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P7 INT Study Text
Advanced Audit and Assurance

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Paper P7 (INT)

Advanced audit and assurance (International)

Welcome to Emile Woolf's study text for
Paper P7 *Advanced Audit and Assurance (International)*
which is:

- Written by tutors
- Comprehensive but concise
- In simple English
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Syllabus and study guide

Aim

To analyse, evaluate and conclude on the assurance engagement and other audit and assurance issues in the context of best practice and current developments.

Main capabilities

On successful completion of this examination candidates should be able to:

A Recognise the legal and regulatory environment and its impact on audit and assurance practice

B Demonstrate the ability to work effectively on an assurance or other service engagement within a professional and ethical framework

C Assess and recommend appropriate quality control policies and procedures in practice management and recognising the auditor's position in relation to the acceptance and retention of professional appointments

D Identify and formulate the work required to meet the objectives of audit and non-audit assignments and apply the International Standards on Auditing

E Evaluate findings and the results of work performed and draft suitable reports on assignments

F Understand the current issues and developments relating to the provision of audit-related and assurance service

Rationale

The Advanced Audit and Assurance syllabus is essentially divided into six areas.

The syllabus starts with the legal and regulatory environment including money laundering, and procedures in practice management, including quality control and the acceptance and retention of professional engagements. This then leads into professional and ethical considerations, including the Code of Ethics and professional liability.

The syllabus then covers various assignments, including an audit of financial statements, audit-related services, and other assurance assignments, as well as the reporting of these assignments.

The final section covers current issues and developments relating to the provision of audit-related and assurance services.

Syllabus

A Regulatory Environment

1 International regulatory frameworks for audit and assurance services
2 Money laundering
3 Laws and regulations

B Professional and Ethical Considerations

1 Code of Ethics for Professional Accountants
2 Fraud and error
3 Professional liability

C Practice Management

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2 Advertising, publicity, obtaining professional work and fees
3 Tendering
4 Professional appointments

D Assignments

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   (ii) Evidence
   (iii) Evaluation and review
2 Group audits
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5 Prospective financial information
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E Reporting

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2 Reports to management
3 Other reports

F Current Issues and Developments

1 Professional, ethical and corporate governance
2 Information technology
3 Transnational audits
4 Social and environmental auditing
5 Other current issues

Approach to examining the syllabus

The examination is a three hour paper constructed in two sections. Questions in both sections will be almost entirely discursive. However, candidates will be expected, for example, to be able to assess materiality and calculate relevant ratios where appropriate.

Section A questions will be based on 'case study' type questions. That is not to say that they will be particularly long, rather that they will provide a setting within a range of topics, issues and requirements can be addressed. Different types of question will be encountered in Section B and will tend to be more focussed on specific topics, for example 'auditor's reports', 'quality control' and topics of ISAs which are not examinable in Paper F8, *Audit and Assurance*. (This does not preclude these topics from appearing in Section A). Current issues will be examined across a number of questions.

		Number of marks
Section A	2 compulsory questions	50-70
Section B	Choice of 2 from 3 questions	30-50
		100

Study guide

This study guide provides more detailed guidance on the syllabus. You should use this as the basis of your studies.

A Regulatory environment

1 International regulatory frameworks for audit and assurance services

(a) Explain the need for laws, regulations, standards and other guidance relating to audit, assurance and related services.

(b) Outline and explain the need for the legal and professional framework including:

(i) the international standard-setting process

(ii) the authority of national and international standards

(iii) public oversight and principles of corporate governance

(iv) the role of audit committees.

(c) Discuss the effectiveness of the different ways in which the auditing profession and audit markets are regulated.

2 Money laundering

(a) Define 'money laundering'.

(b) Explain how international efforts seek to combat money laundering.

(c) Explain the scope of criminal offences of money laundering and how professional accountants may be protected from criminal and civil liability.

(d) Explain the need for ethical guidance in this area.

(e) Describe how accountants meet their obligations to help prevent and detect money laundering including record keeping and reporting of suspicion to the appropriate regulatory body.

(f) Explain the importance of customer due diligence (CDD).

(g) Recognise potentially suspicious transactions and assess their impact on reporting duties.

(h) Describe, with reasons, the basic elements of an anti-money laundering program.

3 Laws and regulations

(a) Compare and contrast the respective responsibilities of management and auditors concerning compliance with laws and regulations in an audit of financial statements.

(b) Describe the auditors considerations of compliance with laws and regulations and plan audit procedures when possible non-compliance is discovered.

(c) Discuss how and to whom non-compliance should be reported.

(d) Recognise when withdrawal from an engagement is necessary.

B Professional and ethical considerations

1 Code of Ethics for Professional Accountants

(a) Explain the Fundamental Principles and the conceptual framework approach.

(b) Identify, evaluate and respond to threats to compliance with the fundamental principles.

(c) Discuss and evaluate the effectiveness of available safeguards.

(d) Recognise and advise on conflicts in the application of fundamental principles.

2 Fraud and error

(a) Define and clearly distinguish between the terms 'error', 'irregularity', 'fraud' and 'misstatement'.

(b) Compare and contrast the respective responsibilities of management and auditors for fraud and error.

(c) Describe the matters to be considered and procedures to be carried out to investigate actual and/or potential misstatements in a given situation.

(d) Explain how, why, when and to whom fraud and error should be reported and the circumstances in which an auditor should withdraw from an engagement.

(e) Discuss the current and possible future role of auditors in preventing, detecting and reporting error and fraud.

3 Professional liability

(a) Recognise circumstances in which professional accountants may have legal liability.

(b) Describe the factors to determine whether or not an auditor is negligent in given situations.

(c) Explain the other criteria for legal liability to be recognised (including 'due professional care' and 'proximity') and apply them to given situations.

(d) Compare and contrast liability to client with liability to third parties.

(e) Comment on precedents of case law.

(f) Evaluate the practicability and effectiveness of ways in which liability may be restricted, including professional indemnity insurance (PII).

(g) Discuss how audit and other opinions may be affected by limiting auditors' liability.

(h) Discuss the advantages and disadvantages of claims against auditors being settled out of court.

(i) Discuss and appraise the principal causes of audit failure and other factors that contribute to the 'expectation gap' (e.g. responsibilities for fraud and error).

(j) Recommend ways in which the expectation gap might be bridged.

C Practice management

1 Quality control

(a) Explain the principles and purpose of quality control of audit and other assurance engagements.

(b) Describe the elements of a system of quality control relevant to a given firm.

(c) Select and justify quality control procedures that are applicable to a given audit engagement.

(d) Assess whether an engagement has been performed in accordance with professional standards and whether reports issued are appropriate in the circumstances.

2 Advertising, publicity, obtaining professional work and fees

(a) Explain the need for guidance in these areas.

(b) Recognise situations in which specified advertisements are acceptable.

(c) Discuss the restrictions on practice descriptions, the use of the ACCA logo and the names of practising firms.

(d) Discuss the extent to which reference to fees may be made in promotional material.

(e) Outline the determinants of fee-setting and justify the bases on which fees and commissions may and may not be charged for services.

(f) Discuss the ethical and other professional problems involved in establishing and negotiating fees for a specified assignment.

3 Tendering

(a) Discuss the reasons why entities change their auditors/professional accountants.

(b) Recognise and explain the matters to be considered when a firm is invited to submit a proposal or fee quote for an audit or other professional engagement.

(c) Identify the information required for a proposal.

(d) Prepare the content of an engagement proposal document.

(e) Discuss and appraise the criteria that might be used to evaluate tenders received from audit firms in a given situation.

(f) Discuss reasons why audit fees may be lowered from the previous year's fees.

(g) Explain 'lowballing' and discuss whether or not it impairs independence.

4 Professional appointments

(a) Explain the matters to be considered and the procedures that an audit firm/professional accountant should carry out before accepting a specified new client/engagement including:

(i) client acceptance

(ii) engagement acceptance

(iii) agreeing the terms of engagement.

(b) Recognise the key issues that underlie the agreement of the scope and terms of an engagement with a client.

(c) Outline the procedures for the transfer of books, papers and information following a new appointment.

D Assignments

1 The audit of historical financial information

(a) Describe the key features of the following audit methodologies:

(i) risk-based auditing

(ii) 'top down' approach

(iii) systems audit

(iv) balance sheet approach

(v) transaction cycle approach

(vi) directional testing.

(b) Justify an appropriate approach to a given assignment and recognise when an approach is unsuitable.

1(i) Planning, materiality and assessing the risk of misstatement

(a) Specify the matters that should be considered in planning a given assignment including:

(i) logistics (e.g. staff and client management, multiple locations, deadlines)

(ii) use of IT in administration

(iii) time budgets

(iv) assignment objectives and reports required

(v) client interface (e.g. communication methods)

(vi) preliminary materiality assessment

(vii) key financial statement risks

(viii) an overall audit strategy.

(b) Define materiality and demonstrate how it should be applied in financial reporting and auditing.

(c) Apply the criteria that determine whether or not a matter is material and discuss the use and limitations of prescriptive rules in making decisions about materiality.

(d) Identify and explain business risks in given situations.

(e) Describe the factors that influence the assessment of a specified risk (e.g. inherent risk, financial statement risk) for a given assignment.

(f) Explain how and why the assessments of risks and materiality affect the nature, timing and extent of auditing procedures in a given situation.

(g) Select and apply appropriate risk assessment procedures, including analytical procedures, to obtain an understanding of a given entity and its environment.

(h) Assess the risk of misstatement at the financial statement level and assertion level and design audit procedures in response to assessed risks.

(i) Recognise and assess the implications of a specified computer system (e.g. network) on an assignment.

1(ii) Evidence

(a) Evaluate the appropriateness and sufficiency of different sources of audit evidence and the procedures by which evidence may be obtained including:

- (i) analytical procedures
- (ii) management representations
- (iii) the work of others
- (iv) audit sampling
- (v) external confirmations
- (vi) audit automation tools.

(b) Specify audit procedures to obtain sufficient audit evidence from identified sources.

(c) Apply the criteria for assessing the extent to which reliance can be placed on substantive analytical procedures and recognise situations in which analytical procedures may be used extensively.

(d) Apply analytical procedures to financial and non-financial data.

(e) Identify and evaluate the audit evidence expected to be available to:

- (i) verify specific assets, liabilities, transactions and events; and
- (ii) support financial statement assertions and accounting treatments (including fair values).

(f) Explain the reasons for preparing and retaining documentation and the importance of reviewing working papers.

(g) Explain the specific audit problems and procedures concerning related parties and related party transactions.

(h) Recognise circumstances that may indicate the existence of unidentified related parties and select appropriate audit procedures.

(i) Demonstrate the use of written management representations as the primary source of audit evidence and as complementary audit evidence.

(j) Discuss the implications of contradictory evidence being discovered.

(k) Recognise when it is justifiable to place reliance on the work of an expert (e.g. a surveyor employed by the audit client).

(l) Assess the appropriateness and sufficiency of the work of internal auditors and the extent to which reliance can be placed on it.

1(iii) Evaluation and review

(a) Explain review procedures (including the use of analytical procedures and checklists) and assess their role in detecting material misstatements.

(b) Evaluate findings quantitatively and qualitatively, e.g:

   (i) the results of audit tests and procedures

   (ii) the effect of actual and potential misstatements.

(c) Compare and contrast how the auditor's responsibilities for corresponding figures, comparative financial statements, 'other information', subsequent events and going concern are discharged.

(d) Apply the further considerations and audit procedures relevant to initial engagements.

(e) Discuss the courses of action available to an auditor if a material inconsistency or misstatement of fact exists.

(f) Specify audit procedures designed to identify subsequent events that may require adjustment to, or disclosure in, the financial statements of a given entity.

(g) List indicators that the going concern basis may be in doubt and recognise mitigating factors.

(h) Evaluate the evidence that might be expected to be available and assess the appropriateness of the going concern basis in given situations.

(i) Assess the adequacy of disclosures in financial statements relating to going concern and explain the implications for the auditor's report with regard to the going concern basis.

(j) Evaluate the matters (e.g. materiality, risk, relevant accounting standards, audit evidence) relating to:

   (i) inventory

   (ii) standard costing systems

   (iii) statements of cash flows

   (iv) changes in accounting policy

   (v) construction contracts

   (vi) taxation

   (vii) segment information

   (viii) non-current assets

   (ix) fair value

   (x) leases

   (xi) revenue recognition

   (xii) employee benefits

   (xiii) government grants and assistance

(xiv) borrowing costs
(xv) related parties
(xvi) earnings per share
(xvii) impairment
(xviii) provisions, contingent liabilities and contingent assets
(xix) goodwill
(xx) brands
(xxi) research and development
(xxii) other intangible assets
(xxiii) capital instruments
(xxiv) financial instruments
(xxv) investment properties
(xxvi) transition to International Financial Reporting Standards (IFRS)
(xxvii) share-based payment transactions
(xxviii) business combinations
(xxix) discontinued operations
(xxx) held for sale non-current assets

2 Group audits

(a) Recognise the specific matters to be considered before accepting appointment as principal auditor to a group in a given situation.

(b) Compare and contrast the organisation, planning, management and administration issues specific to group audits with those of joint audits.

(c) Recognise the specific audit problems and describe audit procedures in a given situation relating to:

(i) the correct classification of investments
(ii) differing accounting policies and frameworks
(iii) fair values on acquisition
(iv) intangibles
(v) taxation
(vi) goodwill on consolidation
(vii) intra-group balances, transactions and profits
(viii) related parties
(ix) events after the reporting period
(x) entities in developing countries.

(d) Discuss letters of support ('comfort letters') as audit evidence.

(e) Identify and describe the matters to be considered and the procedures to be performed when a principal auditor uses the work of other auditors in a given situation.

(f) Explain the implications for the auditor's report on the financial statements of an entity where the opinion on a component is qualified or otherwise modified in a given situation.

3 Audit-related services

(a) Describe the nature of audit-related services, the circumstances in which they might be required and the comparative levels of assurance provided by professional accountants.

(b) Distinguish between:

(i) audit-related services and an audit of historical financial statements

(ii) an attestation engagement and a direct reporting engagement.

(c) Plan review engagements, for example:

(i) a review of interim financial information

(ii) a 'due diligence' assignment (when acquiring a company, business or other assets).

(d) Explain the importance of enquiry and analytical procedures in review engagements and apply these procedures.

(e) Describe and apply the general principles and procedures relating to a compilation engagement (e.g. to prepare financial statements).

(f) Explain why agreed-upon procedures and compilation engagements do not (usually) meet the requirements for an assurance engagement.

(g) Illustrate the form and content of:

(i) a report of factual findings

(ii) a compilation report.

4 Assurance services

(a) Describe the main categories of assurance services that audit firms can provide and assess the benefits of providing these services to management and external users:

(i) risk assessments

(ii) business performance measurement

(iii) systems reliability

(iv) electronic commerce.

(b) Justify a level of assurance (reasonable, high, moderate, limited, negative) for an engagement depending on the subject matter evaluated, the criteria used, the procedures applied and the quality and quantity of evidence obtained.

(c) Recognise the ways in which different types of risk (e.g. strategic, operating, information) may be identified and analysed and assess how management should respond to risk.

(d) Recommend operational measures and describe how the reliability of performance information systems is assessed (including benchmarking).

(e) Describe a value for money audit and recommend measures of economy, efficiency and effectiveness.

(f) Explain the demand for reliable and more timely reporting on financial information and the development of continuous auditing.

(g) Select procedures for assessing internal control effectiveness.

(h) Describe how entities are using core technologies (e.g. EDI, e-mail, Internet, World Wide Web) and explain how e-commerce affects the business risk of a given entity.

5 Prospective financial information

(a) Define 'prospective financial information' (PFI) and distinguish between a 'forecast', a 'projection', a 'hypothetical illustration' and a 'target'.

(b) Explain the principles of useful PFI.

(c) Identify and describe the matters to be considered before accepting a specified engagement to report on PFI.

(d) Discuss the level of assurance that the auditor may provide and explain the other factors to be considered in determining the nature, timing and extent of examination procedures.

(e) Describe examination procedures to verify forecasts and projections relating to:

- (i) revenue
- (ii) capital expenditure
- (iii) revenue expenditure
- (iv) profits
- (v) cash flows
- (vi) working capital.

(f) Compare the content of a report on an examination of PFI with reports made in providing audit-related services.

6 Forensic audits

(a) Define the terms 'forensic accounting', 'forensic investigation' and 'forensic audit'.

(b) Describe the major applications of forensic auditing (e.g. fraud, negligence, insurance claims) and analyse the role of the forensic auditor as an expert witness.

(c) Apply the fundamental ethical principles to professional accountants engaged in forensic audit assignments.

(d) Select investigative procedures and evaluate evidence appropriate to determining the loss in a given situation.

(e) Explain the terms under which experts make reports.

7 Internal audit

(a) Compare the objectives and principal characteristics of internal audit with other assurance engagements.

(b) Compare and contrast operational and compliance audits.

(c) Justify a suitable approach (e.g. cyclical compliance) to specified multi-site operations.

(d) Discuss outsourcing internal auditing services.

8 Outsourcing

(a) Explain the different approaches to 'outsourcing' and compare with 'insourcing'.

(b) Discuss and conclude on the advantages and disadvantages of outsourcing finance and accounting functions including:

  (i) data (transaction) processing

  (ii) pensions

  (iii) information technology (IT)

  (iv) internal auditing

  (v) due diligence work

  (vi) taxes.

(c) Recognise and evaluate the impact of outsourced functions on the conduct of an audit.

E Reporting

1 Auditor's reports

(a) Critically appraise the form and content of a standard unmodified auditor's report.

(b) Recognise and evaluate the factors to be taken into account when forming an audit opinion in a given situation.

(c) Justify audit opinions that are consistent with the results of audit procedures relating to the sufficiency of audit evidence and/or compliance with accounting standards (including the going concern basis).

(d) Draft extracts suitable for inclusion in an audit report.

(e) Discuss the implications for the auditor's report on financial statements that report compliance with IFRSs.

(f) Assess whether or not a proposed audit opinion is appropriate.

(g) Discuss 'a true and fair view'.

(h) Describe special purpose auditors' reports (e.g. on summarised financial statements) and analyse how and why they differ from an auditor's report on historical financial information.

2 Reports to management

(a) Draft suitable content for a report to management, on the basis of given information, including statements of facts, their potential effects and appropriate recommendations for action.

(b) Critically assess the quality of a management letter.

(c) Advise on the content of reports to those charged with governance in a given situation.

(d) Explain the need for timely communication, clearance, feedback and follow up.

(e) Discuss the relative effectiveness of communication methods.

3 Other reports

(a) Analyse the form and content of the professional accountant's report for an assurance engagement with an auditor's report.

(b) Draft the content of a report on examination of prospective financial information.

(c) Discuss the effectiveness of the 'negative assurance' form of reporting and evaluate situations in which it may be appropriate to express a reservation or deny a conclusion.

F Current issues and developments

Discuss the relative merits and the consequences of different standpoints taken in current debates and express opinions supported by reasoned arguments.

1 Professional, ethical and corporate governance

(a) Discuss the relative advantages of an ethical framework and a rulebook.

(b) Evaluate the adequacy of existing ways in which objectivity may be safeguarded and suggest additional measures to improve independence.

(c) Identify and assess relevant to emerging ethical issues and evaluate the safeguards available.

(d) Discuss IFAC developments including:

- (i) the implementation and adoption of International Standards on Auditing (ISAs)
- (ii) significant current assurance issues being dealt with by IAASB.

(e) Assess the relative advantages and disadvantages of partnership status, limited liability partnerships and incorporation of audit firms.

(f) Discuss current developments in the limitation of auditors' liability and the practical ways in which the risk of litigation and liability can be reduced in a given situation.

(g) Discuss innovations in corporate governance (e.g. enterprise-wide risk management) and their impact on boards of directors, audit committees and internal auditors.

2 Information technology

(a) Describe recent trends in IT and their current and potential impact on auditors (e.g. the audit implications of 'cyberincidents' and other risks).

(b) Explain how IT may be used to assist auditors and discuss the problems that may be encountered in automating the audit process.

3 Transnational audits

(a) Define 'transnational audits' and explain the role of the Transnational Audit Committee (TAC) of IFAC.

(b) Discuss how transnational audits may differ from other audits of historical financial information (e.g. in terms of applicable financial reporting and auditing standards, listing requirements and corporate governance requirements).

(c) Discuss the need for international audit firm networks in implementing international auditing standards.

(d) Distinguish, for example, between 'global auditing firms' and second tier firms.

(e) Discuss the impact of globalisation on audit firms and their clients.

(f) Explain the advantages and problems of current trends (e.g. to merge, to divest consultancy services).

4 Social and environmental auditing

(a) Discuss the increasing importance of policies that govern the relationship of an organisation to its employees, society and the environment.

(b) Describe the difficulties in measuring and reporting on economic, environmental and social performance and give examples of performance measures and sustainability indicators.

(c) Explain the auditor's main considerations in respect of social and environmental matters and how they impact on entities and their financial statements (e.g. impairment of assets, provisions and contingent liabilities).

(d) Describe substantive procedures to detect potential misstatements in respect of socio-environmental matters.

(e) Discuss the form and content of an independent verification statement (e.g. on an environmental management system (EMS) and a report to society).

5 Other current issues

(a) Discuss how the potential problems associated with the audit of small enterprises may be overcome.

(b) Explain how International Standards on Auditing affect smaller firms.

(c) Discuss the dominance of the global firms and their influence and impact on the accounting profession.

(d) Discuss the impact of developments in public company oversight on external auditors.

(e) Explain current developments in auditing standards including the need for new and revised standards and evaluate their impact on the conduct of audits.

(f) Discuss other current legal, ethical, other professional and practical matters that affect accountants, auditors, their employers and the profession.

CHAPTER 1

The meaning of audit and assurance

Contents

The meaning of assurance

1 The meaning of assurance

1.1 Introduction

This study text is an advanced text on auditing and assurance services. It assumes that you have already studied the basics, although some revision of basic topics is included. The main aims of this text are to build on the knowledge you gained from your studies of audit and assurance, and:

- extend your basic awareness of professional codes and fundamental principles, so that you develop a detailed understanding of rules of professional conduct
- introduce practice management
- extend the application of procedures involved in planning, conducting and reporting on audit assignments and non-audit assignments, and deal with group audits and audit-related services
- provide a critical evaluation of procedures and reports
- outline current issues and developments in assurance.

1.2 Assurance

In an assurance engagement, an assurance firm:

- is engaged by one party
- to give an opinion
- on a piece of information that has been prepared by another party.

The opinion is an expression of **assurance**, or comfort, about the information that has been reviewed.

A **statutory audit** is one form of assurance engagement. The shareholders of a company do not accept without question that the information provided in the financial statements by the management of the company is sufficiently accurate and reliable. The statutory audit provides assurance about the quality of the information. This makes the financial statements more reliable for the user.

Because of the amount of work carried out, a statutory audit provides a high **level of assurance**. Other assurance engagements may provide a lower level of assurance, or comfort, to the person receiving the opinion. The level of assurance given by other assurance engagements will depend on various factors that are discussed in a later chapter.

1.3 Examples of non-audit assurance engagements

Examples of 'non-audit' assurance engagements might include reports on such matters as:

- corporate social responsibility
- environmental policy
- employment policies
- non-financial performance indicators.

Assurance engagements have become more significant in recent years because the range of information provided by a company's directors in reports to the shareholders and other stakeholders has increased. Auditors can provide assurance by giving an opinion about the information in these reports.

The meaning of audit and audit-related services

- Audit
- Audit-related services

2 The meaning of audit and audit-related services

2.1 Audit

ISA 200 states that the purpose of an audit (a form of assurance engagement) is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the auditor expressing an opinion on whether the financial statements of an entity are prepared, in all material respects, in accordance with an applicable financial reporting framework. A financial reporting framework may be provided, for example, by country-specific legislation plus international financial reporting standards.

The audit opinion typically makes reference to whether the financial statements give a 'true and fair view' or 'present fairly'.

Audits are long-established formalised processes, closely regulated by law and professional practice. Audits were developed because of the separation between the ownership of companies (by the shareholders) and stewardship (by the directors). In order to protect the shareholders from incorrect or misleading information by the directors, an audit is designed to provide a high level of assurance to the users of the financial statements.

2.2 Audit-related services

Audit-related services are engagements undertaken by an accountant or firm of accountants, to perform such assignments as:

- reviews of data
- agreed-upon procedures
- compilations.

Review

A **review** provides a **moderate** level of assurance that the information under review is free from any material misstatement. The accountant's opinion is usually expressed in the form of **negative assurance**, which is an opinion that there is nothing obviously wrong in the information. For example, the opinion might be: 'Nothing has come to our attention to suggest that the information is materially misstated'.

The higher level of assurance provided by an audit enhances the credibility provided by the assurance process. However, an audit is more time-consuming (and therefore more costly) than a review.

Agreed-upon procedures

Agreed-upon procedures are an engagement where the party (client) hiring the accountant specifies the procedures that should be followed by the accountant in performing the engagement.

Compilation

With a compilation, the accountant is engaged to prepare information for the client, rather than audit or check the information prepared by someone else. For example, a firm of accountants may be asked by a client to prepare a tax computation. No assurance is provided in a compilation engagement.

CHAPTER

2

The regulatory environment

Contents

The need for regulation of audit and assurance services

- The public interest
- Ethical regulation
- Legal regulation
- Professional regulation

1 The need for regulation of audit and assurance services

1.1 The public interest

The key reason why audit and assurance services should be regulated is the public interest. Assurance providers give an impartial, professional view on issues that matter to users of financial and other information. It is important that this view can be trusted. Therefore, assurance providers need to operate:

- within ethical boundaries
- to consistent standards.

You know from your previous studies that assurance providers are regulated by:

- the law of the land in which they operate
- the ethical standards of the land and the professional body to which they belong
- the professional standards adopted by their country (for example, ISAs (UK and Ireland) in the UK.

1.2 Ethical regulation

Assurance providers are given ethical guidance by:

- Professional bodies, for example, ACCA
- Law
- IFAC

You should be familiar with most of the ethical guidance relevant to this syllabus, which is revised in Chapter 3.

1.3 Legal regulation

Most countries have legal requirements associated with some assurance providers, particularly audits.

1.4 Professional regulation

Auditors are required to carry out audits according to professional standards (international standards on auditing). Some assurance work is also covered by professional standards, although this is a developing area and less guidance is available. In many cases, guidance given in auditing standards can be adapted for use in assurance services where there is not specific guidance for that service.

As assurance provision goes increasingly 'global' the harmonisation of such professional guidance has become necessary.

Harmonisation of the accountancy and auditing profession

The International Federation of Accountants (IFAC) is an international regulatory body for the profession but each country has its own regulatory regime for auditing, which may not necessarily apply the same principles of audit behaviour as those used by IFAC.

The same arguments that have been made in favour of the universal adoption of international accounting standards can also be made in respect of other regulatory aspects of the auditing and accounting profession.

- These include **advantages** such as the adoption of global auditing standards, which should improve the efficiency of the audit process for multinational companies and should improve transparency in audit reporting.
- **Disadvantages** include the problems of getting international agreement on auditing practices, and the need for many countries to change their local law to bring it into line with the agreed international practice.

A number of initiatives are taking place to harmonise the regulation of the auditing profession internationally. These include the following:

- All listed companies in the European Union should now be carried out in accordance with International Standards on Auditing.
- There have been moves to establish a more formal, statute-based corporate governance regime (such as Sarbanes-Oxley in the USA).
- The development of national regulatory models for the profession, headed by a single unified body.

The SEC in the USA is a long-established example of a unified body. In the UK, the Financial Reporting Council also has a unified role, and

- sets accounting standards
- sets auditing standards
- enforces and monitors those standards
- oversees the self-regulatory professional bodies, such as ACCA.

It has been suggested that stricter regulation from an external authority (such as the SEC in the US and the FRC in the UK) is needed to balance the increasing global power of the 'Big Four' professional accountancy firms.

Professional standards

- The international standard-setting process
- The authority of national and international standards
- Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services
- ISA 200: Overall objectives of the independent auditor and the conduct of an audit in accordanec with International Standards on Auditing

2 Professional standards

2.1 The international standard-setting process

International Standards on Auditing (ISAs) are set by the International Audit and Assurance Standards Board (IAASB), which is a part of IFAC.

A subcommittee of IAASB is asked to write an exposure draft of the new standard when IAASB considers that one is required. This draft is then 'exposed' to interested parties, who comment on the exposure draft. Interested parties include national standard setters (such as the Auditing Practices Board in the UK) and professional bodies, such as ACCA.

The comments are reviewed within the IAASB and the draft is amended as required. Finally a new ISA will be issued.

2.2 The authority of national and international standards

International standards are drafted to be used internationally, but situations may arise where the requirements of the international standard clash with national standards.

In this situation, there are a number of matters that should be considered:

- ISAs are not designed to overrule national requirements, so auditors should follow national requirements.
- However, as ISAs represent international best practice, countries are encouraged by IFAC to change their national practice so that ISAs can be followed. For example, in the UK, since December 2004, all financial statements have been audited using the UK version of ISAs, known as ISAs (UK and Ireland). These are based on ISAs with any additional, UK-specific, provisions shown in shaded boxes.
- If there is no comparable guidance to the ISA in the country, then individual ISA practice can be adopted immediately.

2.3 Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services

The IAASB issues a number of other international standards, in addition to ISAs. The table below sets out these standards, including ISAs, and when the preface says they are to be applied.

Type of standard	When applied
International Standards on Auditing (ISAs)	In the audit of historical financial information
International Standards on Review Engagements (ISREs)	In the review of historical financial information
International Standards on Assurance Engagements (ISAEs)	In assurance engagements other than audits or reviews of historical financial information
International Standards on Related Services (ISRSs)	On compilation engagements, engagements to apply agreed upon procedures to information and other related services engagements
International Standards on Quality Control (ISQCs)	For all the above services

In addition to this preface, certain ISREs, ISAEs, ISRSs and ISQC 1 are examinable in this paper. They are covered in later chapters.

As discussed above, the IAASB's pronouncements do not override local laws or regulations. If local laws or regulations differ from, or conflict with, the IAASB's standards then a professional accountant should not state that he has complied with the IAASB's standards unless he has **fully complied** with all of those relevant to the engagement.

International Standards on Auditing (ISAs)

ISAs are written in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary when applied to audits of other historical financial statements.

Each ISA contains:

- an introduction
- objectives
- definitions (if necessary)
- requirements which are shown by the word 'shall' and are to be applied as relevant to the audit
- application and other explanatory material which is for guidance only.

This structure arose out of the work carried out as part of the IAASB's "Clarity Project".

IAASB Clarity Project Update

In October 2008 the IAASB issued a final *Clarity Project Update* – slightly ahead of the December 2008 date by which the last of the clarified ISAs were to be approved by the Public Interest Oversight Board. The clarified ISAs come into effect for audits of financial statements beginning on or after 15 December 2009.

Key points from this update, which give some background to the project, are as follows:

- The Clarity Project was the IAASB's 18 month program to comprehensively review all of its ISAs and ISQCs to improve their clarity and therefore the consistency of their application.
- 36 clarified ISAs were issued, along with a clarified ISQC1.
- 16 of the ISAs were substantially revised as well as redrafted and one new ISA (ISA 265) was issued. The other 19 ISAs were redrafted, but not revised.
- All the clarified ISAs contain improvements, including:
  - identifying the overall objectives of the auditor when conducting an audit in accordance with ISAs
  - setting an objective in each ISA
  - establishing an obligation on the auditor in relation to those objectives
  - clarifying the obligations imposed on auditor by the requirements of the ISAs and the language used (using "shall" instead of the previous "should")
  - eliminating ambiguity about the requirements which an auditor needs to fulfil.
- As set out above, the ISAs have a new structure with Introductory Material, Objectives, Definitions, Requirements and Application and Other Explanatory Material presented in separate sections in the ISA.
- In order to allow stakeholders a period of stability in which to implement the clarified ISAs and ISQC1, the IAASB has agreed, subject to any unforeseen circumstances, not to issue any additional standards that would become effective in the next two years.

International Standards on Quality Control (ISQCs)

ISQCs apply to all services carried out under the IAASB's **engagement standards** (ISAs, ISREs, ISAEs and ISRSs).

Other International Standards

The other international standards (ISREs, ISAEs and ISRSs) follow the format of the original ISAs. They contain:

- basic principles and essential procedures (identified in bold type and by the word '**should')**, and
- related guidance in the form of explanatory and other material, including appendices.

The basic principles and procedures must be followed. In exceptional circumstances, a professional accountant may judge it necessary not to follow a relevant essential procedure in order to achieve their objectives. In these circumstances, the auditor must be prepared to justify the departure from the requirements of the standard.

Professional judgement

The nature of the international standards requires the professional accountant to **exercise professional judgment** in applying them.

2.4 ISA 200: Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing

The **objectives** of the auditor, per ISA 200 are:

- to **obtain reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. This allows the auditor to give an opinion on whether the financial statements have been prepared in accordance with the applicable financial reporting framework.
- to **report on the financial statements**, and communicate as required by the ISAs, in accordance with the auditor's findings.

Where the auditor is unable to obtain reasonable assurance and a qualified opinion is insufficient, the auditor must disclaim an opinion or resign. The different types of opinions are revised in a later chapter.

In line with what you should remember from your previous studies, ISA 200 **requires** the auditor to:

- comply with all **ISAs** relevant to the audit
- comply with relevant **ethical requirements**
- plan and perform an audit with **professional scepticism**
- exercise **professional judgement** in planning and performing an audit
- obtain **sufficient and appropriate audit evidence** to allow him to obtain reasonable assurance.

Corporate governance

- The meaning and nature of corporate governance
- Directors' and auditors' responsibilities
- The requirement for an audit committee

3 Corporate governance

3.1 The meaning and nature of corporate governance

Corporate governance is the way in which companies are managed and controlled. In particular, it focuses on the role of directors and their responsibilities to shareholders and other stakeholders.

As a form of business entity, an important feature of companies is the divorce of ownership from control.

- One group (the directors) manage the business and make the important strategic decisions.
- A different group (the shareholders) finance the company and own it.

Directors are seen as 'agents' of the shareholders. As agents of the shareholders:

- they should take decisions that are in the best interests of their shareholders, and
- they should be accountable to the shareholders for the way in which they have used the company's resources.

The need for regulation for good corporate governance

There is some regulation of corporate governance in company law. However, basic legal requirements have proved inadequate for protecting shareholders from losses, in a number of corporate scandals caused by directors of the company.

As a result, more specific regulations or guidelines have been introduced to improve corporate governance.

Regulations and guidelines vary from country to country. In some countries there are detailed 'rules', in others there are none. You are not expected to have a detailed knowledge of the corporate governance rules in any particular country. Examination questions will deal with general principles of good corporate governance. However, it may be helpful if you are able to illustrate the general principles by reference to the rules that apply in a particular country. For example, you could develop your knowledge of the corporate governance rules that apply in your own country.

