

F8 Acowtancy Course notes

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Syllabus A: AUDIT FRAMEWORK AND REGULATION

Syllabus A1: The concept of audit and other assurance engagements

Syllabus A1a) Identify and describe the objective and general principles of external audit engagements.

General Principles

The objective of an Audit

The Auditor must state an opinion as to whether the financial statements...

1. Give a true and fair view 2. The accounting records are accurate and complete 3. Are prepared in accordance with an applicable financial reporting framework in all material respects

General Principles for the auditor to follow

1. Compliance with applicable ethical principles (such as the ACCA's Rules of Professional Conduct) 2. Compliance with International Standards on Auditing 3. Keeping an attitude of professional scepticism when planning and performing the audit (i.e. don't accept on face value – get evidence)

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Syllabus A1b: Explain the nature and development of audit and other assurance engagements.

Development of audit and other assurance engagements

The accounting and auditing professions have been under the public spotlight, and as a result of certain events, many changes have occurred in relation to audit and assurance engagements.

ENRON Scandal

In 2000, Enron, a US energy company, deceived investors by fraudulently overstating profitability.

Its auditor, Arthur Andersen, was shown to have lacked objectivity in evaluating Enron's accounting methods.

Other companies that were also involved in corporate frauds included WorldCom, Parmalat, Cable & Wireless and Xerox.

The result of these frauds was a lack of confidence in the way companies were run and audited.

In the USA, this resulted in the Sarbanes-Oxley Act 2002.

Lehman Brothers Scandal

In September 2008 Lehman Brothers, a global financial services firm, filed for bankruptcy in the US triggering a severe world-wide financial crisis.

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Lehman lent money to people on low incomes or with poor credit histories.

Following the collapse of Lehman Brothers, other banks failed worldwide and many needed government support to continue.

In light of this global financial crisis, regulators have been considering the effectiveness of the audit and the auditor's role in helping to prevent corporate and financial institution collapses.

One important area being focused on is the importance of professional scepticism for audit quality.

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Syllabus A1c: Discuss the concepts of accountability, stewardship and agency.

Accountability, Stewardship and Agency

1. Accountability

Accountability means holding those in charge accountable for their actions.

In the context of a company, it means holding the directors who manage the company responsible for explaining their actions to the shareholders who own the company.

2. Stewardship

Stewardship is when a person is responsible for taking care of something on behalf of another.

This is known as a 'Fiduciary Relationship' and exists between directors and shareholders as directors are responsible for the management of the shareholders property.

3. Agency

Agency is where an agent acts on behalf of a principle to perform tasks for them.

In the context of a company, the directors are the agents of the shareholders (principles) who entrust them to manage the running of the business.

This separation of ownership and management is often referred to as the 'Agency Problem'.

Syllabus A1d: Define and provide the objectives of an assurance engagement.

Objectives of an Assurance Engagements To provide assurance from an independent source that the subject matter agrees with set criteria

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Syllabus A1e) Explain the five elements of an assurance engagement.

5 Elements of Assurance engagements

Every assurance project needs 3 users, some subject matter, judged against some criteria by gathering evidence, to then be reported on

5 Elements of Assurance engagements are:

1. 3 Parties - users (Public, Client, Auditor) 2. The Subject Matter 3. Criteria to judge reliability and accuracy (e.g. IFRS) 4. Sufficient Evidence to make an opinion 5. A written report

Every assurance project needs:

3 users The intended user - the person who wants the report The responsible party - the person who provides the subject matter The Practitioner - the person who reviews the subject matter and provides assurance

Subject matter The material provided by the responsible party, which needs assurance on

Criteria This is so the subject matter can be assessed

Evidence This is obtained by the practitioner so to give assurance

Report This is given to the intended user and the responsible party from the practitioner

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Types of assurance engagement

An assurance engagement is when a professional examines information for which another party is responsible for

Assurance engagements are:

- External Audits An Auditor states an opinion as to whether the financial statements Give a true and fair view.

An Auditor examining financial statements prepared by a board of directors to express an opinion as to whether they comply with accounting standards.

- Review engagements The auditor reviews the financial statements using less evidence than required by an audit

The report will be to the body that commissioned the review e.g. Bank, Directors.

Types of Review engagements:

- Risk assessment reports
- Review of internal controls
- System reliability reports
- Value for money reviews
- Social and environmental reports

Remember they're basically something that someone wants assurance over - so it might be you're buying something and you want assurance you're paying a fair price

We would call this a value for money review

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Assurance engagements will have:

- An engagement letter agreeing terms
- A decision on methods to gather and evaluate evidence to support a conclusion
- A type of report to be produced at the end of the engagement.

External Audit

It reports to shareholders that the financial statements provide a true and fair view.

There are two types:

- Statutory
- Non - Statutory

Statutory Audit

- This is when entities are required by law to have an audit
- All public and large companies are required to have one
- Other organisations such as Building Societies and certain charities must also

Non Statutory Audit

This is when there is no legal requirement. A small company for example may choose to be audited when not legally obliged.

Reasons to undertake a non-statutory audit will include:

- Providing assurance to the owners over financial results
- Making accounts more acceptable to Tax authorities
- Making a sale of the business easier
- Providing assurance to those financing the business e.g. Banks

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Syllabus A1g) Explain the level of assurance provided by an external audit and other review engagements and the concept of true and fair presentation.

Levels of Assurance

Reasonable Assurance is where there is sufficient evidence that the subject matter agrees to certain criteria.

True and Fair

As we know, auditors are required to express an opinion as to whether the financial statements give a 'true and fair' view.

The financial statements must reflect accurately the underlying accounting information, they must be clearly presented, free from material misstatement and provide an impartial unbiased report.

Levels of Assurance

Reasonable Assurance Engagement

To carry out a reasonable assurance engagement, the practitioner gathers sufficient evidence to conclude that the subject matter agrees in all material respects to the agreed criteria.

The assurance given is in the form of positive assurance. This means that in their opinion the subject has been prepared in accordance with the criteria required.

To carry out such an engagement the information must have been prepared by another party, be identifiable and in a form that enables the auditor to gather evidence to form the opinion.

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Reasonable assurance engagements provide a high level of assurance

An example of a reasonable assurance engagement is the external audit.

Think about how the external audit fulfils all the criteria of a reasonable assurance engagement as outlined above.

Limited Assurance Agreement

Only necessary to gather enough evidence to be satisfied that the subject matter is plausible in the circumstances.

In this case negative assurance is provided.

Negative assurance is satisfaction that there is nothing to suggest that the subject has not been prepared in line with the relevant criteria.

Limited assurance engagements provide a moderate level of assurance.

An example of a limited assurance engagement is a review engagement.

A review engagement is undertaken by an auditor using less evidence than required by an audit to review the financial statements.

The auditor will state their opinion in the form of negative assurance i.e. that they are not aware that anything is materially misstated.

This is not an audit. The report will not be to the shareholders but to the body that commissioned the review e.g. Bank, Directors.

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Remember!

An Audit Report gives Positive Assurance

A Review Engagement gives Negative Assurance

Never Absolute Assurance

Note that neither of the above are absolute assurance as the evidence is gathered on a test basis and there is judgement involved in the preparation of the information.

Absolute assurance will never be provided by an assurance engagement whether audit or review.

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Syllabus A2: External audits

Syllabus A2a: Describe the regulatory environment within which statutory audits take place.

Regulatory Environment for External Audits

What are the general regulations surrounding external Audits, udder features?

Provision of audit services is regulated by International Standards on Auditing (ISAs) as well as Codes of Ethics and Company Law.

IFAC The International Federation of Accountants (IFAC) serves to strengthen the accountancy profession worldwide, to serve the public interest and promote adherence to high quality standards.

IAASB The International Auditing and Assurance Standards Board (IAASB) is a subsidiary of IFAC and sets the International Standards on Auditing (ISAs) of which there are more than 30.

The IAASB also sets quality control principles for all assurance engagements as well as standards for other types of assurance engagements

ISAs These only apply to the audit of historical financial information

Since 2005 all audits carried out under the laws of EU member states have to be conducted under ISAs.

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Note:

- If, in exceptional cases, the auditor departs from an ISA to achieve the overall aim of the audit, then this departure must be justified.
- The entire text of an ISA is needed to understand and apply the basic principles and essential procedures.

Syllabus A2b: Discuss the reasons and mechanisms for the regulation of auditors

Mechanisms for Regulating Auditors

IFAC is basically just a group of accountancy bodies (including ACCA) - it has no legal standing

Therefore, countries need to have regulations in place for regulating auditors (and implementing audit standards)

National Regulatory bodies will enforce quality control of audit and inspect audit files.

Self-regulation by the audit profession

Normally an external auditor has to be a member of an appropriate 'regulatory body', such as the ACCA.

Ok so what do these bodies do?

- Offer professional qualifications
- Provide evidence of technical competence (unless you're one of those idiot f8 students :P)
- Make sure the competence is maintained
- Make sure only 'fit and proper' persons, who act with professional integrity can be an auditor
- Make sure their members use appropriate technical standards (for example, ISAs)
- Monitor compliance by its members with the rules of the regulatory body

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Regulation by government The alternative is regulation by government. The government may establish rules and procedures to do all the work the regulatory bodies do now

So which is best? Well, The US government has got involved over there They introduced the Sarbanes-Oxley Act of 2002.

Similarly Canada with a national inspections unit

And the EU commission recently stated... "Self-regulation is not sufficient to address the independence issue, both in terms of independence of statutory auditors from the audited entity, and in terms of independence of the supervisors of the auditors from the latter.

"The crisis has also shown that self-regulation is not adequate when looking towards the future."

Leaving the profession to investigate and regulate itself could be seen as a conflict of interest, but equally it could be seen as being the most practical solution as they understand the situation better

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Syllabus A2c: Explain the statutory regulations governing the appointment, rights, removal and resignation of auditors

Appointment of the Auditor

The auditor must be sufficiently safe in their appointment to maintain independence from management.

In order to be appointed as an auditor a person must be:

1. A member of a recognised Supervisory Body (RSB) such as ACCA.
2. Allowed by that body to act as an auditor Or
3. Be directly authorised by the state.

Audit work may be undertaken by:

- an accountancy practice,
- sole practitioners,
- members of a Limited Liability Partnership or
- directors of an audit company.

Anyone who can't be an auditor?

- The directors or secretary of the company
- Employees of the company
- Business partners or employees of the above

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And how are they appointed?

- The shareholders appoint the auditor.
- The appointment will be made at an AGM and run until the next AGM.
- If there is no AGM, the appointment will be automatic each year unless a shareholder objects.

What are the Auditors Responsibilities when becoming appointed?

- Obtain clearance from the client to write to existing auditor (if denied the appointment should be declined)
- Write to the existing auditor requesting any reasons why the appointment should not be made

And what rights does the auditor have when being appointed?

1. Unfettered access to company's books and records 2. All explanations and information to be provided 3. Notice of all general meetings 4. Right to be heard at all such meetings on matters of concern to the auditor

When isn't the auditor appointed by shareholders?

- *First Appointment*

This is made by directors as normally the company won't have had an AGM by then

- *Casual Vacancy*

Such as when the current auditor resigns

- *Normal re-appointment*

This is normally by shareholders at an AGM - but often it is simply automatic when no AGM is required by shareholders

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Syllabus A2c) Explain the statutory regulations governing the appointment, rights, removal and resignation of auditors

Auditor Removal

However, if doubts as to whether the auditor is able to carry out their duties exist, they can be removed.

So what are the ways an Auditor can be removed?

1. By majority at a general meeting (but a specified notice period must be given of the resolution to prevent it being 'sprung' on the meeting)
2. The auditor may resign (but must submit a statement outlining the circumstances of their resignation)

What do the Auditors have to do on Removal/Resignation

They have 3 responsibilities as follows:

1. Deposit statement of circumstances connected with removal/resignation at the company's registered office.
2. If there are no circumstances, a statement stating this.
3. Reply promptly to requests for clearance from new auditors.

And what rights do they have when resigning?

Just the 2 rights to remember here..

1. To request an extraordinary general meeting to explain the circumstances of the resignation
2. To require company to circulate notice of circumstances relating to resignation

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Syllabus A2d) Explain the regulations governing the rights and duties of auditors

Duties / Rights of the Auditor

Duties of The Auditor

These are to form an Opinion on:

- Do the financial statements provide a true and fair view?
- Are they prepared in accordance with applicable accounting standards?
- And to prepare and issue a report

*Note that it is the management of the company who has responsibility of preparing the financial statements.

The auditor does this by ensuring:

1. Proper accounting records are kept
2. The FS reflect the underlying accounting records.
3. If the auditor has not visited a branch, that branch has made proper returns.
4. All necessary information and explanations have been received.
5. Information issued with the financial statements is consistent with the financial statements.
6. If any information required by law is not in the financial statements, it is in the auditors' report.

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Rights of the external auditor

They have basically 5 rights - remember these for the exam my friend..

1. The right of access to all accounting books and records at all times.
2. The right to all information and explanations (from management) necessary for the proper conduct of the audit.
3. The right to receive notice of all meetings of the shareholders (such as the annual general meeting) and to attend those meetings.
4. The right to speak at shareholders' meetings on matters affecting the audit or the auditor.

This can be important when the auditors are in disagreement with the directors of the client entity and are unable to communicate with the shareholders effectively by any other method.

5. If the company uses written resolutions, the auditors should have a right to receive a copy of all such resolutions.

Syllabus A2e) Describe the limitations of external audits.

Limitations of external audits

Audits have many beneficial uses

Benefits of Statutory Audits

- Investors are more able to rely on the information provide
- Management can verify that their systems are sound.
- Management are less likely to commit fraud
- The business more able to raise finance
- The auditor will highlight any deficiencies in their letter to management.

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There are drawbacks too however..

Problems

- Many businesses with a recent clean audit report have subsequently gone out of business.
- Not all transactions are checked.
- The opinion is based on evidence, often provided by management.
- Many controls can be overridden by management

Where do we get the information from?

To understand a client (new or old)

- **Prior year audit file**

Identification of issues that arose in the prior year audit and how these were resolved.
Also whether any points brought forward were noted for consideration for this year's audit

- **Prior year financial statements**

Provides information in relation to the size of the entity as well as the key accounting policies and disclosure notes

- **Accounting systems notes**

Provides information on how each of the key accounting systems operates.

- **Discussions with management**

Provides information in relation to any important issues which have arisen or changes to the company during the year

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- **Current year budgets and management**

Provides relevant financial information for the year to date

- **Permanent audit file**

Provides information in relation to matters of continuing importance for the company and the audit team, such as statutory books information or important agreement

- **Client website**

Recent press releases from the company may provide background on changes to the business during the year as this could lead to additional audit risks

- **Prior year report to management**

Provides information on the internal control deficiencies noted in the prior year; if these have not been rectified by management then they could arise in the current year audit as well

- **Financial statements of competitors**

This will provide information about competitors, in relation to their financial results and their accounting policies

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Syllabus A2f) Explain the development and status of International Standards on Auditing (ISAs).

The development and status of ISAs

Setting the Standards

1. IAASB reviews auditing developments and takes suggestions from interested parties.
2. Project task force appointed to work on the detail.
3. Consultation by meeting or consultation paper.
4. Draft standard produced and commented on by interested parties for a period of 120 days (Exposure period).
5. Project task force considers comments and amendments made if appropriate.
6. If changes significant there may be another exposure period.
7. Standard finalised and approved by meeting of IAASB at which there must be a minimum of 12 members.

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Syllabus A2g) Explain the relationship between International Standards on Auditing and national standards.

The relationship between ISAa and national standards

ISAs V Local Legislation

- IFAC is not able to enforce its standards.
- It is up to individual countries to implement the standards if they deem it appropriate.
- National Regulatory bodies will be charged with enforcing implementation of auditing standards, enforce quality control of audit and inspect audit files.
- Countries may do this by allowing the accountancy profession to implement the above, or set up an independent authority to do it.
- Countries also have the choice to set their own standards of implement or modify ISAs' to suit their needs.

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Syllabus A3: Corporate Governance

Syllabus A3a) Discuss the objectives, relevance and importance of corporate governance.

Corporate Governance & Auditing

Corporate governance is the system by which companies are directed and controlled

It is concerned with matters such as directors responsibilities, the board of directors, the audit committee and relationship with external auditors.

It ensures that companies are run in the interests of their shareholders and the wider community

Poor Corporate Governance

Many corporate failures have been blamed on poor corporate governance such as WorldCom and Enron.

Poor controls allowed management to abuse their position either in the form of excessive executive pay or manipulation of results to the ultimate detriment of shareholders.

Who is Responsible?

The directors are responsible for implementing a sound system of governance.

Auditors will have an interest also because poor governance makes it more likely that material errors exist in the firms' financial statements.

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Responsibility of Auditors for reporting on Corporate Governance

A statement regarding corporate governance included in the Annual Report is reviewed by the auditor and any inconsistencies highlighted as below:

1. An error in the financial statements

The auditor will issue a qualified report if the directors refuse to amend the error

2. An error in the corporate governance statement

The auditor will add an emphasis of matter paragraph to their report

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Syllabus A3b) Discuss the provisions of international codes of corporate governance (such as OECD) that are most relevant to auditors.

International Codes of CG (OECD)

The Organisation for Economic Co-operation and Development issued principles of Corporate Governance in 1999

These principles are intended to ‘improve the legal, institutional and regulatory framework for corporate governance’

and....

‘to provide guidance and suggestions for stock exchanges, investors, corporations and other parties that have a role in the process of developing good corporate governance’

6 Principles relevant to the Auditor

1. There should be a clear basis for an effective corporate governance framework

This should ensure transparency and acceptance of responsibility of all parties involved.

2. Shareholders Rights should be upheld.

Management of the company should recognise that they are agents of the shareholders and act in their interests at all times.

3. Shareholders should be treated equitably

All shareholders whether institutional or minority should be treated in a fair and just manner.

4. Rights of Stakeholders should be recognised

Co-operation between the organisation and stakeholders should be encouraged.

5. Timely and accurate disclosures should be made.

All Material matters such as the financial situation, performance, ownership and governance of the company should be disclosed.

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6. Duties of the board

The strategic guidance of the company should be ensured by the corporate governance framework.

The board should effectively monitor management and be accountable to the company and shareholders.

Audit and OECD Principles

The OECD principles state that an annual audit should be carried out by an independent, competent, qualified auditor to provide assurance to the board and to shareholders.

The auditors are also under a duty of care to provide a competent service and are accountable to the shareholders.

The Board and the OECD Principles

- The board have responsibility under the principles to:
- Review and guide corporate strategy e.g. risk policy, business plans, capital investment, mergers and acquisitions and setting performance objectives.
- Evaluate and monitor the effectiveness of corporate governance policy
- **Appointment and monitoring of key executives**
- Align executive and board remuneration in the long term interests of the company
- Monitor and manage the 'agency problem'
- Taking responsibility for the accounting and financial reporting system ensuring an **appropriate system of control to manage risk is in place**
- Ensure appropriate disclosures and communication

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Syllabus A3c) Describe good corporate governance requirements relating to directors' responsibilities (e.g. for risk management and internal control) and the reporting responsibilities of auditors.

A3d) Evaluate corporate governance deficiencies and provide recommendations to allow compliance with international codes of corporate governance.

Good Corporate Governance

This is good corporate governance regarding directors responsibilities

Directors Responsibilities

The directors are responsible for implementing a sound system of governance.

