficulties.
- Liaising with the entity's legal advisers concerning any ongoing litigation or future litigation and assessing the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Evaluating the entity's plans to deal with unfulfilled customer orders.
- Obtaining and reviewing reports of regulatory actions.

Reporting

An important point to emphasise at the outset is that candidates are strongly advised not to use the 'scattergun' approach when it comes to deciding on the audit opinion to be expressed within the auditor's report. The scattergun approach is when a candidate will say that the auditor may express more than one opinion depending on a varying degree of situations. For example, where candidates write 'an unmodified opinion should be expressed, but the auditor may include an emphasis of matter paragraph if X is disclosed, or the opinion could be qualified "except for" if Y has happened or maybe an adverse or disclaimer should be expressed if Z occurs'. This is not going to earn many (if any) marks because Paper F8 candidates are expected to be able to come to a conclusion as to the auditor's opinion, depending on the circumstances presented in the question.

There are three situations that ISA 570 identifies in terms of the going concern assumption:

- use of the going concern assumption is appropriate but a material uncertainty exists
- use of the going concern assumption is inappropriate
- management unwilling to make or extend its assessment.

Use of the going concern assumption is appropriate but a material uncertainty exists

A reporting entity that considers the going concern assumption to be appropriate, but still has a material uncertainty present will have to make disclosure of the fact in the financial statements that there are uncertain future transactions/events that may result in the entity being unable to continue in business in the foreseeable future.

The auditor will consider the adequacy of the disclosures made in the financial statements by management. If the auditor considers the disclosures to be adequate, then the audit report will be modified by the inclusion of an Emphasis of Matter paragraph. The Emphasis of Matter paragraph will follow immediately after the opinion paragraph and will always cross-reference the reader's attention to the relevant disclosure in the financial statements, and the opinion will be unmodified.

If the auditor concludes that the disclosures are inadequate, or if management have not made any disclosure at all and management refuse to remedy the situation, the opinion will be qualified or adverse.

In both cases a paragraph explaining the basis for the qualified or adverse opinion will be included before the opinion paragraph and the opinion paragraph will be qualified 'except for' or express an adverse opinion.

Use of the going concern assumption is inappropriate

Consider the following example:

An entity has borrowings of $10m which became immediately repayable in full on 31 March 2012. The entity is already in breach of its agreed overdraft and the bank has refused to renew the borrowings. The entity has also been unsuccessful in applying to other financial institutions for re-financing. It is highly unlikely that the entity will be successful in renewing or re-financing the $10m borrowings and, in such an event, the directors will have no alternative but to cease to trade. The bank have already indicated that they are shortly going to commence legal proceedings to force the company to cease trading and sell off its assets to generate funds to pay off some of the borrowings. In order to avoid the entity's credit rating suffering any further decline, the directors have refused to make disclosures in the financial statements and have prepared the financial statements for the year ended 31 March 2012 on the going concern basis.

In this example it is clear that the going concern basis is inappropriate in the entity's circumstances. The directors have no realistic alternative but to liquidate in order to raise funds to pay back the bank and the bank have already confirmed that they will commence legal proceedings to force the entity into selling off assets to raise finance to repay their borrowings.

If the directors do not make adequate disclosure of the material uncertainty, the auditor must express an adverse opinion. An adverse opinion states that the financial statements do not present fairly (or give a true and fair view). This opinion will be expressed regardless of whether or not the financial statements include disclosure of the inappropriateness of management's use of the going concern assumption.

Management unwilling to make or extend its assessment

There are situations that may arise when the auditor may request management to make an assessment, or extend their original assessment of going concern. If management refuse to make, or extend, an assessment of going concern the auditor will consider the implications for the report.

Conclusion

Going concern is an important syllabus area for Paper F8 and candidates attempting the exam must ensure they are familiar with the requirements of the syllabus. This article has covered management's responsibility, the auditor's responsibility, indicators that an entity may not be a going concern and the reporting aspects relating to going concern. Candidates need to be aware that the syllabus also requires them to:

- define and discuss the significance of the concept of going concern
- explain the importance of, and the need for, going concern reviews, and
- discuss the disclosure requirements in relation to going concern issues.