3.2 Directors' and auditors' responsibilities

In all aspects of corporate reporting there is a basic distinction between the role of the directors and the role of the auditors:

- The directors are responsible for the preparation of information that complies with the relevant regulations.
- The auditors are responsible for reviewing that information and, in some cases, reporting on the extent to which the directors have complied with their responsibilities.

It is good practice in accordance with ISA 210 *Agreeing the terms of audit engagements* to clarify the relative responsibilities of the directors and auditors in corporate governance matters.

Taking the UK as an example, the respective responsibilities of directors and auditors are set out in the table below.

Note that where the auditor's role is to **read** a document, the objective is to identify and then try to resolve any possible misstatements in the document, or any inconsistencies with the information contained in the audited financial statements. This is simply an application of the general principles of ISA 720 *Other information in documents containing audited financial statements*.

Area	Directors' responsibility in relation to the annual report	Auditors' responsibility
General compliance with the Combined Code (UK Listing Rules requirement)	Disclose in a narrative statement as to how they have complied with the principles of the Code.	**Read** the narrative statement.
Detailed provisions of the Code	Present a statement as to whether they have complied with the provisions of the Code throughout the year. Comply or explain.	**Review** seven defined items and report if there is non-compliance (see below). **Read** other material.
Directors' remuneration	Include a detailed statement of directors' remuneration.	**Audit** the statement as if it were part of the financial statements and include in the scope of the normal audit opinion.
Going concern status	Include a statement that the business is a going concern with any necessary supporting assumptions or qualifications.	**Review** and report if there is non-compliance.

The nine defined items in the Combined Code which should be reviewed by the auditors are as follows:

(1) C1 Does the annual report contain a statement of the directors' and auditors' responsibilities?

(2) C2 Have the directors carried out a review of the effectiveness of internal controls and reported to the shareholders that they have done so?

(3) C3 Has the board established an audit committee (see next section)?

(4) C3 Is the role of the audit committee appropriate?

(5) C3 Does the annual report describe the work of the audit committee?

(6) C3 Has the audit committee ensured adequate arrangements whereby staff of the company may raise concerns to them in confidence?

(7) C3 Has the audit committee reviewed the effectiveness of internal audit?

(8) C3 Does the audit committee have primary responsibility for recommending the appointment of external auditors?

(9) C3 Does the annual report explain how the objectivity of auditors is safeguarded, if non-audit services are provided?

3.3 The requirement for an audit committee

In many countries, listed companies are required or expected to have an audit committee. In the UK for example, an audit committee is a requirement of the Combined Code for listed companies.

The audit committee is a 'sub-committee' of the board of directors, and it reports to the main board. In the UK, it should be made up entirely of independent non-executive directors. ('Independence' is defined in the Combined Code.)

One purpose of an audit committee is to establish a 'buffer' between the auditors and the executive directors, in order to minimise the risk that the auditors might come under undue pressure from the executive members of the board. (For example, the auditors may be influenced by the threat that the company will take away their audit work or non-audit work, and so may be more inclined to agree with the opinions and arguments of the management.)

The audit committee should therefore help to ensure the independence of the external auditors.

Money laundering

- Definition of money laundering
- Regulation
- Obligations placed on professional firms
- Duty of confidentiality and money laundering
- Global dimension

4 Money laundering

4.1 Definition of money laundering

Money laundering can be defined as the process by which criminals attempt to conceal the true origin and ownership of the proceeds of their criminal activities.

Criminal activities include drug trafficking, terrorism, theft, fraud and tax evasion.

Money laundering is a process by which money earned from criminal activities ('dirty money') is transferred and transformed so that it appears to have come from a legitimate source ('clean money').

If it is undertaken successfully, money laundering allows criminals to maintain control over the proceeds of their criminal activity and to provide a legitimate cover for their sources of income.

There are various criminal offences connected with money laundering. The UK examples are:

- possessing, in any way dealing with, or concealing, the proceeds of any crime
- attempting, conspiracy or incitement to commit the above offence
- aiding, abetting, counselling or procuring the commission of such an offence
- an act which would constitute any of these offences if done in the UK
- failure by a person in the regulated sector to inform the appropriate party of a knowledge or suspicion that another person is engaged in money laundering
- making a disclosure which is likely to prejudice an investigation into money laundering (tipping off)

The last two offences are the ones that accountants may find themselves affected by even inadvertently, as accountants operate in the regulated sector and are therefore required to report suspicions of money laundering.

It is made more complicated by the fact that 'suspicion' is not defined in the law. However, it appears to be somewhere between mere speculation and actual proof.

There are various defences to charges of money laundering:

- a report had been made to the appropriate party
- there was an intention to make a report and a reasonable excuse (likely to include fear of physical violence or other menaces) for not having done so
- acquiring or using property for adequate consideration in good faith

4.2 Regulation

Due to the work of inter-governmental bodies such as the Financial Action Task Force on Money Laundering (FATF), many countries now have legal provisions in place designed to detect, report and ultimately prevent money-laundering activities. These provisions vary from country to country. The following notes are based mainly on regulations in the UK, but similar regulations are applied by many other countries.

An important feature of the UK regulations is that the proceeds of any crime come within the scope of UK regulation if they are laundered and detected in the UK. This is **irrespective of where in the world the criminal activity took place**.

The UK Money Laundering Regulations 2003 implement the recommendations of FATF in relation to customer due diligence, record-keeping, reporting of suspicious transactions and compliance.

4.3 Obligations placed on professional firms

Money laundering may be of particular relevance to accountants, and in particular auditors, in cases where criminals establish companies and use transactions between their companies to 'launder' their dirty money.

Specific obligations for detecting and reporting suspicions of money laundering are placed on professional firms (for example, lawyers and accountants) and financial institutions. These requirements include the following.

- Putting into place systems, controls and procedures to ensure that the firm is not used for money laundering purposes.
- Appointing a Money Laundering Reporting Officer, whose responsibility is to receive reports on suspected money laundering activities from other employees and report them to the appropriate authorities, that is, the Serious Organised Crime Agency (SOCA). (Note that the **responsibility** for having appropriate systems in place to prevent and detect money laundering **rests collectively with senior management**. The responsibility for compliance with the money laundering regulations does not rest solely with the Money Laundering Reporting Officer.)
- Establishing and enhancing the record-keeping systems (1) for all transactions (which must be kept for at least five years, with controls to ensure that they are not inadvertently destroyed) and (2) for verifying the identity of clients (by obtaining official documents, such as – for an individual – passport or driving license, supported by recent utilities bills, and – for a company – certificate or

incorporation, the registered address and a list of shareholders and directors, all of which can be obtained from the Registrar of Companies.

- Establishing procedures within the firm for reporting any suspicion of money laundering by client companies.
- Training and educating staff in procedures for detecting and reporting suspicions of money laundering activities.

These obligations are wide-ranging and auditors and other professionals need to be fully aware of the extent of their obligations.

Example

A case in the UK involved a solicitor who was imprisoned for six months for failing to report his suspicion in relation to money paid to his firm by a client who was later convicted of drug trafficking. The solicitor misunderstood his obligation to report the suspicion, thus unintentionally committing an offence.

Guidance from professional bodies

To ensure that practitioners are aware of their responsibilities, the ACCA's Monitoring Unit – as part of its monitoring process – checks to see if practitioners have understood their obligations by asking a series of questions during their visits.

In addition to any disciplinary action that may be taken by the ACCA for breaches of the regulations, penalties for non-compliance with money laundering obligations can:

- make a firm liable (under criminal law) to unlimited fines, and
- make its principals (usually its partners) liable to possible imprisonment.

In response to the increased expectations of legislators and regulators in many countries with respect to the accounting profession's role in detecting money laundering, IFAC has published a second paper on this topic.

This paper highlights:

- the causes and possible means of preventing money laundering
- the signs of money laundering activity
- the vulnerability of banks, non-bank financial institutions and other entities to money laundering
- governance-related issues (the relative responsibilities of directors and auditors for monitoring and reporting suspicions of money laundering).

4.4 Duty of confidentiality and money laundering

The accountant's normal professional duty of confidentiality to clients is not an adequate defence where money laundering is concerned.

In the case of reporting suspicions of money laundering, practitioners in the UK are afforded statutory protection against claims for breach of confidence where reports are made in good faith and to the appropriate authority. This will be so even in cases where the suspicions later prove to be unfounded and wrong.

An accountant may in fact find it hard to not to commit the offence of 'tipping off' bearing in mind all the reporting requirements that an auditor has to fulfil. For example, bear in mind that if an auditor had a strong suspicion or knowledge of money laundering, he might want to resign his position. However, doing so would mean that he was required to report to the shareholders on his reasons (in a statement of circumstances) and also report any professional matters arising to his successor in a professional clearance letter. In such a circumstance, the auditor might be better placed not resigning at that time and should certainly take legal advice before doing so (remember that taking advice from a solicitor would not constitute tipping off because it is protected by legal privilege).

Accountants may find themselves in a position where they are prevented from making a report of a suspicion of money laundering because they have received information under a legal privilege. This will be rare. It will be considered further when you look at forensic auditing in Chapter 12.

4.5 Global dimension

The rules above, although based on FATF recommendations are the legal situation in the UK. Several countries have very similar legislation.

The US Patriot Act 2001 requires all financial institutions to establish anti-money laundering programmes to include development of internal policies, the appointment of a compliance officer, an ongoing employee training programme and an independent audit function.

Compliance with laws and regulations in an audit of financial statements: ISA 250

- The legal environment and non-compliance by a client company
- Action by the auditor in the event of non-compliance or suspected non-compliance by a client company

5 Compliance with laws and regulations in an audit of financial statements: ISA 250

5.1 The legal environment and non-compliance by a client company

ISA 250 *Consideration of laws and regulations in an audit of financial statements* **requires** the auditor to:

- **obtain a general understanding** of the applicable legal and regulatory framework and how the entity is complying with that framework. This is part of obtaining an understanding of the entity and its environment – here, the legal environment – as required by ISA 315
- **obtain sufficient appropriate audit evidence** in respect of compliance with those laws and regulations which might be expected to have a direct effect on material amounts and disclosures in the financial statements
- **perform the following audit procedures** to help identify such instances of non-compliance:
  - make enquiries of management as to whether the entity is complying with the relevant laws and regulations
  - inspect any correspondence with the relevant authorities
- during the audit, remain alert to the possibility that **other audit procedures might bring instances of non-compliance to the auditor's attention**
- obtain **written representations from management** that all known instances of non-compliance or suspected non-compliance have been disclosed to the auditor
- document all identified or suspected instances of non-compliance and the results of discussions with management and/or other parties.

5.2 Action by the auditor in the event of non-compliance or suspected non-compliance by a client company

If the auditor **identifies or suspects** material areas of non-compliance by the company, the following procedures are **required**:

- Obtain an understanding of the nature of the act and the circumstances under which it has occurred.
- Evaluate the possible effect of the non-compliance on the financial statements.
- For suspected non-compliance, discuss the matter with management. If compliance is not proved, take legal advice.

- If there is insufficient evidence re a suspected non-compliance, consider the impact on the audit report (this would constitute a "limitation on scope" which is considered in a later chapter).
- Consider whether the non-compliance impacts on other areas of the audit (for example, on the overall risk assessment).
- Consider how to report the non-compliance – to those charged with governance and/or to shareholders and/or to the authorities.

CHAPTER

3

Rules of professional conduct

Contents

The fundamental principles

- Introduction: rules of conduct for professional accountant
- The fundamental principles

1 The fundamental principles

1.1 Introduction: rules of conduct for professional accountants

The professional bodies that regulate the auditing profession set high standards of behaviour for their members (including student members). Their codes of practice apply to all members, whether in public practice or not. The detailed rules of conduct vary between the professional bodies, but all the major bodies have codes that are broadly similar.

In setting a code of practice, each professional body is complying with one of its regulatory functions, which is to ensure that statutory audits are performed only by 'fit and proper' persons who act with professional integrity.

For your examination, you need to be aware of:

- the 'ACCA Code of Ethics and Conduct', and
- the 'IFAC Code of Ethics for Professional Accountants'.

As the ACCA has adopted the IFAC Code, the content of these two sets of regulations is largely the same. IFAC has recently issued an exposure draft of its independence provisions, splitting them between 'audit and review engagements' and 'other assurance engagements' and proposing some amendments to the requirements. These will be referred to as relevant in this section.

1.2 The fundamental principles in the IFAC Code

The five fundamental principles of the IFAC and ACCA Codes are set out below.

Principle	Explanation
Integrity	A professional accountant should be straightforward and honest in all professional and business relationships.
Objectivity	A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgements.

Principle	Explanation
Professional competence and due care	A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services.
Confidentiality	A professional accountant should respect the confidentiality of information acquired as a result of professional or business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information should not be used for the personal advantage of the professional accountant or third parties.
Technical standards	A professional accountant should comply with relevant laws and regulations and should avoid any action which discredits the profession.

You need to know these five fundamental principles and what each of them means. An exam question may ask you to discuss the relevance of the five fundamental principles to a particular situation in a case study.

Integrity, objectivity and independence

- The requirement for independence
- Threats to independence
- Specialist valuations and threats to independence
- Safeguarding independence
- The provision by auditors of non-audit services
- Commercial transactions between an audit client and a member of the audit team
- Making referrals

2 Integrity, objectivity and independence

2.1 The requirement for independence

For an audit report to be of value, the auditor:

- **must be independent**, and also
- **must be seen to be independent**.

The opinion of an auditor must be an independent opinion given by a professional person with appropriate skills in audit work, and the opinion must not be influenced by anyone else, and in particular must not be influenced by the opinions and views of the management of the company whose financial statements have been audited.

In order that a member's audit report is of value auditors must have '**independence of mind**' and to be '**independent in appearance**'. These principles of both **being** and **being seen to be** independent are at the centre of the role played by independence in auditing.

Independence of the auditor is a matter of public confidence in the audit process.

- Auditors need to be fully aware of situations that may damage their independence and objectivity. Such situations are referred to as **threats** to auditor independence.
- Any threats to independence may be reduced by **safeguards** that are taken by an audit practice (audit firm).

It is matter of public confidence in the audit process.

Both the ACCA Rules and the IFAC Code take the form of guidance on independence, rather than specific rules. It is left to the individual member to apply judgement about how the guidance should be applied in practice.

The guidance sets out a number of general categories of threat to independence, and then goes on to list specific threats and associated guidance.

2.2 Threats to independence

General categories of threat

Threats to the fundamental principles are matters that could result in the accountant or audit firm acting without integrity, without sufficient competence, without ensuring confidentiality or in a way that discredits the profession. However threats to the fundamental principles are largely threats to the independence and objectivity of the accountant or the audit firm.

The Code recognises the following general sources of threat to the fundamental principles:

- **Self-interest threat**. This arises when the accountant or the audit firm has a financial interest or other interest in a matter. Typically this means that the accountant's decisions may be influenced by self-interest and the accountant will therefore not act with objectivity and independence.
- **Self-review threat**. This occurs when an accountant is required to review or re-evaluate (for a different purpose) a previous judgement he has made or action that he has taken. Self-review threats can also apply to audit firms. For example if an audit firm prepared the financial statements for a client company and then acted as auditor, it would be reviewing its own work and would be reluctant to criticise or question it. This would be a threat to objectivity and independence.
- **Advocacy threat**. This occurs when the accountant is in a position where he is expected to defend or justify the position of the client, and act as an 'advocate' for the client's position or point of view. This would be a threat to objectivity and independence.
- **Intimidation threat**. This occurs when the accountant is deterred from acting with objectivity due to threats against him or his firm. The nature of the threat may be a threat by the client that it will take work away from the audit firm unless it agrees with the point of view of the client management.
- **Familiarity threat**. This occurs when the accountant becomes too sympathetic with the client's position due to close relationships, for example due to a long association over many years in carrying out the annual audit..

The Code goes on to give guidance about a number of specific threats which an accountant might be faced with.

Financial interests

A financial interest in a client would constitute a self-interest threat, although the nature of the interest and the degree of control the accountant has over it will affect the level of the risk.

The guidance recommends that a member of the assurance team or an immediate family member of that team should not hold a direct financial interest or an indirect material interest in a client. The interest should either be disposed of, or the team member removed from the engagement.

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Example: Financial interest

Drin Company is developing a new product which is expected to be very profitable, but it needs additional finance to complete the product development work and for the market launch. It has invited its audit firm, Pull & Push, to make an investment in the product. The financing arrangement would take the form of either convertible debentures in Drin Company or a separate joint venture company. If a joint venture company is established, Drin Company and Pull & Push would share control of the business. The joint venture company would develop, manufacture and market the new product.

What are the ethical issues to consider in this situation?

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Answer

If Pull & Push retain Drin Company as an audit client, the ethical situation is as follows.

Convertible debentures

The audit firm **must not** provide a loan to a client. Buying debentures in the company would be a form of loan. It would create a major self-interest threat for which there could be no suitable safeguards.

A further problem is that convertible debentures could eventually be converted into equity shares in Drin Company, which would also create a major self-interest threat for Pull & Push.

Joint venture company

A joint venture arrangement would also be unacceptable on ethical grounds, because of the significant mutual financial interests that Drin Company and Pull & Push would share.

A financial interest by an audit firm in an audit client is permissible only if the interest is not material, the relationship with the client is insignificant and the audit firm does not exercise significant influence. These conditions do not apply here.

If the audit firm resigns from the audit

If Pull & Push resigned from the audit of Drin Company, a different situation would arise. The audit firm would be allowed to invest in its former audit client, since the ethical threats would no longer exist. However, it is questionable whether an audit firm would want to diversify its business interests in to the manufacture and marketing of a new product – an area of business in which the firm's partners would have no direct experience or expertise.

Loans and guarantees

A loan from a client which is a bank or similar institution, made on normal commercial terms would not constitute a threat to independence. However, loans or guarantees made to or by assurance clients in other circumstances constitute a self-interest threat and should be avoided.

Close business relationships

Close business relationships with assurance clients, such as having a material joint venture represent a self-interest and possibly an intimidation threat. They should be avoided. Purchasing goods and services from an assurance client would not generally cause a threat to independence providing that it was on normal commercial terms and in the normal course of business.

Family and personal relationships

Family and personal relationships between assurance staff and clients might cause self-interest, familiarity or intimidation threats. It is impracticable to outline every relationship that might cause such a risk and each situation should be considered individually, bearing in mind the role of the assurance staff and the closeness of the relationship.

However, when an immediate family member of a member of the assurance team is a director, officer or employee in a position to exert direct and significant influence over the subject matter of the engagement then the threat to independence is great and can only be avoided by removing the individual from the assurance team.

Employment with assurance clients

The assurance team's independence may be threatened if a director or other senior employee at the client has recently been employed by the assurance firm. There may be self-interest, familiarity and intimidation threats, particularly if close connections remain between the individual and the assurance firm.

However, it may be possible to reduce the threat with safeguards, such as involving an independent third party to review the audit file.

Self-interest threats may also arise if a member of the assurance team has reason to believe that they might soon be employed by the assurance client, for example, if they have applied for a job there. This threat can be avoided by having disclosure policies within the firm for if an employee is entering into employment negotiations with an assurance client.

Recent service with assurance clients

If an employee of the assurance client transfers to the assurance firm, then self-interest, self-review and familiarity threats may arise. Therefore individuals who have served as a director or officer of an assurance client in the period under review should not be assigned to the assurance team.

In other situations, it may be sufficient to apply safeguards to independence.

Serving as an officer or director on the board of assurance clients

Assurance providers should not serve on the board of directors of an assurance client. However, providing routine administrative services, perhaps such as those provided by a company secretary may be appropriate. It is important not to be involved in making management decisions.

Long association of senior personnel with assurance clients

Using the same staff on an assurance engagement over a long period of times may cause a familiarity threat. The firm should consider factors such as the nature of the person's role and the length of time that he has been doing it when deciding which staff members to involve in assurance work.
In terms of audit engagements, the same person should not be involved with an audit as audit engagement partner and/or quality control reviewer for more than seven years and should not be returned to the engagement for at least two years after being rotated off the team.

Fees

Where fees from a particular client represent a large proportion of a firm's total fees, there is a significant self-interest threat. This will depend on factors such as the structure of the firm and whether it is established or emerging.

ACCA rules state that recurring fees paid by one client or a related group of clients should not exceed 15% of the income of the audit practice (10% if the client is listed).

Larger firms may find that the proportion of an individual office's income is higher than these figures, but not firm income as a whole. Where an individual office has fee income in excess of these figures from a single client, responsibility for signing off the audit file should be passed to a different office.

Overdue fees from an assurance client may become in effect a loan to that client and should therefore be avoided.

Gifts and hospitality

Assurance team members/firms should not accept goods or hospitality from an assurance client unless the value of that gift is clearly insignificant (to all parties).

You should already be aware of the rules on accepting gifts and hospitality from a client from your previous studies, but this topic has been examined at the P7 level.

If members of an audit team accept hospitality from an audit client, the following issues might need consideration.

- Materiality. Was the value of the gifts or hospitality sufficiently large that it could affect the objectivity and independence of the audit team member(s)?

- In the case of hospitality, was the hospitality accepted during normal working hours? If so, this would raise questions about the professional conduct of the auditors. The auditors should be carrying out their professional duties in normal working time – this is what the audit client pays them to do. It might also raise questions about the adequacy of supervision of the audit: with proper supervision, audit team members should not have been allowed to accept hospitality during working hours. This would raise a broader question about quality control in the audit firm.
- Did the individuals receiving gifts or hospitality check first with a senior person whether this would be acceptable? If not, there may be a disciplinary matter to deal with.

Actual and threatened litigation

Threatened or actual litigation between the client and the firm may cause threats to independence. Safeguards can be applied, but the only appropriate response, particularly in the case of actual litigation, may be resignation from the engagement.

Provision of other services (non-audit work)

The independence of an audit firm may be threatened when the firm carries out a large amount of non-audit work for a company that is also its audit client.

- The non-audit work may provide a large amount of income that makes the audit firm economically dependent on the company.
- In addition, employees of the audit firm who carry out the audit may be required to audit the work that has been done for the company by colleagues in the audit firm. It might be difficult for them to find faults with the work that has been done by other employees of the firm.

Accountancy work should therefore not be undertaken for a **listed company** client, **except** in an emergency or where the work is of a routine clerical nature.

The provision of any other services is not prohibited, but the auditor must ensure that he does not perform management functions and does not make management decisions for the client company.

Where an audit practice does carry out accountancy work for an audit client:

- the client must accept responsibility for the accounting records
- the audit practice should not assume any management role
- appropriate audit tests should still be carried out by the practice (on the accounting work done for the client by other employees of the practice).

Temporary staff assignments

An audit client may ask an audit firm to 'lend' it one or more of its staff to work in the audit client's accounts department on a temporary basis. This creates several ethical threats.

- **Self review threat**. There is a risk that the individual, having worked for the audit client for a time, will be assigned to the audit team on returning to the audit firm. This would create a self-review threat, because the individual would not want to be critical of any work that he has done for the client.

- **Familiarity threat**. There is also the risk that the individual will become familiar with the audit client's staff during the temporary assignment, and so might be reluctant to challenge them properly if he subsequently returns as a member of the audit team.
- **Threat of management involvement.** If the individual is seconded to the accounts department of the audit client, it is probable that he will become involved in some way in management decisions in the department. This should be avoided.

It is permissible for an audit firm to provide staff on a temporary basis to an audit client, especially in an emergency, but it must be on the strict understanding that the individual who is assigned to the client must not be involved in any management decisions and should not have management authority.

This may be difficult if the person who is assigned has been a senior person in the audit team: such an individual would have status as a senior auditor and would have extensive knowledge of the client's business. It might therefore be difficult to avoid involvement in management decisions.

To deal with the ethical threat, the audit form may decide that a person who has been on temporary assignment should not be allowed to work again as a member of the audit team. However, there is a practical problem for the audit team in this arrangement, since it would be unable to use members of its staff on an audit, even though they have extensive knowledge of the client and may be experienced and senior auditors.

Small and medium-sized audit firms will therefore be reluctant to allow their staff to work on temporary assignment with a client, even though the practice is not prohibited.

(Note. The ethical threat will not exist if the individual is assigned to do work for the client in an area not connected in any way with accounting and finance.)

2.3 Specialist valuations and threats to independence

An accountant may be asked by a client to carry out a specialist valuation. Specialist valuations include:

- actuarial valuations
- valuations of intellectual property and brands
- valuations of other intangible assets
- valuations of property
- valuations of unquoted investments.

Specialist valuations do not include valuations of shares prior to a stock exchange listing.

The threat to independence is that an audit firm may be required, when performing an audit, to review a valuation that it has made for the client. The audit would therefore involve a review of the audit firm's own work (a self-review threat to independence).

The IFAC Code states that the threat to independence from self-review of a specialist valuation threat created **cannot** be reduced to an acceptable level by any safeguard:

- if the valuation service involves the valuation of matters that are material to the financial statements, and
- the valuation involves a significant degree of subjectivity and judgement.

In such a situation, either:

- the valuation services should not be provided by the audit firm **or**
- the audit firm should resign.

Second opinions

Second opinions are opinions that are provided when a company approaches an ACCA member (who is not that company's auditor) for a second opinion on the treatment of items in the financial statements.

The member should obtain the company's permission to contact the company's auditor. If permission is not given then the member should refuse to act.

2.4 Safeguarding independence

The responsibility for safeguarding independence is shared between:

- the individual auditor (or audit practice) and
- the profession as a whole.

The responsibilities of individual auditors and audit practices

There should be a **culture** of independence, and a **belief** in auditors' independence, that is shared by all partners and employees in an audit firm. It has been suggested by some commentators that detailed rules and regulations to preserve independence can be avoided if all auditors accept the concept that 'a good auditor is an independent auditor'.

Where possible, there should be rotation of the engagement partner (the partner in charge of the audit) and of senior staff. Rotation means that an individual should not be involved in the annual audit of the same client company for more than a maximum number of years.

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

- **Appropriate training**, including training in how to maintain an independent opinion during audit work.

- **Quality control procedures**. A firm should have procedures for quality control to ensure that independence is considered in respect of all work undertaken by the audit firm.
- **Consultation procedures**. A firm should have internal procedures for consultation, whereby questions arising in relation to independence can be discussed.

If an auditor becomes aware of a situation that may be seen to threaten his independence, appropriate action should be taken to resolve the issue. The action to be taken will depend on the circumstances, but might include any of the following:

- It may be possible to remove the threat to independence by a simple action, such as not accepting an offered gift, or for an audit partner to dispose of shares that he holds in a client company, and so on.
- Sometimes, it may be necessary to reject a proposed appointment as auditor. For example, an audit firm may have to reject its appointment as auditor of a new client company where the guidance on fee income level would be breached (because the fee income from the client would exceed the maximum limits established by the professional guidelines).
- With an existing client, if an independence issue cannot be resolved, the ultimate action is to resign from the audit of the client.

The responsibilities of the profession

Professional bodies expect their members to comply with codes of conduct relating to independence and will take disciplinary action as appropriate. Such action might lead to a fine, reprimand or exclusion from membership.

The profession and other interested parties regularly suggest new practices and procedures designed to improve auditor independence. Suggestions have included:

- the regular rotation of auditors, to avoid too close a relationship developing between the auditor and the client over a long period of time
- the use of audit committees.

The responsibility for safeguarding independence is seen as shared between the individual auditor (or audit practice) and the profession as a whole.

2.5 The provision by auditors of non-audit services

In addition to the provision of accountancy or valuation services considered above, both ACCA and IFAC recognise that there may be (or there may appear to be) a threat to objectivity and independence where the auditor provides additional, non-audit, services to the client.

Such non-audit services might include:

- the 'outsourcing' of internal audit services (to the external audit firm)
- accounting services and services in connection with preparing the financial statements
- taxation work

- IT work
- consultancy assignments.

The provision of non-audit services is now common among audit firms of all sizes. Most auditors recognise the potential threat to their independence and try to deal with the problem through their internal organisation structure.

- Larger firms will operate in a number of separate departments, each with its own partners and members of staff. By dividing the work of the audit firm into different functions, employees involved in audit work will not be the same as those involved in providing, say, consultancy advice to the same client.
- In some of the largest practices, the consultancy department has been legally separated from the accounting/auditing arm of the firm as a further step towards preserving auditor objectivity and independence.
- A similar approach is often taken by smaller audit firms. Although these firms may not be large enough to be organised in separate departments, efforts are usually made to ensure that different members of staff and partners are responsible for different services provided to clients.

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Example: non-audit work and safeguards

An audit firm has completed the annual audit for a client company and the audit team has identified a number of weaknesses in internal controls that have been notified to the client's management. As a result the client has asked the firm to carry out a review of its financial IT systems.

What are the ethical issues to consider in this situation and how might the problems be dealt with?

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Answer

The engagement would involve non-audit work. The audit firm can accept this engagement subject to certain conditions:

- The management of the client company must recognise that they have the responsibility for internal controls in the company. This responsibility cannot be passed on to the auditors.
- The engagement team will not be required to act in a management capacity in any way. For example, they must not be given any responsibility for the implementation of any improvements in internal control that they recommend.
- There must be sufficient controls against self-review threat. For example, the individuals assigned to the engagement team to do the work should not include anyone who will also be a member of the audit team.

ACCA and IFAC guidance on providing non-audit services

The IFAC Code recognises the value to both client and auditor of the provision of non-audit services, but requires the auditor to evaluate the significance of any threat to independence created by the provision of such services.

In some cases it may be possible to eliminate or reduce the threat by applying safeguards. However, IFAC considers that safeguards are not possible for the following activities:

- authorising or executing a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so
- determining which recommendation of the firm should be implemented
- reporting, in a management role, to those charged with governance.

All the above activities involve the auditor or audit firm in **assuming a management role**.

IFAC considers several specific areas of non-audit service provision. Most of these activities are considered permissible, provided that:

- management decisions are not taken and
- appropriate safeguards are put in place.

Some of these areas are set out below:

- **Taxation services**. Routine compliance, planning and advisory work on taxation is generally permissible, subject to the condition that the auditor must not make management decisions.
- **Internal audit services**. Internal audit services may be provided by an external audit firm, if there are appropriate safeguards, on condition that the auditor does not act in a management capacity, and that the client acknowledges its responsibilities for internal controls.
- **IT systems services**. IT systems services are permissible with appropriate safeguards. (The client must acknowledge its responsibilities and make all management decisions.)

2.6 Commercial transactions between an audit client and a member of the audit team

The IFAC Code does not prohibit commercial transactions between an audit client and a member of the audit team, provided that:

- they are made in the normal course of the client's business, and
- they are at an arm's length (in other words, they are made on normal commercial terms), and
- the value of the transaction is not material to either party.

Example: commercial transaction with an audit team member

An audit form has a client company, Zoomco, which operates a motor racing circuit. The audit firm has discovered that the audit manager for the Zoomco audit keeps a racing car at Zoomco's circuit and uses the race track regularly. Because he is the audit manager, Zoomco allow him 50% off normal charges for garaging the car and for use of the race track.

What is the ethical position and what measures should the audit firm take to deal with this situation?

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Answer

The transaction between Zoomco and the audit manager is a normal commercial transaction for Zoomco, but it is not at arm's length because the audit manager gets 50% off normal prices. The transaction may not be material for Zoomco, but it is likely to be material for the audit manager.

Consequently there has been a breach of the ethical code by the audit manager. The audit manager has created a self-interest threat (and possibly a familiarity threat) by entering into the transaction with Zoomco.

- The ethics partner of the audit firm should be consulted and asked to assess the materiality of the transaction between Zoomco and the audit manager and to consider whether disciplinary action is appropriate.
- The audit manager should be removed immediately from the Zoomco audit team and replaced by someone else.
- Those charged with governance of Zoomco (the board of directors) or the audit committee should be told about the action that the audit form has taken, and the reasons why the action was necessary.
- In view of the threat to the objectivity and independence of the former audit manager, the audit plan for the Zoomco audit should be reviewed and amended if this is considered necessary.
- The ethics partner may also wish to check whether the former audit manager has entered into commercial arrangements on favourable terms with any other audit client.

2.7 Making referrals

An audit firm may enter into an arrangement with another entity, whereby the other entity agrees to pay a fee to the audit firm for referring clients. For example a software company may specialise in selling accounting software packages or writing bespoke accounting software. It may enter an arrangement with an audit firm whereby the audit firm will receive a fee every time that it refers a client to the software firm with a view to buying a software package or software services.

This type of arrangement could create a self-interest threat for the audit firm. However, it is permissible, provided that suitable safeguards are in place. Suitable safeguards would include the following:

- When making a referral, the audit firm should notify a client it will receive a fee for the referral. This means that the client will be made fully aware of the financial benefit for the audit firm.
- The audit firm should monitor the quality of the products or services provided. In the case of referrals to a software company, this means having to keep the quality of the software packages and services under review, to make sure that they meet appropriate standards. (It is important that audit clients should not be referred to someone who provides poor-quality goods or services.)

- The firm should also obtain verification from all its staff involved with the audit of a client who is referred, that they do not personally have any financial interest in the company or other entity to which the referrals are made.

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Further examples: threats to independence

A UK audit firm, Tyre and Sleep, are faced with the following situations:

Situation 1

Mr Tyre is one of the audit firm's partners. He and his wife have been invited by the managing director of Entity X to a weekend of celebrations in Paris to mark the 20th anniversary of the incorporation of Entity X. Mr Tyre has been the engagement partner throughout this time

Situation 2

The firm has been approached by the directors of Entity Y, with a view to being appointed as auditors. One of the firm's audit managers, Mr Knapp, is company secretary of Entity Y, although he takes no part in its management. His parents are the sole directors and shareholders of Entity Y.

Situation 3

The finance director of Entity Z, a private limited company, has requested that only certain staff are to be included on the audit team to prevent unnecessary interruption to the entity's accounting department during the audit. In particular, he has requested that David, who has been the accountant in charge of the audit for the last two years, be assigned to the audit and that the team contain no new trainees.

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What threats to objectivity are present in each of these situations and how should the audit firm deal with them?

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Answer

Situation 1

The fact that Mr Tyre and his wife have been invited to a 'free' weekend in Paris represents a threat to the firm's independence, because it would be perceived that they are too close to Entity X and therefore not truly independent.

The offer should be refused as goods, services or hospitality should only be accepted when the value is clearly insignificant, which it is not to Mr Tyre and his wife.

Even if the invitation is declined, there is a potential problem with regard to the length of time that Mr Tyre has been the engagement partner – 20 years. He is by now likely to be over-familiar with the client, and may be too trusting and/or sympathetic. The form should strongly consider safeguards to independence in this situation such as rotating Mr Tyre away from this engagement.

Situation 2

Mr Knapp takes no part in the management of Entity Y. However, if he is involved with the audit there may be actual or perceived threats to his objectivity as his immediate family members, his parents, are the director of Entity Y.

The firm must ensure that Mr Knapp is not part of the audit team and is not in a position to influence any members of the audit team. If this cannot be demonstrated, then the firm should not accept the audit engagement.

Situation 3

The key ethical issues that arise in this situation are familiarity and possible intimidation.