(Auditors will have an interest in the standards of corporate governance at a firm because a poor system of governance will make it more likely that material errors exist in the firms' financial statements)

The Board

Good corporate governance here includes..

- Chairman and Chief Executive should be different people to prevent unfettered power
- Half of the board to be Non-Executive Directors (NEDs)
- There should be a rigorous and transparent nomination process.
- Directors should submit for re-election regularly

Communication with Shareholders

- Board is responsible for ensuring satisfactory dialogue with shareholders.
- The AGM should be used to encourage communication with investors

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Remuneration

Good corporate governance here includes..

1. Excessive remuneration should be avoided
2. Linked to the performance of the corporation.
3. The directors should not be responsible for setting their own pay.
4. There should be a transparent procedure for setting directors remuneration

Internal Controls

Good corporate governance here includes..

1. A sound system of internal controls should be maintained.
2. An audit committee should be established.
3. If no internal audit function, the need for one should be considered on an annual basis.

Auditors requirements

- Explain responsibility of directors for preparing financial statements.
- Review and report on system of internal control.
- Has an Audit Committee with at least 3 non-executive directors been set up?
- Are Audit Committee terms of reference set out in writing and described in report?
- Is there a whistle-blowing facility?
- Does Audit Committee review and monitor internal control system.
- Audit Committee responsible for appointment of external auditor.

Responsibility of Auditors for reporting on Corporate Governance

A statement regarding corporate governance must be included in the Annual Report

This statement is reviewed by the auditor and any inconsistencies with the information in the annual report highlighted.

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If the inconsistency highlights an error in the financial statements, the auditor will issue a qualified report if the directors refuse to amend the error.

If the error is in the corporate governance statement, the auditor will add an emphasis of matter paragraph to their report.

Sarbanes Oxley in the US requires auditors to state an opinion on the system of internal control and whether the company has complied with corporate governance requirements.

External Audit v Management Responsibilities

Management and the external auditors have different responsibilities when it comes to various aspects of the client business.

We will look at several aspects and draw the distinction between the responsibilities of management and the responsibilities of the external auditor.

Corporate Governance

Management Responsibilities

- To ensure that effective measures to ensure good corporate governance are in place

Auditor Responsibilities

- If under combined code, to report on any conflicts between reported corporate governance and the financial statements

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Financial Reporting

Management Responsibilities

- Prepare financial statements which provide a ‘true and fair’ view of the company’s results.
- Select and apply suitable accounting policies.
- Base judgements on prudent and responsible basis.
- Implement suitable internal controls.

Auditor Responsibilities

- Report an opinion as to whether the financial statements give a ‘true and fair’ view.
- Planning the work to be undertaken.
- Gathering sufficient audit evidence.
- Communicating with those charged with governance:

o ISA 260 Communication of audit matters with those charge with governance

places responsibilities on the external auditor.

o Communication takes the form of the letter of engagement and the management letter sent at the beginning and end of the audit respectively.

o Ongoing communication should be undertaken throughout the audit.

In order to avoid an ‘expectation gap’ the auditor should ensure that management are aware that the external auditor is not responsible for:

- The preparation of the financial statements
- Selection of accounting policies
- Implementing or ensuring good standards of corporate governance
- Systems and controls implementation

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Systems and Controls

Management Responsibilities

- Establishing suitable systems and controls to safeguard assets, produce accurate accounting information and prevent and detect fraud.

Auditor Responsibilities

- Assess risk of material misstatement due to poor systems and controls
- Document tests of controls undertaken
- Report weaknesses to those charged with governance

Fraud and Error

Management Responsibilities

Safeguards should be in place to avoid fraud and error through the systems and controls the company operates

Internal audit function will be responsible for monitoring and implementation of these

Auditor Responsibilities

If fraud or error leads to material misstatement, the auditor is responsible for detecting it.

If immaterial, these should be reported to those charged with governance, but there is no responsibility to detect them.

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The inherent limitations of audit mean that the auditor cannot guarantee that the financial statements are free from fraud and error.

The auditor must consider the risk of material misstatement due to fraud and error when planning and performing their audit.

If discovered, fraud should be reported to the audit committee (if one exists), or the highest level of management (if not involved in the fraud), or the shareholders if the fraud is by those in senior management.

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Syllabus A3e) Analyse the structure and roles of audit committees and discuss their benefits and limitations.

Audit Committees

Know the Structure, Role & Benefits / Drawbacks

Structure of the Committee

At least one member of the committee should have recent and relevant financial experience.

There should be at least 3 non executive directors. In the case of smaller companies, this may be 2.

Role of the committee

1. To improve the quality of financial reporting
2. To increase the confidence of the public in the financial statements.
3. Assist directors in meeting their responsibilities in respect of financial reporting.
4. Provide a channel to external auditors to report concerns or issues.
5. Review the company's system of internal controls.
6. Strengthen the position of internal audit by providing greater independence from management.
7. Appointment of external auditor.

Advantages of a committee

• Independent Reporting

Provides internal audit with an independent reporting mechanism. Without this management may be tempted to hide unfavourable reports.

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- **Frees up Executive time**

Leaves top executives free to manage by providing expertise on financial reporting

- **Corporate Governance monitored**

Ensures that corporate governance requirements are brought to attention of the board

- **Appropriate Internal Controls**

Should ensure that an appropriate system of internal control is maintained.

- **Better Communication**

Better communication between the directors, external audit and management is facilitated.

- **Strengthens external audit independence**

Strengthens independence of external audit as their appointment is now not made by the board.

Disadvantages of Committee

1. Executive directors may perceive it as a threat to their authority.
2. Finding non executive directors with appropriate expertise may be difficult.
3. Additional costs will be involved.
4. Too much detail may be thrust upon non executive directors.

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Communication with the audit committee

Why does the external auditor speak first to the Audit Committee?

1. To ensure independence between the board and the audit firm.

The audit committee consists of independent NEDs, who can therefore take an objective view of the audit report.

2. The audit committee has more time to review the audit report and other communications (e.g. management letters) than the board.

The auditor should therefore benefit from their reports being reviewed carefully

3. The audit committee can ensure that any recommendations from the auditor are implemented.

The NEDs can pressurise the board to taking action on auditor recommendations

4. The audit committee also has more time to review the effectiveness and efficiency of the work of the external auditor than the board.

The committee can therefore make recommendations on the re-appointment of the auditor, or recommend a different firm if this is appropriate

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Syllabus A3f) Explain the importance of internal control and risk management.

Internal Controls & Risk Management

Internal controls cannot eliminate risk, but they can minimise it.

Internal controls help:

1. Safeguard the assets of the company
2. Prevent and detect fraud
3. Safeguard the investment of the shareholders

They are designed to minimise the risk of fraud and error

and will include such procedures as:

- Carrying out regular reconciliations on key ledgers
- Keeping assets under lock and key
- Passwords and computer system security

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Responsibilities for systems and controls

It is the responsibility of executive management to put in place a suitable system of internal controls to manage the risks of the company

In the UK, internal controls are divided into three categories for the purpose of corporate governance:

1. Financial controls
2. Compliance controls
3. Operational controls

Financial controls

- These safeguard the company assets
- Ensure adequate accounting records are kept
- Include the preparation of Financial Statements

Management must design and implement internal controls,

The company's governors (directors) must satisfy themselves that the IC system is adequate and works properly

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Syllabus A3g) Discuss the need for auditors to communicate with those charged with governance.

The need for auditors to communicate with TCWG

Those charged with governance are basically those responsible for running the company - those responsible for good corporate governance too therefore

Why communicate with TCWG?

1. Help build a working relationship between each other
2. Help the Auditor get information about specific transactions etc
3. Help TCWG oversee the FR process, which is their responsibility

Objectives of the Auditor

1. To communicate clearly with TCWG the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
2. To obtain from TCWG information relevant to the audit;
3. To provide TCWG with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process
4. To promote effective two-way communication between the auditor and those charged with governance.

Communication with Shareholders

- Board is responsible for ensuring satisfactory dialogue with shareholders
- The AGM should be used to encourage communication with investors

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Auditors Reporting Responsibilities

- Review and report on system of internal control.
- Report on whether Audit Committee review and monitor internal control system

The external auditor is also required by ISA 260 Communication of audit matters to those charged with governance to provide management periodically with observations arising from the audit that are significant and relevant to management's responsibility to oversee the financial reporting process.

These observations might include:

- Weaknesses in internal control
- Inappropriate accounting policies

Communication takes the form of the letter of engagement and the management letter sent at the beginning and end of the audit respectively.

Ongoing communication should be undertaken throughout the audit.

Those charged with governance are responsible for overseeing:

1. The strategic direction of the entity
 2. Obligations related to the accountability of the entity
 3. Good corporate governance
 4. Risk assessment
- the establishment and monitoring of internal controls
 - compliance with applicable law and regulations
 - implementation of controls to prevent and detect fraud and errors

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What should be communicated?

1. Auditor's responsibility for providing the opinion etc
2. Auditors plan & approach
3. Key risks identified at planning
4. Any significant difficulties or matters arising during the audit
5. Any significant adjustments
6. Any written representations needed
7. Any suspected frauds
8. Any modification to the opinion
9. Compliance with ethical standards

Expectations Gap

In order to avoid an 'expectation gap' the auditor should ensure that management are aware that the external auditor is not responsible for:

1. The preparation of the financial statements
2. Selection of accounting policies
3. Implementing or ensuring good standards of corporate governance
4. Systems and controls implementation

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Syllabus A4: Professional ethics and ACCA's Code of Ethics and Conduct

Syllabus A4a) Define and apply the fundamental principles of professional ethics of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

Fundamental Principles

Professional ethics could be examined as part of any question on the F8 exam. It is very important that you know this section well.

The ACCA sets out a code of ethics for members and disciplinary action is taken against those who fail to uphold them.

The 5 Fundamental principles and what they mean:

Integrity

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

Objectivity

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

Professional Competence & Due Care

Members have a continuing duty to maintain professional knowledge and skill at a level

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required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques.

Members should act diligently and in accordance with applicable technical and professional standards when providing professional services.

Confidentiality

Members should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper or specific authority or unless there is a legal or professional **right or duty to disclose.**

Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of members or third parties.

Professional behaviour

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

In the exam question you may have to apply these to a case study - groovy baby..

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Syllabus A4b) Define and apply the conceptual framework, including the threats to the fundamental principles of self-interest, self-review, advocacy, familiarity, and intimidation.

Conceptual framework

Accounting standards need to be built on a reliable set of concepts

It's an attempt to define the nature and purpose of accounting

It's a coherent and consistent foundation that will underpin the development of accounting standards

It's a statement of generally accepted accounting principles (GAAP) for evaluating existing practices and developing new ones

It's a theoretical basis for determining how transactions should be measured (historical value or current value) and reported

It's a basis for economic decision making

In summary it's...

- a framework for setting accounting standards
- a basis for resolving accounting disputes
- fundamental principles which then do not have to be repeated in accounting standards

Who else is the framework useful to?

- Auditors
- Users of accounts
- Anyone interested in how IFRS's are formulated

The Framework is NOT an accounting standard, and if there's a conflict between the two then the IFRS wins

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Syllabus A4b) Define and apply the conceptual framework, including the threats to the fundamental principles of self-interest, self-review, advocacy, familiarity, and intimidation.

Threats

An auditor must be independent and be seen to be independent

Five potential threats are identified in the ACCA's code of ethics. Safeguards are suggested in order to counter each of the threats.

The specific threats outlined are Self Interest, Self Review, Advocacy, Familiarity and Intimidation.

Categories of Threat

1. Self-interest

Here the auditor may have a financial (or other) interest in a matter.

Therefore the auditor may not act with objectivity and independence.

Examples outlined in the code, along with the safeguards to prevent them are as follows:

Dependence on Client

If a client makes up too high a percentage of an auditors income, they may be afraid of losing the income.

Safeguard – If a Listed company makes up more than 10% of a firms income, they should not audit that client. (15% for non listed companies)

Lowballing

Lowballing is setting a very low fee either to attract new clients or ensure further work.

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Safeguard – Auditors should not set fees in this way, the fee must be based on a pre- determined level of work required. Loans, Guarantees and overdue fees

If an auditor fears he may not get such items paid back his objectivity may be threatened. In this case significant overdue fees constitute a loan.

Safeguard – Do not offer loans, guarantees or allow fees to go unpaid for a significant time.

Hospitality and Benefits

Any such items given to the auditor by a client could be seen to be a bribe.

Safeguard – Do not accept.

Contingent Fees

Where auditors fees are contingent on another event happening.

Safeguard – Fees are not to be determined in this way.

Financial or Business interest

Where a close family member or personal friend is in a senior position within the client firm, or the auditor seeks employment with the client.

Safeguard – Avoid such situations i.e. do not take on the audit.

Financial interest such as shares etc.

If an auditor owns shares in a business they may be tempted to avoid revealing information which will have an effect on the value of their investment.

Safeguard – An assurance firm, any partner in the firm or an immediate family member of these may not have a direct or indirect interest in the client. Any member of the team who has such an interest must dispose of it or be removed from the team.

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2. Self-review

Here the auditor reviews a judgement she has taken herself.

Or an audit firm prepared the financial statements and then acted as auditor.

If an auditor provides other services to a client such as Tax advice, then the auditor will be reviewing their own work during the course of the audit.

This is a threat to objectivity and independence.

Accounting Services

If an auditor prepares the accounts it is 100% sure that they will be reviewing their own work. They may be tempted to hide errors to save face.

Safeguard - Auditor must not undertake accounting services for a client if they are a LISTED company. No management decisions should be made in other companies and a different team should provide each service.

IT

If the auditor advises on or installs accounting software for a client this will have to be reviewed during the audit.

Safeguard - If the IT system is important to a significant part of the accounting system, the auditor should not design, provide or implement it.

Valuation Services

A valuation made by the auditor could have a material effect on the financial statements.

Safeguard – If valuation requires a degree of judgement and have a material effect on the financial statements, then the auditor should not undertake to provide it.

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Tax Services

As mentioned above, the tax work carried out will be reviewed during the course of the audit and may encourage the auditor to hide mistakes.

Safeguard – If likely to have a material effect on the financial statements, should not be taken on

Corporate Financial Services

This could be construed as making management decisions.

Safeguard – As long as not making decisions it is acceptable to assist client in raising finance or developing corporate strategies.

Internal Audit Services

External audit may use the work of internal audit as evidence of some of their conclusions.

Safeguard – If significant reliance is to be placed on the work of Internal Audit, this should not be undertaken.

Former Employee of Client joining Audit Firm

If this occurs there is a chance the person could be auditing work or systems they were previously responsible for.

Safeguard – The employee cannot be involved in the audit until two years have elapsed.

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3. Advocacy

Here the auditor is expected to defend or justify the position of the client, and act as an 'advocate'.

This is a threat to objectivity and independence.

Legal Services

If an auditor provides legal services, they may be perceived to take the same view as the client and therefore lose independence.

Safeguard – No legal services to be offered to client or defence in dispute material to the financial statements.

Corporate Financial Services

May be seen to be less than independent if advising on such matters

Safeguard – Don't negotiate on clients behalf with the bank or advise on debt restructuring.

4. Intimidation

Here the auditor can't act independently as she is scared due to intimidatory threats such as the threat to take away the work unless they do as the client wishes.

i.e. that the auditor feels unable to give an independent opinion for fear of losing the client or upsetting someone.

5. Familiarity

Here the auditor and client have a too close relationship, for example due to a long association over many years in carrying out the annual audit.

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Participation in Client Affairs

The auditor may be too familiar with the client and be unwilling to upset them.

Safeguard – Auditor cannot be a director, employee or business partner of client. Cannot be part of team if have been one of these in the last 2 years.

Family/Personal Relationship

An auditor may be unwilling to criticise or upset a family member if they work for the client.

Safeguard – No member of the audit team may have a family member or close personal relation in the client firm.

Audit Partners joining client

If a partner joins the client firm this may affect the judgement of the auditors involved.

Safeguard – All links to audit firm severed. Removed from audit team as soon as appointment made. If made director or key management and has worked for auditor in previous two years the audit firm must resign. (Can be reappointed after 2 yr period is up).

Acting as Auditor for prolonged period

If a partner has acted as auditor for a client for too long a period, they may become complacent or over familiar with them.

Safeguard - If client is listed company engagement partners should act for maximum of 5 yrs with 5 yr break in between rotations.

A Key audit partner must have a break of 2 yrs after a period of 7 yrs and senior staff on listed audits should also not act for more than 7 yrs.

For non-listed clients it is advised that partners act for no longer than 10 years

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Consider the following:

- Could the value affect objectivity?
- Was the hospitality when the auditors should have been working?
- Were remaining members of the team properly supervised?
- Ensure the member checked with more senior people in the firm to check if it was allowed - otherwise it is a disciplinary offence also.

• Actual and threatened litigation

If actual litigation then resign from the engagement.

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Syllabus A4c) Discuss the safeguards to offset the threats to the fundamental principles.

Safeguards

Safeguarding independence is the responsibility of the audit firm & the profession

Audit Firm Level

A culture of independence should be created, this means a rotation of the engagement partner and senior staff.

In addition, an audit firm should have the following procedures in place:

- **Training**

To an appropriate level for the role

- **Quality control procedures**

This ensures that independence is considered in all work performed by the audit firm.

- **Consultation**

So issues can be discussed internally and procedures are laid out to facilitate this

- **Ethical Codes**

of conduct

- **Internal Controls**

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The Profession

The profession should take disciplinary action as appropriate.

The profession regularly suggest new practices and procedures designed to improve auditor independence.

So things that the profession do to help safeguard against ethical threats are:

1. Regular rotation of auditors made compulsory
2. Using audit committees
3. ACCA Exams and CPD :)
4. Corporate Governance and of course auditing standards

The Individual

An individual auditor can limit ethical threats by..

Complying with CPD regulations - and staying up to date

Keeping in contact with fellow professionals

To informally discuss issues and problems

Independent Mentor used to discuss individual threats

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Syllabus A4d) Describe the auditor's responsibility with regard to auditor independence, conflicts of interest and confidentiality.

Independence & Confidentiality

Dealing with Threats

The way in which an audit firm should deal with potential threats to independence is to have in place procedures to:

1. Identify any potential threats
2. Evaluate what level of risk they pose
3. Check that necessary safeguards are in place
4. Correct any problems if necessary

The audit firm should have a checklist to ensure that they meet with the standards required on Independence.

The checklist will be completed when a new client is taken on, as well as at the planning stage of each audit, at completion and when any other services are provided to the client.

Confidentiality

Information should only be disclosed by auditors:

- If the client has given their consent
- Under a legal obligation e.g. money laundering, terrorism, drug trafficking

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- If required by regulatory body e.g. FSA
- Under a court order
- If in the public interest e.g. environmental pollution
- If one of these categories is not applicable, then the auditor is under no obligation to disclose information and in fact may be in breach of the ACCA code of conduct for doing so.

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Syllabus A5: IA and governance, and the differences between external and internal audit

Syllabus A5a) Discuss the factors to be taken into account when assessing the need for internal audit.

Is there a need for Internal audit?

Internal Audit is a department within the company which oversees internal control systems and ensures that procedures are in place to ensure good corporate governance.

Internal Audit provides assurance to the board by:

- Reporting on and monitoring the effectiveness of internal controls.
- Assisting with implementation of required accounting standards.
- Ensuring that laid down procedures are being followed.
- Liaising with external auditor to reduce time and expense of external audit.
- Ensures compliance with OECD Principles.