Candidates are therefore encouraged to practise as many exam standard questions as possible as the syllabus offers a variety of ways in which the concept of going concern can be examined.

Written by a member of the Paper F8 examining team

Reference
(1) ISA 570, paragraph 5

Questions

ISA 570 Going concern identifies events and conditions that may cast doubt about the going concern assumption.
Which of the following are identified by ISA 570 as financial factors?
(1) Loss of key customers
(2) Net liability position
(3) Substantial operating losses
(4) Shortages of key raw materials

A (1) and (2)
B (1) and (4)
C (2) and (3)
D (3) and (4)

Answer: C

In accordance with ISA 570 Going concern, (1) and (4) are operating factors, not financial factors.

Chapter 18 Subsequent events

Executive Summary

This article considers how subsequent events can affect an entity's financial statements, and discusses the auditing requirements AA candidates need to know.

Students of financial reporting and auditing papers will have to gain an understanding of how subsequent events (also known as 'events after the reporting period') affect the financial statements of an entity. This article will consider the financial reporting aspects concerning subsequent events using a case study type scenario, and will then discuss the auditing requirements that candidates of Paper F8, *Audit and Assurance* need to be aware of.

Financial reporting considerations

In almost all circumstances, financial statements will not be finalised until a period of time has elapsed between the year-end date and the date on which the financial statements are (expected to be) issued. Therefore, regard has to be given to events that occur between the reporting date and the date on which the financial statements are (expected to be) authorised for issue.

IAS 10, *Events After the Reporting Period* stipulates the accounting and disclosure requirements concerning transactions and events that occur between the reporting date and the (expected) date of approval of the financial statements. Among other things, IAS 10 determines when an event that occurs after the reporting date will result in the financial statements being adjusted, or where such events merely require disclosure within the financial statements. Such events are referred to in IAS 10 as 'adjusting' or 'non-adjusting' events.

Students who have studied Paper F3, *Financial Accounting* will have come across such terminology and it is imperative that they can differentiate between an *adjusting* and a *non-adjusting* event. IAS 10 prescribes the definitions of such events as follows:

Adjusting event
An event after the reporting period that provides further evidence of conditions that existed at the end of the reporting period, including an event that indicates that the going concern assumption in relation to the whole or part of the enterprise is not appropriate. *(1)*

Non-adjusting event
An event after the reporting period that is indicative of a condition that arose after the end of the reporting period. (1)

Example 1
You are the trainee accountant of Gabriella Enterprises Co and are preparing the financial statements for the year-ended 30 September 2010. The financial statements are expected to be approved in the Annual General Meeting, which is to be held on Monday 29 November 2010. Today's date is 22 November 2010. You have been made aware of the following matters:

1. On 14 October 2010, a material fraud was discovered by the bookkeeper. The payables ledger assistant had been diverting funds into a fictitious supplier bank account, set up by the employee, which had been occurring for the past six months. The employee was immediately dismissed, legal proceedings against the employee have been initiated and the employee's final wages have been withheld as part-reimbursement back to the company.
2. On 20 September 2010, a customer initiated legal proceedings against the company in relation to a breach of contract. On 29 September 2010, the company's legal advisers informed the directors that it was unlikely the company would be found liable; therefore no provision has been made in the financial statements, but disclosure as a contingent liability has been made. On 29 October 2010, the court found the company liable on a technicality and is now required to pay damages amounting to a material sum.
3. On 19 November 2010, a customer ceased trading due to financial difficulties owing $2,500. As the financial statements are needed for the board meeting on 22 November 2010, you have decided that because the amount is immaterial, no adjustment is required. The auditors have also confirmed that this amount is immaterial to the draft financial statements.

Required:
(a) For each of the three events above, you are required to discuss whether the financial statements require amendment.

Answer:
When presented with such scenarios, it is important to be alert to the timing of the events in relation to the reporting date and to consider whether the events existed at the year-end, or not. If the conditions *did* exist at the year-end, the event will become an *adjusting* event. If the event occurred after the year-end, it will become a *non-adjusting* event and may simply require disclosure within the financial statements.