There is a risk that if David is assigned to the audit over too long a period he might become unduly familiar with the client and its staff and lose his objectivity in relation to the assignment.

The finance director's request could amount to intimidation if there is any question that the audit would be withdrawn if the request was not complied with. Best practice is that audit firms should not allow clients to dictate staffing issues as it is important that audit firms staff their teams in the most appropriate way in terms of safeguarding against ethical threats, quality control on the audit and technical expertise.

If the firm considers it not appropriate to comply with the finance director's request, they should not do so, while assuring him that if different staff are assigned, they are required by professional standards to have obtained a good knowledge of the business and to be directed, supervised and reviewed well, hopefully therefore causing minimum disruption to operations.

Professional duty of confidentiality

- The basic principle
- Recognised exceptions to the duty of confidentiality
- Improper use of information
- Confidentiality of working papers

3 Professional duty of confidentiality

3.1 The basic principle

It is a fundamental principle of professional behaviour that information obtained in the course of professional work should not be **disclosed** to others or **used** unless:

- consent has been obtained from the party to whom the duty of confidentiality is owed, or
- there is a right or obligation to disclose.

Part of the rationale behind this requirement is that auditors need full and frank disclosure of information from a client in order to carry out their duties. If the client is not assured of confidentiality of this information, he may be unwilling to provide all relevant information to the auditor.

3.2 Recognised exceptions to the duty of confidentiality

There are some recognised exceptions to the duty of confidentiality. Where one of these exceptions applies, the auditor may be required to disclose the information to a third party, or may voluntarily choose to disclose confidential information.

The detailed rules on permissible exceptions vary from one country to another, in accordance with national laws.

Obligatory disclosure

An auditor/ACCA member is **obliged** to disclose relevant information to an appropriate authority if he knows, or has reason to suspect that a client has committed:

- treason
- terrorism
- drug trafficking, or
- money laundering.

In these circumstances, the requirements of the law override the duty of confidentiality.

Voluntary disclosure

Voluntary disclosure of confidential information is permitted in the following circumstances:

- when it is reasonably necessary to protect the interests of the member (for example, in making a defence against an official accusation of professional negligence)
- when it is necessary in a legal process; for example, a court case might require the production of audit documents for inspection by the court
- when disclosure is necessary in the public interest. This might apply, for example, to making disclosures to the tax authorities of non-compliance by a client company with tax regulations.

3.3 Improper use of information

An ACCA member should not use, or appear to use, confidential information gained in the course of professional work for his personal advantage or for the advantage of a third party.

For example:

- A member should not deal in the shares of a client company in such a way that it might seem that information obtained in a professional capacity has been used for his personal advantage (so-called 'insider dealing').
- Where a member has confidential information from Client 1, which affects an assurance report on Client 2, he cannot provide an opinion on Client 2 that he already knows, from this other source, to be untrue. If the member is to continue as auditor to Client 2, he must carry out normal audit procedures to enable the same information to be obtained from another source. Under no circumstances should there be any disclosure of confidential information outside the firm. Ultimately the auditor may have to resign.

3.4 Confidentiality of working papers

An accountant's working papers, which contain confidential client information, are the property of the accountant and should not normally be made available to outside parties.

However, situations may arise where government agencies (for example, tax authorities) ask to see the accountant's working papers relating to a particular client. In such situations, the accountant should act in the best interests of his client. If he feels that releasing the papers is in the best interests of his client, and the client has no objections, then the papers should be made available. Ultimately the tax authorities are likely to have legislative powers to obtain the papers. Any lack of co-operation on behalf of the auditor or his client may add to any existing suspicions.

Occasionally, the authorities may ask to see a sample of working papers from a firm of accountants, but not in relation to any particular client. This may occur when the authorities have doubts about the quality of the work performed by that practice. Again, a 'best interest' approach should be adopted, allowing the authorities to review the papers if the accountant judges that this is in the best interests of the practice and its clients.

An appropriate practical compromise may be achieved in this situation by arranging for an independent accountant to review the work and issue a report to the authorities.

Corporate financial advice and conflicts of interest

- Advising clients involved in take-over bids or share issues
- Safeguards

4 Corporate financial advice and conflicts of interest

4.1 Advising clients involved in take-over bids or share issues

Auditors are often asked to give advice. However, where clients are involved in a contested take-over bid, the auditors could find themselves in a position where they are potentially acting for both parties.

In this situation:

- there is a danger that the firm cannot give objective professional advice in the best interests of both parties (a possible lack of independence)
- the firm may be in possession of confidential information relating to each party, with a risk that the information may inadvertently become available to the other party (a possible breach of confidentiality).

Guidelines in this area are as follows:

- There is no reason, in principle, why firms should not act for both parties when a contested takeover bid occurs. However, a firm should **not be the sole or main advisor to both parties**.
- If the accountants are in possession of material confidential information and feel that their position in this respect is questionable, they should take advice from the appropriate financial regulatory authority (for example, the stock exchange involved in the take-over or the national regulator of the financial markets).

Similar conflicts of interest may arise in connection with issues of shares to the public, because the accountants may be advising both the company issuing the shares and potential investors (such as companies interested in buying an investment in the shares, or investment institutions).

4.2 Safeguards

Accountant should have procedures in place to:

- identify possible conflict of interest situations
- evaluate the possible problem, and
- where necessary, take action to manage or avoid the conflict.

Possible procedures include the following:

- Review relationships with all clients on a regular basis.
- Take care to consider potential conflicts of interest when deciding whether to take on new clients.

- If a potential conflict is identified, decide on an appropriate course of action. An appropriate course of action may be any of the following:
  - Notify the clients involved and discuss the matter with them.
  - Set up 'Chinese walls' to manage the problem. A Chinese wall is set up by using different members of staff on the assignments for each of the clients, and locating them in different offices. The two groups of staff act independently of each other, and do not communicate with each other except in an official capacity.
  - Consider resigning (or declining the new engagement offered) in respect of one of the two clients.

CHAPTER

4

Professional responsibility and liability

Contents

Auditors' liability and the expectations gap

1 Auditors' liability and the expectations gap

1.1 Introduction

This chapter deals with a number of aspects of law and regulation under which auditors:

- may have penalties imposed on them for a criminal offence, or
- may have legal claims made against them (for 'damages') for negligence.

The potential liability of auditors has become an important topic in recent years, due to the growing complexity of the business and legal environment and an increase in legal actions against auditors.

One explanation put forward to explain the high number of legal actions against auditors is the 'expectations gap'.

1.2 The expectations gap

The expectations gap is the difference (or 'gap') between:

- what the users of financial statements and other members of the public think that auditors do, and
- what auditors actually do.

There are three main elements in the expectations gap:

- A **standards gap**. This occurs because of a perception that auditing standards are more prescriptive than they actually are, and that auditors have wide-ranging rules that they must follow:
- A **performance gap**. This occurs because of a perception that audit work has fallen below the required standards.
- A **liability gap**. This arises from a lack of understanding about the auditor's liability and who the auditor may be liable to.

In addition, there is a perception that auditors have a responsibility for detecting all **fraud**, whenever this occurs.

High levels of expectation about what auditors should do may lead to legal action against auditors if this level of expectation is not met. To reduce the frequency and cost of legal action, and to maintain the image of the audit profession in the mind of the public, it is in the interests of the profession to take steps to close the expectations gap.

1.3 Closing the expectations gap

Ways of attempting to close the gap include the following:

- The profession should attempt to improve the general level of knowledge and understanding about the audit process. One such attempt has been made with ISA 700, the auditing standard on auditor's reports. This requires the audit report to include an explanation of the nature of an audit.
- The profession should improve the public's knowledge of the auditor's responsibility in the area of fraud. (Responsibility for error and fraud is discussed in more detail later.)
- Controls over the auditing profession may be improved, as a means of enhancing public confidence. A problem arises, however, from the fact that regulation is often at a national level and non-statutory. It is worth noting that the European Union requires the audit of companies whose shares are quoted on a stock market in the EU to be conducted in accordance with international auditing standards (ISAs).

Fraud and error: ISA 240

- The distinction between fraud and error
- Responsibilities of management and auditors for fraud and error
- The auditor's procedures where fraud or error is suspected

2 Fraud and error: ISA 240

2.1 The distinction between fraud and error

ISA 240 *The auditor's responsibilities relating to fraud in an audit of financial statements* regulates this area. It makes the following distinction between fraud and error:

Fraud: may be defined as intentional acts which may involve:

- fraudulent financial reporting (falsification of records or documents, a deliberately incorrect application of accounting policies)
- misappropriation of assets.

Both types of fraud can result in material misstatements in the financial statements.

Error may be defined as:

- unintentional misapplication of accounting policies
- oversights
- unintentional clerical errors, or
- misinterpretation of facts.

The key distinction between fraud and error is therefore whether the effect on the financial statements is deliberate (fraud) or unintentional (error). However, there may be little or no difference between fraud and error as far as the impact on the audit is concerned. In both cases the auditor will be concerned about the impact on the 'true and fair view' presented by the financial statements.

The main difference between fraud and error may arise in relation to any national reporting requirements. There may be requirements to report suspicions of fraud, but not error.

2.2 Responsibilities of management and auditors for fraud and error

Responsibilities of management

Management is responsible for **preparing** financial statements that show a 'true and fair view'. This role is reinforced by principles of good corporate governance, which require management to set up appropriate systems and controls.

Management is therefore responsible for the **prevention and detection** of fraud and error.

Responsibilities of the auditor

The auditor is responsible for **reporting** on whether the financial statements show a 'true and fair view'. He is therefore only concerned with fraud and error that has a material effect on the true and fair view.

The auditor's responsibility is to obtain **reasonable assurance** that the financial statements, taken as a whole, are **free from material misstatement**, whether caused by fraud or error.

It is **not** the primary responsibility of the auditor to prevent or detect fraud or error, although the audit may act as a deterrent to fraud. Auditors may also discover error or fraud during the course of their audit work, but they are by no means certain to do so whenever error or fraud has occurred.

It must be recognised that some material misstatements caused by fraud or error may go undetected, because of the inherent limitations in any audit and the fact that deliberate attempts may be made to conceal fraud from the auditor.

ISA240 states the responsibilities of management and the auditor as follows:

- 'The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.'
- 'An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.'

Professional scepticism

The auditor should perform the audit with a suitable degree of professional scepticism.

- The audit team should discuss the possibility of fraud in the context of the specific characteristics of the audit engagement.
- Discussions should be held with management on the procedures (controls) in place to detect or prevent fraud.
- The risks of possible fraud should be identified and its possible impact on the financial statements should be evaluated.
- Audit procedures should be designed to obtain evidence that fraud, which may impair the financial statements, has not occurred, or has been detected and corrected (or disclosed in the financial statements).

2.3 The auditor's procedures where fraud or error is suspected

The auditor should take the following steps when fraud or error is suspected:

- Identify the extent and possible impact on the financial statements of the fraud or error. Document the facts fully in the audit files. Additional testing may be required to establish the likely extent of any misstatement.
- Consider the possible impact on other areas of the audit and on the overall assessment of audit risk. This may result in a revision to the original audit plan.
- The findings should be discussed with management, regardless of the extent of the problem, and management should be kept informed of developments.
- The auditor should determine the action that management should take. This should include the possibility of seeking legal advice if fraud is suspected.
- The auditor should normally communicate on a formal basis to management at an appropriate level. In the case of a company, the auditor communicates formally with the board of directors or the audit committee. However, if management themselves are involved in a suspected fraud, the auditor should consider taking legal advice to decide the best course of action. In extreme cases, the auditor may feel it is appropriate to resign.
- The auditor should consider the impact on his audit report to the shareholders, in terms of any impact on the true and fair view presented by the financial statements.
- The auditor should consider whether there is any requirement to report to appropriate authorities. This must be considered in the context of the auditor's duty of confidentiality to his client.

The auditor's liability

- Criminal liability
- Civil liability

3 The auditor's liability

Legal claims may be made against an auditor on a number of grounds.

- The auditor may be prosecuted by the authorities for a criminal act, and be criminally liable if found guilty. (The penalty may be a fine, or possibly imprisonment for a guilty individual.)
- The auditor may be liable under civil law. A 'civil' legal action may be brought against an auditor by another person who has suffered loss or damage because of the auditor's actions. The person bringing the legal action usually seeks a money payment ('damages') from the auditor, to recover their losses they have suffered.

The precise details about an auditor's criminal and civil liabilities vary from one country to another, depending on national legislation. However, the general position is described below.

3.1 Criminal liability

The auditor may be criminally liable in the following circumstances:

(1) Where he accepts appointment as auditor under a statutory provision without being qualified to act.

(2) Where he is involved in fraud, such as falsifying accounting documents or records.

(3) Where he is guilty of '**insider dealing**'. The criminal law of many countries makes it an offence for a person with inside knowledge of price-sensitive information to use or pass on that information. Insider dealing is also prohibited under the IFAC and ACCA rules of professional conduct. Auditing practices should take suitable steps to reduce the risk of insider dealing. For example, it is normal practice for audit firms to impose restrictions on the amount of shares that their staff may hold in client companies, and to require staff to declare all their shareholdings. These procedures also help the audit firm to ensure auditor independence.

(4) Criminal liability may also arise for certain offences relating to:

- the winding up of a company
- tax law
- financial services legislation, in areas such as dealing in investments or giving investment advice.
- Money laundering (as discussed in Chapter 2)

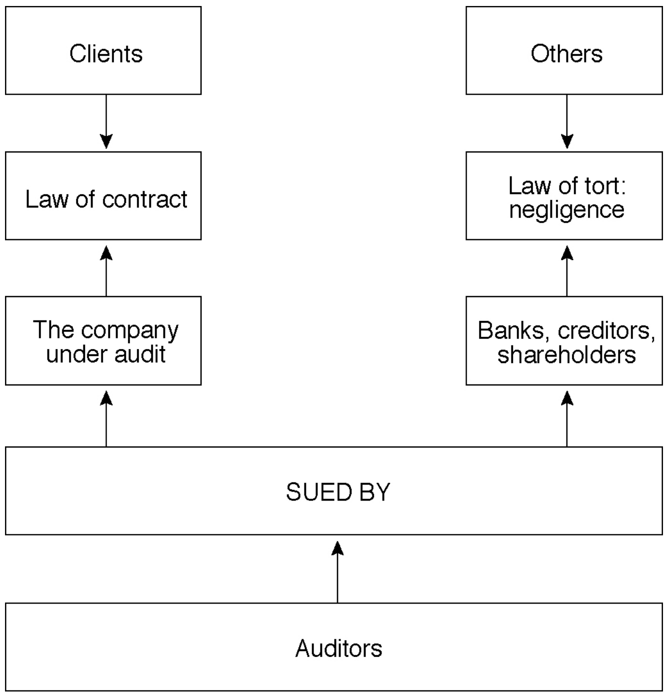
3.2 Civil liability

A major threat faced by the auditing profession is the possibility of legal claims against auditors as a result of **negligent** (or 'careless') auditing. The details of legal liability vary from one country to another. The following discussion is intended to give you an appreciation of the general legal principles involved, and is based on English law.

For your examination, you should focus on the general principles, not the detailed national rules. The legal cases described below show how the legal issues have developed over time.

Contract law and the law of tort

Under English law, an auditor may face legal claims for losses suffered as a result of negligent auditing under two separate branches of law: contract law and the law of tort. A summary of the position is as follows:



Contract law

A company has a contract with its external auditor for the provision of audit services. It can therefore sue the auditor for **breach of contract** if the auditor is negligent in carrying out the terms of the contract.

Note that **only the company** can sue the auditor for a breach of contract. Other persons who might want to sue an auditor, such as banks, creditors and shareholders, do not have a contract with the auditor; therefore they cannot bring a legal action under the law of contract.

When a legal action is brought against an auditor by a company for breach of contract (negligence), the action is usually initiated by the board of directors of the company.

Standards of skill and care

When carrying out their duties for a client, the auditors must exercise reasonable care and skill. The ACCA's Code of Ethics and Conduct require that members should carry out their professional work with **professional competence and due care** and with proper regard for the technical and professional standards expected of them as members.

The degree of skill and care expected of an auditor in a particular situation depends on the circumstances. There is no general standard of skill and care; the auditor is expected to react to the situation and the particular circumstances that he is facing.

The case summarised below indicates the view that English courts have taken of the degree of skill and care owed by an auditor to his client under contract law.

***Re Thomas Gerrard & Son* (1968)**

The managing director of a company falsified the accounts in order to conceal losses. As a consequence, dividends were paid (illegally) either wholly or partially out of capital over a number of years. The managing director had done this by including non-existing goods in inventory and by altering invoices. The auditors discovered the altered invoices, but did not pursue the matter further. They accepted assurances from the management that there was no problem.

The court's decision. It was 'held' (decided) by the court that the discovery of the altered invoices should have put the auditors on alert. Once they had made this discovery they were no longer entitled to accept the assurances of the directors. The auditors' suspicions should have been aroused and enquiries should have been made with suppliers, to verify the assurances given by the company's management. The auditors were therefore negligent.

In the absence of suspicious circumstances, the auditor is entitled to accept the word of a responsible company official. But once an auditor's suspicions have been aroused, he has a duty to investigate the matter until it is satisfactorily resolved.

In general, if the auditor has followed auditing standards and can demonstrate this in his working papers, he will not usually be found guilty of negligence. This is why it is so important for the auditor to ensure that he maintains adequate working papers and obtains sufficient, relevant and reliable evidence to support his audit opinion.

Liability in tort

Only the client company can sue the auditor in the law of contract, because only the company has a contract with the auditor. Others who feel they may have suffered as a result of negligent auditing have to rely on a different branch of law – the law of tort. An important question is: 'To what extent can others rely on the civil law, and bring an action for negligence against the auditors of a company?'

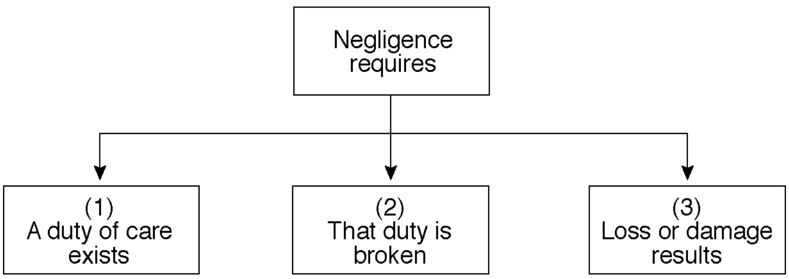
A **tort can be defined** as a 'civil wrong' other than that arising under contract law, giving rise to a claim for damages. (A civil wrong is wrongdoing that is not a criminal offence, but which allows the injured person to bring an action in civil law against the wrongdoer.) **Negligence** is just one of many branches of tort.

Examples of other persons who may suffer loss because of an auditor's negligence and relying on financial statements that do not give a true and fair view are:

- A bank that lends money to a company, and the company subsequently defaults and fails to make payments of interest or repayments of the loan principal
- A supplier who has given credit to the company, whose debts have to be written off as 'bad'.
- Another company who relies on the financial statements when deciding to make a takeover bid for the audited company.
- An investor who relies on the financial statements to buy shares in the company, and the share price falls when the true state of the company later becomes apparent.

Making a successful claim for auditor negligence (law of tort)

If a person is to make a successful claim against the auditor in the tort of negligence, **three conditions** must be satisfied.



- **Condition (1)** – The auditor must owe a duty of care to the person who has suffered a loss due to the auditor's negligence. The existence of a duty of care has proved the most troublesome of the three conditions to establish, in cases brought before the courts. This is considered in more detail below.

- **Condition (2)** – The duty of care must have been broken. The party bringing the claim against the auditor has to show that the auditor did **not** exercise a reasonable degree of care in the circumstances, so that the duty of care was broken. A typical method used in court cases to prove that a duty has been broken is to call another firm of auditors as expert witnesses. The expert witnesses are asked to give their view on whether the audit was performed correctly.
- **Condition (3)** – A loss or damage must result from breach of the duty of care. Proving that this condition has been met is usually a question of demonstrating that the person making the claim suffered a financial loss **as a result of** the negligent auditing. For example, if a bank lent money to a company on the basis of audited accounts that were subsequently found to contain material errors or omissions, and the company subsequently defaulted on its loan, the bank can demonstrate a measurable financial loss.

Establishing the existence of a duty of care (law of tort)

Most of the major court cases on auditor negligence have been concerned with the question of whether the auditor owes a duty of care to the 'plaintiff'. (The plaintiff is the person making the claim for damages.) The cases summarised below, taken from UK law, show how the view of the courts on this question has developed over time, since the 1950s.

You should concentrate on the principles involved, rather than the details of the cases. Some of the cases do not deal specifically with auditors, but the principle established by the court would be applicable to auditors in similar situations.

***Candler v Crane Christmas* (1951)**

In this case, Candler sued the accountants Crane Christmas when he lost money he had invested in a company. Crane Christmas had prepared the accounts, and it was alleged that they had been negligent in doing so. But were the accountants liable to Candler?

The court ruling was that although the accounts were negligently prepared, Candler could not recover his losses from the accountants because **he did not have a contract** with them.

Therefore, in the 1950s, the legal view was that an auditor did not owe a duty of care to third parties who were not in a contractual relationship with the auditor.

***Hedley Byrne v Heller & Partners* (1964)**

This is a case dealing with banks, but it was seen as relevant to all professionals, including auditors and accountants. The plaintiff, Hedley Byrne, lost money when a bank reference from the defendant (Heller & Partners, a bank) turned out to have been negligently produced. The bank indicated in its reference that a mutual client was a good credit risk when this was not the case.

The court ruled that although Hedley Byrne did not have a contract with the bank, Heller & Partners, they could recover their losses due to the negligence and loss involved, because the bank knew the plaintiff by name. However, the bank did not have to pay any damages due to a general disclaimer in its letter (that gave the reference) absolving it from any liability.

This legal decision affected auditors, because the court has decided that if a third party (with whom the auditor did not have a contract) could show that it relied on the work of an auditor which later turned out to be wrong, the auditor might be liable for damages for negligence. However, this principle was only extended to plaintiffs that the auditor actually knew by name. Unidentified third parties were not able to claim against the auditor for negligence.

***JEB Fasteners v Marks Bloom* (1980)**

In this case, the plaintiff acquired the share capital of a company. The audited accounts, due to the negligence of the auditors, did not show a true and fair view of the state of affairs of the company. It was accepted that, at the time of the audit, the defendant auditors did know of the plaintiffs, but did not know that they were contemplating a take-over bid.

Whilst recognising that the auditors *owed a duty of care* in this situation, the court decided that the auditors were not liable because the plaintiff had not actually suffered any loss. It was proved that the plaintiffs would have bought the share capital of the company at the agreed price, no matter what the accounts of the company had shown.

Caparo Industries v Dickman and Touche Ross & Co (1989)

This is seen as a leading case in English law in the area of 'to whom does the auditor owe a duty of care'.

Fidelity plc was taken over by Caparo Industries. Fidelity's accounts had been audited by Touche Ross. Caparo alleged that the accounts overstated the profits of Fidelity plc and that they had relied on the audited accounts of Fidelity when deciding to purchase shares in the company and make a takeover bid.

The court held that a duty of care was *not owed to potential investors* in a company, or persons making a takeover bid, because of:

- a lack of proximity (a lack of 'closeness of relationship') between the auditor and a potential investor, and
- the fact that it would not be just and reasonable to impose a duty on the auditor to such investors.

In the above case, the court identified the auditor's functions as being:

- to protect the company itself from errors and wrongdoing; **not** to protect the shareholders of the company from error, and
- to provide shareholders with information such that they can scrutinise the conduct of a company's affairs and remove or reward those responsible (the directors).

The auditor does not exist to aid investment decisions.

***BBH v ADT* (1995)**

The former BDO Binder Hamlyn (BBH) partnership had audited the 1988/89 accounts of BSG. BSG had been acquired by ADT (an electronic security group) for £105 million in 1990. BSG was later found to be worth only £40 million.

Usually, the auditors do not owe a duty of care to third parties. However, in this case, one of the audit partners had verbally confirmed the accuracy of BSG's accounts during a meeting. At this point, the partner (and the firm) therefore established a verbal contract with ADT.

In December 1995, ADT were awarded £65 million damages plus interest and costs for negligence, against BBH. BBH appealed this decision and an out of court settlement was reached with ADT.

***Royal Bank of Scotland* v *Bannerman Johnstone Maclay* [2002].**

The 'Bannerman case' was a case in Scotland, but was considered to have legal implications for and so is considered to have significant legal implications for England and Wales too. Bannerman were the auditors of a company that had arranged an overdraft facility with the bank. The overdraft arrangement included a requirement for the company to send the bank a copy of its audited annual accounts at the end of each year. The company became insolvent, owing a lot of money to the bank. The bank claimed that it had relied on the auditors' unqualified opinion to continue providing the overdraft facility to the company. The audit firm claimed that it had no duty of care to the bank. The court decided that although there had been no direct contact between the audit firm and the bank, the auditors would have known about the requirement in the overdraft facility arrangement. This was knowledge they would have gained during the course of their audit work was sufficient, **in the absence of any disclaimer**, to create a duty of care to the bank. In the judge's view, the absence of a disclaimer was a crucial feature of the case.

Out-of-court settlements

Large claims against auditors in high-profile cases (such as Enron) receive a high level of publicity. Many other cases are not widely publicised, often because they are settled 'out of court'. This involves the parties who are in dispute reaching a negotiated settlement, rather than taking their case to court.

The **advantages** of out-of-court settlements are that:

- it avoids the cost and time involved in a court case
- it may avoid adverse publicity for the auditor
- the final settlement may be lower (because both sides save legal costs, and the plaintiff might agree to a lower settlement to avoid the cost and the risk of losing the case).

The **disadvantages** of out-of-court settlements are that:

- the final responsibility may be left undecided, so the legal position remains unclear
- it may encourage others to take action against auditors
- insurance premiums may rise (see below).

Example

An audit firm has been the auditor of Entity AZ for a number of years.

Its audit team has recently discovered that during that time, the managing director of AZ has been consistently overvaluing inventories.

Entity B has recently purchased a major stake in Entity Z, relying on the audited financial statements to do so.

Required

What possible defence might the audit firm use if it is sued by Entity B after a successful takeover?

Answer

The audit firm can claim that it did not owe a duty of care to Entity B.

If the audit work has been performed to expected standards, the firm should be able to claim that the audit work was performed with diligence and care, and in accordance with ISAs. The audit work could not reasonably have detected the fraud given its nature and the seniority of the individual committing the fraud.

The firm might also be able to claim that Entity B has not suffered any financial loss as a result of its reliance on the audited financial statements.

Use of disclaimers in audit reports

A disclaimer is not a requirement of an audit report, but some audit reports include one. A disclaimer states that:

- the auditor's report is intended for use of the company and the company's shareholders as a body, and
- no responsibility is accepted by the auditor to anyone except the company or the shareholders as a body for the content of the report.

The purpose of a disclaimer is to reduce the risk of legal claims by 'third parties' against the auditor for negligence.

The main problem with a disclaimer however is that in spite of the ruling in the Bannerman case, a disclaimer cannot guarantee protection for an auditor against third party claims, because the circumstances of each individual claim may be different.

Managing the auditor's liability

- Avoiding liability
- Meeting claims: professional indemnity insurance
- Limiting liability

4 Managing the auditor's liability

4.1 Avoiding liability

Clearly, it is preferable to avoid claims arising for negligent auditing. Firms can minimise the risks of being sued by ensuring that their staff perform high-quality audit work. Auditors should therefore:

- follow appropriate auditing standards
- use effective quality control procedures
- train staff to an appropriate level of knowledge and skill
- ensure that the firm is up-to-date with modern auditing methods.

4.2 Meeting claims: professional indemnity insurance

If successful legal claims are made (or if out-of-court settlements are reached, where the audit firm agrees to make a payment to settle the dispute) the auditor will have to pay damages. If the damages are so large that they are more than the firm can afford, the law in some countries may also allow claims to be made against the personal assets of partners of the audit firm.

The threat of very high claims for damages, beyond the financial means of the audit firm, applies to the major audit firms as well as smaller firms.

The professional accountancy bodies take the view that the image of the profession would be seriously damaged if claims awarded against auditors and accountants are not met because of a lack of financial resources. As a result, the ACCA and other professional bodies **require** members in practice to carry **professional indemnity insurance** (PII).

PII is an insurance policy that provides cover against all civil liabilities that are incurred as a result of the conduct of the firm's business. Money is paid out by the insurance firm on these policies **if** the firm itself is unable to pay.

However, the requirement for compulsory PII has the following disadvantages:

- It may increase the frequency and size of claims made against firms, which are seen to have large amounts of funds at their disposal to meet claims.
- It may encourage more careless auditing.
- It imposes a high cost on audit firms. These costs of insurance are likely to rise as the general level of legal claims rises.

4.3 Limiting liability

Because of the high costs of legal claims and professional indemnity insurance, a number of suggestions have been made for finding other ways of limiting claims against auditors.

- One suggestion is that there should be a statutory limit on claims, either a maximum percentage of the audit fee or a maximum fixed amount.
- Another suggestion is that auditors should be permitted to agree a 'cap' (limit) on their liability with their clients, so that a company cannot make a claim against its auditors for more than the agreed amount (cap). This is now permissible in the UK, where a company and its auditors can agree to a specified monetary sum as a ceiling or use a formula.
- The use of 'limited liability partnerships' (already available under UK law), whereby an audit firm that is structured as a limited liability partnership cannot lose more than its total fixed capital. This is similar to limited liability for companies.
- The use of the equivalent of PII for directors of client companies. This may expose the directors of companies to legal actions by other parties, rather than the audit firm, because the plaintiffs will know that the directors can afford to pay any successful claims for negligence.
- Including disclaimers of liability to parties other than the company and its shareholders in the auditors' report.

CHAPTER

5

Practice management

Contents

Quality control: ISA 220 and ISQC 1

- The need for a quality control system in audit firms
- Quality control procedures
- Quality control arrangements for individual engagements: ISA 220
- Quality control arrangements at the audit firm level: ISQC 1
- Quality control procedures specific to individual engagements
- Quality control in large firms and small firms

1 Quality control: ISA 220 and ISQC 1

It is important to remember that a firm of external auditors is a business, whose objective is to make a profit. This business is subject to regulation, such as the regulation of quality control and fees regulations, and the nature of the regulation may influence the way the business is managed.

This chapter looks at 'business' aspects of running an audit practice that are sometimes referred to as 'managing the client-auditor relationship'.

1.1 The need for a quality control system in audit firms

The ACCA and IFAC codes of conduct both require that members should perform their professional work with due skill and care and with a proper degree of technical competence.

Audit work may be performed by members of a large team of auditors (the 'engagement team'). If so, the members may have different levels of knowledge and experience. To satisfy the professional requirements for due skill and care and technical competence, audit firms need to have a strong system of quality control.

Good procedures for quality control should reduce the risk for the audit firm that it will:

- issue an incorrect audit opinion, and
- be sued for negligence.

The consequences of poor audit work and legal action by the client could be any (or all) of the following:

- legal damages and legal costs
- the loss of the client
- adverse publicity and damage to the reputation of the audit firm
- disciplinary proceedings by a professional body such as the ACCA.

It is also important for the audit profession as a whole that all audit firms should have good procedures for quality control. If the profession as a whole gained a reputation for poor quality audits, its public image would be damaged.

1.2 Quality control procedures

Quality control procedures can be considered at two levels:

- the audit firm as a whole
- each individual audit.

1.3 Quality control arrangements for individual engagements: ISA 220

The **objective** of the auditor as set out in ISA 220 *Quality control for an audit of financial statements* is to **implement quality control procedures at the engagement level** to provide reasonable assurance that:

- the audit complies with professional standards and applicable legal and regulatory regulations, and
- the audit report is issued is appropriate.

This means that quality control procedures should be implemented that are **applicable to the individual audit engagement**.

ISA 220 places the responsibility for key quality control matters on the **engagement partner**. The engagement partner has responsibility for the overall quality of the audit and is **required** to put procedures in place to ensure that:

- ethical standards are complied with and appropriate action taken if there is evidence to the contrary
- independence requirements are met, including:
  - identifying circumstances and relationships that might give rise to threats to independence
  - assessing the impact of breaches of the firm's independence policies and procedures and whether such breaches create a threat to independence
  - taking suitable action to eliminate identified threats or to withdraw from the engagement if appropriate
- procedures are in place to deal with the acceptance of new engagements and the continuance of existing engagements
- the audit is carried out by an audit team with the appropriate competence and capabilities
- appropriate management of the engagement is in place, including the direction and supervision of staff and the review of audit work. On or before the date of the audit report the **engagement partner** must, through a review of audit documentation and discussion with the audit team be satisfied that sufficient, appropriate evidence has been obtained to support the conclusions reached
- adequate consultation has taken place on difficult or contentious matters and the conclusions from such consultation implemented
- an appropriate monitoring system is in place
- the following matters are documented:

- issues in respect of compliance with ethical requirements and how they were resolved
- conclusions on compliance with independence requirements
- conclusions in respect of new and continuing engagements
- the nature and scope of conclusions from consultations undertaken.

For audits of listed companies, and any other audits where the firm has determined that an engagement quality control review is required, the engagement partner is also **required** to appoint an **engagement quality control reviewer**, who:

- performs an objective evaluation of the significant judgements made by the audit team and the conclusions reached, including:
  - discussion of significant matters with the engagement partner
  - review of the financial statements and the proposed audit report
  - review of selected audit documentation relating to significant judgments
  - an evaluation of the conclusions reached and whether the proposed audit report is appropriate
- considers the engagement team's evaluation of the firm's independence in relation to the audit engagement
- considers whether appropriate consultation has taken place on difficult or contentious matters
- considers whether audit documentation selected for review reflects the work performed and the conclusions reached.

The **engagement quality control reviewer** is **required** to document confirmation that:

- the firm's procedures in respect of engagement quality control reviews were followed
- the review was completed on or before the date of the audit report
- he is not aware of any unresolved matters that would cause him to believe that the significant judgements made by the audit team and the conclusions they reached were inappropriate.

More detail on many of the above procedures is given in a later section.

1.4 Quality control arrangements at the audit firm level: ISQC 1

Quality control policies and procedures at a firm level are set out in ISQC 1 *Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements*.

The objective of the firm as set out in ISQC 1 mirrors that of the auditor in ISA 220. The **objective** of the firm is to **establish and maintain a system of quality control** to provide it with reasonable assurance that:

- the firm and its personnel comply with professional standards and applicable legal and regulatory regulations, and
- reports issued by the firm are appropriate.

The quality control procedures that are applied within an audit firm will reflect the nature and size of the audit practice. However, personnel within the firm who are responsible for establishing and maintaining quality control procedures must have an understanding of **the entire text** of ISCQ 1. As the firm must meet the requirements of ISQC 1, it should have a system in place which addresses each of the following elements:

- Leadership responsibilities for quality
- Ethical requirements
- Acceptance and continuance of engagements
- Human resources
- Engagement performance
- Monitoring
- Documentation

The **requirements** of ISQC 1 in each of these areas are considered in turn below.