The Internal Audit department does this by undertaking assignments and reporting their findings to the Audit Committee (or Board if no Audit Committee).

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Systems need to be assessed regularly to ensure they are working effectively

This is where Internal Audit is useful

However...

It is not necessary in all situations e.g. Small, owner managed businesses

The need therefore depends on

1. Scale, diversity and complexity of the business
2. Number of Employees
3. Desire for risk control

If one is deemed necessary, but doesn't currently exist, then the audit committee should make a recommendation to the board

The reason for the absence of an internal audit function should also be explained in the annual report

Reasons to have an IA department

• **Value for money (VFM) audits**

Internal audit may be able to offer VFM services or review potential upgrades systems

• **Accounting system**

While not complex, accounting systems must provide accurate information. Internal audit can audit these systems in detail ensuring that fee calculations, for example, are correct.

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- **Computer systems**

Maintenance of computer systems is critical

Internal audit could review the effectiveness of backup and disaster recovery arrangements

- **Internal control systems**

Internal audit could check whether basic control systems are needed, recommending implementation of controls where appropriate

- **Effect on audit fee**

Provision of internal audit may decrease the audit fee where external auditors can place reliance on the work of internal audit.

This is unlikely to happen during the first year of internal audit due to lack of experience.

- **Corporate governance**

Internal audit could still recommend policies for good corporate governance

- **Compliance with regulations**

An internal audit department could help ensure compliance with regulations

- **Assistance to financial accountant**

Internal audit could therefore provide assistance in compliance with financial reporting standards, etc as well as recommending control systems

Against establishing of internal audit department

1. No statutory requirement

- As there is no statutory requirement, the directors may see internal audit as a waste of time and money and therefore not consider establishing the department

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2. Accounting systems

- Many accounting systems are not necessarily complex so the directors may not see the need for another department to review their operations, check integrity, etc.

3. Family business

- There is therefore not the need to provide assurance to other shareholders on the effectiveness of controls, accuracy of financial accounting systems, etc.

4. Potential cost

- There would be a cost of establishing and maintaining the internal audit department

5. Review threat

- Some directors may feel challenged by an internal audit department reviewing their work (especially the financial accountant).

They are likely therefore not to want to establish an internal audit department.

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Syllabus A5b) Discuss the elements of best practice in the structure and operations of internal audit with reference to appropriate international codes of corporate governance.

Best practice for Internal Audit

Internal Audit is a department within the company which oversees internal control systems and ensures that procedures are in place to ensure good corporate governance

What does the Internal Audit department do?

Internal Audit provides assurance to the board by:

1. Reporting on and monitoring the effectiveness of internal controls.
2. Assisting with implementation of required accounting standards.
3. Ensuring that laid down procedures are being followed.
4. Liaising with external auditor to reduce time and expense of external audit.
5. Ensures compliance with OECD Principles.

Who does it report to?

Internal Audit reports their findings to the Audit Committee (or Board if no Audit Committee).

Is it Independent?

- The Internal Audit function will need to be professionally competent, sufficiently resourced and well organised in order to carry out its' function effectively.
- One of the key concepts surrounding internal audit is the independence of internal audit from management.

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- Although the internal audit department is paid for and part of the company, care must be taken to keep it objective and independent.

How is the Independence maintained?

Ways to keep internal audit independent are to:

Have them report to an independent committee i.e. the Audit Committee.

Ensure that the internal audit function is well regarded by other departments.

Have a 'whistle blowing' function for internal audit to report serious misconduct when found.

Remember that there is no legal requirement for an internal audit function and therefore the scope of the internal audit function will be set by the company

A question regarding Internal Audit on the exam may well focus on the independence of internal audit, so remember:

- Internal Audit should report to the Audit Committee.
- Scope of Internal Audit work should be determined by Audit Committee or chief internal auditor.
- Controls should be established to avoid self review by internal auditors.
- Staff should be rotated into different areas of work.
- The head of internal audit should be sufficiently experienced and professionally qualified.

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Syllabus A5c) Compare and contrast the role of external and internal audit.

Internal v External Audit

Let's look at the difference in roles between internal and external audit

Objective & Planning

- **Internal Audit**

Dictated by management - planning follows this

However, good corporate governance would allow IA a degree of independence over objectives

- **External Audit**

Ensure accounts free from material misstatement and prepared in line with reporting framework.

Planned in accordance with ISAs

Work planned by themselves

Evidence

- **Internal Audit**

The amount / type gathered would depend upon the objective set

Eg It may just be a check that assets exist, with no concern over their value

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- **External Audit**

Governed by IAS 330 - gather evidence to address misstatement risk

The risk would have been analysed during planning and in the light of subsequent evidence

Reporting

- **Internal Audit**

Determined by the nature of the assignment

- **External Audit**

Determined by statute & ISAs 700/5/6

Communicate to stakeholders

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Syllabus A6: The scope of the internal audit function, outsourcing and internal audit

Syllabus A6a) Discuss the scope of internal audit and the limitations of the internal audit function.

Scope and limitations of Internal Audit

The scope is to give assurances on...

Items such as

1. Effectiveness of systems
2. Effectiveness of Internal Controls
3. Whether manuals are followed
4. Whether internally produced info is reliable
5. Compliance with OECD

Oooh nice... What about limitations though?

• Reporting System

Reporting to the Finance Director - who is responsible for some of the info being reported on!

Action

Report to Audit Committee instead

• Scope of Work

Could be decided by executive directors and thus influenced away from their particular areas (the cheeky monkeys)

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Action

Scope decided by chief internal auditor or audit committee

- **Audit Work**

Auditing their own work (Self review threat)

Action

Chief internal auditor doesn't establish any controls herself
(see how modern metrosexual I am... ;)

- **Lengths of Service**

Too long in IA and there may well be a familiarity threat

Action

Rotation of work into different areas

So being an IA is basically just a crazy, roller-coaster of a life..

- **Appointment of Chief Internal Auditor**

Don't let the CEO do it....!

Action

Appointed by the whole of the board or Audit committee

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Syllabus A6b) Explain outsourcing and the associated advantages and disadvantages of outsourcing the internal audit function.

Outsourcing

The use of external suppliers for finished products & services

Outsourcing

is when an external specialist organisation (also known as a service organisation) is used to carry out functions which would normally be performed within the entity.

Service organisations usually operate in one of two ways:

1. The service organisation fully maintains the outsourced function (keeps accounting records and internal records)
2. The service organisation executes transactions only at the request of the entity, or acts as a custodian of assets.

Here the reporting entity will maintain internal records relating to the outsourced function.

The current economic environment presents an excellent opportunity to further utilise outsourcing as a way to reduce their manufacturing and design costs, there are challenges and difficulties that come with this kind of change.

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Outsourcing internal audit

A firm may decide to outsource its internal audit function as this may seem like better value for money

Advantages of Outsourcing

1. The provider will have specialist staff.
2. Cost of employing and training full time staff is avoided.
3. Outsourcing provides an immediate internal audit department.
4. The time scale is flexible with the contract lasting just for the appropriate time.
5. Independence may be improved.
6. Audit methodology and technologies will be up to date.

Disadvantages

- If Internal and External audit are provided by the same firm (prohibited under ethics rules in UK) then there may be a conflict of interest.
- Independence may not be ensured by outsourcing due to threat of management not renewing the contract.
- The cost of outsourcing may be so high as to encourage the firm not to have an internal audit function at all.
- Lack of understanding of firms culture, objectives and attitudes.
- The standard of service provided cannot be controlled.
- Blurring of the distinction between internal and external audit function.

Minimising/Managing risks of Outsourcing

1. Setting and reviewing performance measures
2. Quality reviews and working paper reviews
3. Clear agreement on scope, responsibilities and reporting procedures
4. Ensure external audit and internal audit are two separate functions.

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Syllabus A6c) Discuss the nature and purpose of internal audit assignments including value for money, IT, financial, regulatory compliance, fraud investigations and customer experience.

Value for Money

Value for money can be broken down into 3 sectors:

As follows

1. Economy

Are goals achieved at a minimum cost (still paying attention to quality)?

2. Efficiency

Are resources being used to maximise output?

3. Effectiveness

Are objectives being achieved?

These three areas can be thought of as Input – Process – Output.

Inputs – Economy As cheap as possible given quality

Process – Efficiency Perform the process as efficiently as possible

Outputs – Effectiveness These match objectives set

Problems with Value for Money

- It may be difficult to measure outputs and efficiency. For example, how do we measure the output of a fire service?

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- It may be difficult to define the objectives particularly of a Not for Profit organisations with many different factors influencing policy.
- Economy and efficiency may work against quality which will be required to ensure effectiveness.
- Cost control may be over emphasised.

Best value assignments

Local authorities are required by government to implement the '4 C' principles:

These are the principles..

1. Challenge

Why and how is a service provided?

2. Compare

Assess performance against other providers

3. Consult

Talk to users for feedback

4. Compete

Provide efficient, effective services through fair competition

Internal auditors within an organisation implementing best value will play an integral role in ensuring its' effective implementation.

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IT & Financial assignments

Information Technology

The internal audit function of an organisation may well have an IT specialist in the team.

The main function of internal audit in the area of IT will be to assess the controls in place.

Other functions will be to ensure that the systems in place represent value for money and also to ensure effective controls over the awarding of IT contracts.

Financial Assignments

The role of IA here is to make sure the information required for management and external accounts are reliable and produced timely.

Financial internal audit work echoes the work of the external auditor. Checks will be made of record keeping and implementation of financial procedures

The main concentration will be on preventing fraud and error.

It can also look to design controls which help identify inflation, interest rate and currency risks

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Operational assignments

This looks at..Are business operations being undertaken efficiently and effectively?

An assignment based on operations should identify the possible risks involved in that operation, the procedures in place to mitigate the risks and whether those procedures are being followed.

An Operation which may be examined is:

Procurement

Are the systems in place for control of purchasing operating effectively?

1. Identify key risks
2. What procedures are in place to reduce risk?
3. Are they being followed?
4. Are they effective?
5. Conclude and recommend

Marketing

Is the company getting value for money from its advertising?

What were the objectives of various campaigns? – Were these achieved?

Any evidence of fraudulent use of funds?

Entertainment expenses reasonable?

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Treasury

Treasury is the management of the funds of the business.

This is a high risk area and there should be extensive controls in place to ensure risk is mitigated.

Internal audit should ensure procedures in place to manage exposure to foreign currency risk, interest rate fluctuations and inflation are all working correctly.

Human Resources

It is important that controls over human resources are strong.

The company will have policies in place and it is the responsibility of internal audit to ensure that these policies are adhered to by managers.

Syllabus A6e) Describe the format and content of audit review reports and make appropriate recommendations to management and those charged with governance

Internal Audit Reports

The report should be to the person who commissioned the assignment

Usually this will be the Audit Committee or head of internal audit.

The Report should...

- Be set out clearly and concisely
- Recommendations and findings easy to pick out

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- Be fair & consistent

Internal Audit should discuss with management as they conduct their assignment any issues that arise and not just include unexpected findings in the report.

Formal Internal Report Structure

1. Cover

The cover will set out the subject, who the report is to, the date and any rating/evaluation required

2. Executive Summary

This section summarises the report to get across the essence of the findings

3. Key findings and recommendations

This section gives an overview of the main problems discovered, any breached in procedures and any ineffective procedures

4. Detailed findings and agreed action

How are the problems to be resolved? Sets out timing, actions and responsibilities for corrective action.

5. Assessment grading or ratings

Internal audit may undertake a ratings system for grading those systems under review.

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Syllabus B: PLANNING AND RISK ASSESSMENT

Syllabus B1: Obtaining and accepting audit engagements

Syllabus B1a) Discuss the requirements of professional ethics and ISAs in relation to the acceptance / continuance of audit engagements

Professional ethics and the new audit engagements

Auditors may advertise their services.

However, adverts should not bring the ACCA into disrepute, discredit the services of others, be misleading, or fall short of regulatory or legislative requirements.

An auditor is required under ISA 315 to gain an understanding of their client.

Auditors should screen clients to ensure they are not high risk.

Questions to ask will be:

1) Is the client involved in any fraudulent/illegal activities?

What is the nature of the industry in which they are involved – is it depressed?

Has the client had a history of changing auditor regularly or had qualified audit reports in the past?

Do client directors understand their role and are they able to carry it out?

2) Are management trustworthy?

The risk to the auditor is ‘reputation risk’ i.e. that they will be associated with a poorly regarded client.

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Syllabus B1b) Explain the preconditions for an audit

Preconditions for an audit

Auditors should only accept a new audit engagement when it has been confirmed that the preconditions for an audit are present..

- **Is the FR framework acceptable?**

Consider the entity & the purpose of the FS

Perhaps, also, laws say which FR framework should be used

- **Do Management accept their responsibilities?**

For preparing FS

For internal controls

For giving the auditor all relevant information they request

If the preconditions for an audit are not present..

The auditor shall not accept the proposed audit engagement

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Syllabus B1c) Explain the process by which an auditor obtains an audit engagement

Accepting a new engagement

Auditors should screen clients to ensure they are not high risk

The risk to the auditor is 'reputation risk' i.e. that they will be associated with a poorly regarded client.

An auditor is required under ISA 315 to gain an understanding of their client.

Questions to ask will be:

1. Is the client involved in any fraudulent/illegal activities?
2. What is the nature of the industry in which they are involved – is it depressed?
3. Has the client had a history of changing auditor regularly or had qualified audit reports in the past?
4. Do client directors understand their role and are they able to carry it out?
5. Are management trustworthy?

Other Areas to help gain an understanding are:

- The market and its competition
- Legislation and regulation
- Regulatory framework
- Ownership of the entity
- Nature of products/services and markets
- Location of production facilities and factories
- Key customers and suppliers
- Capital investment activities
- Accounting policies and industry specific guidance
- Financing structure
- Significant changes in the entity on prior year

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New engagement process

The following procedures should be undertaken if an auditor is offered an audit role:

1. The client should be asked for permission to contact the outgoing auditor. (If not given—refuse the position)
2. Contact the outgoing auditor to ask if there is any professional reason not to take the role.
3. Ensure process of appointment and resignation of previous auditor was carried out correctly.
4. Ensure there are no independence issues.
5. Ensure that the audit firm is properly qualified to act for the client (Legality / Ethics).
6. Undertake risk assessment of the firm.
7. Ensure that the audit firm has adequate resources to conduct the audit.
8. Consider size of client, business area etc and how this will affect the audit.
9. What level of fees will be provided – is it worth it? Does it make up more fees % than allowed?

Tendering for audit work

Things to consider...

1. Fee

A fee will be quoted for a piece of audit work before it is carried out under a tendering process

The auditor must not lowball as we have seen above, nor may they make unrealistic claims or promises to win the contract

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2. Get Information

The potential client will inform the auditor of what is expected, the timetable, future plans of the company and any problems with current auditor

3. Proposal

The auditor may then draw up a proposal containing:

- Proposed audit fee
- Nature, purpose and legal requirements of an audit.
- Assessment of the requirements of the client.
- How audit firm proposes to satisfy requirements
- Any assumptions made.
- Proposed audit methodology.
- Outline of audit firm and personnel
- Ability of firm to perform the audit

Pre-conditions

Is the Financial framework used acceptable? (Consider the type of business and relevant laws and the uses of the financial statements)

Client Decision

The client will decide on the basis of clarity, relevance, professionalism, reputation, timeliness of delivery and originality which firm will conduct the audit

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Syllabus B1d) Justify the importance of engagement letters and their contents

Engagement letter

An engagement letter is a letter from the auditor to the client indicating various matters concerning the engagement

The engagement letter is sent before the audit to the client confirming their acceptance of the audit

Contents

ISA 210 Terms of Engagement gives guidance as to their content, but as a rule most will include:

- The Objective of the audit
- Managements' responsibility for the Financial Statements.
- The scope of the audit including reference to legislation and professional standards.
- The form of report to be used
- Use of the work of internal audit
- Reference to inherent limitations of an audit
- Access to information to be allowed
- Deadlines and confidentiality
- Expectations of management representations
- Fees
- Complaints procedures

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Syllabus B1e) Explain the quality control procedures that should be in place over engagement performance, monitoring quality and compliance with ethical requirements

Definitions for Quality Control

Learn the meaning of the following terms:

1. Engagement partner

The partner responsible for the audit engagement, performance and report

Also she has the appropriate authority from a professional, legal or regulatory body

2. Engagement Quality Control Review

Provides an objective evaluation, before signing the report,

of any significant judgments & conclusions

It is for listed entity audits and any where the firm thinks such a review is required

3. Engagement Quality Control Reviewer

Someone not part of the engagement team, with experience and authority to

objectively evaluate the significant judgments & conclusions

4. Engagement team

All partners and staff performing the engagement, plus anyone engaged by to do audit work

This excludes external experts

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5. Firm

A sole practitioner, partnership or corporation of professional accountants

6. Inspection

These provide evidence of compliance with the firm's quality control policies

7. Listed entity

An entity whose shares (or debt) are quoted on a stock exchange

8. Monitoring

An ongoing evaluation of the firm's quality control

It includes periodic inspections of a selection of completed engagements

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Principles & Purpose

Firms need to be sure that the audits they perform meet quality standards

This is to decrease the risks of:

- Litigation against us for professional litigation
- Incorrect Audit opinion and hence an increased investor confidence in the financial statements

There are 2 standards on Quality Control

1. At the FIRM level International Standard on Quality Control 1 (ISQC 1) – Quality Control for firms that perform audits and reviews
2. At the individual AUDIT level ISA 220 – Quality Control for audits of historical financial information

ISQC 1 (firm level)

ISQC 1 identifies six building blocks of a firm's system of quality control:

1. Ethics
2. Client Relationships
3. Leadership
4. Human Resources
5. Engagement Performance
6. Monitoring

We will look at the above in more detail in the next section. See you there, hotpants....

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Elements of a QC system

This follows on from the previous section

Firm Level Quality Control

The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that:

- (a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and
- (b) Reports issued by the firm or engagement partners are appropriate in the circumstances

1. Leadership

- An internal culture focused on quality is key
- This means training, appraisal & mission statements.
- Commercial considerations never override quality
- Pay & Benefits must reflect commitment to quality.
- Resources must be available to support quality

2. Human Resources

- All staff to have the capabilities & competence to ensure quality.
- Appraisals and development regularly

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3. Engagement Issues - Planning

- Discuss known risks with the client and document
- Staff suitably qualified and experienced, have knowledge of the client
- Contentious areas must be consulted on in a cost effective way
- A timetable for suitable reviews
- Ensure independence and any issues addressed
- Time pressure

All audits should be planned to ensure that adequate time can be spent to obtain sufficient appropriate audit evidence to support the audit opinion.

4. Engagement Issues - Supervision

- Staff supervised and assessed to control the work flow.
- Any problems tackled immediately and consultation on any deviations from the original plan.

5. Engagement Issues - Review

- Review has the purpose of identifying previously unrecognised problems and examining them along with the rest of the work carried out.
- Is the amount of evidence gathered sufficient or is further work required?
- Quality control can be achieved during the review stage by:
 - 1) Learn lessons from mistakes made
 - 2) Appraisal staff immediately after assignments to praise &/or constructively criticise

6. Monitoring

- Ensure new developments in standards and regulations are implemented
- Ensure CPD is kept up to date.
- Any breaches to monitoring system dealt with

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7. Ethical Requirements

- Have procedures to comply with ethical requirements eg. independence
- Emphasise through leadership, education/training, monitoring and dealing with non-compliance
- Have procedures to identify independence threats eg. prompt notification by employees
- Ensure that firm is notified of breaches of ethical requirements promptly

Types Of Review

• Hot Reviews

A 'hot' review is carried out before the audit report is signed.