1. Fraud
Clearly the fraud committed by the payables ledger clerk has been ongoing during, and beyond the financial year. Fraud, error and other irregularities that occur prior to the year-end date – but which are only discovered after the year-end – are adjusting items, and therefore the financial statements would require amendment to take account of the fraudulent activity up to the year-end.

2. Legal proceedings
At the year-end, the company had made disclosure of a contingent liability. However, subsequent to the year-end (29 October 2010), the court found the company liable for breach of contract. The legal proceedings were issued on 20 September 2010 (some 10 days before the year-end). This is, therefore, evidence of conditions that existed at the year-end. IAS 10 requires the result of a court case after the reporting date to be taken into consideration to determine whether a provision should be recognised in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* at the year-end. In this case, the financial statements will require adjusting because:

- the conditions existed at the year-end

- the recognition criteria for a provision in accordance with IAS 37 have been met.

3. Loss of customer
A customer ceasing to trade so soon after the reporting period indicates non-recoverability of a receivable at the reporting date and therefore represents an adjusting event under IAS 10, *Events After the Reporting Period*. Assets should not be carried in the statement of financial position at any more than their recoverable amount and, therefore, an allowance for receivables should be made.

Auditor's responsibilities

So far we have considered the financial reporting aspects relating to events after the reporting period. The second part of this article will now consider the auditor's responsibility in relation to ensuring all events occurring between the reporting date and the (expected) date of the auditor's report have been adequately taken into consideration, and sufficient appropriate audit evidence has been gathered to achieve the objective. It is important that where students have studied Paper F3, *Financial Accounting*, knowledge of accounting standards such as IAS 10 is not set aside or forgotten when it comes to papers such as Paper F8, *Audit and Assurance*. There is a very close relationship between accounting standards and auditing standards.

ISA 560, *Subsequent Events* outlines the auditor's responsibility in relation to subsequent events. For the purposes of ISA 560, subsequent events are those events that occur between the reporting date and the date of approval of the financial statements and the signing of the auditor's report.

The overall objective of ISA 560 is to ensure the auditor performs audit procedures that are designed to obtain sufficient appropriate audit evidence to give reasonable assurance that all events up to the (expected) date of the auditor's report have been identified, properly accounted for/r disclosed in the financial statements.

ISA 560 also covers events that are discovered by the auditor after the date of the auditor's report but before the financial statements are issued.

Audit procedures

In Example 1 above, we identified that fraud and the legal proceedings were *adjusting* events that gave rise to an adjustment within the financial statements as at 30 September 2010. We also identified that the loss of the customer was also an adjusting event, but as the value of the receivable was considered immaterial, no adjustment was made to the financial statements. Let us expand on the requirement in Example 1 as follows:

Required:
(b) Describe the audit procedures that should be performed to obtain sufficient appropriate evidence that the subsequent events have been appropriately treated in the financial statements.

Answer:
Candidates who are faced with scenarios such as those in Example 1 should think about the information needed that would prompt an accountant or finance director to go back to the year-end and retrospectively amend the financial statements. You could interpret the question as asking 'what information would I need in real-life to justify a provision or disclosure within the financial statements before making such provision or disclosure?' Where candidates have studied Paper F3 and have knowledge of IAS 10, thinking about the provisions contained in this IAS 10 will often lead you into thinking about the audit evidence you would need to satisfy yourself that the requirements in IAS 10 have been met, as well as offering ideas as to how you would go about obtaining this evidence for the audit file.

Fraud
Fraud risk factors are covered in ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*. The fact that fraud has occurred at Gabriella Enterprises Co will increase the risk of material misstatement due to fraud.