Leadership responsibilities for quality

ISQC 1 **requires** the firm to establish policies and procedures designed to promote an internal culture recognising that quality is essential. Ultimate responsibility for quality control policies and procedures should rest with the firm's CEO (or equivalent) or managing board of partners (or equivalent).

Any person to who has operational responsibility for quality control should have appropriate experience and ability and the necessary authority.

Ethical requirements

ISQC 1 **requires** the firm to establish policies and procedures to provide it with reasonable assurance that the firm and its staff:

- comply with relevant ethical requirements, and
- maintain independence where required to do so by those requirements.

The firm should:

- communicate its independence requirements to staff, and
- identify and evaluate circumstances and relationships that create threats to independence, assessing the impact of such threats and applying safeguards or withdrawing from the engagement if appropriate.

The policies and procedures should include requiring:

- staff to notify the firm of circumstances and relationships that might create a threat to independence

- staff to notify the firm of any breaches of independence of which they have become aware
- the firm to communicate such breaches to the engagement partner and other relevant staff
- the engagement partner to advise the firm of action to be taken.

At least annually, the firm should obtain written confirmation from all staff of compliance with the firm's policies and procedures on independence.

The firm should also establish criteria for determining the use of safeguards to reduce the familiarity threat to an acceptable level when the same senior personnel have been used on an assurance engagement for a long time. For listed entity clients, there must be rotation of the engagement partner after a specified period, in compliance with relevant ethical requirements.

Acceptance and continuance of engagements

ISQC 1 **requires** the firm to establish policies and procedures to provide it with reasonable assurance that the firm will only take on or continue work where the firm:

- is competent to perform the engagement
- has the capabilities (including the necessary resources) to do so
- can comply with the relevant ethical requirements, and
- has considered the integrity of the client and does not have information which would lead it to conclude that the client lacks integrity.

The policies and procedures should include requiring the firm to:

- obtain sufficient information to make such decisions (for new or existing engagements)
- consider potential conflicts of interest (and therefore whether it should accept the engagement)
- document all identified issues and how they were resolved.

These requirements mean that there should be a review of proposed new clients and (at regular intervals) of existing clients, to make sure that the firm will be independent, that there are no conflicts of interest and the firm has the technical competence to do the audit work.

When an audit firm accepts an audit engagement from a new client, suitable procedures should therefore be carried out to ensure that:

- the firm will be independent and there are no conflicts of interest
- the firm has the technical competence to do the work
- professional clearance has been obtained from the previous auditors of the new client

- appropriate anti-money laundering (client identification) procedures are performed.

Before the start of the audit each year, the engagement partner for the audit should:

- ensure that all members of the audit team are independent of the client and there are no conflicts of interest
- be satisfied with the ethical integrity of the client entity and its management.

Human resources

ISQC 1 **requires** the firm to ensure:

- it has sufficient personnel with the **competence, capabilities and commitment to ethical principles** to meet its overall quality control objectives, and
- that for each engagement an appropriate engagement partner and team are assigned.

Policies should therefore exist for the recruitment, training and development of staff. The firm should ensure compliance with ISAs and audit staff should have a good knowledge of accounting standards and local/national statutory accounting regulations.

The firm's technical auditing procedures should be set out in a manual and reinforced by training. Newsletters and/or meetings could be used as a means of ensuring that professional staff are kept up-to-date on current developments.

Work should be assigned to staff who are competent to perform that work. There should be procedures for ensuring that an audit team collectively has the appropriate level of technical knowledge for the audit engagement and includes individuals with:

- experience of audits of a similar complexity, and
- an ability to apply professional judgement.

Engagement performance

Policies and procedures are **required** to include:

- those to promote consistent quality engagement performance
- supervision responsibilities
- review responsibilities (on the basis that more experienced team members review the work of less experienced team members)
- guidance on consultation to ensure that:
  - appropriate consultation takes place on difficult or contentious matters
  - sufficient resources are available for such consultation
  - the nature, scope and conclusions of the consultation are documented (by both parties)
  - conclusions arising from the consultation are implemented.

- guidance on engagement quality control reviews to ensure that:
  - an engagement quality control review is required for audits of all listed entity clients
  - criteria are established to determine which other engagements should be subject to a engagement quality control review
  - the review covers certain procedures (the same as set out in ISA 220 – see above)
  - engagement quality control reviewers are eligible to carry out such reviews via technical qualifications, experience, authority and objectivity from the engagement
  - engagement quality control reviews are properly documented (again, as also set out in ISA 220)
- procedures for dealing with any differences of opinion between the engagement team and those consulted or between the engagement partner and the engagement quality control reviewer
- procedures in respect of completion of the final audit files on a timely basis and the confidentiality and safe custody of such documentation for an appropriate period.

Monitoring of quality control procedures

The firm is **required** to establish a monitoring process designed to provide it with reasonable assurance that its quality control system is **relevant, adequate and operating effectively**. This process should include inspecting, on a cyclical basis, at least one completed engagement for each engagement partner.

Responsibility for the monitoring process should be given to a partner or other appropriate person with sufficient experience and authority. When monitoring reviews are carried out they should not be performed by those involved with the engagement or the engagement quality control review.

The firm should:

- **evaluate the effect of any deficiencies** found to determine if they do indicate a failing in the firm's quality control system
- **communicate such deficiencies** to relevant personnel, together with appropriate remedial action.

Appropriate remedial action might include:

- action in relation to individual engagements or employees
- communication of findings to those responsible for training and professional development
- changes to the firm's quality control system
- disciplinary action, especially against repeat offenders.

If the results of monitoring procedures indicate that:

- an inappropriate report may have been issued, or

- procedures were omitted during the engagement

the firm should determine what further action is needed. This might include obtaining legal advice.

The firm should produce an **annual report** for partners setting out:

- the monitoring procedures performed
- the conclusions drawn
- any systematic deficiencies found and remedial action taken.

The monitoring system should include procedures for dealing with complaints and allegations against the firm. These should include establishing channels through which employees can come forward without fear of reprisals.

Documentation of quality control procedures

The following matters are **required** to be documented.

- Evidence of the operation of each element of the system of quality control.
- Complaints and allegations made against the firm and how these were resolved.

Documentation must be retained for a sufficient period of time, as a minimum to comply with relevant laws and regulations.

1.5 Quality control procedures specific to individual engagements

The quality control procedures applied to the conduct of each individual audit engagement will be based around the effective management of the audit team working on that engagement. This will involve:

- the direction and supervision of staff, and
- review of their work.

Direction of audit staff

The direction of audit staff is the responsibility of the engagement partner for the audit. Direction is achieved by the following methods:

- The audit team members should be informed of the work they are expected to carry out and the objectives that the work is intended to achieve.
- There should be a well-prepared audit work programme and staff should be familiar with the overall audit plan.

In addition, the members of the audit team should understand:

- their responsibilities
- the nature of the business of the client company
- risk-related issues
- problems that may arise with the audit and how these problems should be dealt with if they do occur
- the detailed approach to the performance of the audit work.

The members of the audit team should:

- maintain an objective state of mind and retain their independence
- perform their work with due care, and
- raise any questions they might have with more experienced members of the audit team.

Supervision of audit staff

Supervision should continue throughout the audit. It includes the following:

- Tracking the progress of the audit.
- Monitoring the competence of team members, including:
  - whether they have sufficient time to carry out their work
  - whether they understand their instructions
  - whether they are carrying out their work in accordance with the audit plan.
- Addressing significant issues that arise during the audit, assessing how significant they are and modifying the audit approach accordingly.
- Identifying where there is a need for an audit team member to consult more experienced members of the team.
- Monitoring the behaviour of team members (particularly inexperienced junior members of the team), to ensure that they maintain ethical standards.

Review of audit work

Review of audit work is a key aspect of quality control. All audit work should be reviewed, ideally by an auditor with a higher level of competence and experience than the audit team member who performed the audit work. The review process may take any of the following forms:

- **Hot review**: This is a review that takes place during the course of the audit.
- **Post audit review**: This is a review that takes place between the end of the audit work and the issue of the audit report. This review will usually be performed by the audit manager first and then by the audit partner (see below).
- **Second partner review**: A review by another partner may be appropriate, especially where a modified audit opinion is under consideration.
- **Peer review**: This is a review by another firm of auditors, or a partner from another office of the audit firm.
- **Review by a specialist 'Audit review department'**. This may only be appropriate in larger audit practices that can afford to operate a specialist department.

The purpose of audit review is to check whether:

- the audit work was carried out to proper professional standards
- the objectives of the audit have been achieved

- the work carried out during the audit and the audit evidence are suitably documented, and that the audit evidence supports the conclusions that have been reached.

The review of the audit work should cover:

- the audit planning process
- audit procedures, including:
  - documentation (the audit working papers)
  - the audit tests performed and the audit evidence gathered
  - compliance with the audit work programme
  - the resolution of problems encountered on the audit
- whether the conclusion reached is consistent with the audit evidence obtained and documented.

The review process itself should also be documented.

Review by the engagement partner (and audit manager)

As discussed above, **before the audit report is issued**, the engagement partner needs to be satisfied that **sufficient appropriate audit evidence has been obtained** to support the conclusions reached and for the audit report to be issued. He should therefore:

- review the audit documentation, and
- hold discussions with the audit team.

This process is usually referred to as the **partner's review**. It should be scheduled into the audit plan, towards the completion of the audit.

Before the partner's review, the audit senior should try to ensure that every file is complete and cross-referenced, in order to cut down the number of points that might be raised by the partner's review.

The partner's review will usually be preceded by a **manager review**, in the hope that the audit manager will identify some matters that can be resolved before they come to the attention of the engagement partner.

Assessing the adequacy of quality control

An exam question that asks you to discuss the adequacy of quality control in an audit will probably expect you to identify weaknesses in the conduct of the audit, such as:

- poor or inadequate planning of the audit, such as a failure to identify the key audit risks
- giving complex audit work to relatively inexperienced members of the audit team
- inadequate supervision
- inadequate review of the audit working papers by the audit manager.

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Example: quality control issues

An audit firm has just carried out the annual audit for a client company. The audit manager has just learned that during the audit planning process, a junior member of the audit team, who is an IT graduate from a major university, gave advice to the client about improvements that could be made in the client's finance and accounting IT systems.

What professional and ethical issues exist in this situation?

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Answer

The situation raises some questions about quality control in the audit.

- Junior members of an audit team must be given suitable directions about their responsibilities, and their activities should also be properly supervised. In this situation, a junior member considered that he was allowed to offer advice to the client, which clearly should not be the case. This suggests poor direction and supervision in the audit.
- The junior member obviously believed that he could offer advice directly to the client. In practice, if any member of the audit team identifies weaknesses in the client's internal controls their findings should be reported to a senior member of the audit team, who should then decide the appropriate action to take. Failure by the junior team member to report his findings to a senior auditor also raises a concern about quality control. The firm may require much better training of staff about audit responsibilities and procedures.
- It is important to establish the details of the advice that the junior team member has given to the client, and to find out whether the client has acted on that advice yet. The audit partner should discuss the situation with the client's management in order to find out whether the advice has been acted upon. If the client has acted on the advice and this advice was poor, the audit firm may be liable.

1.6 Quality control in large firms and small firms

Quality control in large firms

Large international practices operate in several countries, with local partnerships and offices further down the chain of control. Local partnerships and offices within a large practice will have access to:

- regional and national training programmes
- the firm's comprehensive audit manual
- a central technical department, available to answer technical questions from any office or local partnership
- in-house technical publications
- the firm's standardised audit documentation
- a formal system of inter-office reviews..

Quality control in small firms

The need for quality control in a small firm is just as important as for large firms. However, many of the facilities listed above are not available to small firms, because they cannot afford them. Alternative arrangements for quality control might include:

- reciprocal arrangements for review and consultation with other audit firms
- the use of audit manuals and standardised documentation from third parties or professional bodies
- external training, and sending staff on courses provided by third parties or professional bodies.

Changes in a professional appointment

- Why a change might arise
- Procedures before accepting a new audit appointment
- Deciding whether to accept a new audit appointment
- Books, documents and records

2 Changes in a professional appointment

2.1 Why a change might arise

An ACCA member may be asked to accept a new audit appointment in a situation where the previous auditor ('old' auditor) will not be reappointed.

This may be for any of the following reasons:

- The current firm is too small to cope with the demands of an expanding client (who now operates from multiple locations, in different towns or countries).
- There may be a change in the composition of the company's board of directors, and the new directors wish to appoint an auditor of their own choice.
- There may be a perceived lack of independence, possibly one that has just arisen.
- There may have been a disagreement between the directors and the 'old' audit firm (for example, over the accounting treatment of an item in the financial statements).
- There may have been a loss of confidence in the 'old' audit firm.

In theory, the auditor is appointed by the shareholders. However, in practice recommendations are made by the directors to the shareholders when they consider that there should be a change of auditors.

If the outgoing auditor feels that the change is for a reason that should be brought to the attention of the shareholders (for example, in the case of a dispute) then national legislation will allow him to make representations to the shareholders.

2.2 Procedures before accepting a new audit appointment

Before accepting an appointment, the audit firm should take the following steps:

- It should assess whether there are any professional problems attached to accepting the engagement. These might include, for example, problems of lack of independence, or a lack of technical expertise, or a conflict of interest.
- It should ensure that resources are available to complete the audit assignment; in particular it must ensure that there will be sufficient staff (of the right level of expertise) available at the right time.

- It should take up references on the proposed client company and its directors, if they are not already known to the auditors. This is usually referred to as **client screening**.
- It should communicate with the 'old' auditors, if there are any, to discuss the appointment, the client and the audit work. The method of communication should be a **professional etiquette letter**.

Client identification

In order to comply with anti-money laundering regulations, the audit firm should carry out client identification procedures. The purpose of these procedures is to confirm that the client 'is who he says he is', and that there are no grounds for suspicion that the client may be involved in money laundering activities.

- If the client is a company or other business entity, documentary evidence of the identity of the entity should be obtained – for example a certificate of incorporation in the case of a company.
- Evidence should also be obtained to confirm the address of the entity, such as headed letter paper.
- If the client is an individual, evidence of identity can be obtained from a passport or driving licence, and evidence of address (possibly) from a recent utility bill.
- The audit firm should consider whether the business of the potential new client 'makes commercial sense'. For example, it would not make sense for a very large company to be engaged in operating a number of dry cleaning shops, because the size of the company would be too large for the nature of its business operations. When this happens, the client's declared business may simply be a front or cover for hidden illegal activities.

In most cases, the client identification procedures should be a formality, and the client may be surprised that they are necessary. The audit firm should explain the regulatory purpose of client identification, to remove any doubts or concerns that the new client may have.

Communication with the current auditors

The reason for communication with the current auditors is:

- partly a matter of courtesy between professionals, and
- partly to establish whether there are circumstances relating to the change which the incoming auditors should be aware of before accepting the appointment.

The following points should be noted in connection with communicating with the current auditors:

- Client permission is required for any such communication. If the client refuses to give its permission, the appointment as auditor should not be accepted.
- If the client does not give the current auditor permission to reply to any relevant questions, the appointment as auditor should not be accepted.

- If the current auditor does not provide any information relevant to the appointment, the new auditor should accept or reject the engagement based on other available knowledge.
- If the current auditor does provide such information, the new auditor should assess all the available information and take a decision about whether or not to accept the audit work.

Note that if the 'old' auditor provides information that is relevant to the decision to accept the audit engagement, the new auditor may still accept the engagement. However, he should exercise appropriate professional and commercial judgement in doing so.

2.3 Deciding whether to accept a new audit appointment

An audit firm may occasionally decide that to accept a new audit appointment would threaten the firm's reputation and might also raise serious ethical issues. The following example is based on a previous P7 examination question.

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Example: accepting a new audit appointment

Backle Company is an owner-managed company. It has asked your firm to become its auditors. The following information has been obtained about the company, mainly from the company's current auditors.

(1) The current auditors have just resigned from the audit because they no longer have sufficient resources to carry out the audit work for Backle. They had taken on the audit two years earlier, after the previous auditors had resigned due to a dispute about fees. The current auditors commented that the company's management liked to keep a close control over costs, and they had agreed to do the audit for a lower fee.

(2) The current auditors had discovered a number of internal control weaknesses in Backle and had reported them to management, but nothing appeared to have been done by management to improve the control system.

(3) There were ongoing disputes with the tax authorities about the amount of tax payable by Backle on profits for the previous three years.

(4) Backle Company has a poor public relations image. It is currently under investigation by both the police authorities and the regulatory authorities for alleged breaches of regulations, and some of these had been widely reported.

(5) The company is ambitious and plans to expand its business in the next year or so. It expected to obtain bank loans to finance most of the expansion.

What issues should the audit firm consider when deciding whether or not to accept the new audit appointment?

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Answer

The following matters may be considered.

- Reputation. The audit firm may decide that it does not wish to be associated with a client company whose public relations image is poor. The bad reputation of the company may transfer to its auditors.

- Advocacy threat. The criminal or regulatory investigation may lead to legal action, and the audit form may be faced with an advocacy threat, and be expected to defend the company against the allegations that have been made against it.
- Aggressive management. Backle Company has aggressive managers who are willing to argue with auditors and who want to keep costs as low as possible. There is a high risk of continuing disputes over audit fees.
- Audit risk. If the company applies for new bank loans, it will probably be required to submit audited financial statements to the bank as part of the loan application. The management of Backle have a strong interest in presenting financial statements that show strong profits and a healthy statement of financial position. The risk that the financial statements may be misstated could therefore be high. (The audit firm would probably wish to consider including a disclaimer in their audit report, to reduce the risk of liability to a bank for 'negligent' auditing in the event that the financial statements turn out to be misstated and the errors are not identified by the auditors.)
- High audit risk is also suggested by the weak internal controls and failure by management to improve controls.
- The high audit risk means that a new auditor would want to conduct a very careful audit of the opening balances: this would add to the cost and time required for the audit, which Backle management may refuse to accept.

However there is no evidence of fraud (or suggestion of fraud) by anyone in the company, and the audit firm may decide to accept the audit appointment, subject to agreement about fees. Acceptance of a new audit client is a matter of judgement.

2.4 Books, documents and records

Client books and records: right of lien

Once a new auditor has been appointed, the outgoing auditor should arrange for the transfer of any books and records belonging to the client that are in his possession.

However, where fees remain unpaid, the outgoing auditor may wish to exercise a legal **right of lien** over those client books and records.

- A lien is a right to retain possession of property belonging to another until amounts due are paid.
- Auditors have a 'particular' (as opposed to a 'general') lien. This means that the right of lien is only in respect of those books and records on which the auditor has performed audit work.

In order for the lien to be applied:

- the documents must have come into the auditor's possession lawfully, and
- an invoice must have been sent to the client company for the fees owing, and there must be no dispute over fees.

Unfortunately, in some countries, legal decisions have been taken that mean a lien cannot be exercised over books and records which the client is required to keep by law. In many cases, this legal requirement applies to most of the client's books and records. Consequently, these legal decisions may significantly reduce the effectiveness of the right of lien.

Auditor working papers

Audit working papers are documents prepared by the auditors for the purpose of carrying out their audit work. In general, these belong to the auditors, unless there is a provision to the contrary in the engagement letter or in national law.

However, the outgoing auditor will be expected to provide the proposed new auditor with information that is sufficient for a reasonable handover of audit responsibilities. The precise nature of this information will depend on the stage that the audit has reached when the responsibility for the audit passes from the 'old' audit firm to the new one.

Obtaining and charging for professional work

- Obtaining professional work
- Advertising and publicity
- Practice descriptions
- Fees
- Tendering
- Credit control within an audit firm

3 Obtaining and charging for professional work

3.1 Obtaining professional work

Audit practices will want to increase the size of their client base as a means of increasing the profits of the practice. This can be achieved by:

- promoting their (good) reputation in the business community
- recommendations from existing clients
- advertising
- publicity and promotion (such as sponsorship activities).

3.2 Advertising and publicity

Advertising and publicity activities by audit firms are regulated by the ACCA and IFAC rules. The main requirements are that the advertising and publicity material used by any firm:

- must not bring into disrepute the professional body, the firm or the profession as a whole
- must not be misleading
- must not discredit the services provided by other firms
- must not break any locally-recognised codes of advertising practice.

In addition, it is recommended that advertising and publicity material should avoid any reference to fees. If fees are mentioned, there should be a statement of the basis on which the fees are to be charged. Comments about fees:

- must not be misleading
- must not offer discounts, and
- must not make comparison with the fees of other service providers.

3.3 Practice descriptions

Unincorporated firms may describe themselves as 'Chartered Certified Accountants' or 'Certified Accountants' provided that:

- at least half the partners are ACCA members
- the principals control at least 51% of the voting rights under the partnership agreement.

3.4 Fees

The question of setting a 'price' for the provision of a service is always a sensitive matter, because of disputes that may arise if the fees are unreasonable.

In establishing the fee for an audit (or for other professional work), the auditor should follow professional guidance.

For example the ACCA rules require that:

- fees should be mentioned in the engagement letter (see below)
- fees should reflect
  - the time spent on the audit and the level and experience of staff used
  - the importance of the work to the client
  - any specific overheads or other costs incurred
- fees should not be based on a percentage or on contingency calculations, unless there is an established convention of doing so (for example, in insolvency work)

Firms must then charge the client the fee that they have quoted or the tender that the client has accepted, unless extra work is required. If extra work is required that was not expected when the original fee was agreed, the firm must provide an explanation to justify the higher fee.

3.5 Tendering

Tendering for audit work is now a widely-used practice, especially by larger companies. When it invites two or more audit firms to submit a tender for its audit work, a company may want to change its auditors. However, a company may also invite firms to tender for the audit work when the term of the appointment for the current audit firm has come to an end. In this case, if the current auditor wishes to be re-appointed, it will have to go through a tendering process.

Before submitting a tender, the audit firm should consider several matters. It must not submit a tender for the work unless it can give satisfactory answers to the following questions:

- Does the firm have the expertise to carry out this audit?
- Does the firm have (or could it have) sufficient staff available at the appropriate time?

- Are there any ethical reasons why the firm could not act (for example, a problem with independence, or a conflict of interest)?
- Are there any problems, of which the firm is aware, with the current audit or auditors?

Specifically in relation to a tender, the firm should also ask itself:

- Why has it been asked to tender?
- Could it (and should it?) offer to do the audit for a lower fee than other firms are likely to quote?
- Are there any reasons why this audit is particularly attractive to the firm? For example, will the work be carried out at a quiet time of year, or is the company in an industry area where the firm wishes to develop its audit experience and expertise?
- What audit risks might arise with this particular client?

The tendering process

The principal benefit to the client of a tendering process should be lower audit fees, because several firms are competing for the work.

In response to the pressure to reduce their fees, audit firms have become more efficient and lowered their costs. Even so, the tendering process can still be 'high risk' for a firm. For example:

- The firm needs to be confident that the client is one that it can deal with professionally and economically if the tender is accepted.
- If the tender is not accepted, the time and cost involved in the tendering process (which may be considerable) has been wasted. The firm needs to be sure that a sufficiently high proportion of its tenders will be successful, to justify the costs.

The tendering process should be broken down into the following stages (assuming that a firm is submitting a tender for the audit of a new client):

(1) Collect background information about the possible new client. (This is necessary when evaluating any new client, whether the fee is to be set by tender or by any other method.)

(2) Establish the precise scope of the work to be performed and the specific requirements of the prospective client.

(3) Carry out a preliminary audit risk assessment and prepare a preliminary plan for the audit. The plan must cover the staffing requirements and the time requirements for the work.

(4) Estimate a fee.

(5) Prepare a **submission document** for the potential client. The contents of this document will typically include:
   - an outline of the key characteristics of the firm
   - clarification of the nature of the audit work or other non-audit work to be performed

- a statement of the requirements of the client and how the firm will comply with them
- an outline of how the work will be performed
- the proposed fee and the basis of its calculation
- the range of other services which the firm could offer to the client.

(6) If required, prepare and give a presentation to the potential client.

Evaluating the tender

In evaluating the tender, the client (company) is likely to consider the following issues:

- Fees
- The services that the firm is able to provide
- Geographical locations and coverage of the firm's offices
- Expertise of the firm and its staff
- Reputation of the firm
- Whether the senior management of the company think that they will be able to work well (on a personal level) with the potential engagement partner and key audit staff
- The formal presentation itself by the audit firm
- The extent to which the company wants to change its audit firm, and its dissatisfaction with the current audit firm.

Lowballing

Lowballing is the practice of tendering for the audit work at a very low fee, with the objective of winning the audit. If it is successful in obtaining the audit, the firm will hope that:

- it will be able to raise the audit fee in future years, or
- it will be able to recover losses on the audit fee by providing other, more lucrative non-audit services.

Although there is no evidence that lowballing leads to a poor-quality audit, the fact that it exists does nothing to improve the reputation of the auditing profession. The existence of low fees may suggest to the business community and to the general public that audit work is of a low quality. All fees should be sufficiently adequate to compensate a firm for the work that it carries out.

3.6 Credit control within an audit firm

An audit firm does not just charge fees. It has to collect the fees that it charges. A failure to invoice clients promptly or a failure to collect payment within a reasonable time after the invoice date would be an indication of poor credit management. Any such management weaknesses should be corrected if they occur.

Occasionally, non-payment of fees may be due to the fact that the audit client is in financial difficulties and cannot pay.

- Overdue fees are a threat to the independence and objectivity of the auditor, because it might be argued that audit work has been provided free of charge. If the unpaid amount has been overdue for a long time, it could be regarded as a form of loan by the audit firm to the client.
- The risk to auditor independence could be significant if the unpaid amount is material.
- When a client is in temporary financial difficulties it is permissible for an auditor to make commercial arrangements for staged payments of the fees receivable. The client should be made aware, however, of the ethical problems that non-payment or late payment create for the audit firm.
- For future audits, if the audit engagement is retained, the auditor should pay particular attention to the going concern assumption. If the client still has continuing cash flow problems, the going concern assumption may be challenged.

When unpaid fees are owed by a client, and the period of late payment is in excess of what might be regarded as commercially acceptable, the audit firm should consider whether it would be ethically appropriate to resign as auditors.

- The ethics partner of the firm should be asked to assess the ethical threat to the firm's independence and integrity.
- If the decision is to continue as auditor of the client, the reason should be documented.
- The most recent audit papers should be checked to ensure that sufficient appropriate evidence was obtained to support the going concern assumption in the financial statements.

Agreeing the terms of audit engagements: ISA 210

- The objective of the engagement letter
- The content of the engagement letter
- Annual review of the engagement letter
- Acceptance of a change in the terms of the engagement

4 Agreeing the terms of audit engagements: ISA 210

4.1 The objective of the engagement letter

The **objective** of the auditor, per ISA 210 *Agreeing the terms of audit engagements* is accept or continue an audit engagement **only when the basis upon which it is to be performed has been agreed**. This is done by:

- establishing whether the **preconditions for an audit are present**; and
- confirming that there is a **common understanding between the auditor and management**.

To establish if the preconditions for an audit are present ISA 210 **requires** the auditor to:

- establish if the financial reporting framework to be used in the preparation of the financial statements is acceptable
- obtain the agreement of management that it **acknowledges and understands its responsibility**:
  - for the preparation of the financial statements
  - for internal controls to ensure that the financial statements are not materially misstated
  - to provide the auditor with all relevant and requested information and unrestricted access to all personnel.

The auditor is **required** to refuse the engagement where:

- a limitation on scope is imposed by management such that he auditor would be unable to express an opinion on the financial statements, or
- the financial reporting framework to be used in the preparation of the financial statements is unacceptable, or
- management do not agree to the above responsibilities.

4.2 The content of the engagement letter

The engagement letter should include reference to the following:

- The objective and scope of the audit.

- The responsibilities of the auditor.
- The responsibilities of management.
- Identification of the underlying financial reporting framework.
- Reference to the expected form and content of any reports to be issued.

Because it specifies what the auditor will be doing and what the auditor's exact responsibilities will be, the engagement letter is also seen to be an important way of reducing the 'expectation gap'. This is the difference between:

- the view of the role and responsibilities of the auditors that is held by the users of financial statements, and
- the auditor's actual (statutory) role and responsibilities.

In addition to the above, the auditor may feel that it is appropriate to include additional points in the engagement letter, such as:

- Regulations, ISAs, and ethical pronouncements.
- The fact that because of the inherent limitations of an audit, and the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected even though the audit was properly planned and performed in accordance with ISAs.
- Arrangements regarding the planning and performance of the audit, including the composition of the audit team.
- The expectation that management will provide written representations.
- The basis on which fees are computed and any billing arrangements.
- A request for management to acknowledge receipt of the engagement letter and to agree to its terms.
- Arrangements concerning the involvement of other auditors, experts or internal auditors (or other staff of the entity).
- Any restriction of the auditor's liability when such possibility exists.

Best practice also recommends that the engagement letter should include an explanation of the auditor's responsibility with regard to anti-money laundering checks and procedures.

4.3 Annual review of the engagement letter

The engagement letter that is issued on the initial appointment of the firm as auditors may specify that its provisions will apply to all future audits, until it is revised.

However, ISA 210 **requires** the auditor, for recurring audits, to assess whether:

- circumstances mean that the terms of engagement need to be revised
- management need to be reminded of the existing terms of the engagement.

The ISA suggests that the following factors may indicate that the above is appropriate:

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

4.4 Acceptance of a change in the terms of the engagement

The entity might, in certain circumstances, ask the auditor to change the terms of the audit engagement. This might result from a genuine change in circumstances or from a misunderstanding as to the nature of an audit as originally requested. However, it could result from a situation where the auditor is unable to obtain sufficient appropriate audit evidence regarding a material item. The entity might then ask for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

ISA 210 **requires** the auditor to consider the justification for the request and whether it is "reasonable".

- If the auditor considers that it is a reasonable request then revised terms should be agreed and recorded.
- If the auditor is unable to agree to a change of terms he should withdraw from the engagement and consider whether there is any obligation to report the circumstances to those charged with governance, owners or regulators.

CHAPTER 6

The audit approach

Contents

Audit strategies

1 Audit strategies

1.1 A choice of audit strategies

An audit strategy is the **overall approach** that the auditor decides to take for an audit, from which a detailed audit plan can be developed.

Several possible audit strategies are available:

- a business risk approach, or risk-based approach
- a systems-based approach
- a substantive testing approach
- a statement of financial position approach (usually for small entities).

These strategies are not mutually exclusive, and they may be used in combination. For example, although most of the work on a particular audit might be 'systems-based', the auditor will also carry out some substantive testing on balances and transactions.

The different approaches describe the emphasis of the audit approach, and where the auditor expects to find most of the evidence that he needs to reach an audit opinion about the 'fair presentation' or 'true and fair view' in the financial statements.

1.2 Summary of available audit strategies

The main audit strategies are summarised in the following table. They will be described in more detail in the rest of the chapter.

Strategy/approach	Outline of approach
Substantive testing approach	■ This approach focuses on applying substantive tests to a large number of transactions and account balances recorded in the accounting system of the client. ■ This focus on recorded transactions and balances means that under-statements may not be detected. (The auditor may ignore transactions that have not been recorded.) ■ This approach is time-consuming and costly for the audit of large companies. ■ This approach is appropriate where systems and controls are weak or not operating. Substantive tests on transactions and balances are therefore necessary to reach an opinion about the financial statements. ■ It is widely used for the audit of smaller entities where controls are likely to be weak. ■ There is a danger of spending too much time auditing transactions or balances that are not material. ■ There is a risk that misstatements in the financial transactions will not be detected unless **all** transactions and balances are tested, not just a sample.
Systems-based approach	■ The audit focus is on the **application of tests of control to the systems** that produce the figures in the financial statements, rather than on the figures themselves. ■ A systems-based approach is supported by some degree of substantive testing, because of the unavoidable limitations or weaknesses in internal control systems. (The amount of substantive testing required will depend on the auditor's judgement about the effectiveness of the internal controls.) ■ It is also supported by the use of analytical procedures. ■ It is more cost-effective than a full substantive testing approach, but there is still a danger of doing too much unnecessary auditing of areas where controls are operating well.
Risk-based approach and business risk approach	■ An assessment is made of the likelihood of material misstatements existing in each area of the audit. ■ Areas that are assessed as high-risk are audited extensively (using substantive tests, a systems-based approach and analytical procedures). ■ Areas assessed as low-risk are given a low level of attention in the audit. ■ Auditing methods (applied mainly by large audit practices) focus on 'business risk' rather than overall 'audit risk'.

1.3 Factors in the choice of audit strategy

The selection of the audit strategy will depend on a number of factors, including:

- the nature and size of the client's business: a business risk approach is best-suited for large companies, and a statement of financial position approach is usually the most suitable for small companies
- the control procedures and control environment in place: a systems-based approach is most suitable when there is a strong control environment and internal control system
- the audit methods and techniques favoured by the audit firm: for example, larger audit firms may favour a business risk approach.

You may be asked to select and justify an audit strategy for a particular client in the exam, in which case, you would be considering factors such as these.

The business risk approach

- The development of audit strategy and practices
- The meaning of the business risk approach
- The nature of the business risk approach
- Internal business risks and external business risks
- Risk evaluation
- Advantages and disadvantages of the business risk approach
- Comparison of business risk and financial statement risk

2 The business risk approach

2.1 The development of audit strategy and practices

Auditing practice has developed significantly over recent years. The main reasons have been:

- the increasing size and complexity of business units, and the challenges created for the audit process by size and complexity
- an attempt to improve the efficiency of the audit process.

The first major development in the 'normal' audit approach was a switch from an emphasis on substantive testing to a systems-based approach, that concentrates much more on internal control systems and the testing of systems and controls, and normally relies much less on substantive testing.

Then the concept of the 'risk-based' audit developed. In a risk-based audit, the auditor concentrates most of the audit work on areas of high overall audit risk. (As you know, audit risk is a combination of inherent risk, control risk and detection risk.)

More recently, larger audit practices in particular have developed a 'business risk' approach to audit work.

Business risk is the threat that an event or development may adversely affect the ability of the entity to achieve its objectives. It is the risk of an adverse development that could have a major impact on the company's business, such as the loss of a major customer, or an increase in the cost of a key commodity. An adverse business event is likely to affect the company's business significantly, and so should be expected to affect its financial statements.

Business risks are risks faced by management of the client entity, which could have an impact on the financial statements (including the going concern assumption).

2.2 The meaning of the business risk approach

The business risk approach involves the auditor looking **at the business as a whole** and carrying out an evaluation of the risks to which it may be exposed.

The auditor identifies the business risks which may have an impact on the financial statements of the client company. The general approach is to:

- identify the key business risks
- evaluate their possible impact on the financial statements
- plan the approach to the audit around the key business risks that have been identified.

This approach cannot work effectively unless the auditor has a good understanding of the client's business and the environment in which it operates. (Understanding the client's business and business environment is a requirement for all auditors, in ISA 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment.*)

2.3 The nature of the business risk approach

The business risk approach starts at an earlier stage than the 'conventional' audit risk model, which is based on inherent risks and control risks (and detection risks).