Performed by a suitably independent reviewer such as a senior manager (not part of the management team).

Listed company engagements must have a hot review as well as those of public interest or with significant risks.

It reviews the quality of the judgements made such as:

- Is the firm independent?
- Are risk assessment judgements justified?
- Use of work outside the audit team.
- Have misstatements been correctly dealt with?
- Do working papers support the conclusions reached?
- Is the final engagement report justified in the circumstances?

• Cold Reviews

- A 'cold' review is a review carried out after the audit report is signed.
- It will be designed to identify problems in procedures and poor practice.
- The cold review should make recommendations for improvements.

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Engagement Performance

Direction, Supervision and Performance

Directing the engagement team means telling them about:

1. Their ethical responsibilities
- Their need to plan and perform an audit with professional skepticism
2. The objectives of the work to be performed
3. The nature of the entity's business
4. Risk-related issues
5. Problems that may arise
6. The detailed approach to the performance of the engagement

Supervision includes:

- Seeing if the team has enough time and competence to do their job
- Also whether they understand their instructions
- Addressing significant matters arising during the audit and modifying the plan appropriately
 - Identifying matters for consultation with experienced engagement team members

Reviews include:

- Ensuring that work of less experienced team members is reviewed by more experienced ones
- Ensuring that significant matters have been raised for further consideration
- Appropriate consultations have happened
- The work performed supports the conclusions reached and is appropriately documented

The Engagement Partner's Review of Work Performed

This involves timely reviews of the following:

1. Critical areas of judgment
2. Significant risks

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Engagement Quality Control Review

Note the following:

- It helps to see if sufficient appropriate evidence has been obtained
- It is done throughout the audit so significant matters are promptly resolved before the date of the auditor's report.
- Documentation of the review may be completed after the auditor's report (as part of the assembly of the final audit file)
- The extent of the review depends on:
 - 1) The complexity of the audit
 - 2) If the entity is listed and
 - 3) The risk of an inappropriate auditor's report

Assigning the Audit Team

You need to consider the team's competence and capabilities

This means looking at their:

1. Understanding of, and experience with, similar audits
2. Understanding of professional standards and regulations
3. IT expertise and any specialist accounting / auditing
4. Knowledge of the client's industry
5. Ability to apply professional judgment
6. Understanding of the firm's quality control policies

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Individual level of Quality Control

Individual Level Quality Control

ISA 220 Quality Control for Audits of Historical Financial Information specifies the following quality control procedures that should be applied by the engagement team in individual audit assignments.

Client acceptance procedures

There should be full documentation, and conclusion on, ethical and client acceptance issues in each audit assignment.

The engagement partner should consider whether members of the audit team have complied with ethical requirements, for example, whether all members of the team are independent of the client.

Additionally, the engagement partner should conclude whether all acceptance procedures have been followed, for example, that the audit firm has considered the integrity of the principal owners and key management of the client.

Other procedures on client acceptance should include:

1. Obtaining professional clearance from previous auditors
 2. Consideration of any conflict of interest
 3. Money laundering (client identification) procedures.
- Establish the identity of the entity and its business activity e.g. by obtaining a certificate of incorporation
 - If the client is an individual, obtain official documentation including a name and address, e.g. by looking at photographic identification such as passports and driving licences
 - Consider whether the commercial activity makes business sense (i.e. it is not just a 'front' for illegal activities)

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- Obtain evidence of the company's registered address e.g. by obtaining headed letter paper
- Establish the current list of principal shareholders and directors.

Engagement team

Procedures should be followed to ensure that the engagement team collectively has the skills, competence and time to perform the audit engagement.

The engagement partner should assess that the audit team, for example:

1. Has the appropriate level of technical knowledge
2. Has experience of audit engagements of a similar nature and complexity
3. Has the ability to apply professional judgement
4. Understands professional standards, and regulatory and legal requirements.

Direction

The engagement team should be directed by the engagement partner.

The planning meeting should be led by the partner and should include all people involved with the audit.

There should be a discussion of the key issues identified at the planning stage.

Procedures such as an engagement planning meeting should be undertaken to ensure that the team understands:

1. Their responsibilities
2. The objectives of the work they are to perform
3. The nature of the client's business
4. Risk related issues
5. How to deal with any problems that may arise; and

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Supervision

Supervision should be continuous during the engagement.

Any problems that arise during the audit should be rectified as soon as possible.

Attention should be focused on ensuring that members of the audit team are carrying out their work in accordance with the planned approach to the engagement.

Significant matters should be brought to the attention of senior members of the audit team.

Review

The review process is one of the key quality control procedures.

All work performed must be reviewed by a more senior member of the audit team.

Reviewers should consider for example whether:

1. Work has been performed in accordance with professional standards
2. The objectives of the procedures performed have been achieved
3. Work supports conclusions drawn and is appropriately documented.

Consultation

Finally the engagement partner should arrange consultation on difficult or contentious matters.

This is a procedure whereby the matter is discussed with a professional outside the engagement team, and sometimes outside the audit firm.

Consultations must be documented to show:

1. The issue on which the consultation was sought; and
2. The results of the consultation.

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Syllabus B2: Objective and general principles

Syllabus B2a) Identify the overall objectives of the auditor and the need to conduct an audit in accordance with ISAs.

Auditor Objectives

ISA 200 says “to obtain reasonable assurance, the auditor shall obtain sufficient appropriate evidence to reduce audit risk to an acceptably low level”

ISA 315 extends this “to identify and assess the risk of material misstatement...designing and implementing responses to the assessed risks of misstatement”

Misstatement

ISA 450 Evaluation of Misstatements Identified During the Audit states that this occurs when something in the accounts is not in accordance with the applicable financial reporting framework

They can arise from error or fraud

There are 3 categories...

- **Factual Misstatements**

Those where there is no doubt

- **Judgmental misstatements**

Those where the managements judgements on estimates not considered reasonable or the policies are inappropriate

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- **Projected misstatements**

These come from extrapolating misstatements in samples across a population

Uncorrected Misstatements

Misstatements that the auditor has accumulated during the audit and that have not been corrected.

The auditor has a responsibility to accumulate misstatements which arise over the course of the audit unless they are very small amounts.

Identified misstatements should be considered during the course of the audit to assess whether the audit strategy and plan should be revised

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Syllabus B2b) Explain the need to plan and perform audits with an attitude of professional scepticism, and to exercise professional judgment.

Professional Scepticism and Judgement

When planning and performing an audit, the auditor should adopt an attitude of professional scepticism

It is “An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence”

In other words, they must not simply believe everything management tells them

The exercise of professional judgement in planning and performing an audit

The auditor will need to exercise professional judgement on both the quantity and the quality of evidence.

So he has to judge..

1. When is there sufficient evidence?
2. What is the quality of this evidence
3. Is it consistent with what is known from elsewhere?
4. Are assumptions reasonable?

The auditor needs to not only see a record of what the assumptions are, but also challenge them and understand how they affect the conclusions the client has come to.

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Factors to help with the judgement are...

- The seriousness of the risk
- The materiality of the item
- The strength of internal controls
- The sampling method used (see later)

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Syllabus B3: Assessing audit risks

Syllabus B3a) Explain the components of audit risk.

Components of Audit Risk

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

Stated another way, this is the risk that there is a material misstatement in the financial statements, but the auditor misses it and says that they present a true and fair view.

Formula for audit risk is:

Inherent Risk x Control Risk x Detection Risk

Inherent Risk

This will be considered at the planning meeting as it depends on the auditors' knowledge of the business

Examples are...

- **A cash based business**

This is often a problem as there must be very strong controls in place if a business is a cash based one.

The auditor may feel that there are insufficient controls in place to mitigate this risk which may lead to limitation of scope.

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- **Fast moving Industry**

In fast moving industries such as IT or fashion there may be a risk that the inventory held by the business becomes obsolete.

The auditor may take expert advice on the valuation of inventory, or they may review post year-end sales to ensure the goods are sold for more than they are valued at in the financial statements.

- **Control Risk**

This is the risk of material misstatement due to inadequate internal controls within the business.

The auditor will make a judgement as to the suitability and strength of internal controls – we will examine how this is done at a later stage.

Examples are...

- **No segregation of duties**

Segregation of duties is where different tasks in a process are performed by different people

e.g. an invoice is raised by one person and the cheque is written by another and authorised by someone else.

If this control is weak or not in place, the auditor may have to increase the sample size to ensure the financial statements present a true and fair view.

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- **No controls over access to assets**

If employees have unfettered access to the assets of the business with no restrictions, this will increase the risk of theft or damage to those assets

If the auditor finds this to be the case, more physical checks of the existence and condition of assets will have to be carried out.

- **No controls over access to IT**

If a business does not use passwords and other protection to protect its' computer systems this can lead to data loss or manipulation without authorisation.

If these controls are not in place the auditor will have to understand the system to assess the ease of which it can be manipulated and check for anomalous trends using analytical review.

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Detection Risk

This is the risk that the work carried out by the auditor does not uncover a material misstatement that exists.

Detection risk can be split into sampling & non-sampling risk

- **Non-sampling risks**

- The auditor did not sufficiently investigate a significant balance
- The procedures used may have been inappropriate or misinterpreted

- **Sampling risk**

‘arises from the possibility that the auditor’s conclusion, based on a sample may be different from the conclusion reached if the entire population were subjected to the same audit procedure’.

This is another way of saying that the sample selected by the auditor was not representative of the data.

Detection risk may be increased by things such as inexperienced audit staff or tight deadlines to complete the audit.

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Syllabus B3b) Explain the audit risks in the financial statements and explain the auditor's response to each risk.

Affecting Audit Risk

This element of the syllabus can ONLY be learnt by attempting past paper questions

The idea is that the examiner will give you a scenario - where there's a risk that the FS may be materially misstated

What you have to do is explain what that risk is (e.g. Risk stock is overvalued because it is getting old) and then say what you would do as an auditor (to see if it is actually overvalued - look at post year end sale prices of the stock)

The key is practice these AUDIT RISK questions - they're in virtually every past paper

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: 1. Providing definitions of the audit risk model, even though this was not part of the

question requirement 2. A lack of understanding of what audit risk is and providing business risks instead 3. Not providing an adequate response to the risk. This needs to be from the perspective

of the auditor and not from management's perspective 4. A limited range of risks identified, often just focusing on one area such as going concern.

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

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In many 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.

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...

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.

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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.

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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.

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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.

The auditor cannot affect inherent risk or control risk as these are internal (called Entity Risk)

The auditor therefore concentrates on detection risk once they have assessed the control and inherent risk.

Consider the elements of Audit risk and how they relate in our formula:

Inherent Risk x Control Risk x Detection Risk

If Inherent & Control risk are judged to be high, then to minimise overall audit risk, the auditor must attempt to minimise detection risk.

The auditor will have to increase the amount of tests or the number of samples to ensure that there is less chance of a material misstatement being overlooked or missed.

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*Syllabus B3c) Define and explain the concepts of materiality and performance materiality.
and*

Syllabus B3d) Explain and calculate materiality levels from financial information.

Materiality

ISA 320 defines information as material if ‘its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.’

Material items could be large transactions or significant events.

Materiality is important to the auditor because if a material item is incorrect, the financial statements will not show a ‘true and fair view.’

Materiality Levels

1. The auditor will decide materiality levels and design their audit procedures to ensure that the risk of material misstatements is reduced to an acceptable level.

Generally, materiality will be set with reference to the financial statements such as:

0.5 – 1% of turnover

5 – 10% of profits reported

1 – 2 % of gross assets

Judgement will be used by the auditor in charge and will depend on the type of business and the risks it faces.

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2. Considerations

Quantity

The relative size of the item

Quality

This might be something that's low in value but could still affect users' decisions

e.g.. Directors wages

Tolerable Error

This is when the auditor accepts the error

For example finding one error out of 100 tested, might be ignored

The tolerable level will be decided at planning stage

Performance Materiality

This is lower than normal materiality

The idea is that this will try to prevent all those small, undetected errors do not aggregate to become material

• There are now 2 standards to consider..

1. ISA 320 Audit Materiality

2. ISA 450 Evaluation of Misstatements Identified During the Audit

• As we know, materiality is calculated at the planning stage

But it might not stay at that amount - oh no baby

Things happen that make the auditor change the level

Such things are often immaterial in quantity but material by their nature

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- **Example**

The company you are auditing makes a \$5,000 profit.

The materiality is set at \$10,000

You notice that an invoice for \$6,000 has been incorrectly placed into next year.

This would be material as it changes the look of the whole accounts (changing a profit into loss)

- The new standard recognises that there could well be instances where certain classes of transactions, account balances or disclosures might be affected by misstatements which are less than the materiality level for the financial statements as a whole, but which may well influence the decisions of the user of those financial statements regardless of the fact they are below materiality – this is where performance materiality is to be applied.
- Specifically, the clarified ISA 320 suggests performance materiality be applied to areas such as related party transactions and directors' remuneration.

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Syllabus B4: Understanding the entity and its environment

Syllabus B4a) Explain how auditors obtain an initial understanding of the entity and its environment.

How to get Initial Understanding

Firstly the auditor needs to understand the entity's environment, this will require the auditor to assess:

- Industry conditions
- Principle business strategies
- Competitors
- Laws and regulations
- Technology
- Stakeholders
- Financing
- Acquisitions and disposals
- Related parties
- Competence of management
- Accounting policies

From a number of sources..

1. Internal to the audit firm such as last years' file.
2. External sources such as credit reference agencies.
3. Information provided by the client.
4. The auditor's personal experience and knowledge

ISA 315 requires a planning meeting where 'the members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatements.'

The minutes of this meeting should be documented as evidence of its occurrence.

Analytical procedures should be undertaken at this stage to establish an understanding of the financial statements and draw attention to anomalies.

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Risk Assessment Procedures

Risk assessment procedures assess the risk that material misstatement exists

This involves recognising the nature of the company and management, interviewing employees, performing analytical procedures, observing employees at work, and inspecting company records.

After you run through all applicable risk-assessment procedures, you use the results to figure out how high the chance is that your client has material financial-statement mistakes.

Not every mistake is important.

Let's look at these in more detail now..

The nature of the company

Here are some crucial questions to ask the client during your risk assessment procedures..

- What's the company's market overview? For example, if the client is a bank, in how many countries does it operate?
- Who (if anyone) regulates the client? Many businesses don't have an outside regulatory agency, but any publicly traded company will have stock exchange rules to follow
- What's the company's business strategy? Most business strategies are to maximise shareholder value by increasing profitability and serving the community in which they're located.

The answer may lead you to more probing follow-up questions.

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- **The quality of company management**

Look for things like..

- Do they enforce procedures - check their attitude in interviews
- Is there high employment turnover
- Are the top management experienced
- Any accounting adjustments needed in prior years
- Ask Employees for information

Talk with individuals holding different levels of authority, from low-level clerks all the way up to the board of directors.

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Syllabus B4b) Describe and explain the nature, and purpose of, analytical procedures in planning.

Analytical Procedures in Planning

Analytical procedures consist of ‘evaluations of financial information through analysis of plausible relationships among both financial and non-financial data’

Analytical procedures are compulsory at two stages of the audit under ISA 520 namely the planning stage and the review stage.

Analytical procedures use calculations such as financial ratios to generate an expectation of what a figure is likely to be and then comparing this to the actual figure in the accounts.

They can be used to highlight unusual figures in order to focus the audit on them or to establish that a trend has continued.

At the planning stage they help you understand the business and its environment

Because you compare figures to the industry and to previous years

Any items which go against the expected relationships help you assess the risk of material misstatement

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How to perform Analytical Procedures

A step by step guide

1. Predict a figure, based on a relationship

Eg. This could be gross profit as a % of revenue (based on previous years and industry averages)

2. Define what a significant difference is

We call this the threshold below which we see any difference as just a tolerable 'error'

3. Calculate the procedure and the difference to the prediction in step 1

4. Investigate the difference

Differences indicate an increased likelihood of misstatements

If caused by factors previously overlooked, look at 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

Types of analytical procedures

Trend analysis

The analysis of changes in an account over time

Ratio analysis

The comparison of relationships using financial and non- financial data

Reasonableness testing

Comparing expectations based on financial data, non-financial data, or both to actual results

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Limitations when used for Planning

1. Often budgets and forecasts needed
2. If done before Y/E extrapolations used - these aren't reliable if business is seasonal
3. Many accounting adjustments missed as only done at Y/E
4. Often uses less rigorous management accounts
5. Even more difficult for smaller companies who don't have good management accounts

Syllabus B4c) Compute and interpret key ratios used in analytical procedures.

The financial ratios used by the auditor will fall into 3 general categories:

Profitability/Return

Gross Margin Net Margin ROCE

Liquidity/Efficiency

Receivables/Payables/Inventory Days Current Ratio Quick Ratio

Gearing

Financial Gearing Operational Gearing

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ROCE:

Profit Before Interest and Tax Total Assets – Current Liabilities (Capital Employed)

ROE:

Profit after tax – preference dividends Equity shareholders funds

Gross Margin

Gross profit Revenue

Operating Margin

Profit before interest and tax Revenue

Current Ratio

____Current Assets____ Current Liabilities

Quick Ratio

Current Assets – Inventories Current Liabilities

Inventory Days

Closing (or average) Inventory_ x 365

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Receivable Days

Trade Receivables x 365

Credit Sales

Payable Days

___Trade Payables___ x 365

Credit Purchases¹

Gearing

$$\frac{\text{Debt}}{\text{Debt} + \text{Equity}} \times 100$$

OR

$$\frac{\text{Debt}}{\text{Equity}} \times 100$$

Interest Cover

Profit before Interest and Tax (PBIT)

Interest payable

Take cost of sales if credit purchases are not given ¹

Debt = Loans + Preference Shares ²

Equity = Ordinary share capital + Reserves + Non-controlling interest ³

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Syllabus B5: Fraud, laws and regulations

Syllabus B5a) Discuss the effect of fraud and misstatements on the audit strategy and extent of audit work.

In order to detect fraud, the auditor must maintain an attitude of professional scepticism - meaning to always be aware of the possibility of fraud, regardless of past experience of the client

Once an error (unintentional) or fraud (intentional) has been found by the auditor then the auditor needs to re-assess his original risk assessment of the audit

It will make the audit higher risk and hence increase the testing that needs to be done

Also it may well make the auditor question further the integrity of the management and the effectiveness of controls

All of this will result in:

- More testing on the areas in which fraud is suspected.
- perhaps not relying on the representations of management if they are suspected of involvement in fraud.
- Materiality may be reduced.
- Evidence provided by the client may not be relied upon.
- The auditor may have to generate more 3rd party evidence.

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Reporting fraud and error

Fraud and error must be reported to management or the audit committee ASAP

What about reporting to shareholders?

By including a paragraph in the audit report

What if it's in the public interest?

Report to a 3rd party (e.g. Regulator)

Especially if management involved

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Syllabus B5b) Discuss the responsibilities of internal and external auditors for the prevention and detection of fraud and error.