The audit procedures to be performed to ensure the fraud has been correctly accounted for in the financial statements may include:

- Recalculation of the amounts involved.
- Discussions with management as to how such a fraud occurred and why it took six months' to discover the fraud (controls should prevent, detect and correct material misstatements on a timely basis).
- Establishing how the bookkeeper discovered the fraud and what controls (if any) contain weaknesses to allow the employee to commit the fraud. Note that employee fraud usually involves the manipulation of controls, whereas management fraud often involves the overriding of controls.
- Performing substantive procedures on journal entries (particularly those close to, or at, the year-end).
- Confirming directly with suppliers the account activity for the period under audit.
- Reviewing the purchase invoices and being on alert for any 'doctored' or 'copy' invoices and making enquiries as to their authenticity.
- A review of human resources files for evidence of disciplinary proceedings taken against the employee. This will also confirm compliance with laws and regulations, particularly in relation to employment legislation and the withholding of monies.
- Testing of other controls to identify other weaknesses that may indicate employee or management fraud.

- Obtaining written representations from management concerning the fraud.
- Test checking after-date cash for evidence of reimbursements by the employee, such as the withheld wages/salaries by the entity.
- Discussions with the entity's legal advisers as to the possibility of reimbursement of the balance of the misappropriated funds.

Legal proceedings

- Obtaining a copy of the court order or other correspondence confirming the company has been found liable to pay compensation to its customer.
- Test checking after-date cash to confirm payment to the customer.
- Ensuring a provision has been recognised as opposed to disclosure as a contingent liability to meet the requirements in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.
- Ensuring the provision is reasonable in relation to the outcome of the court case.
- Obtaining written representation from management to confirm the treatment of the provision.

Loss of customer

- Discuss with management the reason for not adjusting the irrecoverable receivable.
- The auditors have already agreed this amount is immaterial to the financial statements, so this amount would be put on an 'audit error schedule'. Provided this amount remains immaterial at the completion stage, both individually and when aggregated with other misstatements, the auditor can still express an unmodified opinion.

Financial statements amended *after* the date of the auditor's report, but *before* the financial statements are issued.

Circumstances may arise when the auditor becomes aware of facts that may materially affect the financial statements and, in such situations, the auditor will consider whether the financial statements need amending. The auditor is required to discuss with management how they intend to deal with events that will require the financial statements to be amended after the auditors have signed their report, but before the financial statements are issued.

Where the financial statements are amended, the auditor is required to carry out necessary audit procedures in light of the circumstances giving rise to the amendment. The auditor will also be required to issue a new auditor's report on the amended financial statements and, therefore, must extend their subsequent events testing up to the (expected) date of the new auditor's report. The revised auditor's report must not be dated any earlier than the date of the amended financial statements. In situations where management refuses to make amendments to the financial statements, the auditor must take all steps required to avoid reliance by third parties on the auditor's report. The auditor should also consider the need to resign from the audit.

Conclusion

Subsequent events are a key examinable area in auditing papers and it is crucial that students have an understanding of the types of audit evidence that the auditor should obtain to confirm that the accounting and disclosure requirements (particularly in IAS 10) have been applied correctly within the financial statements.

Candidates who simply write 'obtain a management representation' cannot expect to pass a question on subsequent events because written representations, on their own, are not a substitute for alternative audit evidence. Where candidates have knowledge of IAS 10 through studying Paper F3, you should not be afraid to think about the accounting requirements in order to help you consider how you will obtain sufficient appropriate audit evidence to achieve the auditing objectives. However, sticking to the question requirement is vital. If you are asked about the types of procedure(s) you should perform in determining whether the accounting treatment has been correctly applied, this is exactly what you must do.

Candidates should take care not to digress into irrelevant areas by writing everything they know about IAS 10, and instead should just answer the question set by the examiner.

Written by a member of the F8 examining team

Reference

(1) IAS 10, *Events After the Reporting Date*, Paragraph 3.

Questions

As part of the review stage of an audit, the auditor will consider subsequent events.
Up to which date does the auditor have an active responsibility to perform procedures designed to identify subsequent events?

A The reporting date
B The date of the auditor's report
C The date of issue of the financial statements
D The date of approval of the financial statements

Answer: B

The auditor has an active responsibility to perform procedures designed to obtain sufficient appropriate evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified.

Chapter 19 The auditor's report

Executive Summary

The completion of an IAASB project in 2015 resulted in a set of new and revised standards on auditor reporting.

These standards are examinable from the September 2016 exam session, meaning that F8 (now AA) and P7 (now AAA) candidates will be expected to understand the requirements and responsibilities of the auditor as set out in the standards.