By looking at the nature of the client's business, the auditor should develop an understanding of the events and circumstances that may affect the entity's ability to meet its objectives. By understanding business risks, the auditor should also develop a better understanding of the inherent risks and the control risks facing the client.

The business risk approach is sometimes referred to as a '**top down**' approach to an audit.

- The approach starts 'at the top' with the business, which generates the financial transactions.
- The approach ends 'at the bottom' with the financial statements which record the outcome of the business transactions.

The business 'drives' the financial statements.

This is a 'high level' approach to the audit, and has similarities with business management and strategy. Using this approach to an audit successfully depends on having adequate and up-to-date information about the client's business and business environment.

For this reason, the larger auditing practices that use the business risk approach will often organise their audit teams into specialised industry groups, or may have industry experts available or may construct specialised databases for particular industries.

When the auditor takes a business risk approach he needs to be aware not only of the current position of the client's business, but also of possible future developments that may affect its goals and objectives.

The auditor is interested in business risk not for its own sake, but in the light of its possible impact on the financial statements.

2.4 Internal business risks and external business risks

With the business risk approach, the auditor must identify key business risks for the client company. Business risks may arise from the external environment in which a company operates, or from within the company itself.

External business risks

Examples of **external** business risks might include the following:

- The possible loss of a major contract as a result of a dispute with the customer.
- Long-term decline in demand for the company's products, and failure to invest in research and development of new products.
- The impact of a new competitor moving into the market.
- The impact of proposed changes in laws and regulations: for example where a company needs a licence to operate (as in financial services) there may be a risk that the licence will be withdrawn or will not be renewed.
- The effect of recently discovered new technology.
- The effect of changes in the macro-economy, such as changes in interest rates or exchange rates, or a downturn in the economy (lower economic growth, or possibly an economic recession).
- The impact of natural hazards (such as storms and flooding that may affect the company's ability to maintain operational capacity).
- Threats from competitors to a company's patents or copyrights.

Internal business risks

Examples of **internal** business risks might include the following:

- Risks arising from ineffective employees or weak management.
- The risks from a lack of customer care and attention to customer needs: poor customer awareness will eventually have an effect on sales demand.
- Poor financial management (such as excessive levels of gearing, poor cash management and poor working capital control).
- Lack of finance for capital expenditure on equipment replacement or modernisation.
- Risks due to systems weaknesses or system failures: internal control weaknesses.
- Risks from over-reliance on one or two key individuals.
- The risk of fraud or the misappropriation of assets.

The internal and external risks listed above are examples of risk, not a comprehensive list of business risks. In an examination question, you may be expected to identify key business risks (both external and internal) from the nature of the business and the facts given to you in the question.

For your examination, you need the ability to read a case study or scenario and:

- identify and explain business risks that are apparent in the information you are given, and
- explain how these risks have an impact on the company's ability to meet its objectives, and so have an impact on the audit.

Attempt your own answer to the following example before reading the answer provided.

e

Example: Business risks

Sting, a limited liability company, was incorporated in Ruritania on 1 June Year 1. In July, the company exercised an exclusive right that it had been granted by the government of Sordobia to provide daily flights direct between Zob (the capital city of Sordobia) and Polletta (the main commercial city of Ruritania).

The service has been widely advertised in the national newspapers of both countries as 'prompt, efficient and reliable'. As a result of these flights, it is expected that the travelling time between Zob and Polletta will be reduced by about eight to ten hours. This shortened travelling time should increase the volume of commerce and trade between the two countries.

Sting operates a refurbished 30-year-old aircraft. This is leased from an international airline and registered with the Sordobian Airways Authority (SAA) The SAA has a strict requirement that the engines of all aircraft on its register should be overhauled every two years. The overhaul of an aircraft engine usually puts the aircraft out of operational activity for up to five weeks.

The aircraft can carry 20 First Class, 50 Business Class and 80 Economy Class passengers. It also has a large hold for transporting cargo, in addition to passenger luggage.

On-board meals for the three-hour journey are prepared in Zob under a contract with an airport catering company. Market research by Sting has shown that passengers are in general dissatisfied with the quality of in-flight food, especially on the Polletta to Zob flight.

Sting employs 12 full-time cabin crew attendants whose training in air-stewardship includes first aid training and medical procedures in the event that passengers are taken ill or injured during a flight. The captain and co-pilots for the aircraft are provided under contract by the international airline that leases the aircraft to Sting.

Flight tickets are sold by Sting (by telephone and at its offices and airport reception desks) and by travel agents in Ruritania and Sordobia. On several occasions there has been over-booking of Economy Class seats. When this happens, customers are upgraded to Business Class. At the moment there is spare capacity in First Class and Business Class on all flights. Ticket prices for each class depend on several factors, such as whether the tickets are refundable (so that customers get their money back if they cancel their trip), exchangeable (so that customers can exchange tickets on one flight for tickets on an earlier or later flight). Ticket prices also vary with the day of the week and time of year.

Sting has extensive insurance cover, including employer's liability insurance (against the risk of accidents to employees) and passenger liability insurance (against the risk of liability to passengers for death, injury, extensive flight delays and other risks)

Required

Identify and explain the business risks facing Sting.

a

Answer

The business objective of Sting is to make profits from the provision of a daily air service between the two cities.

An analysis of business risks should identify what risks exist within the business of Sting that might threaten the successful achievement of this objective, and in doing so have an impact on the financial statements of Sting.

Key word or phrase in the text of the scenario	**Business risk indicated**
Exclusive **right**	Sting has a right to operate the flights, but there are presumably terms and conditions attached to this right that Sting must comply with. The risk is a risk of non-compliance with the terms and conditions, which might put into doubt the company's continued right to operate the flights.
Exclusive right	Sting is currently operating a monopoly, but this may not always be the case and potential future competition could significantly affect the company's business.
Widely advertised … as 'prompt, efficient and reliable'	Sting might not live up to its own advertising and might disappoint customers, affecting its business.
30 year-old aircraft	The age of the aircraft could cause operating problems if it needs frequent repair. The relatively old age might also mean that fuel consumption (and therefore costs) are higher.
Leased	Sting will have no means of operating its service if it does not keep up the lease payments.
Overhaul of an engine usually puts the aircraft out of operational activity for up to five weeks.	Sting must have the engine overhauled regularly under the regulations of the SAA, but this will mean a break in its services as there is only one plane.

Note that a case study might include information about problems that are not sufficiently to justify the attention of the auditors. There are three examples here:

the quality of in-flight food, over-selling Economy Class tickets and having to upgrade some passengers to Business Class, and the need to obtain insurance.

2.5 Risk evaluation

Not all risks are of equal significance. The significance of a risk to the auditors depends on two factors:

- The 'impact' that it will have on the financial statements if an adverse event occurs. It is the 'size' of the risk. In an auditing context, this could be broadly interpreted as the 'materiality' of the risk.
- The likelihood or probability that an adverse event will occur so that the risk becomes 'reality'.

Auditors may use a standard model to assist them to rank risks in order of importance. The model below is widely used in management and strategy areas – it is not specifically an auditing model.

	High likelihood	**Low likelihood**
High impact	Category 1 risk	Category 2 risk
Low impact	Category 3 risk	Category 4 risk

Most of the emphasis in an audit will be placed on risks in Category 1, where the impact of an adverse event and the probability that it will happen are both high. The least emphasis will be placed on risks in Category 4, because the impact of an adverse event will be small and the probability of it happening is low. Ranking risks in categories 2 and 3 in order of seriousness/priority will depend on the judgement of the auditor.

2.6 Advantages and disadvantages of the business risk approach

The business risk approach has some advantages, but also some disadvantages.

Advantages

- The approach requires the auditors to acquire an in-depth knowledge of the client's business. This should make the auditors more knowledgeable, and able to make a better judgement about the client's financial statements.
- When the business environment is changing rapidly, a business risk approach keeps the auditor up-to-date.
- Evidence suggests that major audit problems are more likely to result from business-related problems than from internal control weaknesses.
- A business risk approach may allow the auditor to 'add value' by making effective recommendations to improve the performance of the client's business.
- Audit costs may be reduced, because there is less audit testing, which saves time, especially the time of junior audit staff.

- The approach may benefit the auditor's own business, because its use of a 'modern' business risk approach may differentiate the firm's audit services from those of its competitors.

Disadvantages

- The business risk approach requires audit staff with suitable experience, including partners and managers. The time of these individuals is expensive. This may offset some of the cost savings (mentioned above) from a reduced need for junior audit staff.
- The business risk approach requires a closer involvement by the auditor in the client's business. This may raise questions about auditor independence.
- Some auditors feel uneasy about the 'broad' view taken by the business risk approach, and consider a systems-based view to be more appropriate for reaching an opinion on the financial statements.
- The approach may be effective only for the audits of larger companies.

2.7 Comparison of business risk and financial statement risk

Business risk is a risk that the business entity will fail to meet its objectives. Financial statement risk is the risk that the financial statements will not give a true and fair view, due to misstatements and omissions.

There is normally a close connection between these two categories of risk.

- When there is a significant business risk, failure by management to deal with the risk could affect items in the financial statements. For example a risk from declining sales demand for a product should raise questions about the obsolescence of product inventories and the realistic useful economic life and net realisable value of the non-current assets that make the product. The going concern assumption may be challenged, if the product has been a major source of income and profit in the past.
- Weaknesses in internal control are a business risk which could result in misstatements in the financial statements.

A past P7 examination question involved a case study in which a new research laboratory was threatened with closure due to failure by the company to obtain official planning permission for its construction. The laboratory was therefore constructed illegally, and there was the risk that it would have to be demolished. The business risk was the risk that the laboratory would be forced to close, for regulatory reasons. The financial statement risk was that if this were to happen, the value of the laboratory (and possibly all the equipment within it) would be overstated in the accounts and should be written down substantially in value, possibly to $0.

Both business risk and financial risk should be assessed by the auditor, in order to assess the elements of the financial statements where misstatement is most likely to happen.

The systems-based approach

3 The systems-based approach

3.1 The nature of a systems-based approach to an audit

A systems-based approach to an audit focuses on the internal control system of the client company and the adequacy of its internal controls.

As part of his risk assessment exercise, the auditor is required by ISA 315 to 'obtain an understanding of the entity and its environment, including its internal controls.'

It is the responsibility of management to put in place a suitable system of internal controls, to address identified financial risks, operational risks and compliance risks. Effective internal controls, provided that they are implemented properly, should ensure:

- reliable financial reporting
- the effectiveness and efficiency of operations
- compliance with appropriate laws and regulations.

The effectiveness of internal controls: testing the controls for effectiveness

With a systems-based approach, the auditor **aims to rely** on the accounting systems and the related internal controls to ensure that transactions are properly recorded.

- His assumption is that if the systems and the internal controls are adequate, the transactions should be processed correctly, and the financial statements should therefore give a true and fair view.
- The audit emphasis is therefore, as much as possible, on the systems that process the transactions rather than on the transactions themselves.

Before the auditor can rely on the systems and controls that are in place, he must establish what those systems and controls are, and carry out an evaluation of the effectiveness of the controls.

3.2 What makes an effective system of internal controls?

ISA 315 identifies five elements which together make up an internal control system. These are:

- the control environment
- the entity's risk assessment process
- the information system
- control activities (internal controls)
- the review and monitoring of controls.

3.3 The control environment

The 'control environment' is often referred to as the general 'attitude' to internal control of management and employees in the organisation.

The control environment has been defined by the Institute of Internal Auditors as follows: 'the attitude and actions of the board [of directors] and management regarding the significance of control within the organisation. The control environment provides the discipline and structure for the achievement of the primary objectives of the system of internal control. The control environment includes the following elements:

- integrity and ethical values
- management's philosophy and operating style
- organisational structure
- assignment of authority and responsibility
- human resource policies and practice
- competence of personnel.'

A strong control environment is typically one where management shows a high level of commitment to establishing and operating sound controls.

The existence of a strong control environment cannot guarantee that controls are operating effectively, but it is seen as a positive factor in the auditor's risk assessment process. Without a strong control environment, the control system as a whole is likely to be weak.

Evaluating the control environment

ISA 315 requires auditors to gain an understanding of the control environment. Part of this understanding involves the auditor evaluating the control environment, and assessing its effectiveness.

In evaluating the control environment, the auditor should consider such factors as:

- management participation in the control process, including participation by the board of directors
- management's commitment to a control culture
- the existence of an appropriate organisation structure with clear divisions of authority and responsibility
- an organisation culture that expects ethically-acceptable behaviour from its managers and employees
- appropriate human resource policies, covering recruitment, training, development and motivation, which reflect a commitment to quality and competence in the organisation.

3.4 The entity's risk assessment process

Within a strong system of internal control, management should identify, assess and manage business risks, on a continual basis. Significant business risks are any events or omissions that may prevent the entity from achieving its objectives.

Identifying risks means recognising the existence of risks or potential risks. Assessing the risks means deciding whether the risks are significant, and possibly ranking risks in order of significance. Managing risks means developing and implementing controls and other measures to deal with those risks.

ISA 315 requires the auditor to gain an understanding of these risk assessment processes used by the client company's management, to the extent that those risk assessment processes may affect the financial reporting process.

The quality of the risk assessment and management process within the client company can be used by the auditor to assess the overall level of audit risk. If management has no such process in place, the auditor will need to do more work on this aspect of the audit planning.

3.5 The information system

ISA 315 requires the auditor to gain an understanding of the business information systems (including the accounting systems) used by management to the extent that they may affect the financial reporting process.

This aspect of the auditor's work will involve identifying and understanding the following:

- the entity's principal business transactions
- how these transactions and other events relevant to the financial reporting process are 'captured' (identified and recorded) by the entity
- the processing methods, both manual and electronic, applied to those transactions

- the accounting records used, both manual and electronic, to support the figures appearing in the financial statements
- the processes used in the preparation of the financial statements.

The information system therefore consists of:

- infrastructure (physical and hardware components) – manual accounting systems may have little infrastructure.
- software (in IT-based accounting systems)
- people
- procedures
- data.

3.6 Control activities

Control activities are the practices and procedures, other than the control environment, used to ensure that the entity's objectives are achieved. They are the application of internal controls.

Control activities are the specific procedures designed:

- to prevent errors that may arise in processing information, or
- to detect and correct errors that may arise in processing information.

Categories of control activities (internal controls)

Controls include the following types: (In the examination, if you are asked to suggest suitable internal controls within a given system the items in this list should provide a useful checklist.)

- **Authorisation controls**. These require that all significant transactions must be authorised by a manager at an appropriate level in the organisation.
- **Physical controls** over assets. These are controls for safeguarding assets from unauthorised use, or from theft or damage. An example is limiting access to inventory areas to a restricted number of authorised personnel.
- **Arithmetic controls**. These are checks on the arithmetical accuracy of processing. An example is checking invoices from suppliers, to make sure that the amount payable has been calculated correctly.
- **Accounting controls**. These are controls that are provided within accounting procedures to ensure the accuracy or completeness of records. An example is the use of control account reconciliations to check the accuracy of total trade receivables or total trade payables.
- **Management controls**. These are controls applied by management. They include supervision by management of the work of subordinates, management review of performance and control reporting (including management accounting techniques such as variance analysis).
- **Segregation of duties**. This type of control is explained below.

Segregation of duties

Segregation of duties means dividing the work to be done between two or more individuals, so that the work done by one individual acts as a check on the work of the others. This reduces the risk of error or fraud.

- If several individuals are involved in the completion of an overall task, this increases the likelihood that errors will be detected when they are made. Individuals can often spot mistakes of other people more easily than they can identify their own mistakes.
- It is more difficult for a person to commit fraud, because a colleague may identify suspicious transactions by a colleague who is trying to commit a fraud.

3.7 Monitoring of controls

It is important within an internal control system that management should review and monitor the operation of the controls, on a systematic basis, to satisfy themselves that the controls remain adequate and that they are being applied properly. ISA 315 requires the auditor to obtain an understanding of this monitoring process.

3.8 How the auditor uses internal controls

Most audits are, wherever possible, based on a systems-based approach. The auditor **relies** on the accounting systems and the related controls to ensure that transactions are properly recorded. The audit emphasis is therefore, as much as possible, on the systems processing the transactions rather than on the transactions themselves.

Understanding the controls

ISA 315 requires the auditor to:

- gain an understanding of each of the five elements of the client's internal control system, and
- document the relevant features of the control systems.

Once this understanding has been gained, the auditor should confirm that his understanding is correct by performing **'walk-through' tests** on each major type of transaction (for example, sales transactions, purchase transactions, payroll).

Walk-through testing involves the auditor selecting a small sample of transactions and following them through the various stages in their processing in order to establish whether his understanding of the process is correct.

If he understands the controls that are in place, the auditor can go on to assess their effectiveness, and the extent to which he can rely on those controls for the purpose of the audit.

Assessing the effectiveness of controls

The degree of effectiveness of an internal control system will depend on the following two factors:

- The **design of the internal control system** and the individual internal controls. Is the control system able to prevent material misstatements, or is it able to detect and correct material misstatements if they occur? Do the internal controls appear to be adequate and effective 'on paper'?
- The proper **implementation of the controls**. Controls are not effective unless they are implemented properly. So are the controls operated properly by the client's management and other employees?

The outcome of this evaluation helps the auditor to assess the **control risk**. This is the risk that the internal controls will fail to prevent or detect and correct errors in the financial statements. This evaluation will allow the auditor to decide on the extent to which he can take a systems-based approach to the audit.

3.9 The auditor's evaluation of internal controls

The auditor may judge that the control risk is high, or that the control risk is low because the internal controls are effective.

- If the auditor assesses the control risk as **very high**, he will probably take the view that a systems-based audit approach will not be appropriate. He will therefore move on to detailed testing of transactions and balances (and take a **substantive testing** approach to the audit).
- Before he can assess the control risk as **low**, the auditor must be satisfied that the controls are well-designed and should be effective (in other words, they seem effective 'on paper'). Even if the controls appear to be acceptable on paper, the auditor cannot rely on them and perform a systems-based audit unless he is confident that the controls are actually working in practice. In this situation, the next stage in the audit process is to carry out **tests of controls**.

If the outcome of the tests of control indicates that controls are actually operating effectively, the audit can use a systems-based approach, with a reduced amount of substantive testing. Even if the internal control system seems to be effective, the auditor will never rely 100% on his assessment of the controls. He will always do some substantive testing before reaching his conclusion about the financial statements.

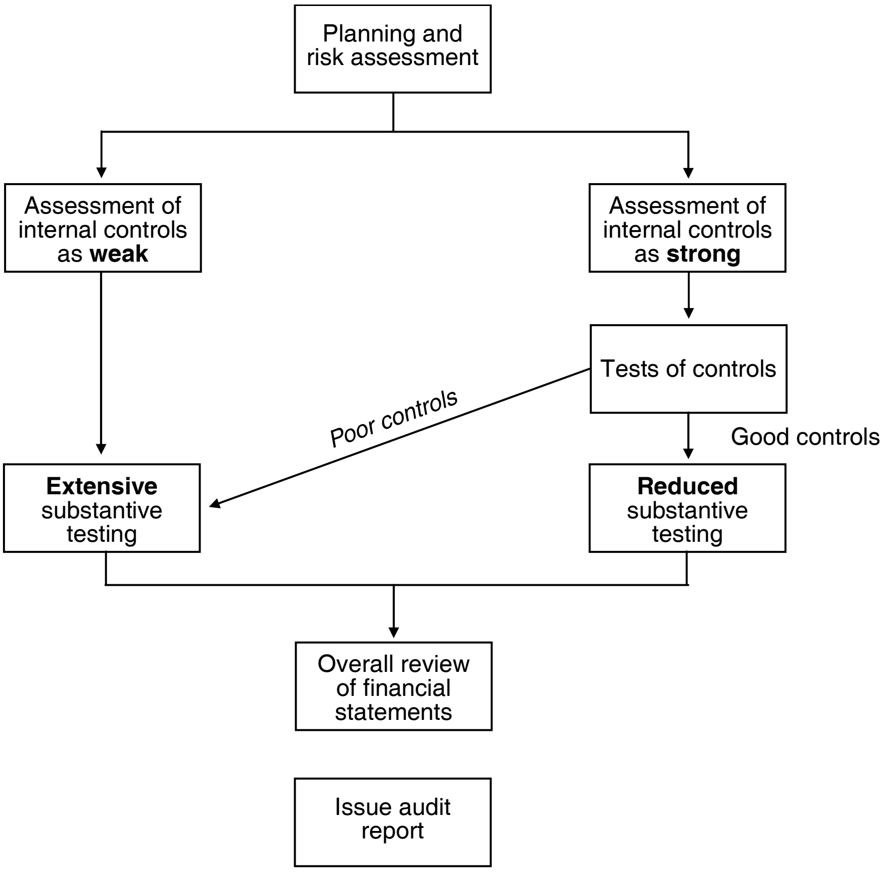
This is because of the limitations that are inherent in **all** control systems. It is impossible to avoid the risk of control failure that is caused by:

- human error (and a failure to apply a control properly)
- over-riding of controls by management (which is a deliberate decision to ignore a control), and
- the possibility of collusion and fraud.

Auditors will always supplement their work on systems with some substantive testing. The amount of this testing will depend on the auditor's evaluation of the effectiveness of the controls.

3.10 Summary of the approach to reliance on internal controls

The auditor's use of a systems-based approach to an audit is summarised in the following flowchart:



The statement of financial position approach

- Substantive tests
- The statement of financial position approach
- Smaller entities

4 The statement of financial position approach

4.1 Substantive tests

When an auditor assesses the control risk as high, he will not be able to adopt a systems-based approach to the audit. Instead he will carry out extensive substantive testing.

Substantive tests are audit procedures performed to detect material misstatements in the figures reported in the financial statements. They are designed to obtain evidence about the financial statement assertions. They include:

- tests of detail on transactions, account balances and disclosures, and
- analytical procedures.

4.2 The statement of financial position approach

The **statement of financial position approach** is also an approach to the audit based wholly on substantive testing. However, with this approach the auditor concentrates primarily on:

- testing **balances,** as opposed to
- testing balances and transactions.

It is an approach that is often well-suited to small companies and to companies where assets and liabilities are substantial in relation to transactions (e.g. investment companies).

This approach is based on the following accounting equation:

Opening net assets + Profit for the year = Closing net assets

The theory is that if the opening and closing statements of financial position are 'correct' then the profit for the year must also be correct.

4.3 Smaller entities

ISAs apply to the audits of all entities – whatever their size. However, additional considerations specific to audits of smaller entities are included within the application and other explanatory material of a ISAs, where appropriate. These additional considerations assist in the application of the requirements of the ISA in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of the ISAs.

The IAASB's *Glossary of terms* defines a s*maller entity* as one which typically possesses the following characteristics:

- Concentration of ownership and management in a small number of individuals (often a single owner-manager)
- One or more of the following:
  - Uncomplicated transactions
  - Simple record-keeping
  - Few lines of business/products
  - Few internal controls
  - Few levels of management with responsibility for a broad range of controls
  - Few personnel, many having a wide range of duties.

Many of the control activities that would typically be found in a large company may be inappropriate, too costly or impractical for a small entity. Segregation of duties is an obvious example of this. Smaller entities do not have enough employees for an 'ideal' segregation of duties.

Often, control systems in smaller entities are based on a high level of involvement in day-to-day operations by the directors or owners of the company. Authorisation controls and review controls, with the owner-manager personally authorising many transactions, might therefore be a key feature of the control systems in smaller entities.

Although the active involvement of an owner-manager might mitigate risks arising for a lack of segregation of duties, the auditor will often see the involvement of an owner-manager in day-to-day operations as only a partial substitute for 'normal' control systems. The following problems may arise:

- There may be a lack of evidence as to how systems are supposed to operate. The auditor will need to rely more on enquiry than on review of documentation.
- There may be a lack of evidence of the application of controls in practice (for example, authorisations may not be documented).
- Management may override whatever internal controls are in place.
- Management may lack the expertise necessary to control the entity effectively.
- There is unlikely to be any independent person within the management team as there would be within "those charged with governance" in a larger entity.

The attitudes and actions of the owner-manager will be key to the auditor's risk assessment. There is unlikely to be a written code of conduct so a culture of integrity and ethical behaviour, as demonstrated by management example, will be important.

The auditor needs to understand and evaluate whatever controls are in place and plan his audit work accordingly. However, it is likely that a lower level of reliance will be placed on controls in a smaller entity, which means that a considerable amount of substantive testing will be needed.

CHAPTER

7

Planning

Contents

The audit plan (strategy document)

1 The audit plan (strategy document)

1.1 The need for an audit plan (strategy document)

A plan is a course of action, decided in advance, to achieve a stated goal or objective. A plan is necessary for each audit so that the auditor can decide in advance what needs to be done so that (by the required date for completion of the audit) he will be able to express an opinion on the truth and fairness of the financial statements.

The extent and type of audit work performed is determined largely by the professional judgement of the auditor. The planning process enables the auditor to apply his judgement to the circumstances of the particular audit to decide how the audit will be conducted.

A starting point for the audit plan is deciding which audit strategy to adopt. The auditor will need to consider, amongst other things:

- audit risk (including control risk)
- materiality
- the use he might make of computers, and the effect that the client's computer-based system might have on his audit approach.

These factors are described in the rest of this chapter.

1.2 ISA 300: Planning an audit of financial statements

The auditor's work on planning is regulated primarily by ISA 300 *Planning an audit of financial statements*, which requires the auditor to plan the audit so that the audit work will be performed in an effective manner. An overall audit plan should be developed, detailing the expected scope of the audit and how the audit should be conducted.

ISA 300 states that:

- an audit should be planned so that it is performed effectively
- the auditor should establish an overall audit strategy, and
- the audit plan should include measures for the direction, supervision and review of audit work.

1.3 Audit strategy memorandum

Most auditors prepare an **audit strategy memorandum**. This is a document setting out the main points involved in the planning process and the key planning decisions that have been taken.

The memorandum will cover the following areas:

- The assignment objectives and reports to be issued.
- The audit timetable, to meet the required reporting deadlines for the audit report.
- Changes in the client's organisation or business, or external ('environmental') changes affecting the client's business, since the previous audit.
- A summary of key financial ratios and other ratios from previous years.
- Planning decisions for the audit.
- The use that will be made of the client's staff in the audit (for example, internal auditors) and the use that will be made of external experts.
- Possible problem areas in the audit and the approach to be adopted to deal with them.
- Staffing requirements for the audit, the planned allocation of the work between members of the audit team, time budgets and records from previous audits.
- Attendance locations (if the client has more than one location).
- Proposed methods of communication with the client (for example, meeting/reports).

The memorandum should be reviewed and approved by the audit engagement partner.

Audit risk

- Risk-based approach to auditing
- The audit risk model
- Inherent risk
- Control risk
- Detection risk
- Audit risk assessment: a summary
- The connection between business risk, financial statement risk and audit risk

2 Audit risk

2.1 Risk-based approach to auditing

A key feature of modern auditing is the 'risk-based' approach that is taken in most audits. At the planning stage, as required by ISAs 300 and 315, the auditor will identify and analyse the main risks associated with the business to be audited and will prepare an audit plan to focus the audit work on the high risk areas.

This area of risk assessment in audit planning is also covered by ISA 330 *The auditor's responses to assessed risks.* ISA 330 requires the auditor to:

- assess the risks involved in the audit
- plan the audit work so that any material misstatements are identified and corrected if necessary.

This should then ensure that a 'true and fair view' is presented by the financial statements.

2.2 The audit risk model

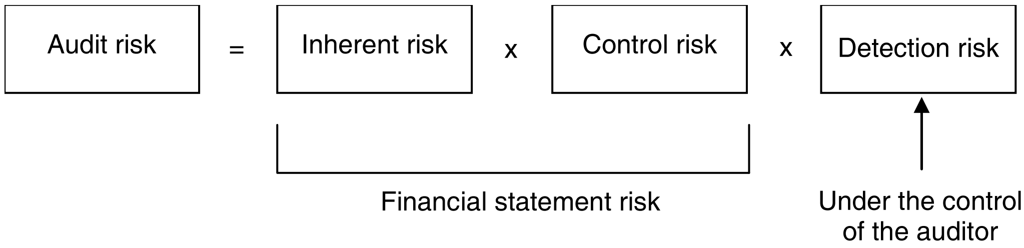
A standard audit risk model is available to help auditors to identify and quantify the main elements making up overall audit risk.

Audit risk is the risk (chance) that the auditor reaches an inappropriate (wrong) conclusion on the area under audit. For example, if the audit risk is 5%, this means that the auditor accepts that there will be only a 5% risk that the audited item will be mis-stated in the financial statements, and a 95% chance that it is materially correct.

The audit process is designed to give a **high level of assurance** about the information that is subject to audit. However, the audit process does not give an absolute level of assurance, that the information is 100% correct.

The implication of this is that the auditor will seek to reduce the level of audit risk to an 'acceptable' level, but will not attempt to eliminate audit risk entirely.

If the auditor is to 'manage' risk effectively, he needs to be able to measure the risk attached to any given audit situation, and establish a maximum acceptable limit to the audit risk. This led to the development of the **audit risk model**.



This model can be stated as a formula:

$AR = IR \times CR \times DR$

where:

AR = audit risk
IR = inherent risk
CR = control risk, and
DR = detection risk.

Risks are expressed as proportions, so a risk of 10% would be included in the formula as 0.10.

2.3 Inherent risk

Inherent risk is the risk that items may be misstated as a result of their inherent characteristics. Inherent risk may result from either:

- the nature of the items themselves: for example, estimated items are inherently risky because their measurement depends on an estimate rather than a precise measure; or
- the nature of the entity and the industry in which it operates. For example, a company in the construction industry operates in a volatile and high-risk environment, and items in its financial statements are more likely to be misstated than items in the financial statements of companies in a more low-risk environment, such as a manufacturer of food and drinks.

When inherent risk is high, this means that there is a high risk of misstatement of an item in the financial statements.

Inherent risk operates independently of controls. It cannot be controlled. The auditor must accept that the risk exists and will not 'go away'.

The assessment of inherent risk

The auditor's assessment of inherent risk will be based mainly on:

- the knowledge gained from previous audits, and
- an assessment of the current environment within which the entity operates.

It is normal practice to assess inherent risk at two 'levels':

- the financial statement level, and
- the account balance and transaction level.

At **the financial statement level,** the auditor will consider the inherent risk in the client's business, such as:

- the integrity, skills and abilities of the management
- the nature of the business
- industry-wide and macroeconomic factors.

At **the account balance and transaction level**, the auditor will consider:

- the degree of subjectivity involved in the account balance or the transaction
- the degree of complexity of a transaction and how it is processed
- the characteristics of the client's assets and the level of risk that they may be misappropriated.

e

Example: Inherent risk

It is difficult to provide a comprehensive list of inherent risks, but you may be required to identify one or more such risks within a case-study type of exam question.

For example suppose that the CEO of an audit client company is also a majority shareholder of the company, and you are aware that he intends to sell some of his shares soon after the financial statements are approved and issued. In this situation there would be an inherent risk at the financial statement level, arising from the fact that the CEO/majority shareholder has a personal interest in presenting favourable financial statements – the reported profit for the year or the reported statement of financial position – and may therefore have deliberately 'window dressed' (misstated) the draft financial statements.

2.4 Control risk

Control risk is the risk that a misstatement would **not** be prevented or detected by the **internal control systems** that the client has in operation.

In preparing an audit plan, the auditor needs to make an assessment of control risk for different areas of the audit. Evidence about control risk can be obtained through 'tests of control' for each of the major transactions cycles.

The initial assumption should be that control risk is very high, and that existing internal controls are insufficient to prevent the risk of material misstatement. However, tests of control may provide sufficient evidence to justify a reduction in the estimated control risk, for the purpose of audit planning.

It is unlikely that control risk will be zero because of the inherent limitations of any internal control system.

(**Note**: Control risk can be reduced by introducing new controls or better controls. However, the design and implementation of controls is the responsibility of the management of the company. Management may introduce better controls to reduce the control risk in next year's audit, perhaps on the recommendation of the auditors, but control risk cannot be reduced for the current year's audit.)

2.5 Detection risk

Detection risk is the risk that the **audit testing procedures will fail to detect a misstatement** in a transaction or in an account balance. For example, if detection risk is 10%, this means that there is a 10% probability that the audit tests will fail to detect a material misstatement.

Detection risk can be lowered by carrying out more tests in the audit. For example, to reduce the detection risk from 10% to 5%, the auditor should carry out more tests.

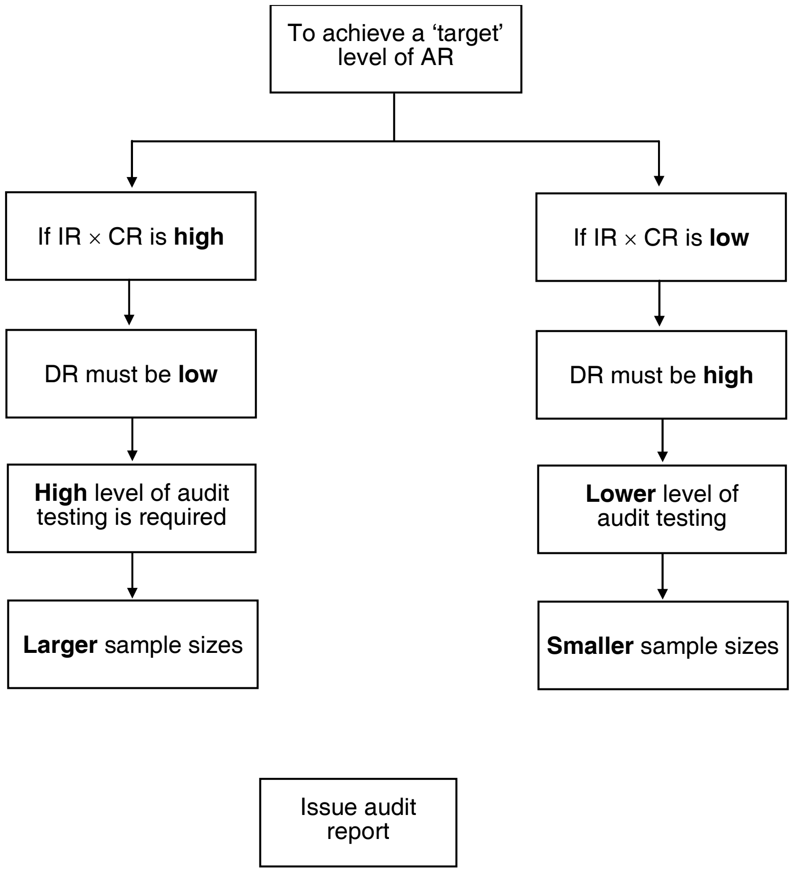
In preparing an audit plan, the auditor will usually:

- **set** an overall level of audit risk which he judges to be acceptable for the particular audit
- **assess** the levels of inherent risk and control risk, and then
- **adjust** the level of detection risk in order to achieve the overall required level of risk in the audit.