Management and Auditor Responsibilities

Fraud and Error

Management Responsibilities

- Safeguards should be in place to avoid fraud and error through the systems and controls the company operates
- Internal audit function will be responsible for monitoring and implementation of these

Auditor Responsibilities

- If fraud or error leads to a material misstatement, the auditor is responsible for detecting it.
- If immaterial, these should be reported to those charged with governance, but there is no responsibility to detect them.
- The inherent limitations of audit mean that the auditor cannot guarantee that the financial statements are free from fraud and error.
- The auditor must consider the risk of material misstatement due to fraud and error when planning and performing their audit.
- If discovered, fraud should be reported to the audit committee (if one exists), or the highest level of management (if not involved in the fraud), or the shareholders if the fraud is by those in senior management.

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Syllabus B5c) Explain the auditor's responsibility to consider laws and regulations.

Responsibilities of management and auditors

Management is responsible for ensuring that the company complies with laws and regulations

Auditors are responsible for

- concluding FS free from misstatements caused by non-compliance with laws and regulations
- having a general understanding of the legal and regulatory framework within which the company operates
- applying professional scepticism
- obtaining a general understanding of applicable laws and regulations
- understanding how the entity complies with those laws and regulations
- identifying instances of non-compliance
- being aware of the impact of breaches of regulations on the assertions

Responsibilities of Management (and Those Charged With Governance)

1. Prevention AND detection of fraud and error
2. Strong risk management and internal control
3. A culture of honesty and ethical behaviour
4. Compliance with applicable laws and regulations
5. Monitoring legal requirements
6. Developing, publicising and following a Code of Conduct
7. Training

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Syllabus B6: Audit planning and documentation

Syllabus B6a) Identify and explain the need for and importance of planning an audit.

Why Plan an Audit?

Plan the audit so that the engagement will be performed in an effective manner

Time spent planning the audit to ensure it is carried out efficiently will reduce the time taken and thus the cost.

The planning process will also assess and thus reduce risk.

The auditor will want to ensure that the correct team is in place to conduct the audit, they are working efficiently and that work is focused on material areas of risk and potential problem areas.

Planning Activities

- **Risk Assessment**

We will look in detail later at risk assessment, but at this point we should be aware that the identification of risk will determine the entire audit process.

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- **Audit Strategy**

The audit strategy sets out the scope, timing and direction of the audit.

The Scope:

The scope of the audit will be determined by the reporting framework applied as well as any industry specific requirements.

If there are any geographical or other factors which may affect the audit, they will be considered here.

Timing:

The timing of the audit will set out any deadlines applicable and the dates of the interim and final audit visits.

The interim audit is conducted before the final audit to evaluate controls and document the systems in place.

In addition there may be some substantive tests carried out.

The attendance at the stock count will be carried out at this time and perhaps the receivables circularisation.

The final audit will involve the bulk of the audit work and it may be possible to concentrate on the statement of financial position figures if sufficient work has been carried out during the interim audit.

Direction:

The direction of the audit will be determined by the identification of high risk areas and materiality.

The strategy decided upon will be tailored to the client and the nature of their business and their structure. The auditor must ensure that the strategy selected is appropriate.

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Syllabus B6b) Identify and describe the contents of the overall audit strategy and audit plan.

Contents of the Plan

There are several stages in the planning process:

As follows

- Ensure understanding of the business
- Undertake analytical review
- Assess the risks involved with the business
- Establish materiality levels
- Establish tolerable error for material errors
- Decide the audit approach
- Ensure auditor independence
- Decide the budget and staff requirements
- Timetable the audit & set deadlines

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Permanent file

The permanent file kept by the audit firm will bring forward a lot of the knowledge of the business, but this must be kept up to date.

Current File

The current file contains the evidence and documents relevant to the current year.

The planning section of the file will cover all of the areas above, and there will be a completion section which will review the audit.

In between there will be a sub-section for each balance sheet item (e.g. Non Current Assets) and for each income statement item (e.g. purchases) with the work done outlined and evidence documented

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Syllabus B6c) Explain and describe the relationship between the overall audit strategy and the audit plan.

Audit Strategy vs Audit Plan

Whilst the strategy sets out the overall approach, the plan fills in the operational details

Both strategy and plan need to be fully documented

The Audit Strategy document should identify the main characteristics of the engagement which define its scope

1. If the accounts have been prepared in accordance with IFRS
2. How much audit evidence obtained in previous audits will be used
3. Whether computer-assisted audit techniques will be used
4. The availability of key personnel

The document should understand the reporting objective

In order to plan the timing of the audit

Things to include are...

- The audit timetable for reporting and whether there will be an interim as well as final audit
- Organisation of meetings with management to discuss any audit issues arising
- Location of Inventory counts
- The timings of the audit team meetings and review of work performed

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The document should show the factors directing the audit team's effort such as:

- Materiality levels
- Using professional skepticism in gathering and evaluating audit evidence

It should consider the knowledge from prelim planning & other areas such as:

1. Results of previous audits and any tests of internal controls
2. Evidence of management's commitment to the design, implementation and maintenance of sound internal control
3. Volume of transactions, which may determine whether it is more efficient for the audit team to rely on internal control

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Syllabus B6d) Explain the difference between interim and final audit.

Syllabus B6e) Describe the purpose of an interim audit, and the procedures likely to be adopted at this stage in the audit.

Syllabus B6f) Describe the impact of the work performed during the interim audit on the final audit.

Difference between Interim and Final audit

The interim audit is used to lessen the amount of work at the final audit.

Which testing gets done where needs planning - although some tests such as year end stock take can only be performed at the year end as the interim is performed during the year

This is a matter of timing and the auditor has the following choice:

1. Interim and Final audits
2. Final audit only
3. Continually using CAATs

Interim Audits

Basically before the Year-end, allowing procedures to be more spread out and improve planning of the final audit

The interim audit should improve risk assessment and therefore make the final procedures more efficient

It will help with the levels of materiality and allow the final audit to concentrate on year end valuations and matters of significant subjectivity

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4. The interim audit will normally be used for:

- Documenting the system
- Evaluating controls
- Testing specific transactions (e.g. big NCA purchase)
- Interim receivables circular

2. Timings

- Early enough - so not interfering with Y/E client work
- Late enough - to give adequate warning of specific problems that will need to be addressed

Final Audit

Post year-end, focus on year end valuations and areas of significant subjectivity

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Syllabus B6g) Explain the need for, and the importance of, audit documentation.

Audit documentation relates to the working papers generated by the auditor during the audit.

The auditor should prepare, on a timely basis, audit documentation that provides:

- a sufficient appropriate record of the basis for the auditor's report, and
- evidence that the audit was performed in accordance with ISAs and applicable legal and regulatory requirements.

The auditor should prepare the audit documentation 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 and the conclusions reached.

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.

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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 should record:

who performed the audit work and the date such work was completed, and who reviewed the audit work and the date and extent of such review

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

If the working papers do not exist then the auditor will be unable to prove how and why the opinion expressed was arrived at. There will also be nothing to prove that the audit was carried out in accordance with the ISA's.

The working papers should provide evidence such that a suitably qualified practitioner could follow the procedures outlined and come to the same conclusion as the person who carried out the audit.

If the working papers do not exist, then this will be impossible and likewise if they are unclear as to the work carried out.

IMPORTANCE OF WORKING PAPERS

Working papers are important because they:

- are necessary for audit quality control purposes
- provide assurance that the work is 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

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Syllabus B6h) Describe the form and contents of working papers and supporting documentation.

Contents of Documentation

All documentation should be retained in an audit file

The audit file will follow the structure below:

- Planning
- Audit work carried out on each section of the financial statements (e.g. Non Current Assets, Inventory)
- Completion and review

Auditors must document

1. What items were tested
2. Who did the testing
3. When was the testing
4. Who reviewed the work and when

Discussion of all significant matters with management must also be documented

Types of Audit Documentation

Includes

1. Planning Documentation (Strategy, plan, risk analysis)
2. Audit programmes
3. Summary of significant matters
4. Letters of confirmation / representation
5. Correspondence

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The permanent file will include

Names of management, those charged with governance, shareholders

Systems Information

Business and Industry background

Title deeds

Contracts

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Syllabus B6i) Explain the procedures to ensure safe custody and retention of working papers.

Keeping Working Papers

The Auditor owns the working papers

The auditor retains ownership of the working papers and the client does not have the right to view or copy any of the work the auditor carries out.

This is important because..

Auditor controls them and not the client

This helps keep the auditor independent

The auditor must be careful if they include copies of client generated items

Working papers must be kept secure

Why is security so important?

If lost, all would need to be recreated!

It includes sensitive and confidential information

Prevention of any unauthorised alterations to them

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What about IT based audit systems?

Laptops are very susceptible to theft, not just for the contents, but for the machine itself

Unauthorised alterations are harder to spot

So, ensure laptops should always be locked away securely or taken home by the audit team

IT based systems should be subject to passwords, encryption and back up procedures

Retention of working papers

Audit files should be updated and finished no later than 60 days after the report

They should then normally be kept for at least 5 years

• So arrangements need to be made for..

1. Secure storage
2. Archiving of the old files
3. IT back ups

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Syllabus C: INTERNAL CONTROL

Syllabus C1: Internal control systems

Syllabus C1a) Explain why an auditor needs to obtain an understanding of internal control relevant to the audit.

Understanding the Controls

By understanding the controls in place, the auditor will be able to determine what audit procedures will be required

Understanding it means you can trust that the system gives reliable information

This can be seen in 2 ways

1. It records substance not form

Internal controls ensure that when a business undertakes a transaction such as a sale, the final recording of the transaction on the accounts system reflects the true substance of the transaction

2. Helping prevent fraud & errors

All this means is that internal controls help prevent fraud and errors which would make the accounting information incorrect.

In this way internal controls will have a direct effect on Audit Risk

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Syllabus C1b) Describe and explain the five components of internal control

i) the control environment

ii) the entity's risk assessment process,

*iii) the information system, including the
related business processes, relevant to
financial reporting and communication*

iv) control activities relevant to the audit

v) monitoring of controls

The 5 components of Internal Control

There are 5 key components of an internal control system

These are

1. Control Activities
2. Risk Assessment
3. Information Systems
4. Monitoring of Controls
5. Strong Control Environment

Control Activities

This includes all procedures designed to ensure management directives are carried out

• Approval and Control of Documents

Documents should be approved by an appropriate person. For example, wages calculations and payments should be approved by a senior manager.

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- **Controls over IT**

Passwords, usernames, back-ups and any other appropriate controls should be in place.

- **Reconciliations**

Key account balances such as bank and debtors should be reconciled on a regular basis.

- **Arithmetical Accuracy**

Items such as invoices etc should be checked to ensure they are arithmetically correct.

- **Control Accounts**

Control accounts for accounts such as wages, PAYE, VAT should be maintained.

- **Restricted access to physical assets**

Only authorised staff should have access to certain areas of the business such as valuable or sensitive assets.

- **Compare physical counts with accounting records**

Items such as cash and inventory should be counted periodically and compared to the amount in the accounting records.

- **Segregation of Duties**

Responsibilities should be divided to reduce the risk of fraud and error by employees

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Risk Assessment

1. The auditor should understand how management assess risk and how they take action to mitigate risks discovered
2. Management should be undertaking regular risk assessments to ensure that all risks are identified and mitigated.

Information System

The auditor must 'obtain an understanding of the information system, including the related business processes, relevant to financial reporting.'

The auditor must decide what areas of the information system are relevant to the financial reporting of the entity and only concentrate on those systems.

• The ISA defines these areas as:

The classes of transactions in the entities operations which are significant to the financial statements.

The procedures, within both IT and manual systems, by which those transactions are initiated, recorded, processed and reported in the financial statements.

The related accounting records, whether electronic or manual, supporting information and specific accounts in the financial statements, in respect of initiating, recording, processing and reporting transactions.

How the information system captures events and conditions other than classes of transactions, that are significant to the financial statements.

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The financial reporting procedure used to prepare the entities financial statements, including significant accounting estimates and disclosures.

- This is a key area to the exam as a question will often require you to understand business systems in a scenario. Read and ensure you understand the above areas.

Monitoring of Controls

1. Controls may be monitored either by management or by the internal audit function if one exists.
2. The auditor may be able to rely on some of the work of internal audit as we will see later, but must first gain an understanding of how controls are monitored and how effective the monitoring is.

The Control Environment

- The control environment refers to the framework around which the controls of the organisation operate.

Management attitude will largely determine the nature of the control environment.

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• **ISA 315 requires the auditor to consider the following aspects:**

Communication and enforcement of integrity and ethical values.

Commitment to competence.

Participation of those charged with governance.

Management philosophy and operating style.

Organisational structure.

Assignment of authority and responsibility.

Human resources policies and practices.

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Syllabus C2: The use and evaluation of internal control systems by auditors

Syllabus C2a) Explain how auditors record internal control systems including the use of, narrative notes, flowcharts, internal control questionnaires and internal control evaluation questionnaires.

How Auditors Record Systems

The first step the auditor will take is to document the system

This may be done in several ways including:

- Organisational Charts
- Notes made by the auditor
- Internal Control Questionnaire (ICQ)
- Internal Control Evaluation Questionnaire (ICEQ)
- Flowcharts - can make complex systems easier to follow

Narrative notes - Advantages

A written description of the system showing what happens and the controls operating at each stage

1. They are simple to record after discussion with staff members
2. They are simple to understand by all members of the internal audit team

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Narrative Notes - Disadvantages

A written description of the system showing what happens and the controls operating at each stage

1. Narrative notes can become too much, especially if the system is complex
2. They don't identify control exceptions - they just record what is there

ICQ's and ICEQ's - Advantages

...simply a list of questions

ICQs test if controls exist

ICEQs test the controls' effectiveness

1. Super quick to prepare
2. They ensure all controls exist - so any deficiencies are highlighted

ICQ's and ICEQ's - Disadvantages

...are simply a list of questions

ICQs test if controls exist

ICEQs test the controls' effectiveness

1. Too easy for staff to overstate controls present (as the questions relate to potential controls)
2. A standard list of questions may miss out unusual controls

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Flowcharts - Advantages

These diagrammatically illustrate the internal control system

Lines show the sequence of events

Symbols signify controls (or documents)

1. It is easy to view the system as a whole because it is presented in one diagram
2. Standard controls symbols means missing controls are easy to spot

Flowcharts - Disadvantages

These diagrammatically illustrate the internal control system

Lines show the sequence of events

Symbols signify controls (or documents)

1. Changes can be difficult as often the whole flowchart needs re-drawing
2. Narrative notes will still be needed to explain the flowchart and hence it can be time consuming

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Syllabus C2b) Evaluate internal control components, including deficiencies and significant deficiencies in internal control.

How Auditors Identify Deficiencies

The auditor needs to assess if the system is implemented correctly and is effective

So now the system is documented it is time to see if:

- The controls are implemented?
- The controls are effective?

To do this we use tests of controls

Tests of Controls will be performed to test the effectiveness

The tests concern:

- How controls were applied
- The consistency of the application
- Who applied them

Typical tests include:

- Walkthrough tests (follow a transaction through the system)
-
- Observation (Eg Observe the stock count)
-
- Computer aided audit techniques

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Syllabus C2c) Discuss the limitations of internal control components

The limitations of internal control components

Controls are only as good as those applying them..

- **Collusion from staff**

May result in fraud no matter how strong the controls are

- **Practice is different from theory**

The specific circumstances of the entity make some controls unworkable or be manipulated in practice by those involved in the system

If controls are insufficient

- More testing needed Increased sample sizes directly on the specific risk in question
- Alternative sources of evidence needed These could include external confirmation, or analytical procedures

The possibility of FRAUD means substantive testing is always required

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Syllabus C3: Tests of control

Syllabus C3a) Describe computer systems controls including general IT controls and application controls

Application & General IT controls

Application controls apply to the processing of transactions

Examples are..

Batch total checks

Sequence checks

Arithmetic checks

Existence checks

Authorisation checks

General IT controls ensure the information system can run properly

Examples include:

Software system acquisition controls

Software change and maintenance controls

Security (password etc) controls

Backup controls

So a good IT system should have both application and general IT controls

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The auditor must be aware of the implications of the IT systems of the entity.

Many transactions may now be automated and the automation must be checked and understood.

Large volumes of transactions can now be performed by IT systems leading to greater focus on how the transactions are generated

ACCA MAPS

This is a little memory technique for remembering the typical controls in a business

Authorisation

Computer controls

Comparison

Arithmetic

Maintain control accounts

Account reconciliations

Physical controls

Segregation of duties

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Syllabus C3b) Describe control objectives, control procedures, activities and tests of control in relation to:

i) The sales system;

Revenue (Sales Cycle)

Objective to ensure all valid sales recorded accurately and cash received promptly

Tests of Control - Sales Cycle - These include:

- Review new customers' files for references, credit checks, authorisation by senior staff
- Ensure credit limits for customers are not exceeded by trying to post a sale which is beyond the credit limit
- Match GDN with sales invoices checking prices, quantities, arithmetical accuracy, VAT and postings
- Verify credit notes with correspondence, original invoices, amounts and authorisation
- Check numerical sequence of invoices, credit notes, GDN's and sales orders – enquire into missing number
- Review sales ledger reconciliations
- Agree sample of accounts in sales ledger re-performing additions and balances carried down
- Inspect correspondence on overdue accounts
- Review process for dispatch of statements and ensure regularly sent
- Ensure bad debt write offs are authorised by managers

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Syllabus C3b) Describe control objectives, control procedures, activities and tests of control in relation to:

ii) The purchases system

Purchases

The control objectives for the purchases cycle are..

As follows:

1. Purchases made only when needed.
2. Purchased at a reasonable price.
3. The goods have satisfactory quality.
4. The goods delivered match those ordered.
5. Purchases are recorded accurately.
6. Payments are valid and paid for in a reasonable timescale.

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Syllabus C3b) Describe control objectives, control procedures, activities and tests of control in relation to:

iii) The payroll system

Payroll

The control objectives for the payroll cycle are:

as follows:

1. Only work done is paid for
2. Pay is accurately calculated
3. Pay is correctly made
4. Pay is authorised
5. Deductions are correctly calculated and paid

Tests of Control - Payroll Cycle

These will potentially include:

1. A sample of wages and salaries should be re-performed
2. The calculation will agree with authorised pay rates and time-sheets
3. Test sample of time-sheets for authorisation (esp. overtime)
4. Attend a cash pay out looking for two people present & one wage per person
5. Review wages reconciliation and ensure done regularly
6. Ensure changes to payroll are authorised
7. Check reasonableness of payroll deductions and ensure authorised
8. Test controls over unclaimed wages

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Syllabus C3b) Describe control objectives, control procedures, activities and tests of control in relation to:

iv) The inventory system

Inventory

The control objectives for inventory are:

as follows:

1. Inventory movements are recorded and authorised
2. Only items belonging to the client are included in inventory
3. Inventory records are accurate
4. Cut-off procedures are correct
5. Inventory is valued correctly
6. Inventory levels are neither too low nor too high
7. Liabilities are recorded accurately
8. Allowance is made for slow moving and obsolete inventory

Tests of Control - Inventory

These may include:

1. Ensuring environment suitably secure and safe
2. For a sample of inventory records and agree to GRN or GDN
3. Confirm that all movements are authorised
4. For a sample of GRN and GDN's agree to inventory records
5. Test check inventory count and investigate discrepancies
6. Review sequentially numbered GRN and GDN for completeness
7. Attend inventory count to ensure it is carried out correctly

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Inventory System continued

Perpetual Inventory

Perpetual inventory is the recording as they occur of receipts, issues and the resulting balances of individual items of inventory in both quantity and value. These inventory records are updated using stores ledger cards and bin cards.