The International Auditing and Assurance Standards Board (IAASB) finalised its project on auditor reporting in 2015, which resulted in a set of new and revised standards on auditor reporting as well as revised versions of ISA, 570 *Going Concern* and a number of other International Standards on Auditing (ISAs).

Candidates attempting *Audit and Assurance* (AA) and *Advanced Audit and Assurance (AAA)* are required to have a sound understanding of these standards.

This article will focus primarily on: the requirements of ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*; how ISA 701 interacts with the other reporting standards (ISA 705 and 706); and the reporting requirements in ISA 570 (Revised), *Going Concern*.

Candidates often find auditor's reports a challenging part of the syllabus and in preparation for exams it is imperative that candidates can:

- describe the different elements of the auditor's report (particularly relevant for AA candidates)
- determine the most appropriate type of audit opinion in a given scenario, often through an explanation of why a certain opinion is appropriate which will test the application of the candidate's knowledge
- understand the issues that may arise during the course of an audit that could require an Emphasis of Matter or Other Matter paragraph to be included in the auditor's report, and
- identify Key Audit Matters (KAM) that are required to be disclosed in an auditor's report.

Candidates will not be expected to draft an auditor's report in either AA or AAA, but may be asked to present reasons for an unmodified or a modified opinion, or the inclusion of an Emphasis of Matter paragraph. Candidates attempting AA may be required to identify and describe the elements of the auditor's report and therefore candidates should ensure that they have a sound understanding of ISA 700, *Forming an Opinion and Reporting on Financial Statements*. AAA questions may require a candidate to determine whether a transaction, or a series of transactions and events or other issues arising during the audit, gives rise to a KAM and should also be prepared to critique the content of a KAM section of an auditor's report. AA candidates should be able to discuss what should be included in the KAM section to ensure the auditor's report is compliant with ISA 701.

Candidates may also be presented with extracts from an auditor's report and be asked to critically appraise the extracts, or challenge the proposed audit opinion. Candidates are therefore reminded to ensure they have a sound understanding of the relevant *Syllabus and Study Guide* and ensure the revision phase in the lead-up to the examination includes plenty of exam-standard question practise, particularly if this is an area of the syllabus which a candidate finds challenging.

Key Audit Matters (KAM)

In January 2015 the IAASB issued ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*. This standard is required to be applied to the audit of all listed entities. The objectives of ISA 701 are for the auditor to:

- determine those matters which are to be regarded as KAM; and
- communicate those matters in the auditor's report.

The term 'key audit matters' is defined in ISA 701 as:

'Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.' (1)

Determination of KAM

The definition in paragraph 8 of ISA 701 states that KAM are selected from matters which are communicated with those charged with governance. Matters which are discussed with those charged with governance are then evaluated by the auditor who then determines those matters which required significant auditor attention during the course of the audit. There are three matters which the ISA requires the auditor to take into account when making this determination:

1. Areas which were considered to be susceptible to higher risks of material misstatement or which were deemed to be 'significant risks' in accordance with ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.
2. Significant auditor judgments in relation to areas of the financial statements that involved significant management judgment. This might include accounting estimates which have been identified by the auditor as having a high degree of estimation uncertainty.
3. The effect on the audit of significant events or transactions that have taken place during the period.

The auditor must determine which matters are of most significance in the audit of the financial statements and these will be regarded as KAM.

Communicating KAM

Once the auditor has determined which matters will be included as KAM, the auditor must ensure that each matter is appropriately described in the auditor's report including a description of:

1. Why the matter was determined to be one of most significance and therefore a key audit matter, and
2. How the matter was addressed in the audit (which may include a description of the auditor's approach, a brief overview of procedures performed with an indication of their outcome and any other key observations in respect of the matter).

Reporting in line with ISA 570, *Going concern*

Exam questions might ask the candidate to recognise indicators that an entity may not be a going concern, or require candidates to arrive at an appropriate audit opinion depending on the circumstances presented in the scenario. It may be the case that candidates are presented with a situation where the auditor has concluded that there are material uncertainties relating to going concern and the directors have made appropriate disclosures in relation to going concern and candidates must understand the auditor reporting requirements in this respect.