In other words, the detection risk can be managed by the auditor in order to control the overall audit risk. Inherent risk cannot be controlled. Control risk can be reduced by improving the quality of internal controls; however, recommendations to the client about improvements in its internal controls can only affect control risk in the future, not control risk for the financial period that is subject to audit. However, audit risk can be reduced by increasing testing, and reducing detection risk.

2.6 Audit risk assessment: a summary

The implications of this approach for the audit work can be summarised as follows:



2.7 The connection between business risk, financial statement risk and audit risk

It is important to understand the connection between business risk, financial statement risk and audit risk. The connection between business risk and financial statement risk was mentioned in a previous chapter. The connection is explained in more detail here.

Business risk

Business risk is any risk that threatens the ability of a business entity to achieve its objective, which can usually be stated as the objective of maximising profit. Anything that threatens this objective is therefore a risk that profits might be lower. In extreme cases, it could mean a risk that losses will be very large and the going concern status of the business entity might be called into question.

Business risks can be divided into two categories.

- A risk might have a low probability of happening, or if an adverse event does occur, the resulting loss might be small. Where the probability of loss is low and the severity of the loss would be low, the risk can be regarded as acceptable. The cost of control measures to reduce the risk would not justify the benefits from the lower risk.

- A business risk is an **applicable risk** when the financial impact of the risk could be high.

For applicable risks, management should decide on a suitable plan or strategy for managing the risk. The chosen strategy might be any of the following.

- **Reduce the risk** by introducing more **internal controls**.
- **Transfer the risk**, for example by insuring against it.
- **Avoid the risk** entirely, by withdrawing from the business operations to which the risk relates.
- **Accept the risk**, and take no action to reduce it or transfer it.

Business risk and financial statement risk

For the auditor, the significance of business risk is the impact that it could have on the financial statements. Most business risks increase the likelihood that the financial statements could be materially wrong. Some business risks can be linked to specific financial statement risks such as the risk of:

- an understatement of bad debts or the allowance for doubtful debts
- over-stating the value of inventory (where net realisable value is less than cost)
- over-stating the value of a non-current asset (tangible or intangible) due to a failure to recognise impairment.

Some business risks do not create any specific financial statement risk, although the risk might ultimately lead to going concern problems for the business entity.

Audit risk and financial statement risk

Business risk is risk that management must deal with. Audit risk is a risk that faces the auditor. It is the risk that the auditor will give an inappropriate audit opinion when the financial statements are materially wrong (mis-stated),

Audit risk follows on from financial statement risk. The auditor should therefore assess the financial statement risks as a step towards assessing the audit risk.

Business risk

Business risk could lead to …

Financial statement risk

Financial statement risk affects …

Audit risk

Audit risk results from:

(1) **Inherent risk**: risk of a misstatement where there is no internal control to prevent it

(2) **Control risk**: risk that existing internal controls will fail to detect or prevent a material misstatement

(3) **Detection risk**: Risk that substantive testing will fail to detect a misstatement.

You may be required in the exam to identify the main audit risks in a case study. Within the case study, there may be inherent risk, risk from weaknesses in the internal control system and even detection risk (for example there might be only a short amount of time and limited resources to perform the audit).

It is probable, however, that most of the audit risks will be identifiable as financial statement risks The types of risk to consider will include the following:

- **Risk of over-statement of revenue** or other income. There may be some risk that revenue has not been recognised in accordance with the requirements of IAS18 *Revenue*, and is over-stated. This risk will occur when customers make staged payments (for example staged payments for contract work) or pay deposits in advance (for example customer bookings for holidays): revenue should not be recognised until the goods or services have been provided, not when the payment is received.
- **Risk of over-statement of current assets**. For example, there may be some doubts about whether amounts receivable will actually be recovered. A company may fail to make a sufficient allowance for irrecoverable amounts, and when this happens receivables and profit will be over-stated. Another example may be the risk of over-statement of inventories, due to the timing of the physical inventory count or the procedures used in the inventory counting process.
- **Risk of over-statement of non-current assets**. There may be a risk that some non-current assets are over-stated in value, when there is some reason to suppose that impairment has occurred (for example impairment to a building due to fire or flood damage).
- **Risk of under-statement of liabilities**. There may be a risk that some liabilities are not fully stated, particularly provisions. There may be no provision in the financial statements when it would be appropriate to make one, and so reduce profit and increase liabilities. (However, a past exam question has included a case study where the company had made a provision for the cost of repairs to fire damage, when the losses were insured, and had ignored the amount recoverable through the insurance claim.)
- **Risk of understatement of operating expenses**. As a general rule there is usually a fairly consistent ratio from one year to the next between elements of cost and sales revenue. For example the ratio of administrative expenses to revenue and the ratio of sales and distribution costs to expenses are often fairly consistent from one year to the next. Some changes may occur, but not usually large changes. So for example if sales revenue is increasing but the ratio of administrative costs to sales is falling sharply, this could indicate a risk of under-statement of operating expenses.
- **Risk from accounting estimates**. The auditor should check accounting estimates carefully. These rely on management judgement and when estimates are a material amount there will be a significant risk of misstatement.
- **Failure to comply with the requirements of specific accounting standards**. An exam question may provide details about the accounting treatment of items that are the subject of specific accounting standards, such as contingent liabilities, deferred tax, share-based payments and related party transactions. You may be required to discuss the risks of misstatement or non-disclosure due to a failure to comply properly with the requirements of the accounting standard.

Example: Financial statement risks

Zarma, a limited liability company, manufactures 'high-tech' computer-controlled equipment for use in other production industries. Its directors and senior managers are also the company's shareholders. On 1 July Year 7 they accepted an offer from a US corporation to buy Zarma's own manufacturing equipment and technology, which is protected by patent rights.

Management notified the employees, suppliers and customers that Zarma would cease all manufacturing activities on 31 August Year 7. All the factory workers and most of the employees in the accounts and administration departments were made redundant, and the same was duly completed on 31 August.

Most of the employees who remained in employment with the company after 31 August were made redundant from 31 October Year 7. However, the company retained a small head office operation, consisting of the chief executive officer, the marketing and sales directors, the chief accountant and a small accounting and administrative support team. This head office unit will continue to operate for a few more years until the company's operations are wound down completely.

Before the sale, Zarma operated from twelve premises. Eight of these were put on the market on 1August. Three of the other premises are held on leases that will expire in the next three to five years. Under the terms of the lease agreements, none of these premises can be sub-let and the leases cannot be sold. A small head office building will continue to be occupied and used until the lease expires in thee years' time. Zarma accounts for all its tangible non-current assets at depreciated cost.

All the products sold by Zarma carry a one-year warranty. Until 31 August, the company sold extended two-year and five-year warranties, but extended warranties were not offered on any products sold from 1 September.

Zarma sold its products through national and international distributors, under three-year agreements. Zarma also had annual contracts with its major suppliers for the purchase of components. So far, none of the distributors or suppliers has initiated legal proceedings against Zarma for breach of contract. However, some distributors are withholding payments from Zarma on their account balances, awaiting settlement of the large penalty payments that they claim are now due to them from Zarma.

Required

Using the information provided, identify and explain the financial statement risks to be taken into account in planning the final audit of Zarma in respect of the year ended 30 September Year 7.

a

Answer

Tutorial note

There are some points that you should note about this question, for answering examination questions on financial statement risks.

- The 'question' refers to **financial statement risk**. Any comments about general business risks will not gain marks in an examination unless you link them directly to financial statement risks.
- The 'question' asks about financial statement risks in relation to the **final audit of Zarma**. This means that general comments about financial statement risks, or comments about financial statement risks that are not relevant to Zarma, would not earn you any marks in an examination.

It is particularly important when discussing financial statement risks to ensure that the risks you identify are specifically linked to the financial statements.

For example, Zarma manufactures 'high-tech' products. A business risk associated with this is that inventory might quickly become obsolete. This means that there is a financial statement risk, that **so inventory might be overstated in the financial statements**. It is important in answering an examination question on financial statement risk that you should identify the financial statement risk, not (just) the business risk. The implication for planning the audit is that audit work should be directed at testing for a possible overvalue of the inventory due to obsolescence.

Suggested ideas for a solution

The financial statement risks that might be identified are set out in the table below. The left-hand column identifies the words or phrases in the case study that should enable you to identify the risks.

Key words or phrases in the case study	Financial statement risk
manufactures 'high-tech' computer-controlled equipment	The company operates in a high-tech environment and inventories might be subject to obsolescence (business risk). Therefore **inventories in the financial statements might be overstated (financial statement risk)**.
offer from a US corporation to buy Zarma's own manufacturing equipment	This will affect **the way that items are presented in the financial statements**. Profits or losses on sales must be disclosed separately, for example.
cease all manufacturing activities on 31 August Year 7	**Financial statements should therefore not be prepared on a going concern basis**, but on a different basis, such as a break-up basis.

Key words or phrases in the case study	Financial statement risk
made redundant	If redundancy payments have not been paid at year end, **provisions for redundancy payments will be needed in the financial statements**.
small accounting … team	This may increase errors in processing accounting transactions towards the end of the year. Segregation of duties (as an internal control) might have been affected
Eight [premises] were put on the market on 1August	This will affect the way that the premises are **presented in the financial statements – as assets held for sale**.
leases that will expire in the next three to five years. …. none of these premises can be sub-let and the leases cannot be sold.	**Full provision should be made for these onerous contracts in the financial statements**. (This does not apply to the head office building which is still being used)
…warranty	**Provisions will be needed in the financial statements for these warranties**.
national and international distributors, under three-year agreements	The financial statements will need to include a **provision for costs associated with breaching these agreements**

Example: Business risks and financial statement risks

Fitkeeper, a limited liability company, operates twelve fitness centres around the country. The facilities at each centre are of a standard design and each centre contains a heated twenty-five metre swimming pool, a sauna, a gymnasium and a fitness lounge. Each centre also provides supervised childcare facilities. The day-to-day operations of each centre are the responsibility of a centre manager, who is required however to manage the centre in accordance with strict company policies. The centre manager is also responsible for preparing and submitting monthly accounting returns to head office.

By law, each centre must have a licence to operate from the local government authority. Licences are granted for periods four years and are renewable at the end of each four-year period subject to satisfactory inspection reports from local authority inspectors. The average annual cost of a licence is $9,500.

All customers of the centres are enrolled as 'members'. Members pay a $150 joining fee, plus $80 per month for 'peak' membership or $40 per month for 'off-peak' membership. Fees are payable annually in advance. All fees are stated to be non-refundable.

One of the fitness centres was closed between May and August in the financial year just ended, after a serious accident in the sauna involving chemicals. The centre was re-opened at the end of August, but head office management issued an instruction to all the fitness centre managers that the sauna facilities should be shut down until further notice.

Head office also issued the fitness centre managers with revised guidelines for the minimum levels of supervision for child care. This followed complaints from some dissatisfied members to the local government authority. Centre managers have been finding it difficult to provide the additional supervision specified in the revised guidelines and some of them have recommended strongly that the childcare facilities should be withdrawn.

Each centre operates early morning fitness sessions for members that run from 07.00 to 08.00 on four days each week. Every centre has had problems with late arrivals by staff, and many members have complained strongly that they have turned up for sessions that were shortened in length or did not run at all.

Training staff is costly and time-consuming but staff retention rates in the fitness centres are poor. In addition, staff turnover rates among the centre managers are also high. Most leavers complain of excessive directions imposed on them by head office and by company policy.

Three of the fitness centres are expected to have run at a loss for the year to 31 December (just ended) due to falling membership. Fitkeeper has invested heavily in building a hydrotherapy pool at one of these centres, with the aim of attracting members who are past retirement age. Completion of construction is behind schedule and costs to date are far in excess of the original budget. The pool is now expected to open within the next two months.

The company has experienced cash flow difficulties in the current year. As a consequence, head office management have decided to defer by at least one year the replacement of gym equipment in most of its centres.

Required

(a) Identify and explain the business risks that should be assessed by the management of Fitkeeper.

(b) Identify how each of the business risks identified in (a) may be linked to a financial statement risk.

a

Answer

Tutorial note

You should approach a solution to this question in two stages.

(1) Identify business risks. Note that part (a) refers to **business risks** relevant to Fitkeeper, so comments about audit risk will not gain any marks in an examination.

(2) Having identified a business risk, consider the impact of this risk on the financial statements. You should comment on the financial statement risk associated with the business risks you identify in part (a), so introducing different risks in part (b) will not gain marks in an examination.

Suggested ideas for a solution

The business risks and the financial statement risks that might be identified are set out in the table below. The left-hand column identifies the words or phrases in the case study that should enable you to identify the risks.

Words or phrase indicating a risk	Business risk indicated	Financial statement risk indicated
Standard design	Operational risk is increased by standard design of each centre, because a problem with one facility at one centre is likely to be repeated at all the centres.	Asset values might be affected – for example, non-current assets might be overstated if they have been impaired by lack of use (e.g. saunas – see below). Asset impairment has probably not been recognised.
each centre must have a licence to operate	An operational risk exists, because a centre cannot operate if its licence is withdrawn.	Each centre's licence must be accounted for properly, i.e. capitalised.
Fees are payable annually in advance	Financial risk is increased by payments in advance because cash has to be available to fund services later when they are due.	Deferred income must be calculated correctly in the financial statements.
serious accident in the sauna involving chemicals	Serious accidents may prompt investigation by the local government authority, leading to fines or penalties or loss of licence.	Provisions should be recognised for any fines that might be pending. If any centre's licence is affected by such events, the licence may be impaired.
revised guidelines	Compliance risk that the fitness centres cannot meet the new guidelines	If failure to comply leads to punitive action by the local government authority, it may be necessary to make provisions for fines/penalties.

Words or phrase indicating a risk	Business risk indicated	Financial statement risk indicated
many members have complained strongly	Risk that falling membership will continue	Fees payable in advance are said to be non-refundable. This might be incorrect, and a provision might be required for refunds of fees.
Three … fitness centres are expected to have run at a loss	Risk that more centres will become loss-making.	Possible need to consider the going concern status of the company, or at least to test the fitness centres for impairment as cash-generating units.
construction behind schedule and costs to date far in excess of budget	Risk that the new hydrotherapy pool will not attract the expected new members	The value of the asset should be considered. There might be a loss of value due to impairment even before it has opened for use.
defer by at least one year the replacement of gym equipment	Risk of more customer dissatisfaction and loss of members	Risk that depreciation might be charged for equipment that is already fully depreciated.

Materiality

- General principles
- Materiality thresholds
- ISA 320: Audit materiality

3 Materiality

3.1 General principles

The IASB's *Framework for the preparation and presentation of financial statements* states that "*i*nformation is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements."

ISA 320 *Audit materiality*, which was revised and redrafted in October 2008, deals with the auditor's responsibility to apply the concept of materiality when planning and performing his audit. The revised ISA makes it clear that materiality depends on the **size and nature** of an item judged in the surrounding circumstances.

It is important to appreciate that the **assessment of materiality** is always based on the **judgement of the auditor** applied to the circumstances of a particular case. There are guidelines on materiality – but no rules.

Materiality is relative

Materiality is a relative factor. What, and what amount will be material in the financial statements of one company may not be material in the financial statements of another?

Example

An unrecorded sales invoice of $1,000 is unlikely to be material to the income statement/statement of comprehensive income of a multinational company with revenue of many millions of dollars. However, it would probably be considered material to a small company with annual revenue of, say, $30,000.

Even so, such an error, even in the context of a large company must be considered carefully – as one error could indicate the existence of others which could, in total, be material.

3.2 Materiality thresholds

In order to deal with materiality on a consistent basis, most audit firms set their own '**materiality thresholds'**. Their audit staff are trained to use these thresholds to 'measure' whether or not an item is material. Materiality thresholds vary from one firm to another, but will usually fall within the following ranges:

Revenue	1% – 2%	An item of revenue is material if it is at least 1% or 2% of annual sales revenue.
Pre-tax profit	5% – 10%	An item is material if it is at least 5% or 10% of reported pre-tax profit.
Total assets	5% – 10%	A balance is material if it represents at least 5% or 10% of total assets.

The 'danger' of materiality thresholds is that they are used simply to 'measure' whether an item is material, without considering important other factors as well. Other factors that the auditor should consider in evaluating materiality may include the following:

- **The nature of the item involved** – The valuations of some items in the financial statements are more subjective than others, and depend on estimation. The more subjective the item, the more flexible the auditor should be in assessing the materiality of possible misstatements. The auditor will have to take a very different view on materiality when considering a warranty provision (which is a subjective estimate), compared with the approach taken when auditing share capital, which is capable of precise measurement.
- **The significance of the item** – Some items may be insignificant in terms of their monetary amount, but may nevertheless be of particular interest to the users of the financial statements. An example might be bonus payments to directors.
- **The impact of the item on the view presented by the financial statements**. A small and apparently insignificant error or omission may be material if, by correcting it:
  - a reported profit is converted into a reported loss, or
  - the correction significantly alters the trend of profits (growth rate in profits) over the past few financial years.

3.3 ISA 320: Audit materiality

ISA 320 requires the auditor to apply the concept of materiality:

- when **planning and performing** the audit, and
- when **evaluating the effect of misstatements** on the financial statements and therefore on his audit opinion (covered in a later chapter under ISA 450 *Evaluation of misstatements identified during the audit*).

At the planning stage, the auditor must determine materiality for the financial statements as a whole. As discussed above, this is often set as materiality thresholds. If lower thresholds are required for some areas (for example, directors' remuneration) these must also be set at this stage.

The auditor must also set what ISA 320 refers to as **performance materiality**. Performance materiality recognises the fact that if all areas of the audit are carried out to detect all errors/omissions under the (overall) materiality level, that objective could be achieved, but when all the individual immaterial errors/omissions are added together, overall materiality could in fact be breached. Performance materiality is a way of taking this risk into account and will be set at a lower figure than overall materiality. There may be one or more performance materiality levels, as the level could vary by area.

As the audit progresses, the auditor must revise materiality (and, if appropriate, materiality for particular areas and performance materiality) if he becomes aware of information which would have caused him to have initially set different levels, had that information been known to him at the time.

Documentation must include details of all materiality levels set and any revision of these levels as the audit progresses.

Computers in auditing

- Using computers to perform the audit
- Controls in computer-based information systems: general controls and application controls
- Microcomputers, on-line systems and EDI
- Computer-assisted audit techniques

4 Computers in auditing

Computer systems affect the audit process in two ways.

- The auditor may use computers to perform his audit work.
- The client's accounting systems may be computer-based. If so, the auditor will need to consider:
  - the controls that are in place for the system (and whether these are effective), and
  - whether to use computer-assisted audit techniques (CAATs) to do some of the audit work.

Each of these issues should be considered at the planning stage.

4.1 Using computers to perform the audit

It is usual for members of an audit team to take laptop computers with them to the client's premises, for use with the administration, documentation and performance of the audit assignment. Laptop computers may be used for tasks such as:

- audit administration and control (for example, preparing time sheets and audit work programmes)
- audit planning work (for example, for risk and materiality assessments)
- preparing audit working papers
- analytical procedures (including holding on file a record of statistics and financial ratios for the client for previous years)
- sampling software (if appropriate).

Using computers for the audit may also allow managers or partners to review the audit work that has been done without having to visit the client's premises. Members of the audit team can e-mail papers to managers or partners back at the office. This saves time that would otherwise be wasted by senior managers and partners in travelling to and from the client's premises.

Controls over the auditors' computer systems

When the audit work is performed largely on computers, the auditor must have suitable controls in place. Essentially, these are the same controls that should apply in any computer application. Controls should be in place to ensure that:

- client data remains confidential and cannot be accessed by an unauthorised person
- audit work held on computer file cannot be lost
- an audit trail is created for the work the auditor has done, to assist the audit review and control process
- the programs operate in the way that they are expected to.

4.2 Controls in computer-based information systems: general controls and application controls

In a computer-based system, 'normal' internal controls should be in place. For example, a computerised accounting system should include normal internal controls such as authorisation controls, arithmetic controls and accounting controls. Some of these controls may be 'computerised' and included in the computer software for the system.

In addition, further controls should exist over the computer systems that carry out the processing.

These additional controls fall into two categories:

- general controls, and
- application controls.

The auditor needs to be satisfied that these additional controls are effective.

General controls

General controls are controls over the environment in which the computer-based information system is designed, developed, operated and maintained.

The main categories of general control that an auditor would expect to find in a computer-based information system are summarised in the table below.

Control area	Controls
Development of computer-based information systems and applications	▪ Appropriate standards should be established and enforced for designing, developing, programming and documenting each new system. ▪ Suitable testing procedures should be carried out on each new system. ▪ The design of a new system should be approved formally by the management of the system user. ▪ There should be a segregation of duties between system designers and system testers (to reduce the risk of error or fraud) ▪ There should be suitable staff training in the design and testing of systems.

Table continues

Control area	Controls
Documentation and testing of program changes	▪ Formal testing procedures should be applied for any change to a current program. ▪ There should be formal authorisation procedures for program changes. ▪ There should be suitable staff training in making and testing program changes.
Prevention or detection of unauthorised program changes	▪ There should be a segregation of duties between programmers and computer system operators ▪ All program changes must be fully documented. ▪ Access to program files must be restricted ▪ Program logs should be used to record access to program files and programs. ▪ There should be anti-virus software and back-up copies of program files should be kept, to prevent or detect or deal with 'malicious' changes to programs.
Prevention of the use of incorrect programs or data files	▪ Standard operating procedures should be established, and operations should be performed by suitably-trained staff ▪ The scheduling of 'jobs' for a computer centre should specify the program files and data files to be used. ▪ There should be effective supervision of computer centre operations. ▪ Reviews of operations should be carried out regularly by management
Prevention of unauthorised amendments to data files	▪ There must be restricted access to data files, limited to authorised personnel ▪ Transaction logs should be kept of all uses of data files, and these should be reviewed by management
Ensuring continuity of operations	▪ Secure back-up copies should be kept of program files and data files ▪ Measures should be implemented for the protection of equipment against fire, power failure and other hazards ▪ Disaster recovery programmes should be in place, in the event of a major disaster that puts the main computer system out of action. ▪ There should be suitable maintenance and service agreements for all major externally-acquired software.

These general controls should apply to most or all of the entity's computer-based information system applications, not just to computerised accounting systems. If general controls are weak, it is unlikely that the processing undertaken by the system will be complete and accurate.

The auditor should review and test the general controls in order to reach a conclusion about their effectiveness. This will enable him to assess the control risk attached to the entity's computer-based information systems as a whole.

Application controls

It is also necessary for the auditor to identify and assess the application controls in each specific computer-based application, such as the inventory, receivables and payroll systems. The auditor must be satisfied that the application controls for a particular system are effective.

Application controls are specific controls over each specific computerised accounting application or system. The purpose of application controls is to provide assurance that:

- processed transactions have been properly authorised, and
- the processing of data is complete, accurate and timely.

In a manual processing system, internal controls vary according to the application. For example, internal controls over inventory are different from the controls over payroll processing. Similarly, application controls in a computer-based information system will vary depending on the nature of the application.

However, application controls for different computer applications share a number of common features, regardless of the particular application involved.

In particular, the auditor will place a high degree of emphasis on controls over **input**. For application controls to be effective, it is essential that input must be complete and accurate. If the input is not correct, the output from the application cannot be expected to be correct.

A list of application controls that might be found in a computer system is set out below.

Control area	Controls
Input	**Authorisation** ▪ Data for input should be authorised before input. ▪ Data is input only by authorised personnel. **Completeness** There should be checks to ensure that all data has been processed. Checks might consist of: ▪ Document counts (for example, counting the number of invoices) ▪ Control totals ▪ Checking output to input ▪ Review of output against expected values (for example, is the total payroll cost broadly in line with expectations)

Table continues

Control area	Controls
	Accuracy There should be some checks within the computer software on the validity of input data items (data validation checks). These may include: ▪ Check digits for key code items, such as supplier codes, customer codes and employee identification numbers ▪ Range checks (= a check on whether a particular value or figure is feasible and within a realistic range of values) ▪ Existence checks (= a check on whether a particular code exists) ▪ Review and reconciliation of output Use of control totals
Processing	There should be checks that all input has been processed and that processing is complete. Checks might include: ▪ Control totals ▪ Batch totals (where the computer counts the number of transactions in a processed batch, and this is checked against a manual record of the number of items in the batch) ▪ Manual review ▪ On-screen warning that processing is not complete
Master files and standing data	▪ Management review of master files and standing data ▪ Regular updates of master files ▪ Record counts

The auditor should review the application controls for each application, to establish whether they are effective 'on paper'. He should then carry out tests of controls to establish whether the application controls are operating effectively in practice.

4.3 Microcomputers, on-line systems and EDI

Computer systems in many organisations are 'decentralised'. They are not large centralised mainframe computer systems, operated in a computer centre by specialist operating staff. Instead, the entity uses decentralised 'standalone' computers or network systems, which are managed and operated by individuals who are not IT specialists.

The use of decentralised systems is often efficient for the client, but may create additional problems for the auditor, who needs to be satisfied that the controls within the system are effective.

The following types of system may require special attention by the auditor:

- microcomputer systems
- on-line systems
- electronic data interchange (EDI) systems.

Microcomputer systems

'Microcomputer system' is not a precisely-defined term. It refers to a computer system in which the entity uses a number of stand-alone 'desktop' computers that are located throughout the organisation.

For the entity, a microcomputer system will often be more efficient and cost-effective than a centralised mainframe computer system, especially as the systems can normally be operated (and possibly programmed) by staff with little technical training in computers and IT.

The auditor may have some difficulty, however, in satisfying himself that the controls for the system are sufficient and effective. The problems for the auditor in checking the effectiveness of controls happen for the following reasons:

- The difficulty of ensuring adequate physical security of the equipment.
- Difficulties with ensuring the security of the data and storage media (disks, tapes etc).
- These systems may permit access to many individuals, some of whom are not authorised. It may be easy, for example, for an unauthorised person to gain access to a computer system when the authorised user is not at his or her desk. The problem of easy access therefore introduces problems of authorisation. There is the risk of unauthorised amendments to program or data files. The risks in this area can be minimised by restricting access to the computer system and to particular program files and data files through the use of passwords and user names.
- Programs may be written or modified by the user (one of the potential attractions to the entity of the use of microcomputer systems) but this may cause control risks with respect to processing and the software. In an extreme case, the accounting data produced by a microcomputer may not be usable by the auditor.
- The auditor should want to see adequate documentation of the software systems. If this is not provided by the software supplier with the program, it would need to be written by the computer user.

On-line systems

On-line systems are network computer systems that allow users direct access to centrally-held data and programs. Access to the central files is through remote terminals.

On-line systems offer a number of operational advantages to entities that use them.

- They permit the immediate entry of transactions from many different locations, instead of having to submit transactions to a central computer centre for processing. For example, if a retailing company operates an on-line system for sales, sales transaction data can be input immediately for centralised processing through terminals in each retail store.
- In the same way, centralised master files (such as master files for inventory) are updated immediately. This means that subsequent users of the system can use the up-to-date versions of master files.

- On-line systems allow users to make enquiries and obtain immediate responses, by having access to master files or reference files. (For example, users are able to give immediate answers to customers about prices of products or the current status of their order.)

Again, although on-line systems are usually efficient and effective for the user, they create additional problems for the auditor who needs to assess the effectiveness of the system controls. There should be sufficient general controls and application controls to minimise the risks that arise from using on-line systems.

General controls in an on-line system could include the following:

- There must be effective controls over access to the system and its files. This is because in on-line systems, transactions are processed as soon as they are input.
- There should be controls written into the system software to prevent or detect unauthorised changes to programs.
- Transaction logs should be used to create an 'audit trail'. An **audit trail** refers to the ability of the auditor to trace a transaction through all its processing stages. An audit trail may not exist in paper form in computer systems. The computer program should therefore be written in such a way as to generate the audit trail for any transaction, on request.
- Firewalls should be used for systems that have access to the Internet. Firewalls are hardware or software devices that prevent unauthorised access to a system from an Internet user.

Application controls in an on-line system could include the following:

- Pre-processing authorisation (such as logging on to the system, and the use of user names and passwords).
- Data validation checks in the software, to check the completeness and accuracy of processing (such as checking that a product code has been entered with the correct number of digits).
- 'Balancing' – checking control totals of data submitted from remote terminals before and after processing.

Electronic data interchange (EDI) systems

Electronic data interchange (EDI) systems are systems that allow the electronic transmission of business documents, such as invoices or payroll information, between different computer systems. The EDI system provides a form of 'translation' service, so that the data transmitted from one computer system is changed into a form that can be read by the other computer system, without any need for human intervention.

EDI systems may operate:

- within the organisation (for example, the sales department may use EDI to transfer copies of customer orders electronically to a separate computer system of the accounting department), or

- externally (for example, a company may use EDI to submit payroll data for processing to the computer system of a payroll agency, or may submit purchase orders for inventory electronically to the computer system of a supplier).

EDI systems can improve the operational efficiency of an entity, but they may generate the following problems for the auditor who has to assess the efficiency of the system controls:

- The lack of a paper audit trail.
- An increased level of dependency on the computer systems of the organisation and possibly the computer systems of other entities. Any failure or control weakness in one computer system may have an impact on the computer system that is being audited.
- There may be a risk of loss or corruption of data in the process of transmission.
- There will be security risks in the transmission of data.

Auditors should expect to find effective controls in place to minimise the risks inherent in EDI systems. Typically, controls will cover such matters as:

- controls over the transmission of data (such as the encryption of data before transmission, acknowledgement systems, and the use of authentication codes for senders of data)
- monitoring and checking of output
- virus protection systems
- contingency plans and back-up arrangements.

Electronic commerce: IAPS 1013

International Auditing Practice Statement (IAPS) 1013 was issued in response to the growth in electronic commerce (or 'e-commerce'). It provides guidance on the impact of e-commerce on the auditor's risk assessment.

E-commerce is any commercial activity or trading that takes place between computers that are connected over a public network. The most common example is the sale and purchase of goods over the Internet.

IAPS 1013 focuses on the following areas:

- The skills and knowledge needed by the auditor to understand the effect of e-commerce on the entity's activities – the more complex the activities the greater the skills and knowledge required.
- The extent of the knowledge of the business needed by the auditor. E-commerce may have a significant impact on the traditional business environment – increasing security risks and geographical markets.
- Additional business risks arising from e-commerce – loss of transaction integrity, security risks, the use of inappropriate accounting policies (e.g. in respect of the capitalisation of website development costs,) legal and regulatory risks.
- Internal control considerations – internal controls may exist but there may not be an adequate audit trail.

4.4 Computer-assisted audit techniques

CAATs can be defined as any technique that enables the auditor to use computer systems as a source of generating audit evidence. They involve the use of computer techniques by the auditor to obtain audit evidence.

- CAATs are often necessary in the audit of computer-based information systems because these systems may not provide an adequate audit trail.
- In addition, processing is 'invisible' because it is electronic. Therefore the auditor needs to 'get inside the computer' to check the completeness and accuracy of the processing. CAATs allow the auditor to achieve this.

Two commonly-used types of CAATs are:

- audit software, and
- test data.

Audit software

Audit software is computer programs used by the auditor to extract information from a client's computer-based information system, for use in the audit.

The main types of audit software include:

- interrogation programs, to access the client's files and records and extract data for auditing
- interactive software, for use in interrogation of on-line computer systems
- 'resident code' or 'embedded software, to monitor and review transactions as they are being processed by the client's programs. This type of software is called **embedded audit facilities**.

The main use of audit software is in **substantive audit testing**.

Examples

Audit software is used to extract and analyse information in the entity's computer-based information systems for use in the audit work. Here are some examples.

- Account analysis. Audit software may be used to interrogate the client's data files for the general ledger, and extract from the files all items above $5,000 in the repairs expense account.
- Preparing an aged listing of receivables (an aged debtors list), if these are not already produced by the client as a matter of operational routine. The audit software can interrogate the trade receivables file, and produce a list and analysis in date order of unpaid invoices.
- Calculating ratios and making comparisons. Audit software can be used to assist the auditor with analytical procedures (which are described in a later chapter).

Test data

An auditor may use test data to process a sample of transactions through the client's computer-based information system, and compare the results (output) obtained from the processing with the pre-determined results that the auditor would expect.

Test data is used primarily for **tests of control**. The technique provides evidence that specific application controls are operating effectively in a given system.

One of the problems with using test data is that it can only give audit evidence about the computer system at the time the test data is processed. The test data cannot provide assurance that the system and its controls operate effectively at any other time. This problem can be addressed by the use of **embedded audit facilities**.

Embedded audit facilities

Embedded audit facilities may also be called 'resident audit software' or an 'integrated audit module'. It is audit software that is built into the client's computer system, either temporarily or permanently.

The purpose of embedded audit facilities is to allow the auditor to carry out tests at the time that transactions are being processed, in 'real time'.

Procedures are written into the entity's computer-based information system and these generate data for audit purposes every time the system is run. In order to obtain audit data without the risk of corrupting the client's operational data files with the test data, it is usual to establish an extra 'dummy' department. The test data results are allocated to this dummy department, and the test data is therefore kept separate from the client's operational data. Only the auditor should have access to the data stored in this dummy department.

Embedded audit facilities can be very useful for the auditor of on-line computer systems where:

- data is continually processed and master files are being continually updated, and/or
- it is difficult, if not impossible, for the system to provide a satisfactory audit trail for following transactions through the system.

An embedded audit facility may also print out details of the transactions it has monitored, or copy them to a computer file, so that the auditor can study the transactions.

Disadvantages of CAATs

CAATs give the auditor the ability to audit the processing of transactions in a computer-based information system. However, the value of using CAATs should be assessed on a cost-benefit basis. CAATs should only be used if the benefits from their use exceed the costs.

The costs related to the use of CAATs may include:

- purchasing or developing the programs
- keeping the programs up-to-date, for changes in hardware and software
- training audit staff in their use. CAATs are of no value unless auditors are properly trained in how to use them.
- obtaining time on the client's computer systems to run the CAATs.

Advantages of CAATs

CAATs also have many advantages (which is why many audit firms use them).

- They give auditors an ability to test the completeness and accuracy of the electronic processing itself (the computer software), rather than relying only on testing the accuracy and completeness of inputs and outputs.
- They give the auditor an ability to test a larger number of transactions in a relatively short amount of time: testing larger amounts of data reduces the overall audit risk.
- They allow the auditor to test the effectiveness of controls that are programmed into the computer software.

CHAPTER

8

Audit evidence

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Audit testing

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- ISA 500 and the financial statement assertions
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1 Audit testing

1.1 Gathering audit evidence

The **outcome** of an audit is a report, which usually expresses an opinion.

The contents of the report and the auditor's opinion may subsequently be challenged. If this happens, the auditor must be able to justify what he has written. In other words, the report and opinion must be **supportable** by the auditor, if challenged.

The auditor will therefore collect **evidence** on which to base the report and opinion.