Stocktaking

The process of stocktaking involves checking the physical quantity of inventory held on a certain date with the balance on the stores ledger cards or bin cards.

Stocktaking can be carried out either on a periodic basis or continuous basis.

Periodic stocktaking

Periodic stocktaking involves checking the balance of every item in inventory at a set point in time, usually at the end of an accounting year.

Continuous stocktaking

This involves counting and valuing selected items of inventory on a rotating basis. Each item is checked at least once a year.

Control procedures to minimize discrepancies and losses

Inventories cost a considerable amount of money and therefore, control procedures must be in place.

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Such control procedures would include:

1. physical security procedures, regular stocktaking and recording of all issues to eliminate unnecessary losses from inventory;
2. separation of ordering and purchasing activities to eliminate fictitious purchases;
3. quotation for special order to reduce the probability of ordering goods at inflated prices.

Inventory losses arising from theft, pilferage or damage must be written off against profits as soon as they occur.

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Syllabus C3b) Describe control objectives, control procedures, activities and tests of control in relation to:

vi) Non-current assets

Capital expenditure

The auditor will test the controls in place over capital expenditure.

The tests used will vary according to the entity being audited and are similar to the tests of control over purchases, but will usually include:

- Capital expenditure will usually be substantial, and as such should be authorised by senior management.
- The asset register should contain all information surrounding the asset such as invoice for the purchase, location, value etc.
- The existence of the assets should be checked on a regular basis.
- The documents confirming the ownership of the assets should be kept safe in a fire proof environment.

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Syllabus C3b) Describe control objectives, control procedures, activities and tests of control in relation to: v) The cash system

Bank & Cash

OBJECTIVE CONTROL PROCEDURES TESTS OF CONTROL

Cash amounts should be safeguarded

Cash should be locked in safe.

Access to cash restricted.

Security movements for large amounts.

Banking times/routes varied.

Perform surprise cash count. Ensure only authorised staff have access to cash. Check sequential numbering of cash receipts. Check mail is opened by two members of staff to reduce the chance of fraud.

Cash held at premises is kept to a minimum

Cash should be banked regularly.

Cash balances in tills should be emptied regularly

Check all cash lodged intact to bank regularly. All lodgements are authorised. Examine bank reconciliations and ensure regularly performed. Investigate old outstanding items.

Amounts can only be extracted from bank accounts for authorised purposes.

Limited number of authorised signatories. Banking online should have restricted access. Cheques should not be signed in advance. Cheque books should be kept under lock and key.

Cheque book should be reviewed to ensure no cheques are missing and no cheques are signed in advance. Verify that cash payments are arithmetically correct. Direct debits should be consistent and authorised.

Petty cash balances should be counted and checks made that controls are in place over petty cash.

Syllabus C4: Communication on internal control

Syllabus C4a) Discuss the requirements and methods of reporting significant deficiencies in internal control are provided to management and those charged with governance.

Syllabus C4b: Explain, in a format suitable for inclusion in a management letter, significant deficiencies

within an internal control system and provide recommendations for overcoming these deficiencies to

management

Reporting on Internal Controls

Control weaknesses will form part of the letter to management which the auditor provides to the management

The management letter will express the fact that the weaknesses found are not necessarily all weaknesses but just those found by the auditor.

The report will also express that it is for the sole use of management and no disclosure will be made to third parties

The structure of the report will be:

1. Weakness 2. Consequence 3. Recommendation

Significant deficiencies should always be reported to those charged with governance

In the Exam

Often you have to report deficiencies in the form of a management letter in the exam...

So use this structure..

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- **Deficiency**

Clear description of what is wrong

- **Consequence**

What would happen if this is not corrected

Look at this from the client viewpoint - not the audit

So think of costs, time, reputation, lost sales etc

- **Recommendation**

Be specific here - on the actual deficiency in the scenario

Also make sure that the benefit of the recommended action outweighs the cost

Don't just think of what to do, also think of who and when

- A table format is perfect for the exam...

Deficiency Consequence Recommendation

I'm an idiot I will fail my ACCA exam Buy aCOWtancy.com now :)

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Syllabus D: AUDIT EVIDENCE

Syllabus D1: Financial statement assertions and audit evidence

Syllabus D1a) a) Explain the assertions contained in the financial statements about:[2]

(i) Classes of transactions and events and related disclosures;

(ii) Account balances and related disclosures at the period end;

The Assertions Explained

Assertions are used for transactions, balances and disclosures to see if sufficient evidence on them has been collected

The 3 types of figure in the financial statements are:

- Transactions and Events: In general this refers to income statement figures, but will include events such as the purchase of a non current assets.
- Account Balances at the Year End: These will be the items on the statement of financial position.
- Presentation and Disclosure: This is how the financial statements are presented and how items have been disclosed.

Different assertions apply to each of these three areas of the financial statements.

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Transactions and Events - Assertions

- Occurrence: transactions and events that have been recorded have occurred and pertain to the entity.
- Completeness: all transactions and events that should have been recorded have been recorded.
- Accuracy: amounts and other data relating to recorded transactions and events have been recorded appropriately.
- Cut-off: transactions and events have been recorded in the correct accounting period.
- Classification: transactions and events have been recorded in the proper accounts.

Period End Balances - Assertions

- Existence: assets, liabilities and equity interests exist.
- Rights and Obligations: the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- Completeness: all assets, liabilities and equity interests that should have been recorded have been recorded.
- Valuation and Allocation: assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

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Presentation and Disclosure - Assertions

- Occurrence and rights and obligations: disclosed events, transactions and other matters have occurred and pertain to the entity.
- Completeness: all disclosures that should have been disclosed in the financial statements have been included.
- Classification and understandability: financial information is appropriately presented and described, and disclosures are clearly expressed.
- Accuracy and Valuation: financial and other information are disclosed fairly and at appropriate amounts.

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Syllabus D1b) Describe audit procedures to obtain audit evidence , including inspection , observation, external confirmation, recalculation, re-performance, analytical procedures and enquiry

Using Assertions

So the assertions need testing to see if they're true

This is done by

1. Inspection

This means a physical examination

Things to inspect include: documentation, contracts, records and minutes.

It also includes physical examination of the assets.

This enables the auditor to verify the existence (though not ownership) of them

2. Observation

This means watching others perform a procedure

Examples include observation of

Payment of wages

Inventory counts

Opening mail

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It gives assurance that official procedures are followed

3. Inquiry

This means getting information from people inside or outside the entity.

It can be a formal written or an oral inquiry

4. Confirmation

This means corroborating evidence from third parties with the internal evidence

For example, confirming accounts receivables by circularising the debtors

5. Re-Performance

This can be recalculating figures or re-counting stock etc

6. Analytical Procedures

This is the analysis of ratios and trends

It includes investigating fluctuations between current and previous performance and check whether other information is consistent with such relationship.

For example, comparing the rent charge from one period to the next and see if other evidence such as number of rental properties corroborates the increase or decrease

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Syllabus D1c) Discuss the quality and quantity of audit evidence

Quality and Quantity of Evidence

Auditors need sufficient appropriate audit evidence

Sufficient

refers to the quantity of the audit evidence needed

Appropriate

refers to the quality, relevance and reliability of the audit evidence

So how much is sufficient?

Well it depends on how risky the amount being audited is

1. You need enough to have reasonable assurance that the specific audit area is free from material misstatement
2. A high quantity of poor quality evidence does not mean its sufficient (or appropriate)
3. The auditor must consider both the relevance and the reliability of the evidence
4. Be careful though of over auditing.

Lots of high quality evidence on immaterial areas is a waste of resources

So is testing 75% of all records better than testing 25%

- Generally yes.. but be careful... think of the fact you may be over auditing and therefore wasting resources, particularly if the area is low risk and immaterial

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- Also be careful that the sample is representative of the population

What is sufficient and appropriate?

1. It reflects appropriately the level of risk in that specific area
2. Evidence that is generated from external sources is more reliable than evidence gathered from internal records
3. Written evidence is more reliable than oral evidence
4. Auditor-generated evidence is much more reliable than evidence obtained indirectly
5. Where the audit firm concludes that tests of control can be relied upon, evidence from the client's records is a reliable source of evidence

What is NOT 'sufficient and appropriate'

• Invisible Evidence

Ticks on audit programmes that say a procedure has been done, but where there is no evidence of it

Audit programmes should contain a cross-reference to the tangible evidence on file.

• Management Representations ONLY

The use of management representations alone is not sufficient and appropriate audit evidence

It could constitute a limitation on the scope of an audit that might result in the wrong opinion being expressed

Management representations are, again, complementary evidence to other audit evidence in a relevant audit area

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- **Lead schedules**

Eg The Investment Property lead schedule that reconciles the opening fair value to the closing fair value

Lead schedules should be cross-referenced to the audit evidence that supports the relevant figures/disclosures

- **Redundant accounts**

Accounts and trial balances which have been superseded

Particularly where the audit firm is involved in the accounts preparation, these are not sufficient or appropriate audit evidence

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Syllabus D1d) Discuss the relevance and reliability of audit evidence

Relevant evidence will be evidence that relates directly to the assertion being tested – if it doesn't then why is it being used?

Reliable evidence is evidence which the auditor can have faith is trustworthy.

ISA 500 sets out types of evidence which are more reliable than others:

More Reliable

- Better when from independent, external sources
- Better when generated internally but the related controls are effective
- Better when obtained directly by the auditor
- Better when in paper or electronic form rather than just spoken
- Better with original documents than photocopies

Less Reliable

- Evidence generated internally to the entity
- Internal evidence not subject to strong controls
- Indirect or inferred evidence
- Oral
- Photocopies, faxes etc.

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Syllabus D2: Audit procedures

Syllabus D2a) Discuss substantive procedures for obtaining audit evidence

Procedures for obtaining evidence

Just remember A,E,I,O and U

So here's a reminder...

1. Analytical Procedures
2. Enquiry
3. Inspection
4. Observation
5. Re-calcUlation / Re-performance

Procedure Meaning Control test Substantive test

Analytical

procedure

Exploring
relationships
between data

Comparing yearly
gross margins

Enquiry Getting confirmation
from a 3rd party

Replies from a
debtors circular

Inspection Examining records Signature as
evidence

Getting title deeds to
a property

Observation Looking at a process Watching staff
complete their
attendance sheet

Re-calculation Checking

mathematical

accuracy

Adding individual

sales in the sdb to

check the totals

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Syllabus D2b) Discuss and provide examples of how analytical procedures are used as substantive procedures

Analytical procedures

Substantive procedures help detect material misstatement or fraud at the assertion level

There are two categories of substantive procedures - analytical procedures* and tests of detail.

*Analytical procedures generally provide less reliable evidence than the tests of detail
AP's are used at different times in the audit whereas tests of detail are only applied in the substantive testing stage

Analytical procedures are compulsory at two stages of the audit under ISA 520:

1. The planning stage &
2. The review stage

Analytical procedures use calculations such as financial ratios to generate an expectation of what a figure is likely to be and then comparing this to the actual figure in the accounts. They can be used to highlight unusual figures in order to focus the audit on them or to establish that a trend has continued.

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The financial ratios used by the auditor will fall into 3 general categories:

• Profitability/Return

1. Gross Margin
2. Net Margin
3. ROCE

• Liquidity/Efficiency

1. Receivables/Payables/Inventory Days
2. Current Ratio
3. Quick Ratio

• Gearing

1. Financial Gearing
2. Operational Gearing

Whether or not the auditor relies on analytical procedures as substantive procedures depends on four factors:

• Suitability

Analytical procedures will not be suitable for every assertion

• Reliability

The auditor may only rely on data generated from a system with strong controls

• Degree of Precision

Some figures will not have a recognisable trend over time or be comparable

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- **Acceptable Variation**

Variations having an immaterial impact on the financial statements will not hold as much interest to the auditor as those that do

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Syllabus D2c) Discuss the problems associated with the audit and review of accounting estimates.

Auditing Accounting Estimates

The auditor must be sure that the judgements and estimates made by management are sound

Management will have to use an element of judgment in preparing the financial statements in areas such as depreciation rates, deferred tax and provisions.

The problem with auditing estimates is a lack of physical evidence and subjectivity.

The auditor will carry out several procedures on an area of accounting estimate

1. Look at the process employed to calculate the estimate and decide whether it is appropriate
2. Use the work of an expert to ascertain whether an estimate is accurate
3. Check that any items accrued for do occur after the balance sheet date
4. Discuss any points of concern with management to see why they included the item at the amount they did

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Syllabus D2d) Describe why smaller entities may have different control environments and describe the types of evidence likely to be available in smaller entities.

Smaller Entity Evidence

Smaller entities have fewer internal controls

Problems will include:

Segregation of duties often lacking due to not enough staff

Owners often dominate all major aspects of the business

When expanding - management focus on this and not on controls

Record keeping and documentation of systems and controls may be informal or inadequate

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Syllabus D2e) Discuss the difference between tests of control and substantive procedures

Control v Substantive Tests

Remember that the auditor is concerned with the risk of material misstatement in the financial statements

Therefore the auditor will assess each of the areas mentioned before (control environment, control procedures etc.) in order to identify risky areas.

The auditor will then undertake tests of control to establish whether the auditor can place reliance on them

Test of Control

These test the systems in place by determining whether the controls over it are sufficient or not

If the control in place is strong, then the auditor is able to place reliance on the information generated by that particular system

Substantive procedures

These, on the other hand, are procedures to gain direct assurance over a figure in the financial statements.

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Syllabus D3: Audit sampling and other means of testing

Syllabus D3a) Define audit sampling and explain the need for sampling.

Definition & need

As the auditor can't test everything, only samples are used for substantive testing

The tests of controls which we have looked at will establish for the auditor how much reliance he can place that the information generated by the system is free from error.

The results of tests of control will therefore determine how much substantive testing is required (tests performed on individual figures in the financial statements).

The amount of substantive testing undertaken can therefore be varied by using different sample sizes.

This is one of the reasons the auditor cannot give absolute assurance over figures in the financial statements – the audit has been carried out on a sample basis.

ISA 530 states

1. All sampling units should have a chance of selection
2. Testing the sample gives evidence which helps form a conclusion for the whole population
3. Either a statistical or a non-statistical approach can be used

This is telling the auditor that they can use a sample to draw conclusions about some aspect of the transactions (e.g. were they authorised?) rather than looking at every transaction.

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Material items in the population must be tested. This means that 100% of transactions may be tested if they are all material.

The ISA's do not require sampling to be used.

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Syllabus D3b) Identify and discuss the differences between statistical and non-statistical sampling.

Statistical or non-statistical?

Statistical sampling uses random selection to select samples and then assesses the results using probability theory

Statistical sampling

A Random selection using generation of a random number and an interval size to select the items

Extrapolate the error rates e.g. (if half of the sample's wrong then half of the population is too)

Sample has to be sufficiently large to be representative of the population

Auditor can increase the sample size if errors are discovered

Non-statistical sampling

Any method which does not fit into the above is non-statistical sampling

Sometimes known as judgemental sampling

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Syllabus D3c) Discuss and provide relevant examples of, the application of the basic principles of statistical sampling and other selective testing procedures.

Methods of Sampling

Methods of sampling in accordance with ISA 530:

These are

Random selection Ensures each item in a population has an equal chance of selection

Systematic selection A number of sampling units in the population is divided by the sample size to give a sampling interval.

Haphazard selection The auditor selects the sample without following a structured technique – the auditor would avoid any conscious bias or predictability

Sequence or block selection Involves selecting a block(s) of continuous items from within a population

Monetary Unit Sampling selection This selection method ensures that each individual \$1 in the population has an equal chance of being selected

Judgemental selection Selecting items based on the skill and judgement of the auditor

If the auditor would have reached a different conclusion if he had tested the entire population, rather than a sample, this is sampling risk.

Non Sampling Risk is the risk that the auditor comes to an incorrect conclusion for reasons other than the size of the sample used.

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Syllabus D3d) Discuss the results of statistical sampling, including consideration of whether additional testing is required.

Misstatement or deviation

Tolerable misstatement looks at individually immaterial misstatements added together

The smaller the tolerable misstatement or rate of deviation, the greater the required sample size

Expected misstatement or rate of deviation

The higher the expected misstatement or rate of deviation, the greater the required sample size.

Performing audit procedures on the sample

If the auditor cannot use the procedure - then this is a misstatement/deviation

Investigate the nature and cause of any misstatements/deviations

Evaluate their effect

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Syllabus D4: The audit of specific items

Syllabus D4a) Explain the audit objectives and the audit procedures in relation to:

Receivables:

i) direct confirmation of accounts receivable

Receivables - Direct Confirmation

Trade Receivables - Confirmation test

Here the main risks of misstatement are..

- Bad debts (Valuation assertion)
- Doubtful debts (Rights & Existence assertions)
- Cut-off problems

Direct Confirmation

This is often referred to as the "Debtors circularisation".

This means asking customers for written confirmation of their account balance

• Problems with the Debtors Circular

1. Not all customers reply
2. Customers may reply without checking properly

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The Assertions and Receivables

This relationship to assertions is important for the exam!

- Existence - Ensure they really do exist and so not overstated
- Rights and obligations Ensure client has the legal right to the amounts receivable
- Valuation Ensure the receivables are stated at their appropriate amount
- Cut-off Ensure transactions have been recorded in the correct accounting period
- **Key things to be aware of..**

1. The auditor decides which customer gets asked (not the client)
2. Auditor states that the reply comes to her directly
3. Auditor sends out the request personally

• The results of the Circular

Things to watch out for

1. Any doubts over the reliability - perform alternative tests
2. If the response is not reliable for sure - then consider the effect on risk assessment and perform more alternative procedures
3. If no response - perform alternative procedures
4. Client confirms different amount - decide if this is just a timing difference or a problem with controls or fraud
5. Finally consider the results as a whole to see if relevant and reliable

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The process of the circular

This comes in 5 steps

1. Planning
2. Deciding Positive or Negative Confirmation
3. Selecting a Sample
4. What to do when you get the Replies
5. Summarising & Concluding

Planning

• 2 things need to be decided

When to do it (Timing)

Who to include (The sample)

Decide Positive or Negative Confirmation

• Let's look at positive first

1. A positive confirmation request asks the customer to reply to the auditor whether or not he agrees with the balance
2. Method 1 Give him the figure and ask to confirm
3. Method 2 Ask him to provide his balance himself
4. Risk with Method 1 - customer confirms without checking

Risk with Method 2 - Lower response rate from customers

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- **Now let's look at negative confirmations**

This asks the customer to reply only where he disagrees with the balance

- If no reply is received - this means he agrees, however it might also mean he never received or checked
- The evidence from negative confirmation circulars is therefore less reliable
- **So why would an auditor use negative confirmation circulars then???**

Well only when all of the following apply..