The auditor's work in relation to going concern has been enhanced in ISA 570 (Revised), *Going Concern* and the ISA includes additional guidance relating to the appropriateness of disclosures when a material uncertainty exists.

Under ISA 570 (Revised), if the use of the going concern basis of accounting is appropriate but a material uncertainty exists and management have included adequate disclosures relating to the material uncertainties the auditor will continue to express an unmodified opinion, but the auditor must include a separate section under the heading 'Material Uncertainty Related to Going Concern' and:

- draw attention to the note in the financial statements that discloses the matters giving rise to the material uncertainty, and
- state that these events or conditions indicate that a material uncertainty exists which may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

The section headed 'Material Uncertainty Related to Going Concern' is included immediately after the Basis for Opinion paragraph but before the KAM section. It should be noted that where the uncertainty is not adequately disclosed in the financial statements the auditor would continue to modify the opinion in line with ISA 705, *Modifications to the Opinion in the Independent Auditor's Report.*

Over and above the reporting requirements under ISA 570, candidates need to understand how issues identified regarding going concern interact with the requirements of ISA 701. By their very nature, issues identified relating to going concern are likely to be considered a key audit matter and hence need to be communicated in the auditor's report. Where the auditor has identified conditions which cast doubt over going concern, but audit evidence confirms that no material uncertainty exists, this 'close call' can be disclosed in line with ISA

701. This is because while the auditor may conclude that no material uncertainty exists, they may determine that one, or more, matters relating to this conclusion are key audit matters. Examples include substantial operating losses, available borrowing facilities and possible debt refinancing, or non-compliance with loan agreements and related mitigating factors.

In summary if a confirmed material uncertainty exists it must be disclosed in accordance with ISA 570 and where there is a 'close call' over going concern which has been determined by the auditor to be a KAM it will be disclosed in line with ISA 701. This is illustrated in the following example:

Example – unmodified audit opinion but material uncertainty exists in relation to going concern and the disclosures are adequate

Report on the Audit of the Financial Statements (extract)

Opinion
In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as at 31 December 20X5, and its financial performance and its cash flows for the year then ended in accordance with IFRS® Standards.

Basis for opinion
We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in Farland, 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 opinion.

Material uncertainty related to going concern
We draw attention to Note 6 in the financial statements, which indicates that the Company incurred a net loss of $125,000 during the year ended 31 December 20X5 and, as of that date, the Company's current liabilities exceeded its total assets by $106,000. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Key audit matters
Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Material Uncertainty Related to Going Concern* section, we have determined the matters described below to be the key audit matters to be communicated in our report.

[Include a description of each key audit matter]

Application of ISA 701 when a Qualified or Adverse Opinion is issued

ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report* outlines the requirements when the auditor concludes that the audit opinion should be modified. ISA 705 (Revised) requires that the auditor includes a Basis for Qualified/Adverse Opinion section in the auditor's report. When the auditor expresses a qualified or adverse opinion, the requirement to communicate other KAM is still relevant and hence will still apply.

When the auditor issues an adverse opinion it means that the financial statements do not give a true and fair view (or present fairly) because the auditor has concluded that misstatements, individually and in aggregate, are both material and pervasive to the financial statements.

Depending on the significance of the matter(s) which has resulted in the auditor expressing an adverse audit opinion, the auditor might determine that no other matters are KAM. In this situation, the auditor will deal with the matter(s) in accordance with applicable ISAs and include a reference to the Basis for Qualified/Adverse Opinion or the Material Uncertainty Related to Going Concern section(s) in the KAM section of the report as illustrated below.

Example – Qualified 'except for' opinion issued but no key audit matters
The audit of Turquoise Industries Co has been completed and the auditor discovered a material amount of research expenditure which had been capitalised as an intangible asset in contravention of IAS 38® *Intangible Assets*. The finance director refused to derecognise the research expenditure as an intangible asset and include it in profit or loss and the auditor therefore issued a qualified 'except for' opinion on the basis of disagreement with the entity's accounting treatment for research expenditure.