The auditor carries out procedures known as '**audit tests**' in order to create this evidence. These tests could be:

- **tests of controls**, and/or
- **tests of detail** (tests of transactions and balances).

It is unlikely that the auditor's tests will be applied to all the transactions that have been undertaken by the entity during the financial period under audit. The audit evidence will typically be drawn from a **sample** of transactions.

Analytical procedures are also carried out, but not typically on a sample basis. These are revised later in this section. Analytical procedures together with tests of detail are referred to as **substantive procedures.**

The tests, the evidence from the tests, and the conclusions that have been drawn must all be **documented** in the audit files.

Key definitions

Audit evidence: This is any information used by the auditor to arrive at the opinion on which his report us based. It includes information in the accounting records and other information.

Audit sampling: This is the application of audit procedures to less than 100% of the population of transactions and balances, such that all units have a chance of selection. Again, this is revised later in this section.

1.2 ISA 500 and the financial statement assertions

ISA 500 *Audit evidence* sets out the **objective** of the auditor as being to design and perform audit procedures in such a way as to enable him to:

- obtain **sufficient, appropriate** audit evidence
- in order to be able to draw reasonable conclusions
- on which to base his audit opinion.

Following on from this, the auditor is **required** by ISA 500 to **design and perform appropriate audit procedures for the purpose of obtaining sufficient, appropriate audit evidence.**

Other **requirements** of ISA 500 are as follows:

- Consider the **relevance and reliability** of the information to be used as audit evidence.
- If information to be used as audit evidence has been prepared using the work of a **management's expert**:
  - evaluate the competence, capabilities and objectivity of that expert
  - obtain an understanding of the expert's work, and
  - evaluate the appropriateness of his report as audit evidence.
- When using **information produced by the entity** evaluate whether the information is sufficiently reliable (accurate, complete, precise and detailed).
- Use effective means of **selecting items for testing** (covered in detail later in this chapter under ISA 530 *Audit sampling*).
- If audit evidence from one source is **inconsistent** with that obtained from another source, or the auditor has **doubts over the reliability of evidence** – consider:
  - what additional audit procedures are needed, and
  - the effects on any other aspects of the audit.

Use of an expert by management

When assessing the **objectivity of an expert employed by management**, issues for the auditor to consider would include whether:

- the expert has a financial interest in the audit client, for example a shareholding
- the expert has a personal relationship with a senior manager in the audit client
- the fee paid for the expert's services was a fair commercial price.

When assessing **whether the work of management's expert provides sufficient and appropriate evidence** for audit purposes.

- The auditor should review the terms on which the expert was engaged by the audit client, such as the objective and scope of the expert's work and whether the expert was notified that his work may be relied on by the auditors.

- The auditor should obviously study the content of the expert's report and the conclusions that the expert reached. Any assumptions used by the expert may be significant (for example in making an asset valuation) and the auditor should compare those assumptions with his own understanding of the audit client's business.
- The auditor may also need to check the methods used by the expert. For example for the valuation of investment property, the method of valuation used should be consistent with the requirements of IAS40.
- If the expert has been used to provide a valuation, the date of the valuation should be close to the end of the financial year of the audit client (so that it is up-to-date and current).

There may be additional evidence that the auditor could obtain to confirm the evidence provided by the expert. For example, if a property valuation expert has been used by the audit client to value a number of properties, the auditor may be able to obtain some additional evidence of the reliability of the valuations in a number of ways:

- By inspecting some of the properties to assess their condition.
- By checking the cost of similar assets acquired by the audit client during the financial year.
- For assets acquired during the year, by comparing their cost with the end-of-year valuation: unless there has been a large rise or fall in property values during the year, current valuation should be fairly close to original cost.
- By checking events after the reporting period: if any of the properties have been sold since the end of the year, their sale value should be compared with their end-of-year valuation. They ought to be similar amounts.
- By obtaining representations from management that the key assumptions used in arriving at estimated values are reasonable.
- Use of fair value accounting may require more frequent use of experts by the auditor.

Sufficient and appropriate audit evidence

Sufficient relates to the **quantity** of evidence. There must be enough audit evidence to support the auditor's conclusion or opinion.

Appropriate relates to the **quality** (relevance and reliability) of the evidence.

The auditor will need to exercise his professional judgement on both of these aspects, in deciding whether there is enough evidence to support a conclusion and assessing the quality of each item of evidence:

- When is there enough evidence to support a conclusion?
- What is the quality of a given piece of evidence, and is this sufficient to justify the audit opinion?

The two characteristics of quantity and quality are also inter-related.

- An auditor may be able to reach a justifiable conclusion based on a smaller quantity of high quality evidence,
- However, a larger quantity of lower quality evidence may be required to reach a justifiable conclusion.

The reliability of audit evidence

There are a number of general principles set out in ISA 500 to assist the auditor in assessing the reliability of audit evidence. These can be summarised as follows.

- **Audit evidence is more reliable when it is obtained from independent sources outside the entity under audit**. As specified above, ISA 500 requires that the auditor should be satisfied as to the accuracy and reliability of any internal evidence used in reaching a conclusion. But….note that
- **Internally generated audit evidence is more reliable when the related controls are effective.**
- **Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference**. For example, observation of the operation of a control by the auditor is more reliable than enquiry about the operation of that control.
- **Audit evidence is more reliable when it exists in documentary form**. This could be paper, electronic or other medium. For example, a written record of a meeting made at the time is more reliable than a subsequent oral representation of the matters discussed.
- **Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies**, or documents that have been filmed, or otherwise transformed into electronic form. This is because the reliability of those other forms may depend on the controls over their preparation and maintenance.

Procedures for generating audit evidence

A number of audit testing procedures are available to the auditor as a means of generating audit evidence.

- More than one procedure may be used in collecting evidence in a particular area.
- Not all procedures may be appropriate to a given objective of the audit.

The auditor should select the most appropriate procedures in each situation. There are five main testing procedures for gathering audit evidence:

- Inspection
- Observation
- Enquiry
- External confirmation
- Recalculation
- Reperformance
- Analytical procedures.

The table below explains these seven main procedures, and gives examples of how they are used and applied.

Procedure	Explanation/application
Inspection (looking at an item)	■ Of tangible assets ■ Of entries in accounting records ■ Of documents (e.g. invoices)
Observation	■ Watching a procedure (e.g. physical inventory counts, distribution of wages, opening of mail) ■ Limited to the point in time when the observation takes place ■ The person performing the procedure may act differently when being observed
Enquiry	■ Seeking information from knowledgeable persons inside or outside the entity, ■ Evaluating responses to those enquiries, and ■ Corroborating those responses with other audit evidence
External confirmation	■ A specific type of enquiry – seeking confirmation from a third party (e.g. a bank or trade receivable)
Recalculation	■ Checking the mathematical accuracy of documents or records (e.g. adding up the list of year-end trade receivables)
Reperformance	■ Independently carrying out procedures or controls, which were originally performed by the client (e.g. reperforming the aging of year-end trade receivables)
Analytical procedures	■ Evaluating and comparing financial and/or non-financial data for plausible relationships and investigating unexpected fluctuations ■ For example, comparing last year's gross profit percentage to this year's and ensuring any change is in line with expectations

The financial statement assertions

Modern auditing theory takes the view that the financial statements are made up of a numbers of '**assertions**' or representations. The auditor should therefore generate evidence designed to reach a conclusion about each of these assertions.

The major assertions contained in a set of financial statements (set out in ISA 315) are as follows.

- **Completeness**: There are no unrecorded assets, liabilities, equity interests, transactions or events or any undisclosed items.
- **Occurrence**: Transactions and events recorded and disclosed in the financial statements took place during the accounting period and relate to the entity.

- **Accuracy**: Transactions or events have been recorded at the proper amounts and disclosed properly.
- **Classification and understandability**: Information is appropriately presented and described and the disclosures are clear.
- **Valuation and allocation**: Assets, liabilities and equity interests are included at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
- **Rights and obligations**: The entity holds or controls the rights to disclosed assets and disclosed liabilities are those of the entity.
- **Existence**: Assets, liabilities and equity interests exist.
- **Cut-off**: Transactions and events have been recorded in the correct period.
- **Classification**: Transactions and events have been recorded in the proper accounts.

The auditor should therefore generate evidence designed to reach a conclusion on the reliability of each of these assertions.

1.3 Directional testing

Directional testing is an audit approach, developed in the 1980s, to provide a framework for the conduct of an audit. Directional testing has a number of advantages. The main advantages are that:

- it helps the auditor to clarify the audit objectives
- it focuses the audit work on areas of high audit risk
- it links together the results of audit tests.

Directional testing has its foundation in the fundamental principle of double entry book-keeping whereby **for every debit entry there is a credit entry**.

If the trial balance balances, but a debit or a credit entry is misstated, there must be a second misstatement somewhere in the trial balance figures.

Example

If non-current assets are overstated by $2,000, but the trial balance balance balances, then one of the following errors must have happened to explain how the situation has arisen.

- Possibility 1. Another asset is understated by $2,000.
- Possibility 2. Liabilities are overstated by $2,000.
- Possibility 3. Income is overstated by $2,000.
- Possibility 4. Expenditure is understated by $2,000.
- Possibility 5. A combination of any as all Possibilities 1 – 4 has occurred, amounting to $2,000.

The nature of directional testing

The following conclusions follow on from the points raised in the above example.

- By testing debit balances (in the client's accounting system) **directly for overstatement**, total credit balances will also be tested - **indirectly** - **for overstatement**.
- By testing credit balances **directly for understatement**, total debit balances will also be tested - **indirectly** - **for understatement**.

Directional testing is therefore based on the following approach to the audit.

- If all asset balances and expenses for the year (**debits**) are tested directly for **overstatement**, and
- all liability balances and income for the year (**credits**) are tested directly for **understatement**
- then misstatement in the opposite directions (overstatement of credit balances and understatement of debit balances) will be tested indirectly.

The main focus or direction of testing is therefore:

- test debits for overstatement and
- test credits for understatement.

This is because:

- in the statement of financial position, assets are more likely to be overstated and liabilities are more likely to be understated
- a misappropriation or fraud will often result in an overstatement of an asset or expense. For example, the theft of cash may be 'hidden' fraudulently by writing it off, by means of the ledger entry: Cr Cash and Dr Expense.

Testing for overstatement of debit balances

A **test for overstatement** starts with the monetary amount recorded in the financial statements. The direction of testing is then '**backwards**' to its source. Such tests seek to confirm **existence**. For example, in testing purchases for overstatement, balances in the financial statements will be traced back to signed goods received notes as evidence that the goods were received.

Testing for understatement of credit balances

A **test for understatement** starts at the source and traces transactions '**forwards**' to the financial statements. These tests are aimed at ensuring the **completeness** (and accuracy) of recorded transactions and balances. For example, in testing sales for understatement, signed despatch notes are traced through to sales in the financial statements to check that the sale was recorded.

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Examples

Testing trade receivables balances for over-statement/existence

A starting point for testing will be the entity's list of receivables balances (the list of customers owing money as at the end of the reporting period. The auditor wants to check that these receivables do in fact exist. One way of doing this is to write directly to customers on the list asking them to confirm the amount that they owe the entity.

Alternatively, if the auditor is checking documentation within the client entity, he can take a sample of receivables from the list of balances, and trace their existence back through the accounting records, from receivables ledger to sales day book (receivables day book) to invoice.

Testing trade payables balances for understatement/completeness

To test payables for completeness, there is no point in taking as a starting point the entity's list of payables balances – because this may not be complete, and the auditor is testing for completeness.

Instead, the auditor may write to regular suppliers who might possibly be year-end payables, based on the total amount of purchases from the supplier during the year. If the supplier is not on the list of trade payables, or is listed as a payable for only a small amount, the auditor can ask the supplier to confirm this fact. This is often referred to as testing the '**reciprocal** population'.

Alternatively, if the auditor is checking documentation within the client entity, he may take as a starting point a sample of documents indicating that goods have been purchased or received – such as a sample of goods received notes – and then trace the purchase through the system from purchase invoice to purchases day book (payables day book) to payables ledger.

1.4 Sampling: ISA 530

ISA 530 *Audit sampling* states that the objective of audit sampling is to give the auditor a **reasonable basis for his conclusion about the population from which the sample is drawn**. The auditor is not interested in the result from the sample itself – he is only interested in it as a basis for reaching a conclusion about the whole population under test.

However, there is always a risk that the auditor will reach a different conclusion based on the sample than he would have reached had he tested the entire population. This is referred to as **sampling risk**. To reduce this risk (and therefore detection risk) to a minimum the sample must be designed in such a way as to be **representative** of the whole population.

In setting his sample size the auditor will need to take into account the **expected misstatement** (for tests of details) or **rate of deviation** (for tests of controls)**.** This assessment will be based on his experience in this area from previous audits and on any related areas on the current audit. The results of the sample (projected for tests of detail) will be compared to **tolerable misstatement/rate of deviation.**

Tolerable misstatement is a monetary amount set by the auditor in order to address the risk that the total of individually immaterial misstatements may cause the financial statements to be materially misstated. It is the application of performance materiality (as discussed in a previous chapter) to a particular sampling procedure. A misstatement above "tolerable misstatement" would therefore be considered material.

Following on from the above, the **tolerable rate of deviation** is a rate of deviation from prescribed control procedures which the auditor is prepared to accept and still be able to conclude that the financial statements are materially correct.

1.5 Analytical procedures: ISA 520

It is important to remember two key points when dealing with analytical procedures.

- The evidence generated is 'supplementary' to evidence gained from other audit testing procedures.
- The basic objective of analytical procedures is to allow the auditor to assess whether the reported figures 'make sense' in the context of known business facts. If the analysis indicates that there are some figures or ratios that do not make sense (there are some 'anomalies'), these require further investigation by the auditor.

The nature and purpose of analytical procedures

'Analytical procedures' are defined by ISA 520 *Analytical procedures* as "evaluations of financial information through analysis of plausible relationships among both financial and non-financial data..

The analysis usually considers both **comparisons** and **relationships**.

Financial information in the draft financial statements is often **compared with a benchmark**. For example, ratios, trends and relationships for the current financial year are compared with:

- prior periods (historical data)
- budgets and forecasts (future-oriented data)
- predictive estimates (in other words, estimates of the expense or income that might have been predicted, such as a prediction of the annual depreciation charge)
- (more rarely) industry averages (= ratios for business entities in the industry as a whole).

Typically, **relationships** are used in analytical procedures to analyse:

- items of financial information that are expected to adhere to a predicted pattern (such as gross profit margins: any significant change in this margin compared with the previous years should be investigated)

- relationships between financial and non-financial information, that might be predictable (such as payroll costs per employee).

Using analytical procedures in the audit process

Analytical procedures can be used at three stages in the audit process.

- They **must** be used **in planning** the nature, timing and extent of other audit procedures.
- They **may** be used **as a substantive procedure** when their use is more effective or efficient than detailed substantive tests of transactions and balances.
- They **must** be used **at the overall review stage**, to allow the auditor to conclude whether the financial statements as a whole are consistent with his knowledge of the business.

Analytical procedures are not concerned only with the analysis of trends. The auditor must use analytical procedures to reach a conclusion about the financial statements. It is not sufficient for the auditor to calculate and summarise ratios for this year and previous years, and to record the trends over time. Analytical procedures are also concerned with:

- the **investigation** of changes away from expected trends, and
- the **corroboration** of explanations as to why these changes have happened when they were not expected to.

Example

An auditor has calculated the gross profit percentage for a client company. This year the gross profit is 25% of sales, but last year it was 20%. The auditor is not aware of any change in the nature of the client's business, and he had been expecting the gross profit percentage to remain constant, at about 20%.
The finance director of the client company gives the explanation that purchase prices have fallen in the past year or so, relative to sales prices. The auditor should not accept this explanation as a proper explanation without finding evidence to corroborate it.

It is possible that purchase prices have fallen in relation to sales prices. However, a possibility that the auditor needs to eliminate is that purchase prices have not fallen, but the client company's management have included an excessively high figure for closing inventory in the statement of financial position, in order to increase profits.

A closer investigation of purchase prices should confirm the finance director's explanation, or leave the auditor with a suspicion that there is something unusual in the financial statements and that a proper explanation has yet to be found.

The extent of use of analytical procedures

Several factors should determine the extent to which the auditor can use analytical procedures as a form of audit evidence. ISA 520 **requires** the auditor to:

- Determine the suitability of particular substantive analytical procedures for given assertions – ie how effective they will be in detecting a particular type of material misstatement. This usually depends on the closeness of relationships between items of data. Analytical procedures are more appropriate when relationships are plausible and predictable. For example, there is normally a close relationship between sales commission and sales revenue, whereas the relationship between administration costs and sales revenue is less close and so less predictable.
- Develop an expectation of recorded amounts or ratios and evaluate whether that expectation is sufficiently precise to identify a misstatement. How effectively this can be done depends on factors such as:
    - the accuracy with which amounts can be predicted
    - the extent to which information can be disaggregated (eg sales split out by product line)
    - the availability of information.
- Evaluate the reliability of the data from which the expectation has been developed. If data is unreliable then it will be of little use. The auditor should consider such factors as:
    - the source of the information
    - comparability of the information available (broad industry data may not be suitable for an entity with more specialised products)
    - the nature and relevance of the information available (budgets may not be suitable if they have been prepared as goals rather than expectations)
    - controls over the preparation of the data.
- Determine what level of difference from expected amounts is acceptable without further investigation (ie link to materiality).

Investigation of fluctuations

Fluctuations are significant changes in a financial ratio or a trend, compared with previous financial years.

When carrying out analytical procedures, the auditor is primarily concerned with identifying the unexpected and reasons to explain why anything unexpected has happened. If the unexpected has occurred and cannot be explained, further investigation by the auditor will be necessary.

Trends or deviations that do not fit with known business facts should be discussed with client staff and explanations must be obtained. It is often more useful to the auditor to discuss matters with several of the client's staff, who are responsible for non-financial as well as for financial operations.

Explanations must not be accepted at face value but should be corroborated by:

- other audit evidence, or
- the auditor's knowledge of the client and the industry in which it operates.

Therefore, if the auditor finds:

- fluctuations or relationships which are inconsistent with other information, or
- unacceptable levels of differences from expected amounts

then ISA 520 **requires** him to:

- make enquiries of management and verify management's responses, and
- perform other audit procedures as necessary.

Audit documentation: ISA 230

- Audit documentation
- Reasons for preparing sufficient and appropriate audit documentation
- Form, content and extent of audit documentation
- Computer-generated audit working papers
- Ownership, custody and confidentiality

2 Audit documentation: ISA 230

2.1 Audit documentation (audit working papers)

All audit work must be properly documented and held in the audit file (also known as audit working papers). This documentation provides a record of:

- the audit procedures performed
- audit evidence obtained, and
- the conclusions reached.

The documentation must provide:

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

ISA 230 requires the auditor to prepare documentation **on a timely basis**, sufficient to enable an experienced auditor **with no previous connection with that audit** to understand:

- the nature, timing and extent of the audit procedures performed
- the results of those procedures and the audit evidence obtained, and
- significant matters which arose during the audit and the conclusions reached thereon.

The auditor is also required to document:

- discussions of all significant matters
- how any inconsistencies with the final conclusion on significant matters were resolved
- and justify any departure from a basic principle or relevant procedure specified by an ISA.

2.2 Reasons for preparing sufficient and appropriate audit documentation

Preparing sufficient and appropriate audit documentation **on a timely basis** helps to:

- enhance the quality of the audit, and
- facilitate the effective review and evaluation of the audit evidence obtained and conclusions reached, before the audit report is finalised.

Documentation prepared at the time the work is performed is likely to be more accurate than documentation prepared later.

Other purposes of audit documentation include the following.

- Assisting the audit team to plan and perform the audit.
- Assisting supervisors in directing and supervising audit work.
- Ensuring members of the audit team are accountable for their work.
- Keeping a record of matters of continuing significance to future audits.
- Enabling an experienced auditor, with no previous connection with that audit, to conduct quality control reviews or other inspections ie by understanding the work that has been performed and the conclusions that have been reached.

2.3 Form, content and extent of audit documentation

Audit documentation may be recorded on paper, or on electronic or other media. The audit documentation for a specific engagement is assembled in an **audit file.** The precise contents of the audit working papers varies, depending on the nature and size of the client and the complexity of the audit processes required to reach a conclusion but will include:

- audit programs
- analyses
- summaries of significant matters
- letters of confirmation and representation
- checklists, and
- correspondence.

Traditionally, it has been normal practice to maintain two types of audit files, a permanent file and a current file.

Permanent file

The **permanent file** records information that is likely to be of significance to every annual audit of that client. Examples of such information might include the following.

- The legal constitution of the company.
- Other important legal documents such as loan agreements.
- A summary of the history, development and ownership of the business.

- A record of the accounting systems and procedures used by the client.
- Copies of the financial statements for the previous years, with key financial ratios and trends.

This information is of continuing significance, and it is therefore important that the auditor should review the contents of the permanent file regularly and update it as appropriate.

Current file

The **current file** contains information of relevance to the current year's audit. This will be the main evidence on which the conclusion for the current audit will be based. Examples of the contents of a current audit file include the following.

- The final financial statements and auditor's report.
- A summary of audit adjustments, including those not included in the final reported figures.
- Audit planning documentation.
- Audit control material (time budgets, review points, points for consideration by the engagement partner).
- Audit letters.
- For each 'audit area' (such as inventory, sales and payroll):
  - an audit plan (detailing the work to be done on that area)
  - details of items selected for testing, the tests performed, problems that were encountered (and how these problems were resolved) and the conclusion reached by the auditor on that area of operations/the financial statements
  - 'lead schedules': these give the figures for the audit area that will appear in the final financial statements.

All audit working papers should clearly show the following (where relevant) and for each audit area as appropriate:

- the name of the client
- the accounting date
- a file reference
- the name of the person preparing the working paper
- the date the paper was prepared
- the name of any person reviewing the work and the extent of such review
- the date of the review
- a key to/explanation of the audit ticks or symbols used in the working papers
- a listing of any errors or omissions identified
- the auditor's conclusion on the area

ISA 230 requires the auditor to assemble the **final audit file**(s) on a timely basis after the date of the audit report. This usually excludes drafts of working papers or financial statements, or notes that reflect incomplete or preliminary thinking. After the assembly of the final audit file has been completed, the auditor **must not delete or discard audit documentation** before the end of its retention period (see below).

If it does become necessary to modify existing or add new documentation after this stage, the auditor must document:

- when and by whom the modifications were made
- the reasons for making them.

If exceptional circumstances arise after the date of the audit report, such that the auditor:

- has to perform new or additional procedures, or
- reaches new conclusions

the auditor is must document:

- the circumstances
- the new or additional procedures performed, audit evidence obtained, conclusions reached and their effect on the auditor's report, and
- when and by whom the resulting changes to audit documentation were made and who reviewed them.

2.4 Computer-generated audit working papers

Auditors often use computer software (with laptop computers) to improve the efficiency of preparing audit working papers. These software packages can be used to help the auditor to prepare:

- analysis schedules (especially where the audit firm uses standardised working papers)
- lead schedules, and
- draft financial statements.

These schedules and statements can usually be cross-referenced and updated automatically as the audit proceeds, to allow for adjustments that the auditor makes.

The advantages of these computer software packages for auditors are as follows.

- The working papers are neat, easy to read and in a standard format.
- There is a lower risk of error by the auditor in processing adjustments.
- The audit review process by senior managers or the audit partner can be carried out remotely, without the necessity for the manager or partner to visit the client's premises to carry out the review.
- The automatic processing of adjustments by the auditor, using software, may result in significant savings in time (and cost).

2.5 Ownership, custody and confidentiality of audit working papers

The audit firm has ownership of the audit working papers. The papers are not a part of the client's accounting records and do not belong to the client.

The auditor needs to decide how long to keep the audit files. The ACCA recommends a minimum period of **seven years**.

Auditing standards require the auditor to ensure that working papers are kept safe and that their contents are kept confidential. Confidential information should only be made available to third parties in accordance with ethical guidelines.

Related parties: ISA 550

- Related parties and related party transactions
- The impact on the audit of related party relationships and transactions
- The requirements of ISA 550

3 Related parties: ISA 550

3.1 Related parties and related party transactions

Related parties are individuals or organisations that might have, or might be expected to have, an undue influence on the company that is being audited. Examples of related parties include:

- the directors and key management of a company
- their families
- other companies controlled by directors, key managers and members of their close family
- other companies in the same group.

Related party transactions are material transactions between the client company and a related party of the company.

It is the responsibility of the client company's management to record and disclose all material **related party transactions**, because these transactions may be carried out on more favourable terms than similar transactions with an independent third party.

The approach required by IAS 24 *Related party disclosures* is to disclose the relevant amounts of related party transactions and the nature of the related party relationships, so that the users of the financial statements can decide for themselves whether these transactions might have resulted in a manipulation of the financial statements.

ISA 550 *Related parties* deals with the auditor's responsibilities in respect of related party transactions. It was revised (and redrafted) in July 2008 for two main reasons.

- The increased public attention given to accounting for related party relationships, because a number of major corporate scandals (such as Enron in the US) have involved related parties.
- The previous version of ISA 550 was mainly procedural in nature and did not discuss the risks of material misstatement that may arise from the existence of related party relationships and transactions.

The requirements of ISA 550 are discussed below.

3.2 The impact on the audit of related party relationships and transactions

Although many related party transactions are in the normal course of business and therefore may carry no higher a risk of material misstatement than ordinary transactions, in some circumstances related party transactions may lead to higher risks. For example:

- related parties may operate through complex structures and relationships and the resulting transactions may therefore also be complex
- accounting systems may not be effective at identifying and summarising related party transactions and balances
- related party transactions may not be conducted on normal market terms – some may even be conducted with nil consideration.

The **objectives** of the auditor with regard to ISA 550 are to obtain:

- an **understanding** of the entity's related party relationships and transactions, and
- sufficient appropriate audit evidence about whether related party relationships and transactions have been **appropriately identified, accounted for and disclosed** in the financial statements.

The understanding must be sufficient for the auditor to be able to:

- recognise **fraud risk factors** arising from related party relationships and transactions
- conclude whether the financial statements achieve **fair presentation** in respect of related party relationships and transactions.

There is an increased risk of fraud in this area as related party relationships may present a greater opportunity for collusion, concealment or manipulation by management. It is therefore particularly important that the auditor approaches this area of the audit with **professional scepticism.**

3.3 The requirements of ISA 550

Most material misstatements linked to related party transactions arise from failure by the management of the client company to disclose related party relationships and transactions to the auditor.

ISA 550 therefore sets out a minimum set of risk assessment procedures specifically directed towards the identification of related party relationships and transactions that have not been identified or disclosed by management.

Risk assessment procedures

As part of the risk assessment procedures required by ISAs 240 and 315 the auditor is required to perform the following procedures in order to **understand the entity's related party relationships and transactions**:

- Consider the risk of material misstatement due to fraud or error arising from related party relationships and transactions.
- Make enquiries of management in respect of:
  - the identity of related parties
  - the nature of relationships with those related parties
  - the nature of any transactions entered into with those parties during the period.
- Obtain an understanding of the internal controls in operation over:
  - the identification of, accounting for and disclosure of related party relationships and transactions
  - the authorisation and approval of significant related party transactions
  - the authorisation and approval of significant transactions outside the normal course of business.

Identifying related parties and related party transactions

In making enquiries of management in respect of the identity of related parties, the auditor will obtain a list of related parties from the directors, and consider if this list is complete. **Tests for completeness** could include the following:

- Review working papers for previous years, to look for names of known related parties.
- Review the company's procedures for identifying related parties.
- Enquire about the relationships between directors and other entities (for example, does any director own another company, and have there been any transactions between that company and the client company?)
- Review shareholder records for the names of major shareholders.
- Review minutes of shareholder meetings (general meetings of the company).
- Ask any other audit firms involved in the audit about related parties (if the audit is the audit of a group of companies and more than one firm of auditors is involved). Or ask previous auditors of the company about their knowledge of related parties.

The auditor may have difficulty in obtaining a complete list of related parties. This is because their main source of information about related parties is the client's management, who may wish to keep related party relationships hidden. Particular problem areas where the disclosure of related parties may be incomplete are:

- close family relationships
- where the related party is another business entity which is owned or influenced by a director of the client company: however two companies are not necessarily related parties just because the same individual is a director or shareholder in both – the key issue is whether the individual is in a position of influence in both companies.

The auditor may also have difficulty in identifying all related party transactions that have occurred, unless the client entity has recorded them separately. Related party transactions may be 'hidden' within all the other transactions recorded in the accounts of the entity.

During the audit the auditor must remain alert, **when inspecting records or documents**, for information which might indicate the existence of previously unidentified or undisclosed related party relationships or related party transactions. The auditor is also specifically required to inspect the following:

- Any bank and legal confirmations obtained as part of his audit work.
- Minutes of shareholder and management meetings.
- Any other records or documents the auditor considers necessary in the specific circumstances.

If the auditor identifies **significant transactions outside the entity's normal course of business** he must enquire as to the nature of these transactions and whether related parties could be involved. This is because these carry a higher risk of involving related parties who have previously been unidentified or undisclosed. ISA 550 states that any significant related party transactions outside the entity's normal course of business must be treated as giving rise to significant risks of material misstatement.

The whole audit team should be made aware of information obtained about the entity's related parties so that they can identify any previously undisclosed transactions with related parties.

If any fraud risk factors are found these must be taken into account when the auditor identifies and assesses the risks of material misstatement due to fraud in accordance with ISA 240. A key fraud risk factor identified by ISA 550 is the existence of a party who exerts **dominant influence** over the entity. Any such party (an individual or a company) is likely to be able to override the views of the entity's management and force the entity to enter into a transaction in which the dominant party has an interest.

Indicators that a person or entity might be a dominant party include:

- the party vetoing significant business decisions of the entity
- significant transactions being referred to the party for final approval
- little or no debate among management in respect of business proposals made by the party
- transactions involving the party (or its close family members) are rarely independently reviewed or approved.

Responses to the risks of material misstatement

As discussed in a previous chapter, the auditor is required by ISA 330 to respond to assessed risks. In the context of the assessed risks of material misstatement arising from related party relationships and transactions ISA 550 requires the following audit procedures.

If the auditor discovers **previously unidentified or undisclosed related parties or** (significant) **related party transactions** he must:

- Determine whether the underlying circumstances confirm the existence of those relationships or transactions.

- Communicate the relevant information to the audit team.
- Request management to identify all transactions with the newly identified related parties.
- Enquire as to why the entity's system failed to identify or disclose these related party relationships or transactions.
- Perform appropriate substantive procedures on the newly identified related parties or significant related party transactions.
- Reconsider the risk of there being unidentified or undisclosed related parties or (significant) related party transactions and perform additional procedures as necessary.
- If the non-disclosure appears intentional, evaluate the implications for the audit.

If the auditor discovers **significant related party transactions outside the entity's normal course of business** he must:

- Inspect the underlying contracts or agreements to evaluate whether:
  - the contracts etc were entered into in order to engage in fraudulent financial reporting or to hide the misappropriation of assets (a lack of business rationale might indicate this)
  - the terms of the contracts etc are consistent with management's explanations, and
  - the transactions have been properly accounted for and disclosed.
- Obtain evidence that the transactions were properly authorised.

If management has made a statement in the notes to the financial statements that a related party transaction was made on the same terms as an arm's length transaction, the auditor must obtain evidence to support this assertion.

Materiality of related party transactions

ISA 450 *Evaluation of misstatements identified during the audit*, which is covered in a later chapter, requires the auditor to consider both the **size and the nature** of a misstatement, and the **particular circumstances of its occurrence**, when evaluating whether a misstatement is material.

In the context of related party transactions, this means that much smaller transactions in monetary terms may be material as the significance of the transaction to the users of the financial statements may not depend solely on the recorded amount of the transaction but also on the nature of the related party relationship. It may be tempting to assume that materiality means 'large', but in the case of related party transactions, a transaction could be material if it has a value as low as $0 (for example, a transaction involving the sale of the company's assets to a related party for a very low price).

Other requirements

Written representations must always be obtained by the auditor from the directors about related parties and related party transactions. The directors are in the best position to know the identities of any related parties. The written representation from the directors must cover:

- the completeness of the information that has been provided about the identity of related parties and related party relationships and transactions, and
- the adequacy of accounting for and disclosure of such related party relationships and transactions in the financial statements.

Unless all of those charged with governance are involved in managing the entity, the auditor **must communicate to those charged with governance** significant matters arising during the audit in connection with the entity's related parties.

The names of all identified related parties and the nature of the related party relationships must be **documented**.

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Example: Audit matters and audit evidence

The draft statement of financial position of ABC Company includes an amount of $30,000 owed by DE Company. The total assets of ABC Company are $20 million.

The auditor has obtained the following audit evidence:

- DE Company is controlled by the chairman of ABC Company, who is its majority shareholder.
- The draft financial statements of ABC Company do not provide any disclosures about the $30,000 transaction, on the grounds that it is immaterial.
- There is no information about the nature of the transaction, but the $30,000 had been included in receivables at the end of the previous financial year.

Required

What further measures should the auditor take?

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Answer

The auditor should first establish whether DE Company is a related party of ABC Company. From the information available it would seem that it is a related party, because the chairman of ABC Company, as a majority shareholder in DE Company, would appear to be in a postion of influence in both companies.

Although the amount receivable is not material in terms of value (in relation to the value of total assets of ABC), the materiality of related party transactions should not be judged only on the basis of value. The nature of the transaction is also relevant for judging materiality. The auditor needs to obtain more information. The chairman should be asked to provide more details. In addition, the auditor should review the written terms of the transaction (if there are any), and should obtain a written representation from the chairman about the nature of his influence over DE

Company, whether the amount receivable by ABC Company is likely to be recoverable and when it is likely to be paid. The auditor should also review board minutes of ABC Company for any recorded discussions by the board of the transaction with DE Company.

If the auditor takes the view that the transaction is a related party transaction, he should notify management of the need for disclosure in the financial statements. Disclosure is required of the nature and amount of the transaction, the amount of any balances (and details of any security given) and any allowances that have been made for an irrecoverable amount. Since the amount was receivable one year ago, the auditor should also consider the expected date of payment, and whether the balance is more in the nature of a long-term loan receivable than a current asset.

Written representations: ISA 580

- Definition and objectives
- Written representations as audit evidence
- Written representations about management's responsibilities
- Form and contents of the letter of representation
- Refusal to provide requested written representations

4 Written representations: ISA 580

4.1 Definition and objectives

ISA 580 defines a **written representation** as a written statement by management provided **to confirm certain matters** or **to support other audit evidence**.

The **objectives** of the auditor in this area, per ISA 580, are to:

- obtain written representations from management that it has fulfilled its responsibilities in respect of the financial statements and the audit
- obtain written representations as appropriate to support other audit evidence
- respond appropriately to written representations provided by management or if management refuse to provide the written representations requested.

ISA 580 requires the auditor to obtain appropriate written representations from management (often referred to as "**management representations**") in the form of a **letter of representation**, addressed to the auditor.