1. Misstatement risk is low and controls are strong
2. Population is made up of lots of small items
3. A very low exception rate is expected
4. No evidence that the customer would ignore the request for confirmation

Sample Selection

- **Procedure for selecting the sample is as follows:**

1. Get the aged receivable listing (for the right date!)
2. Check the listing is accurate by:
 - 1) Checking a sample of debtors individual balances to it
 - 2) Check total balance to control account in main ledger
3. Ensure the sample is representative of the population

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- **Certain balances may always be included**

1. Overdue balances
2. Negative balances
3. Accounts on which round sum payments are received (instead of paying the actual invoice amounts)
4. Nil balances
5. All "material" balances

Procedures when getting replies

1. Check the following:

- signed by a responsible official
- replies are filed in the receivables section of the current audit file

2. If the balance agrees?

- No further work required

3. If the balance doesn't agree?

Ask the client to reconcile their balance to the customers

Then check this reconciliation

Look to see if errors are:

- 1) Control errors or
- 2) Just timing differences

If just timing differences then no further work required

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4. No reply received?

These cannot be ignored!!

- They are part of a sample chosen
- So a conclusion needs to be reached
- So alternative procedures must be carried out..

1) Check cash received from customer after

2) Check for signed purchase order

3) Check for signed delivery conformation

4) Check a sales invoice exists

Preparing the summary & Concluding

The summary shows which balances have not been verified

They may indicate the existence of bad debts.

Then conclude on the likely level of misstatement in the total population based on the sample results, and whether this is material.

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*Syllabus D4a) Explain the audit objectives and the audit procedures in relation to:
Receivables:*

*ii) other evidence in relation to receivables
and prepayments*

Receivables - Other Evidence

Bad debts

Ensure that all bad and doubtful debts are reliable

These are the substantive procedures to be used:

1. Review the company's procedures for identifying them
2. Review aged listings of receivables balances (listen to audio)
3. Review correspondence about unpaid debts (with customer / lawyer etc)
4. Review the calculation of doubtful debts
5. Examine credit notes issued after the year-end, this may show some balances were overstated at the year-end
6. Review the replies from customers for the confirmation of balances exercise

Cut-Off

This ensures that revenue (and therefore receivables) are properly recorded in the correct accounting period.

Sales around the year-end need to be shown in the correct year

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Procedures for cut off are as follows:

Analytical procedures looking at inventory amounts, gross margins etc are in line with expectations

Ensure sales invoices and credit notes around the year end are shown in the correct year

Ask for explanations about unusual control account entries around the year end

Presentation & Disclosure**The following procedures help with this assertion:**

1. Receivables ledger balances agrees to the financial statements
2. Receivables are correctly disclosed and classified

Receivables - Prepayments

Prepayments are often estimates and so difficult to audit

Also prepayments are often not material

Here's some substantive tests for prepayments though:

1. Get the list of prepayments and how they are calculated
2. Check the calculations
3. Use analytical procedures (simple comparison to last year)
4. Review for any obvious omissions or errors

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Syllabus D4a) Explain the audit objectives and the audit procedures in relation to:

Receivables:

iii) completeness and occurrence of sale.

Receivables - The Assertions

Receivables and their assertions

Receipts and their assertions

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Syllabus D4b) Explain the audit objectives and the audit procedures in relation to:

Inventory:

i) inventory counting procedures in relation

to year-end and continuous inventory

systems

ii) cut-off testing

iii) auditor's attendance at inventory counting iv) direct confirmation of inventory held by

third parties, v) valuation

vi) other evidence in relation to inventory.

Inventory - and the Assertions

These are the main risks of misstatement for Inventory

Completeness Assertion

- **Not all stock owned is included in accounts**

Existence Assertion

- **Not all stock included in accounts actually exists**

Valuation Assertion

- **Stock is incorrectly valued**

Due to incorrect cost allocation

Not valuing at NRV (if lower than cost)

Rights & Obligation Assertion

- **Not all inventory belongs to the client**

Presentation and disclosure assertion

- **Inventory is incorrectly classified**

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Inventory - The Physical Count

Even sophisticated inventory systems should be backed up by a regular physical stock count

Why do a physical count?

- Easy if small number of locations
- Gives valuable evidence that the inventory actually exists
- Helps check accuracy of inventory records
- If no continuous inventory system it is the **ONLY** way of knowing the quantity
- Discrepancies can help point to control deficiencies (that would otherwise have gone unnoticed)
- Helps to see the condition of the stock

Why should the auditor attend the count?

Well she needs evidence about the existence and condition of inventory

But also...

- Evaluate management's instructions and procedures
- Observe the performance of the procedures
- Inspect the inventory
- Perform tests counts

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Audit work at the Count

• Observe

Is the count being performed according to managements WRITTEN instructions

If any inventory condition is poor

If any inventory not owned by client is identified and labelled as such

How entries in and out of stock are dealt with during the count

If all items have been tagged as counted

• Record

Any differences between their own test count and that of the client..

Test from stock to client records (for completeness)

Test from client records to stock (for existence)

The sequence numbers of the last tags and summary sheets used during the count.

This record will be used after the count to confirm that all inventory items are included in the client's inventory list

Goods received (& despatch) notes issued before and after the count (for cut-off)

Details of slow-moving or obsolete inventory, or inventory in poor condition

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Continuous counting: several counts during the year

It helps avoid the potential disruption of an annual count at the year end of the reporting period

This is acceptable if....

1. Client has a system for maintaining accurate and up-to-date inventory records
2. Every item is counted at least once a year
3. Counting is well organised and controlled
4. Counts are documented and reviewed by management
5. All differences are investigated

Inventory - Possible Count Weaknesses

The auditor should look for the following:

1. No pre-numbering of count sheets
This ensures none are counted twice or lost
2. No "expected" stock amounts on the count sheets
3. No filling in count sheets in pencil
4. Counters are store staff
5. Inventory not tagged after being counted
6. Count sheets not signed by counter
7. Lack of written instructions for the counter

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Inventory - Cut-off

Cut-off affects inventory, cost of sales, sales, payables & receivables.. phew!

Sales Cut-off

Ensure sales are shown in the right period.

It's not just sales that would be wrong otherwise but also receivables and closing inventory (oh yes it would be a jolly wolly mess if we get it wrong)

- Not only that, my little F8 ball of cut-off awesomeness, you need to be careful that the debit entry is not in receivables AND inventory

Purchases Cut-off

This is just as exciting..

All purchases must be shown in the right period too - amazing right?! :)

This will effect inventory also

• Correct Entries

Dr Purchases Cr Payables

Also it will be in closing stock (if not sold)

Dr Inventory (SFP) Cr Cost of Sales

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Audit work

1. Goods received notes

Record the numbers of these around the year end

Those dated before year end - included in Inventory

Those dated after year end - not included in inventory

2. Despatch notes

Record the numbers of these around the year end

Those dated before year end - not included in Inventory

Those dated after year end - included in inventory

Syllabus D4b) Explain the audit objectives and the audit procedures in relation to:

Inventory:

i) inventory counting procedures in relation

to year-end and continuous inventory

systems

ii) cut-off testing

iii) auditor's attendance at inventory counting iv) direct confirmation of inventory held by

third parties, v) valuation

vi) other evidence in relation to inventory.

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Inventory - Valuation

Inventory is valued at the lower of cost and NRV

NRV = Net realisable value

This is basically selling price less cost to sell it. This is normally higher than cost

Sometimes it is not because it is obsolete or in poor condition

This can be checked at the inventory count

Raw Materials / Goods for resale Cost

- **Cost to be Included:**

- Actual cost of the items (plus delivery)

- **Audit Tests**

- Confirm which Inventory method used (FIFO, AVCO etc)
- Check figures to purchase inventories

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Cost of Manufactured goods and WIP

1. Here you need the different elements of cost:

direct materials

direct labour and

production overheads

2. Audit Tests

- **Get breakdown**

of costs of finished and WIP goods

- **Calculations**

Check and recalculate

- **Materials**

check fifo etc and to purchase invoice

- **Labour**

Check pay rates against payroll records

Check hours worked with time records

- **Production overheads**

Ensure only production overheads (not selling or admin)

Ensure overhead absorption rates are based on normal levels of output

- **Work in Progress**

Check the stage of completion, for both materials, labour and overheads

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Net Realisable Value

1. Audit Tests

- **Review Procedures**

for comparing cost to NRV

- **Follow up**

Evidence from:

- 1) Inventory count
- 2) Lots of returns
- 3) Price reductions given to customers

- **Check**

for slow-moving items

- **Review prices**

after year end

- **Ensure**

estimated costs to complete are accurate

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*Syllabus D4c) Explain the audit objectives and the audit procedures in relation to:
Payables and accruals:*

*i) supplier statement reconciliations and
direct confirmation of accounts payable, ii) obtain evidence in relation to payables
and accruals, and
iii) purchases and other expenses.*

Payables - Trade

Payables are usually tested for understatement

Testing for overstatement = Testing for existence

Testing for understatement = Testing for completeness

Testing for completeness is harder because you're looking for something that has not
been recorded

(whereas when testing for existence you can audit something that is there)

Main Risks with Payables

Not all recorded

Cut-off incorrect

Some included that aren't an obligation for the client (rare)

Not properly disclosed

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Substantive Procedures

- Get a list of balances
- Check arithmetical accuracy
- Check total agrees to payables control account
- Check a sample from supplier statements to listing (completeness)
- Definitely choose nil and negative balances
- Definitely choose major suppliers
- Any differences to be reconciled by the client with explanations
- To test completeness further:
 - 1) Check all regular suppliers are in list
 - 2) Compare to P/Y listing
 - 3) Analytical Procedures: Trade payables to purchases ratio

Purchases Cut-off

Goods received before year end - should be shown in inventory and as a liability

Goods received after year end - not shown as a liability

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Payables - Accruals

Accruals balances are difficult to audit as the figures reported are often based on estimates

Although these are often not material - we are checking mainly for completeness

We will use analytical procedures and the auditors knowledge of the business

Substantive Procedures

- Get a listing of accruals
- Check arithmetical accuracy
- Check total agrees to main ledger
- Check payments and invoices after year end for reasonableness
- Compare to last year - review for completeness

Wages accrual

This is often higher than the others

It consists of unpaid wages, overtime, holiday pay & bonuses

Compare to payroll records and post year end payments

Ensure tax is included

Analytical Procedures: Accrual to total payroll ratio

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Syllabus D4d) Explain the audit objectives and the audit procedures in relation to:

Bank and cash:

*i) bank confirmation reports used in
obtaining evidence in relation to bank and
cash*

ii) other evidence in relation to bank and iii) other evidence in relation to cash..

Bank & Cash

Bank balances and cash are easily checked

However, they are at risk from misappropriation and fraud

Hence, they normally have strong internal controls, such as a bank reconciliation from
bank statements to the cash book

Main Risks & Assertions

Rights and obligations and Existence assertions Bank balances not actually owned by the client

Valuation assertion Reconciliation differences incorrectly dealt with

Completeness assertion Material cash balances are omitted

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Confirmation of Bank Balance

Direct confirmation to the auditor from the bank

- Method 1 The auditor gives the balances from the client's accounting records and asks the bank to confirm
- Method 2 The auditor asks for the balance (not giving the bank the balance first)
- **Miscellaneous points about the bank confirmation letter**

Client must give permission to the bank to reply

Should be in a standard format acceptable to the bank

The authorisation could be a standing authority - this must be referred to in the letter

The letter is sent from the auditor (and the reply back to auditor)

• What's in the letter?

Confirmation of:

balances on all bank accounts

any unpaid bank charges

any liens (charges) over clients assets

any client assets held as security

any other bank accounts known but not listed

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- **When auditor receives the reply**

The following work is performed:

Get the bank reconciliation

Check for arithmetical accuracy

Check bank letter against balance used in bank rec

Use letter for other audit areas eg. Bank charges accrual

Check all bank rec items against supporting evidence (eg Unpresented cheques in later bank statements)

Review cashbook and statements for unusual items

Review letter for any other information (eg Loan Security)

Cash Balances - The Count

- The auditor should count cash at all locations at the same time (to prevent moving cash around)
- Counted in the presence of a company official
- A signed receipt from the official, stating the cash returned after the count by the auditor
- Check cash counted to cash records and cash balance in SFP
- See how money advances to employees are accounted for

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Syllabus D4e) Explain the audit objectives and the audit procedures in relation to:

Tangible and intangible non-current assets

i) evidence in relation to non-current assets

and

ii) depreciation

iii) profit/loss on disposal

Non-current Assets - Tangible

There are many things here.. cost, depreciation, additions, disposals and disclosures..hold tight!

Risks & Assertions

Completeness assertion

Assets owned but not included in the FS

Existence assertion

Assets in the FS don't actually exist (already sold or scrapped)

Valuation assertion

Incorrect recording, valuations, or depreciation calculations

Rights and obligations assertion

Assets in the FS not actually controlled by entity

Presentation and disclosure assertion

Incorrect disclosures

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Substantive tests for the Assertions

• Completeness

(Not so important, but test for understatement)

Get the NCA register (showing cost, additions, disposals, revaluations, impairments, depreciation)

Check the opening balances agree to FS P/Y

Check a sample of assets that definitely exist to the register

Check register to ledger balances

• Existence

Important check here for overstatement

Physically inspect a sample from the register

Check the sample assets are in use (and their current condition)

Investigate any assets not physically found

• Valuation

Land and buildings Cost

Check to purchase invoices

Look for directly attributable costs (such as professional fees and delivery).

Check split between land, buildings and equipment

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Equipment and vehicles cost

Check to the purchase invoices

• Depreciation and impairment

Check rate used (type of asset / UEL & RV)

Ensure consistency of method used

Check accumulated depreciation on disposals has been removed correctly

Check depreciation on additions in year is pro-rata

Check for any indicators of impairment

Check arithmetical accuracy

Check any fully depreciated assets are no longer depreciated

Analytical procedures:

Ratio of depreciation to total asset value

Compare totals to P/Y

Confirm adequate insurance cover

• Rights and obligations

Land and buildings

Inspecting legal documents, contracts & agreements

Vehicles

Examine vehicle registration documents

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- **Presentation and disclosure**

Ensure they are correct and clear

Ensure the schedule of tangible NCA agrees to the figures in the FS

Substantive Procedures - Additions & Disposals

- **Additions**

Get a list in your fist and ensure nothing's missed :)

Check authorisation for the additions

Check to total additions in FS

Check to invoice (in company name)

Physically inspect a sample

Ensure includes no items that should be in P&L (revenue items)

- **Disposals**

Get a list in your fist and give it a kiss

Check authorisation of the disposals

Check cost and accumulated depreciation of disposals has been removed

Check calculation of profit/loss on disposal

Check accounting is correct

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Non-current Assets - Intangible

The key assertions here are existence and valuation

The intangibles are:

Goodwill

Intangibles with a market value

Development costs

Goodwill Proforma

FV of consideration 1,000

FV of NCI 400

FV of Net Assets acquired (1200)

Impairment (100)

Goodwill 100

Substantive tests for Goodwill

Check amount paid for the business acquired

Check the reasonableness of the net assets acquired value

Check the goodwill calculation

Check for any impairment indicator (no amortisation for goodwill)

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Substantive tests for Intangibles

Check to purchase invoice

Check amortisation calculation

Check for indicators of impairment

Ensure correct accounting (eg Development costs not research costs)

Payables - Provisions

Ensure the client has distinguished between provisions & contingent liabilities

Provisions Substantive Procedures

1. Get a list of provisions
2. Confirm in line with IAS 37 (obligation, probable, reliable measure)
3. Review changes in the provisions
4. Review the valuation and think of using an expert
5. Review for omissions based Knowledge of industry
6. Compare to P/Y
7. Look at correspondence with lawyers

Contingencies Substantive Procedures

- Understand the management approach to identifying contingencies
- Review board minutes
- Review business journals for industry wide contingencies
- Review legal correspondence and possible direct confirmation from them (letter from management but reply direct to auditor)

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Contingent Assets

To recognise these potential assets - the company must be virtually certain.

Being probable is not enough - that will result in a disclosure only

Disclosures about contingent liabilities and contingent assets

A brief description of the contingent liability/asset

An estimate of its financial effect

An indication of the uncertainties

For contingent liabilities, the possibility of any reimbursement

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Payables - Non-current Liabilities

Non Current Liabilities

Substantive Procedures

- Obtain the list
- This list should show the movement in the year (an amortised cost table basically)
- Check for arithmetical accuracy
- Agree opening balances to last years SFP
- Check new borrowings have been authorised
- Agree loan details with original agreement
- Check all restrictions have been complied with
- Check all payments / receipts to the cashbook
- Recalculate interest expenses / accrual
- Get direct confirmation from lender of outstanding balance
- Check charges on assets have been registered
- Ensure current / non-current split is correct (capital only)
- Review cashbook for large, unusual receipts that may actually be new loans

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*Syllabus D4g) Explain the audit objectives and the audit procedures in relation to:
Share capital, reserves and directors' emoluments:*

i) evidence in relation to share capital, reserves and directors' emoluments

Equity

This is what is generally audited (though depends on company law)

Substantive procedures - Share Capital

Check authorised share capital is consistent with the company's constitution

Check the nominal value of shares issued during the year to supporting documentation

Ensure share issue terms were complied with

Check cash received for shares is properly recorded in the main ledger (not to sales)

Check issued share capital agrees with the register of members/shareholders

Substantive procedures - Reserves

Get a list of movements in reserves

Check their accuracy to supporting documentation

Check no legal requirements have been broken (eg. Improper use of share premium account)

Check dividends have only been taken from a legally distributable reserve (eg NOT share premium) Check authorisation for dividend

Check total dividend = dividend per share x number of shares

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Syllabus D5: Computer-assisted audit techniques

Syllabus D5a) Explain the use of computer-assisted audit techniques in the context of an audit.

Syllabus D5b) Discuss and provide relevant examples of the use of test data and audit software.

Using CAATs

CAATs use a computer to assist the auditor in testing during the audit procedures

There are 2 categories of CAAT:

1. Audit Software
2. Test Data

Audit Software

The auditor may use audit software to run the client data to check for errors

It can be an off-the-shelf software or bespoke for the client.

They can scrutinise large volumes of data, whose results can be investigated further

The software does not, however, replace the need for the auditor's own procedures

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It can do the following:

select a sample using different sampling techniques

check calculations

automate the confirmation letter process

produce reports

follow transactions

Test Data

Another method which may be used by the auditor is the use of test data.

This is really putting a dummy transaction through the system to ensure that controls are working and that calculations are performed correctly

Examples of errors

Codes don't actually exist, e.g. customer, supplier and employee;

Transactions above pre-set limits, e.g. credit limits

Invoices with arithmetical errors

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Auditing around the computer

Meaning the auditor does not audit how the computer works, but rather checks that the inputs generate the expected outputs from the system

This increases audit risk as the auditor cannot tell with certainty whether the internal processes of the system are working correctly

It is very difficult to determine why errors occurred

Also fixing them may need an external expert

Advantages & Disadvantages of CAATs

• Advantages

1. Independently access computer data
2. Test the reliability of client software
3. Increase the accuracy of audit tests
4. Perform audit tests more efficiently

• Disadvantages

1. CAATs can be expensive and time consuming to set up
2. Client permission and cooperation may be difficult to obtain
3. Potential incompatibility with the client's computer system
4. The audit team may not have sufficient IT skills
5. Data may be corrupted or lost during the application of CAATs

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Syllabus D6: The work of others

Syllabus D6a) Discuss why auditors rely on the work of others.

Why Rely on Experts?

ISA 620 deals with the use of the work of an expert by the auditor

The auditor may not have the expertise to make judgements on all aspects of a clients' business and may seek help in the form of an expert.

Examples of this are specialist inventory, property valuation and complex work in progress.

Why rely on experts?