The auditor has concluded that there are no KAM which require to be communicated in the audit report. The KAM section of the report will therefore be as follows:

Key audit matters
Except for the matter described in the Basis for Qualified Opinion section, we have determined that there are no key audit matters to communicate in our report.

When the auditor has expressed an adverse opinion on the financial statements and communicates KAM, it is important that the descriptions of such KAM do not imply that the financial statements as a whole are more credible in light of the adverse opinion.

Disclaimer of Opinion issued

A disclaimer of opinion is issued when the auditor is unable to form an opinion on the financial statements. ISA 705 states that when the auditor expresses a disclaimer of opinion then the auditor's report **should not** include a KAM section.

Emphasis of Matter and Other Matter paragraphs

Emphasis of Matter and Other Matter paragraphs are still retained in ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* and the concepts involved have not been overridden by the ISA 701 requirements. The IAASB have noted that in some cases, matters which the auditor considers to be KAM will relate to issues that are presented and/or disclosed in the financial statements. Therefore, communicating these as KAM under ISA 701 will serve as the most useful and meaningful mechanism for highlighting the importance of the matter.

Candidates should appreciate that when the auditor communicates matters as KAM, the intention is to provide additional information beyond that which would be included in an Emphasis of Matter paragraph. In recognition of this ISA 706 (Revised) states:

- The auditor is prohibited from using an Emphasis of Matter paragraph or an Other Matter paragraph when the matter has been determined to be a KAM. To that end, the IAASB has emphasised that the use of an Emphasis of Matter paragraph is not a substitute for a description of individual KAM.
- If a KAM is also determined to be fundamental to users' understanding, the auditor may present this issue more prominently in the KAM section. Alternatively, the auditor might also include additional information in the KAM description to indicate the importance of the matter.
- There may be a matter which is not determined to be a KAM, but which, in the auditor's judgement is fundamental to users' understanding and for which an Emphasis of Matter paragraph may be considered necessary.

Additional requirements for candidates attempting AAA

Candidates attempting AAA may be required to determine matters which should be treated as KAM and to discuss the content of the KAM section of the auditor's report. Typical examples of issues which could be regarded as KAM include:

Impairment testing on goodwill

IFRS® 3, *Business Combinations* requires goodwill to be tested for impairment at each reporting date and the annual impairment test may be regarded as a KAM where the carrying amount of goodwill is material. Impairment tests are inherently complex and judgmental and therefore management's assessment process may also be a KAM.

Effects of new IFRS standards

New accounting standards may be introduced by the International Accounting Standards Board (such as IFRS 15, *Revenue from Contracts with Customers)* that will involve a material change of accounting treatment. For example, IFRS 15 requires the application of a new framework in respect of revenue recognition, and hence the implementation of IFRS 15 may give rise to the new accounting requirements becoming a KAM as they will impact on the reporting entity's financial position and performance.

Valuation of financial instruments, and other assets and liabilities at fair value

Significant measurement uncertainties in some financial instruments (for example those for which quoted prices are not available) may give rise to the valuation of financial instruments becoming a KAM because such valuations would invariably rely on entity-developed models. This can also apply to other assets and liabilities, particularly those measured using fair value techniques which can be complex and subjective.

Please note that the examples above are included for illustrative purposes and do not form an exhaustive list of all issues that could be identified as KAM.

Conclusion

The auditor's report was significantly changed by the IAASB in response to the users of financial statements requesting a more informative auditor's report and for the report to include more relevant information for users. Candidates attempting AA will need to be able to identify and describe the basic elements contained in the auditor's report.

Candidates sitting either exam need to understand the requirements and responsibilities of the auditor as set out in the reporting standards, as well as be able to determine the form and content of an unmodified/modified auditor's report or where the use of an Emphasis of Matter or Other Matter paragraph would be appropriate.

In addition, AAA candidates may be required to identify matters relating to the financial statements which should be treated as a KAM and to critically assess the content of the KAM section of a proposed auditor's report.

Reference
(1) ISA 701 paragraph 8

Written by a member of the *Audit and Assurance* examining team