1. Auditors do not have to be experts in everything
2. Often it's effective and efficient to do so
3. They need to where they lack the skills

How much to rely on experts?

Auditor needs to make judgements on:

- Their Independence, Objectivity and Competence

Enquiries:

Competence

Is a member of a recognised professional body?

How long has the expert been a member of the recognised body?

How much experience does the expert have?

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Objectivity

Does the expert have any financial interest in the company?

Does the expert have any personal relationship with any director in the company?

Is the fee paid for the service reasonable and a fair, market based price?

- This is based on their qualifications and their experience
- If an expert in the inventory of the entity being audited is consulted on valuation of inventory, but works for a subsidiary of the entity then the auditor may consider them to be not sufficiently independent

Before any work is performed by the expert the auditor should agree in writing:

1. Nature, scope and objectives
2. Roles and responsibilities
3. Nature of communication
4. Confidentiality of expert

After the work - Auditor ensures it is appropriate

This means considering:

Consistency with other evidence

Any significant assumptions made

The accuracy of source data

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Syllabus D6d) Explain the extent to which reference to the work of others can be made in audit reports.

No reference in the Audit Report

The auditor should make no reference to the use of the work of others in the audit report

It is the auditors' opinion in the report and the work of others is simply one type of evidence that may be used, if sufficient and reliable, to come to that opinion

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Syllabus D6b) Discuss the extent to which external auditors are able to rely on the work of experts, including the work of internal audit.

Why Rely on Internal Audit?

The external auditor must determine whether it is likely to be adequate for the purposes of the audit:

So we look at:

- Whether the internal audit staff are sufficiently independent to retain objectivity
- The qualifications and technical competence of the internal audit staff
- The professionalism of the staff and the standing of internal audit within the organisation
- Are internal audit constrained in any way by management?

If these considerations are fulfilled the auditor may assess the reliability of the work carried out by internal audit by ensuring:

- Internal audit working papers are well documented and have been reviewed
- Evidence gained by internal audit is sufficient and appropriate
- Any conclusions drawn are reasonable and valid
- Management have acted on recommendations made by internal audit

If all of the above is satisfied the auditor may choose to place reliance on some of the work of internal audit.

Remember that although they may use some of the work of internal audit as evidence, the responsibility for the final opinion will always lie with the external auditor.

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Syllabus D6c) Explain the audit considerations relating to entities using service organisations

Using service organisations

Clients won't always perform all of their operations 'in house'

Operations such as payroll or cleaning services may be outsourced to other providers

Is this a good thing for the audit?

It may provide additional independence to the information generated

It makes it more reliable due to the specialist nature of the outsourcing

May therefore cut down on work required to audit it

Why is it maybe a bad thing also?

The outsourcing firms' reliability

More difficult to get evidence from them

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Syllabus D7: Not-for-profit organisations

Syllabus D7a) Apply audit techniques to not-for-profit organisations.

How is the Audit Different?

NFPs have no external shareholders, dividends or profit maximisation objective either

This has potential audit problems:

1. Lack of segregation of duties (small staffing)
2. Unqualified volunteers (poor knowledge of controls)
3. Less formalised systems
4. Donations without audit trail
5. Difficulty in assessing going concern (unpredictability of donations)

Audit Implications

- Value for money audits (see earlier)
- Concentrate on substantive procedures (due to possible weak internal controls)
- Analytical reviews and management representations where little audit trail
- Test larger % of population due to smaller volumes

Reporting

If required by law = Normal audit report

If voluntary = Reflect objective of audit

In either case - follow the accepted structure:

1. Addressee
2. Scope
3. Responsibilities of auditors & managers
4. Work done
5. Opinion
6. Date, name and address of auditor

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Syllabus E: REVIEW AND REPORTING

Syllabus E1: Subsequent events

Syllabus E1a) Explain the purpose of a subsequent events review.

Syllabus E1b) Explain the responsibilities of auditors regarding subsequent events.

Purpose of a Subsequent Events Review

Auditors are responsible for their audit work from Y/E to issuing of FS

This duty is both Active and Passive

And ranges from

- **Active Duty**

Between the Y/E and signing the FS

To search for all material events

- **Passive Duty**

Between the signing and issue date

To act if they become aware of anything that may affect their audit opinion

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Subsequent events are events which occur after the balance sheet date

The auditor must perform a subsequent events review

This involves:

- Review post Y/E management accounts, budgets and cash flow forecast
- Review of post Y/E board minutes
- Review how management assess subsequent events and ask if any have been found
- Obtain a management representation letter confirming this
- Check post Y/E cash received to ensure:
 - 1) Receivables are received and
 - 2) NRV of inventory is as expected

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Syllabus E1c) Discuss the procedures to be undertaken in performing a subsequent events review.

Subsequents Events

Subsequent events are events which occur after the balance sheet date that may have an effect on the financial statements.

The auditor is required under ISA 560 to perform a subsequent events review. The types of procedure this entails are:

- Review of post year end management accounts, budgets and cash flow forecasts.
- Review of post year end board minutes.
- Review of management procedures for assessing subsequent events and enquiry as whether any have been found.
- Obtaining a management representation letter confirming this.
- Check post year-end cash received to ensure receivables are received and net realisable value of inventory.

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Subsequent events discovered can be adjusting or non-adjusting

The basic difference is..

(and yes I know it's obvious you amooooosing monkey head, but I don't make this syllabus up!)

Adjusting

Events which require the FS to be adjusted to provide a 'true and fair view'

Non-Adjusting

Events which do not require the FS to be adjusted to provide a 'true and fair view'

Adjusting Events

1. These provide additional evidence relating to conditions existing at the balance sheet date
2. An example is:

Inventory sold after the year end below cost

This provides evidence that the valuation of inventory at the Y/E was incorrect.

3. The financial statements should be adjusted

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Non-Adjusting Events

1. These are events which are not adjusting :)))

2. An example of a non-adjusting event is:

A fire which destroys inventory after the balance sheet date

This does not provide evidence of conditions existing at the Y/E, but will still need disclosing (not adjusting) if material

3. These events should be disclosed in the financial statements

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Syllabus E2: Going concern

Syllabus E2a) Define and discuss the significance of the concept of going concern.

The concept of going concern

FS are prepared on a going concern basis unless inappropriate to do so

Going concern is defined under IAS 1 as the assumption that the company will continue
in operational existence for the foreseeable future

Some Key Issues:

1. Foreseeable Future

This isn't defined :(

but is generally accepted to be at least one year into the future
and further if specific business reasons make it appropriate

2. Use of Judgement

GC involves the use of judgement on the basis of the information available at the
time

3. Break up basis

This is when GC basis is not appropriate

This values assets at their sale value and inventory at NRV

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Syllabus E2b) Explain the importance of and the need for going concern reviews.

The auditor must be satisfied that the going concern assumption is reasonable because it will affect their opinion as to whether the financial statements present a 'true and fair view'.

If the auditor gave the opinion that the financial statements represented a true and fair view without considering the going concern assumption and the business went bust shortly after, the auditor may be held to account.

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Syllabus E2c) Explain the respective responsibilities of auditors and management regarding going concern.

Director's Responsibility

- **They must assess going concern**

As it is the directors' responsibility to produce the financial statements, they must assess going concern in the course of doing this.

- **They should use a suitable basis on which to base the going concern**

The directors should have a suitable basis on which to base the going concern assumption using information on sources of finance, future profitability and repayment of debt.

- **Disclosure**

If the directors have any material uncertainties as to the going concern of the business they must disclose them in the financial statements.

Auditors Responsibility

- They must assess the appropriateness of the going concern assumption

Under ISA 570 it is the auditors' responsibility to assess the appropriateness of the going concern assumption.

- If there are going concern issues, the auditor must ensure that sufficient disclosures are made

Management Responsibility Assess if can carry on for foreseeable future

At least 12 months

Auditor Responsibility Decide if management are right to use going concern status

Should uncertainties be disclosed

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Syllabus E2d) Identify and explain potential indicators that an entity is not a going concern.

Indicators of Going Concern

- Technology changes in the industry
- Suppliers unwilling to provide credit terms
- Banks withdrawing loan facilities
- Management plans for risky diversification
- Cash-flow problems post year end or large cash outflows
- Deterioration in key ratios
- Loss of Key staff
- Legal action against the company
- Late payment of staff salaries, PAYE payments, VAT or supplier invoices
- Sales of major assets without prior warning
- Loss of key customer or supplier

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Syllabus E2e) Discuss the procedures to be applied in performing going concern reviews.

The auditor will undertake a number of procedures in the going concern review:

- Look at the economic conditions of the industry at that time
- Contact providers of finance to check they're happy to continue
- Assess management intentions for the future
- Review post Y/E cash flow statements, management accounts and budgets
- Review management assumptions - are they reasonable
- Conduct analytical review of the FS to check for worsening performance
- Review correspondence with solicitors to ensure no likely actions or cases
- Review correspondence with banks to provide evidence of continued good relations

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Syllabus E2f) Discuss the disclosure requirements in relation to going concern issues.
and

Syllabus E2g) Discuss the reporting implications of the findings of going concern reviews.

Going Concern Disclosures and Reporting

If the going concern basis is appropriate for the financial statements then the auditors do not need to mention it in their report.

If the auditor decides that the going concern basis is inappropriate then they will qualify the audit report unless management agree to alter the financial statements as they do not give a true and fair view.

If the auditor decides that the going concern disclosures are insufficient then they will qualify the audit report unless management agree to alter the disclosures as they do not give a true and fair view.

If the financial statements are prepared on any other basis other than going concern, even if that basis is appropriate, the auditor will refer to it in their report in an 'emphasis of matter' paragraph.

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Syllabus E3: Written representations

Syllabus E3a) Explain the purpose of and procedure for obtaining written representations.

Management Representations

The auditor may ask management to confirm in writing matters which have arisen during the audit

The ISAs require the auditor to obtain management representations on certain specific issues

Such circumstances may be:

For example

auditor is unable to obtain sufficient appropriate evidence to confirm a balance because the evidence does not exist

(usually an accounting estimate or matter of judgement)

The form of the representations will be one of:

1. Signed Letter on client headed paper
2. Letter from auditors signed and returned
3. Minutes of meeting where issues agreed signed by both parties

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What goes into the letter?

Management confirm...

1. No material management or employee irregularities
2. All books & documents have been made available to the auditors
3. Related parties' disclosures are complete
4. FS are free from material misstatements including omissions
5. No non-compliance with regulations
6. No plans to abandon any product lines causing obsolete inventory
7. No further post reporting period events needing disclosure

The whole idea of getting a management letter is to ensure evidence is sufficient

In some ways - the idea is that if management are going to lie to us - then better they lie to us in writing! This saves us a little in auditor negligence cases

But always remember management representations **ONLY** are never sufficient - always back up with other evidence

How to Obtain the Letter

4 Steps

1. Auditor lists the areas we need representations on
2. Auditor prepares the representation & sends it to management
3. Management review & sign
4. Auditor files it in the working papers

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Syllabus E3b) Discuss the quality and reliability of written representations as audit evidence.

Management representations are not independent evidence and therefore will not be 100% reliable.

The auditor must make a judgement as to whether the management are competent and of sufficient integrity so as to place reliance on their representations.

The auditor may also consider whether conditions are such that management may feel under pressure and thus more susceptible to concealing the truth.

Reliability of the Representation

Potential Problems

1. Management Integrity Issues

One extreme is to resign but at least modify the audit opinion to explain the reliability issue of their representation

2. Representations inconsistent with other evidence

Modify the report and explain the inconsistency

3. Representations not reliable

Possibly a disclaimer of opinion here

4. Representation not provided

Discuss with management and reassess integrity of other evidence and consider modifying report

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Syllabus E3c) Discuss the circumstances where written representations are necessary and the matters on which representations are commonly obtained.

Written representations should be obtained for:

- 1) Management fulfilment of responsibilities (used an applicable FR framework, given the auditor ALL relevant info; ALL transactions recorded)
- 2) Supporting other evidence if deemed needed by the auditor

So when would a written representation commonly be needed to support other evidence?

This is basically when other forms of evidence just aren't available e.g.

- Plans and intentions (which may affect the FS)
- Values with high judgement (Provisions)
- Any directors judgements (asset values)
- Compliance with laws and regulations

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Syllabus E4: Audit finalisation and the final review

Syllabus E4a) Discuss the importance of the overall review in ensuring that sufficient, appropriate evidence has been obtained.

Final Review

This ensures the audit was effective and to a quality standard

ISA 220 sets out that the quality review should consider the planning, supervision and review of the audit in determining whether quality standards have been met.

During the audit it is likely that the auditor will come across errors in the financial statements.

The auditor should keep a list of these throughout the audit and report them to management

The 4 Reviews

1. Engagement Partner Review

Main focus here is Quality Control

It is a review of the audit work - not the evidence - so just ensuring proper standards and procedures followed

- Proper Direction & Supervision was given
- Reviews were carried out throughout
- Consultation where needed occurred (with internal and external people)
- Quality control review

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2. Quality Control Review

Carried out by a senior NOT involved in the audit

Ensure opinion is based on evidence obtained

Ensure independence of team

Ensure documentation reflects the work performed

3. Documentation Review

Evidence that independence issues have been considered

Quality Control Review

4. Audit Evidence Review

Ensure there is sufficient and appropriate evidence

Has the audit strategy and plan been followed?

Has the work been carried out to standards?

Has consultation taken place where needed?

Has a memo been produced with points to be considered on next year's audit?

Is there evidence of review at all levels?

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Syllabus E4b) Describe procedures an auditor should perform in conducting their overall review of financial statements.

Overall review of financial statements

Procedures an auditor should perform include:

1. Reviewing compliance with IFRS and local legislation disclosure
2. Reviewing accounting policy disclosure - checking they agree with the accounting treatment adopted and are sufficiently disclosed
3. Reviewing consistency of FS with the auditor's knowledge of the business and the results of their audit work
4. Perform analytical procedures
5. Reviewing the aggregate of uncorrected misstatements to assess whether in aggregate a material misstatement arises
6. Assess whether the audit evidence gathered by the team is sufficient and appropriate to support the audit opinion

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Syllabus E4c) Explain the significance of uncorrected misstatements.

Syllabus E4d) Evaluate the effect of dealing with uncorrected misstatements.

Evaluation of Misstatements

Material Misstatements normally lead to qualifying the audit report

Misstatements aren't just monetary figures, they could also be incorrect classification or disclosures

Evaluating Misstatements

1. Get a list of misstatements found
2. Discuss these with management at the end of the audit
3. Management will normally correct these
4. Any remaining material misstatements will cause the auditor to qualify the report

Aggregation of Immaterial Errors

- Immaterial errors could aggregate to become material
- These will be brought to the attention of management
- If management amend material errors, then the auditor will issue an unqualified audit report
- If management refuse to adjust the errors then the auditor must persuade them to do so or issue a qualified audit report

All misstatements found must be communicated to those charged with governance

This is to ensure that no management bias exists in the decision taken on what constitutes an 'immaterial misstatement'

Management must also provide written representations that all uncorrected errors are immaterial

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Syllabus E5: Audit reports

Syllabus E5a) Identify and describe the basic elements contained in the independent auditor's report

Syllabus E5b) Explain unmodified audit opinions in the auditor's report.

Structure of an Unmodified Audit Report

ISA 700 sets out the elements of an audit report:

The headings are as follows..

1. Title

Identifies the report as an 'Independent Auditors Report'

2. Addressee

The shareholders i.e. for whom the report is produced.

3. Statement of responsibilities of Management

Management have prepared financial statements in accordance with GAAP and representing a true and fair view.

Application of accounting policies and estimates as well as responsibilities for systems and controls

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4. Statement of responsibilities of Auditor

The audit was planned and assessed the risk of material misstatement considering internal controls and obtaining sufficient appropriate evidence
That the auditor will express an opinion

5. Scope Paragraph

Standards under which the audit was conducted, the processes and the test basis as well as the appropriateness of policies and disclosures

6. Opinion

Do the statements present a true and fair view? Are they prepared according to applicable GAAP and legislation?

7. Auditors signature

Auditor or firm is registered and authorised to conduct the audit.

8. Date of the Report

Signed after approved by directors – on the same day.

9. Auditors address

Liability disclaimer paragraph

It is not a requirement of auditing standards but it has become increasingly common for audit firms to include a disclaimer paragraph within the audit report.

It states the fact that the auditor's report is intended solely for the use of the company's member, and that no responsibility is accepted or assumed to third parties.

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1. Advantages:

- Potential to limit liability exposure
- Clarifies extent of auditor's responsibility
- Reduces expectation gap
- Manages audit firm's risk exposure

2. Disadvantages:

- Each legal case assessed individually – no evidence that a disclaimer would offer protection in all cases
- May lead to reduction in audit quality

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Syllabus E5c) Explain modified audit opinions in the audit report.

Audit Opinion

Modified Audit Reports

If the auditor disagrees with some aspect of the financial statements or is unable to state that they provide a true and fair view, then a modified audit report will be issued

There are two types of modified audit report:

1. An unqualified audit report with an 'emphasis of matter paragraph'
2. A qualified audit report

Emphasis of matter

- If the auditor wishes to draw attention to a particular matter, but agrees with the financial statements an 'emphasis of matter' paragraph will be included in the audit report.
- The matter referred to will be fully disclosed in the accounts and the auditor is simply drawing the users' attention to it.
- The paragraph will make it clear that the opinion is not qualified and will be given a separate heading after the opinion paragraph.

Qualified Reports

There are two reasons that an auditor may qualify an audit report:

1. Disagreement
2. Insufficient Evidence

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Disagreement

A qualified report for the reason of disagreement will be issued if the auditor disagrees with the application of accounting policies, the policies used, treatment of a particular item or the adequacy of disclosures

- The disagreement can be either:

Material or

Material & Pervasive

- **A material disagreement - "Except for" Paragraph**

This will mean that the auditor agrees with the rest of the financial statements, but disagrees with that particular element of them.

“Except for” paragraph

In this situation the auditor will qualify the audit with an ‘except for’ paragraph i.e. In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and fair view,

- **Material and Pervasive - Adverse Opinion**

A disagreement which is material and pervasive is of such significance that the financial statements do not give a true and fair view.

Adverse opinion

In such a situation an adverse opinion is issued i.e. the financial statements do not give a true and fair view.

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Insufficient Evidence

If the auditor is unable to form an opinion, then the report will be qualified for Insufficient Evidence

Insufficient Evidence will be due to being unable to obtain sufficient evidence which should have been available.

- The insufficient evidence can be either:

Material or

Material & Pervasive

- **Material - "Except for" paragraph**

A material insufficient evidence will mean that the auditor agrees with the rest of the financial statements, but is unable to agree with that particular element of them

“Except for” Paragraph

In this situation the auditor will qualify the audit with an ‘except for’ paragraph i.e. In our opinion, except for the matter referred to in the preceding paragraph, the financial statements give a true and fair view

- **Material & Pervasive - Disclaimer of opinion**

Insufficient evidence which is material and pervasive is of such significance that auditor is unable to state whether the financial statements give a true and fair view

Disclaimer of Opinion

In such a situation a disclaimer of opinion is issued i.e. the auditors do not express an opinion on the financial statements

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Syllabus E5d) Describe the format and content of emphasis of matter and other matter paragraphs.

EOM and Other Matter Compared

There are 2 types of modified but not qualified reports..

Emphasis of Matter

This refers specifically to matters in the FS

Other Matters

This refers to anything else the auditor may wish to bring to the users attention

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