These management representations may be an important source of audit evidence.

4.2 Written representations as audit evidence

If the auditor considers that written representations are needed **to support other audit evidence** he must request such other written representations.

During the course of the audit, management will make many representations to the auditor. Some of these will be unsolicited but some will be given in response to specific enquiries from the auditor. The auditor will have recorded such verbal discussions with management in the audit working papers. However, verbal evidence is not strong audit evidence. In order to improve the quality of this evidence, the auditor will ask for any significant discussions to be confirmed in writing.

Such representations are likely to be needed:

- to support the auditor's understanding of management's intention or judgment (for example, in respect of future plans for the business or a specific matter such as the net realisable value of inventory), or
- in respect of the completeness of a specific item (for example, that all liabilities have been provided for).

However, although such written representations provide necessary audit evidence, **they do not provide sufficient appropriate evidence on their own**.

If a written representation is contradicted by other audit evidence, the auditor should:

- consider whether his risk assessment of that area is still appropriate
- consider whether additional audit procedures are needed
- if he has concerns about the integrity of management, document those concerns and consider withdrawing from the audit.

The auditor is also required by specific other ISAs to request certain other written representations. These requirements are illustrated in the example letter set out below.

4.3 Written representations about management's responsibilities

The auditor is also required by ISA 580 to obtain certain other written representations from management. In these representations management acknowledges that:

- it has fulfilled its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
- it has provided the auditor with all relevant information
- all transactions have been recorded and are reflected in the financial statements.

Again, these points are illustrated in the example letter set out below.

4.4 Form and contents of the letter of representation

The letter of representation is:

- usually drafted by the auditor (as he knows the areas on which he requires written representations)
- addressed to the auditor
- dated as near as practicable (but not after) the date of the audit report.

The following example of a letter of representation shows the minimum contents of such a letter. However, remember that the auditor may also need to request management to provide written representations about specific assertions in the financial statements.

Example of a letter of representation

(Entity Letterhead)

(To Auditor) (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Ltd for the year ended 31 December 31 20X1 for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or *give a true and fair view*) in accordance with International Financial Reporting Standards.

We confirm that (*to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*):

Financial statements

We have fulfilled our responsibilities for the preparation and presentation of the financial statements as set out in the terms of the audit engagement dated….. and, in particular, the financial statements are fairly presented (or *give a true and fair view*) in accordance with International Financial Reporting Standards.

Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable. (ISA 540)

Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of International Financial Reporting Standards. (ISA 550)

All events subsequent to the date of the financial statements and for which International Financial Reporting Standards require adjustment or disclosure have been adjusted or disclosed. (ISA 560)

The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (ISA 450)

Information provided

We have provided you with:

- all information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements
- additional information that you have requested from us; and
- unrestricted access to those within the entity.

All transactions have been recorded in the accounting records and are reflected in the financial statements.

We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (ISA 240)

We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:

- management
- employees who have significant roles in internal control; or
- others where the fraud could have a material effect on the financial statements. (ISA 240)

We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (ISA 240)

We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements. (ISA 250)

We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (ISA 550)

4.5 Refusal to provide requested written representations

If management refuse to provide requested written representations the auditor must:

- discuss the matter with management
- re-evaluate the integrity of management and reconsider the impact on other representations and audit evidence, and
- take appropriate action, including considering the effect on the audit report.

Using the work of an auditor's expert: ISA 620

- Definition of an expert
- Assessing the need for an expert
- Assessing the work of an expert

5 Using the work of an expert: ISA 620

5.1 Definition of an expert

The term 'expert' is used here in the sense of an individual or an organisation that possesses skills, knowledge and experience in **fields other than accounting or auditing.**

The auditor may use the work of an expert to provide knowledge relevant to the audit, which the audit firm itself does not possess. ISA 620 *Using the work of an auditor's expert* gives a number of examples where experts may be used by an auditor. These include:

- legal opinions
- specialist valuation areas, such as property or pension liabilities
- the analysis of complex or unusual tax compliance issues.

Note that the ISA covers the work of **the auditor's** expert – the expert is employed by the auditor, not by the entity. The situation where management use the work of an expert was covered above, under ISA 500.

The **objective** of ISA 620 is to allow the auditor to:

- decide whether to use the work of an expert, and
- assess whether that work is adequate.

5.2 Assessing the need for an expert

There is a cost attached to the use of an expert by the auditors. The expert will charge a fee for the professional service he provides. The use of an expert should therefore be evaluated on a cost/benefit basis.

When deciding whether he needs to use an expert to assist him in obtaining sufficient appropriate evidence, the auditor should consider such factors as:

- the nature, significance and complexity of the matter
- the risk of material misstatement
- the availability of alternative sources of audit evidence.

5.3 Assessing the work of an expert

ISA 620 **requires** the auditor to apply the procedures set out below when using the work of an expert. The auditor should:

- obtain an understanding of the expert's field of expertise, sufficient to allow the auditor to determine the nature, scope and objectives of the expert's work and evaluate the adequacy of that work
- agree terms of engagement with the expert, including:
  - the nature, scope and objectives of the expert's work
  - the respective responsibilities of the expert and the auditor
  - the form of the expert's report
  - confidentiality requirements
- evaluate the adequacy of the expert's work, including the:
  - reasonableness of the expert's conclusions
  - consistency of those conclusions with other audit evidence
  - reasonableness of significant assumptions and methods used
  - relevance, completeness and accuracy of source data.

Generally, the auditor is assessing whether the expert's work constitutes sufficient and appropriate audit evidence.

If the auditor decides that the work of the expert is not adequate he is **required** to:

- agree additional work with the expert, or
- perform other appropriate additional audit procedures.

The auditor has sole responsibility for the audit opinion issued and this is not reduced in any way by his use of an expert. Therefore **he should not refer in his report to the use of an expert,** unless that is required by law or regulation. Even then, or if the auditor refers to the expert's work in his report because it is relevant to an understanding of a modified opinion, then he must make it clear that such a reference does not reduce his responsibility for that opinion in any way.

This approach reinforces the point made earlier, that the auditor remains fully responsible for the report produced, even if evidence on which it is based was produced by others. The auditor therefore cannot simply accept work performed by experts. That work must be evaluated in the same way as other audit evidence is evaluated.

The competence, capabilities and objectivity of an expert may be assessed in one or more of the following ways:

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with other auditors or others who are familiar with that expert's work.

- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.

The objectivity of the expert is probably more of an issue when the expert has been employed by the audit client, as discussed earlier in this chapter.

The external auditor's reliance on the work of the internal auditor: ISA 610

- Reliance on internal audit: the external auditor's problem
- ISA 610: Using the work of internal auditors

6 The external auditor's reliance on the work of the internal auditor: ISA 610

6.1 Reliance on internal audit: the external auditor's problem

In many instances the work of the external auditors and internal auditors may overlap, particularly when the internal audit department carry out financial audits. In principle, the external auditors may be able to reduce the amount of testing and checking they carry out for the external audit, by relying on work that has already been carried out by the internal auditors. Reliance by the external auditor on the work of the internal auditors, where it is appropriate to do so, should lead to a more efficient and cost-effective audit.

However, the external auditor has a problem. The external auditor is responsible for his opinion on the financial statements, **even if he has relied on the work of others** such as internal auditors and external experts. The responsibility for relying on work done by the internal auditors rests entirely with the external auditors.

The external auditors must therefore be satisfied that they can rely on the work of the internal auditors to support the external audit opinion. The external auditors must therefore decide whether to rely on work done by the internal auditors, and if so, in what respects.

6.2 ISA 610: Using the work of internal auditors

ISA 610 provides guidance to the external auditor who has decided that the entity's internal audit function is likely to be relevant to his audit. The **objectives** of the external auditor are then to decide:

- whether and to what extent to use specific work of the internal auditors
- if so, whether such work is adequate for the purposes of the external audit.

To determine whether such work is adequate for his purposes, the external auditor is **required** to **evaluate** the internal audit function and its procedures. A decision can then be taken as to whether the work of the internal auditors can be used as part of the evidence on which the external audit opinion will be based.

The following factors should be considered by the external auditors in making the assessment of internal audit:

- The status of the internal audit department within the entity. In particular, the **objectivity** of the internal audit department is important. The external auditors will be more willing to rely on the internal auditors if the internal audit department has a considerable degree of operational independence – for example, in deciding the nature of the audit work it will carry out, and in reporting to an 'independent' senior person or body within the entity, such as the audit committee (rather than the finance director). The external auditor will also need to consider the scope of the internal audit work and any restrictions placed by senior management on the scope of its work and whether management act on recommendations in internal audit reports. If management ignore recommendations in internal audit reports, the external auditors cannot have much confidence in the ability of internal audit to ensure the effectiveness of internal control.
- The **technical competence** and **due professional care** of the internal auditors. The external auditors must be satisfied that the internal audit staff have sufficient technical competence and take a professional approach towards their work.
- There will need to be **effective communication** between the external and internal auditors with meetings held at appropriate intervals and each notifying the other of any significant matters that might affect the other's work.

In addition to the **general** assessment of the internal audit, ISA 610 also requires the external auditor to **evaluate each specific piece of work** performed by internal audit before it is used as external audit evidence.

To determine the **planned effect** of the work of internal audit on the nature, timing and extent of the external auditor's procedures, the external auditor is **required** to consider:

- the nature and scope of specific work performed or to be performed by internal audit
- the assessed risks of material misstatement at the account balance/transaction level
- the degree of subjectivity involved in the evaluation of evidence gathered by internal audit.

Because the external auditor is fully responsible for the audit opinion, he will need to test the work performed by the internal auditors. **Before using specific work** of internal audit the external auditor is **required** to evaluate whether:

- the work was performed by internal auditors with adequate technical training and proficiency
- the work was properly supervised, reviewed and documented
- adequate audit evidence was obtained
- appropriate conclusions were reached, consistent with any reports prepared
- any exceptions or unusual matters were properly resolved.

Procedures to achieve this might include:

- examining items already examined by internal audit
- examining other similar items
- observing procedures performed by internal audit.

The external auditor's evaluation of the internal audit function and its work should be fully documented in the external auditor's working papers.

The audit of accounting estimates: ISA 540

- The nature of accounting estimates and the audit problem
- ISA 540: Auditing accounting estimates

7 The audit of accounting estimates: ISA 540

7.1 The nature of accounting estimates and the audit problem

In the financial statements, estimated figures are used in situations where it is not practical or not possible to obtain a more precise measurement of an item. ISA 540 defines an audit estimate as: 'an approximation of a monetary amount in the absence of a precise means of measurement.' Accruals, prepayments and depreciation are all examples of areas where estimates are widely used. Other examples are the estimation of deferred tax, the estimate of losses or profits on long-term construction contracts, and provisions for the settlement of unfinished legal disputes.

Estimates are made for the financial statements by the management of the entity, using their judgement. The audit problem is therefore fairly clear. How does the auditor satisfy himself that the estimates made by management for inclusion in the financial statements are reasonable? The audit risk can be high.

7.2 ISA 540: Auditing accounting estimates

ISA 540 *Auditing accounting estimates, including fair value estimates, and related disclosures* is concerned with the audit of all accounting estimates, including those involving fair values. It requires auditors to obtain sufficient appropriate audit evidence as to whether:

- accounting estimates (whether recognised or disclosed in the financial statements) are reasonable, and
- whether the related disclosures are adequate.

Because of the number of major corporate scandals in recent years about aggressive 'earnings management', ISA 540 (revised and redrafted in accordance with the IAASB's clarity project) introduces requirements for greater rigour and scepticism in the audit of accounting estimates. It encompasses a risk based approach, focusing on those estimates that have **high estimation uncertainty.**

ISA 540 gives the following examples of accounting estimates.

- Allowance for doubtful accounts
- Inventory obsolescence
- Warranty obligations
- Depreciation method or asset useful life
- Costs arising from litigation settlements and judgments

- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability
- Outcome of long-term contracts

Additional examples of situations where fair value accounting estimates may be required include:

- complex financial instruments, which are not traded in an active and open market
- share-based payments
- property or equipment held for disposal
- certain assets or liabilities acquired in a business combination, including goodwill

  and intangible assets
- transactions involving the exchange of assets or liabilities.

Audit evidence relating to such estimates is often of relatively poor quality, because of the nature of the items involved. This means that the auditor will require a higher volume of this lower quality evidence, **particularly where the estimated item may be material or the audit risk is relatively high**.

Accounting estimates: auditing procedures

As part of his **risk assessment procedures** ISA 540 requires the auditor to obtain an understanding of the following.

- The requirements of the applicable financial reporting framework (for example, international accounting standards) in respect of accounting estimates, including related disclosures.
- How management identify transactions or events that could result in an accounting estimate being recognised or disclosed in the financial statements.
- The nature of the estimates. In the case of a liability, this involves obtaining an understanding of the obligation for which an estimate is needed: for example in the case of a provision for costs of warranties or guarantees, what are the terms of the warranties or guarantees that have been given by the client to its customers?
- The auditor should also review the procedures used by management to make their estimates, including:
  - the method used for estimating (for example in deciding the estimated useful lives of non-current assets)
  - relevant controls
  - the use of experts
  - the underlying assumptions
  - whether there ought to have been any change in the method used since the prior period
  - whether and how management has assessed the effect of estimation uncertainty.

If possible, the auditor should check the amount of an estimate against other known facts, to assess whether the estimated amount seems reasonable.

The auditor should also:

- review the outcome of accounting estimates included in the previous period's financial statements (to assess their reliability) and consider changes in the estimate from one year-end to the next
- evaluate the degree of estimation uncertainty associated with each current period estimate and, if the risk is high, whether this gives rise to significant risks.

Having assessed the risks of material misstatement the auditor must then determine:

- whether management has properly applied the requirements of the applicable financial reporting framework, and
- whether the methods used for making the estimates are appropriate and have been consistently applied (or whether any change in method since the previous period is appropriate).

In response to the assessed risks of material misstatement the auditor must then perform one or more of the following procedures.

- Determine whether events up to the date of the auditor's report provide sufficient audit evidence in respect of the estimate. The auditor should review events after the reporting date, and if possible find evidence to confirm the validity of the estimates.
- Test how management made the estimate and the data on which it is based, considering the method used and assumptions made.
- Test the controls over management's procedures for making estimates and carry out appropriate substantive procedures.
- Develop his own estimate or range of estimates and compare to management's figure, evaluating any significant differences.

The auditor is also required to:

- consider the need for expert evidence
- obtain written representations from management, and
- document the basis for his conclusions and any indications of management bias.

The following examples of indicators of possible management bias in estimates are given in the ISA.

- Changes in an accounting estimate, or the method for making it, where this is a subjective assessment.
- Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
- Selection or construction of significant assumptions that yield an estimate which favours management objectives.
- Selection of an unduly optimistic or pessimistic estimate.

Auditing of fair value measurements

Issues relating to the audit of fair value measurements are similar to those for the audit of accounting estimates (and both are covered by IAS 540). Balances of items measured at fair value, such as property and financial instruments, are often significant items in the statement of financial position.

The auditor needs to recognise the audit risk in fair value measurements:

- **Inherent risk**. Many fair value measurements are largely subjective and imprecise, and there is unavoidable inherent risk in their measurement. Valuation models may be used, but these are often complex and ay be unreliable (for example, in the case of non-marketable financial instruments, or models to assess the amount of liabilities to a company's pension fund). The inherent risk is much less when an open market exists for the items measured at fair value.
- **Control risk**. There is some risk that the entity's systems may fail to prevent or detect valuation errors. Fair value measurements are often made by external experts, outside the normal course of routine business operations, and the controls over the valuation process are therefore likely to be weak.
- **Detection risk**. The auditor should try to minimise detection risk, but the auditor may lack the knowledge and expertise to verify fair value measurements. This means that the auditor mat need to rely on the work of an external expert, increasing the risk that errors in fair value measurements will be discovered.

The audit of specific areas of the financial statements

8 The audit of specific areas of the financial statements

8.1 Introduction

In your examination, you will be required to apply the general principles of obtaining audit evidence to specific areas of the financial statements that are regulated by one or more of the international accounting standards.

In order to deal with exam questions of this type you need to know the details of the relevant IFRS or IAS. You will then need to consider:

- Materiality: is the item material for the financial statements?
- Key requirements of the IFRS or IAS: what does the auditor need to test to ensure compliance?
- How to obtain suitable audit evidence to check compliance with the accounting standard.

The main areas that you may be required to consider in the examination are set out below, as a checklist of the main issues that the auditor should consider when gathering audit evidence.

8.2 Auditor's checklist for specific IASs and IFRSs

IAS 1: Presentation of financial statements

- Has the **going concern basis** been adopted? Is the going concern basis appropriate?
- If the directors of the client company have decided that the going concern basis is not appropriate, have the relevant disclosures been made?
- If there is uncertainty about the going concern status of the company, have the relevant disclosures been made?
- Has the **accruals concept** been complied with?
- Is there consistency in the presentation and classification of items in the financial statements, between the current and previous financial periods?
- Has each material class of items been separately presented in the financial statements?
- Has **offsetting** (of assets and liabilities, or income and expense) been applied only as permitted by an accounting standard?

- Has an **appropriate format** been adopted for the statement of financial position, income statement/statement of comprehensive income and statement of changes in equity?
- Are **appropriate disclosure notes** included?

IAS 2: Inventories

- Has inventory been consistently valued at the **lower of cost and net realisable value**, on an item-by-item basis?
- Has an **acceptable costing method** been used for inventory? (Remember that LIFO is not permitted by IAS 2.)
- Has inventory been **counted accurately**? (What is the evidence for this?)
- Has an appropriate method been used for the treatment of **overheads**?

IAS 7: Statement of cash flows

- Is the presentation of the statement of cash flows in accordance with the requirements of IAS7?

IAS 8: Accounting policies, changes in accounting estimates and errors

- Have appropriate accounting policies been selected and consistently applied?
- Have any changes in accounting policy permitted under IAS 8 been correctly accounted for as prior period adjustments?
- Have fundamental errors in prior period financial statements been accounted for as prior period adjustments?
- Have changes in accounting estimates been reflected on a prospective basis?

IAS 10: Events after the reporting period

- Has the definition of events after the reporting period (as defined by IAS 10) been properly applied?
- Is there a correct **distinction between adjusting and non-adjusting events after the reporting period**?
- Have adjustments been made correctly for **adjusting events**, in accordance with the appropriate IAS /IFRS?
- Have **non-adjusting events** been adequately disclosed?

IAS 11: Construction contracts

- Have revenue and profits been recognised in accordance with the principles of IAS 11?
- Has **full provision** been made for **expected losses**?
- Have the statement of financial position assets and liabilities been calculated and disclosed in accordance with IAS 11?

IAS 12: Income taxes

- Has the income tax liability been correctly calculated and disclosed?
- Have all material timing differences been recognised in the **deferred tax provision**?
- Has an **appropriate rate of tax** been used in determining the amount of the **deferred tax** provision?
- Are **deferred tax assets** recoverable?

IAS 16: Property, plant and equipment

- Has the **cost** of property, plant and equipment been determined in accordance with IAS 16?
- Has **post-acquisition expenditure** on property, plant and equipment been properly analysed between capital expenditure and revenue expenditure?
- Has **depreciation** been properly calculated and accounted for?
- Have **asset revaluations** been performed in accordance with IAS 16 and accounted for correctly?
- Have disposals and the resulting **gain or loss on disposal** been properly calculated and recorded?

IAS 17: Leases

- Have leases been properly classified between **finance leases and operating leases**, and has the appropriate accounting treatment been applied to each type of lease?
- Have leasing obligations (finance leases) been properly analysed into **current and non-current liabilities**?
- For finance leases, have the **depreciation and finance charges** been allocated to accounting periods in accordance with IAS 17?
- Have the appropriate disclosures been made?

IAS 18: Revenue

- Have the appropriate principles of revenue recognition been applied to the recognition of revenue from the sale of goods, the provision of services and other items? (Note: The financial statement risk of non-compliance with IAS18, and the over-statement of revenue by recognising it too early, was discussed in an earlier chapter.)

IAS 19: Employee benefits

- Have appropriate liabilities been recognised correctly when employees have provided service in exchange for employee benefits to be paid in the future/
- Has the expense of the entity consuming the economic benefit arising from service provided by employees in exchange for employee benefits been recognised correctly?

IAS 20: Accounting for government grants and disclosure of government assistance

- Have revenue-based grants been credited to the income statement/statement of comprehensive income?
- Have capital-based grants been accounted for in accordance with IAS 20? The grant should either (1) be credited to the asset account, with depreciation then on the net cost of the asset, or (2) carried as a deferred credit which is then amortised to the income statement/statement of comprehensive income over the life of the asset.

IAS 23: Borrowing costs

- Have borrowing costs been recognised as an expense in the period in which they are incurred?
- If borrowing costs have been capitalised, are they directly attributable to the acquisition, construction or production of a qualifying asset?
- Have appropriate disclosures been made of the accounting policy, the amount of capitalised borrowing costs in the period and the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation?

IAS 24: Related party disclosures

- Have necessary disclosures been made to draw attention to the possibility that the company's financial position or profit/loss has been affected by related parties and related party transactions?

IAS 32: Financial instruments: Presentation and IFRS 7: Financial instruments: Disclosures

- Have financial instruments (liabilities) been **properly classified as debt or equity** based on their substance?
- Have **compound instruments** been properly analysed into their debt and equity elements?
- Have **appropriate disclosures** been made of risk exposures, risk management and hedging policies?

IAS 33: Earnings per share

- Has the **basic earnings per share** been correctly calculated and disclosed for the current and prior reporting period?
- Has **diluted earnings per share** been properly calculated and disclosed where relevant?

IAS 34: Interim financial reporting

- Have the interim financial reports been prepared in accordance with local requirements as well as IAS 34?

- Do the contents comply with the minimum requirements of IAS 34?
- Are appropriate disclosures included in notes to the interim statements?

IAS 36: Impairment of assets

- Have the directors identified events that may indicate that an impairment review is necessary?
- Have **recoverable amounts** been calculated in accordance with IAS 36?
- Where appropriate, have **cash-generating units** been identified?
- If an impairment loss has been recognised, has the loss been allocated to assets and recorded correctly?

IAS 37: Provisions, contingent liabilities and contingent assets

- Have all necessary provisions been recorded?
- Have contingent liabilities/ contingent assets been disclosed as required by IAS 37?

(Note: At the time of writing, a major revision of IAS 37 is proposed, that will 'abolish' contingent liabilities and contingent assets.)

IAS 38: Intangible assets

- Have **purchased intangible assets** been recognised and measured in accordance with IAS 38?
- Have the **useful lives** of intangible assets been estimated in a reasonable way?
- Is there evidence to support the non-depreciation of **intangibles with an indefinite useful life**?
- Have intangible assets been subject to **annual impairment reviews**?

IAS 39: Financial instruments: recognition and measurement

- Have financial instruments been recognised and measured in accordance with IAS 39?

IAS 40: Investment property

- Has the company adopted the cost model or the fair value model?
- If the cost model has been adopted, have the principles of IAS 16 been complied with?
- If the fair value model has been adopted, have annual valuations been performed and the gain or loss correctly accounted for?

IAS 41: Agriculture

- Have changes in fair value less point-of-sale costs in respect of biological assets been included in the profit and loss in the period in which they arose?

- Have government grants relating to biological assets been recognised only when they become receivable and measured as fair value less estimated point-of-sale costs?

IFRS 1: First-time adoption of International Financial Reporting Standards

- Has the company adopted a set of accounting policies that are appropriate and in compliance with IFRSs?
- Have all assets and liabilities recognised under IFRS been properly recognised and classified?
- Have all assets and liabilities not recognised under IFRS been removed from the financial statements?

IFRS 2: Share-based payments

- Is the calculation of share-based payments correct? (Check the number of employees granted share options and the number of options per employee; the official date for the grant of the options; the length of the vesting period; the required performance conditions attached to the options.)
- Has the cost of the share-based payments been spread fairly over the vesting period?
- Are the assumptions used to predict the level of staff turnover reasonable, based on available evidence? (If not, what assumptions would be reasonable?) The assumption about staff turnover affects the estimated cost of the share-based payments.
- Is the estimate of the fair value of the expense reasonable, and is it consistent with any valuation provided by an external expert (such as a chartered financial analyst)?

IFRS 5: Non-current assets held for sale and discontinued operations

- Has the **definition of discontinued operations** in IFRS 5 been properly applied?
- Have the results of discontinued operations been properly quantified and disclosed?
- Has the **definition of assets held for sale** contained in IFRS 5 been properly applied?
- Have assets held for sale been properly valued and disclosed?

IFRS 6: Exploration for evaluation of mineral resources

- Where a company has recognised assets as a result of exploration and evaluation expenditures, and facts and circumstances suggest that the carrying value may exceed the recoverable amount, has an impairment test of those assets been carried out?
- Has any impairment loss been measured, presented and disclosed in accordance with IAS 36?

- Has the entity disclosed information that identifies and explains the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources?

IFRS 8: Operating segments

- Have the criteria for reportable segments been properly applied?
- Has all the required information been disclosed?

8.3 Conclusion: audit papers, audit procedures and audit matters

It is highly probable that a question in your examination will ask you to describe the audit procedures in relation to a specific issue in the financial statements or to comment on audit matters that should be considered in relation to a particular item. The question might also ask about the audit evidence you would expect to see on file in respect of these procedures and matters.

A question may therefore ask any of the following:

- **What audit procedures** should be carried out in respect of…? An audit procedure is **an action**; for example 'discuss with management' or 'vouch to invoice'.
- **What audit evidence** would you expect to see in relation to…? Audit evidence will be **an item or record**; for example a copy of the relevant sales contract. Remember that discussions with managers about significant matters should be included in the documentation in the audit working papers, as audit evidence.
- **What matters** would you consider in respect of…? Relevant matters to consider will include (1) materiality (2) risk and (3) the requirements of any particular accounting or auditing standards.

e

Example: Audit procedures

Your audit firm is carrying out the audit of ABC Company, which owns the well-known Halberd brand name for fashion clothes. The brand name was purchased three years ago, and is being amortised.

What audit procedures might be carried out in respect of the **useful life** of the Halberd brand name?

a

Answer

Tutorial note
You need to identify a suitable audit procedure. Vouching cost to original purchase documents would not be relevant to this question. Instead, it is important to consider how to audit the period over which the brand is being amortised.

Ideas for a solution
So relevant procedures would be as follows.

- Compare the useful life attributed to the Halberd brand with the useful life of brands of other business entities in the industry.
- Review the annual marketing spend on the brand.
- Review planned future expenditure on the brand, to see if its value is likely to be maintained.
- Review the results of management's impairment test on the brand.

e

Example: Provisions and audit evidence

Bitton is a limited liability company. It manufactures and installs drilling equipment. Its charges for installing equipment was raised by 30% with effect from 1 January in the financial year just ended (to 31 December Year 9). The increase in installation charges was made to allow for the fact that from 1 January, Bitton gave a warranty to re-install any of its drilling equipment that did not perform to specification, due to a fault in the equipment or an error in the installation. The warranty is given for a two-year period.

The notes to the financial statements contain the following statements.

'The company guarantees the installation of all its equipment since 1 January Year 9. No provision for the guarantees has been recognised since the amount of the obligation cannot be measured with sufficient reliability.'

Installation fees for the year to 31 December Year 9 amounted to $7.6 million of which $2.1 million related to the three months to 31 December Year 9.'

Required

As auditor of Bitton for the year to 31 December Year 9:

(a) state the matters that should be considered in respect of the warranties

(b) state the audit evidence that you would require in respect of these matters.

a

Answer

Matters to consider are as follows:

- The requirements of IAS 37 and whether a warranty provision was required based on the given facts
- The materiality of a best estimate of a warranty provision
- Whether the audit report would have to be modified if changes were not made

Possible **audit evidence** includes the following:

- The warranty terms offered to customers
- Management's costings in respect of the warranties
- Schedules of installations (from which warranties arose) during the relevant period

- Letters of complaint from customers indicating the level of warranties used
- Costs of reinstallations from job cards.

Example: Development costs and audit evidence

Extracts from the draft financial statements of a company are as follows.

Statement of financial position extract	$000
Development costs	
At cost	3,400
Less: Accumulated amortisation	(1,850)
	1,550
Total assets of the company	20,400
Development costs capitalised during the year	700
Income statement extracts	
Revenue	5,600
Research costs	180
Amortisation of development costs	900
Profit before tax	2,800

Required

What audit evidence should be obtained to check:

(a) that capitalised development costs are properly recognised

(b) the validity of the amortisation rate for development costs?

Answer

Materiality

The carrying value of the development costs is 7.6% of total assets and the item is therefore material.

Development costs capitalised during the year were $700,000. If these had been written off instead, profit would have been $2,100,000 or 25% lower than reported. This is also a material amount.

The total spending during the year on research and development costs was $880,000 ($180,000 + $700,000). This is 15.7% of sales revenue: this too is material.

The auditor therefore should obtain sufficient appropriate audit evidence to support the accounting treatment and the valuation of development costs (and R&D expenses).

IAS38 requirements

IAS38 specifies the conditions that must exist for development costs to be capitalised. Briefly, these are:

- Intention to complete the development and either use or sell the developed item
- Technical feasibility of completing the development and the ability of the entity to use the developed item or sell it
- Ability to create future economic benefits
- Availability of technical, financial and other resources to complete the development
- Ability to measure the costs attributable to the intangible asset.

The audit risk is that development costs have been capitalised when not all of the criteria for capitalisation have been met. The auditor should therefore obtain audit evidence to confirm that each criterion has been met. For example, in order to test the technical feasibility, the auditor should look at test results of the project to date.

To assess the amortisation rates used for development costs already capitalised, the auditor might look for evidence from market research about the likely demand for the item. In the case of development of a new product, the auditor can look at actual sales since the product launch and discuss with management whether these appear to support the estimated amortisation period for the development costs.

Example: Deferred tax asset and audit evidence

In its draft financial statements, a company has included a deferred tax asset of $5 million. This relates to unused tax losses that have accumulated during the past three years. Management are confident that that there will be sufficient future operating profits to claim the benefit of the tax losses in full in future years.

The auditor should assess whether it is appropriate to include a deferred tax asset in the financial statements, and so needs evidence about whether the tax losses will be recoverable.

- He should start by checking whether the amount is reliable. He should obtain a copy of the client's tax computations and should agree the figures in the calculation to the accounting records.
- He should also review any correspondence about tax that may exist.
- He needs to make an assessment about whether the tax losses will be recoverable, by obtaining forecasts from the client of future profitability. The assumptions used in the forecast should be assessed for reasonableness in the context of the auditor's understanding of the client's business.
- If the forecasts of future profitability are reasonable, the auditor should assess how long it will be before the losses are recovered in full. This period should be checked against tax regulations, to confirm that there is no statutory limit on carrying forward tax losses.

Transaction cycles

9 Transaction cycles

9.1 Introduction

For your examination, you may be expected to apply your auditing knowledge to the main transaction cycles of an entity. These are:

- the revenue (sales) and receivables cycle
- the purchases and payables cycle
- the payroll cycle.

You may also be required to show an understanding of controls and audit tests in relation to:

- bank and cash transactions
- inventory
- non-current assets.

This section of the chapter provides you with checklists, for each of these audit areas. The checklists set out:

- the control objectives
- the key internal controls
- tests of control that might be applied
- substantive tests that might be carried out (usually on a sampling basis).

If you are not familiar with the items in the checklists, you should revise tests of control and substantive testing in your study material for basic audit and assurance.

However, auditing of the transaction cycles is examined in detail at the Foundation stage of the examinations (F8) and it is more likely that exam questions at the P7 stage will focus on the audit of items relating to specific IFRSs or IASs.

9.2 Revenue and receivables

Control objectives	Key controls	Tests of control	Substantive tests
■ There must be proper authorisation and recording of customer orders, goods returned and allowances (discounts) given. ■ Revenue must be recorded for all goods or services delivered. ■ All documents and records must be recorded accurately. ■ A policy should be established for the collection of receivables.	■ Segregation of duties (order acceptance/ despatch/ invoicing.) ■ Check that a customer's order is within the customer's credit limit. ■ Authorisation of orders. ■ Use of pre-numbered sales order forms. ■ Despatch notes should be pre-numbered and matched with sales orders and invoices. ■ Authorisation of despatches after checking. ■ Invoices should be authorised for sending to customers, after checking them for accuracy and against sales orders and despatch notes. ■ Invoices should be recorded promptly in the sales ledger. Batching of invoices for input and batch totals may be used as a control.	■ Sequence checks on all documents. ■ Check on evidence of authorisation at each stage in the cycle. ■ Check for evidence that the arithmetic/ calculations in all documents and records have been checked. ■ Check that documents have been matched, where appropriate. ■ Check that control account reconciliations have been performed and reviewed, with appropriate adjustments being made to the records.	■ Check the accuracy of the arithmetic in books of prime entry. ■ Check entries in books of prime entry back to the source documents. ■ Check the accuracy of postings to ledgers. ■ Check invoices and credit notes for accuracy in the arithmetic and pricing. ■ Check that inventory records have been correctly updated for despatches of goods to customers. ■ Review control account reconciliations. ■ Test the sales cut-off. ■ Apply analytical procedures, such as trend analysis for sales, and gross profit margin.

Table continues

Control objectives	Key controls	Tests of control	Substantive tests
	■ Sales returns and allowances (discounts) should be checked and authorised. ■ Credit notes must be recorded accurately. ■ The control account for receivables in the main ledger should be reconciled regularly with account balances in the receivables ledger. ■ Statements should be sent regularly (monthly) to credit customers. ■ Debt collection procedures should be followed systematically, in accordance with debt collection policy. ■ Writing off any bad debts must be authorised.		

9.3 Purchases and payables

Control objectives	Key controls	Tests of control	Substantive tests
Goods and services are purchased: ■ with proper authority ■ under proper procedures ■ for the business ■ from authorised suppliers ■ and are inspected for description, quantity and quality.	■ Segregation of duties (ordering, receipt of goods, recording invoices, payment). ■ Use of official pre-numbered documentation (purchase orders). ■ Appropriate authorisation procedures should be used for orders and payments.	■ Sequence checks on all documents (purchase orders, goods received notes). ■ Check on evidence of authorisation at each stage in the purchasing cycle. ■ Check for evidence that the arithmetic/ calculations in all documents and records have been checked.	■ Check the accuracy of the arithmetic in books of prime entry. ■ Check entries in books of prime entry back to the source documents. ■ Check the accuracy of postings to ledgers.
Before being recorded purchase invoices are: ■ authorised ■ checked for arithmetic accuracy and pricing ■ checked against supporting documentation (for example, purchase orders). Completeness and accuracy of recording.	■ There is a policy for re-ordering regular items of inventory. ■ Goods received notes (GRNs) are used, and signed, as evidence that the quantity, quality and description of all goods received have been checked. ■ Matching of documents (purchase requisitions, purchase orders, GRNs and purchase invoices).	■ Check that documents have been matched where appropriate. ■ Check that control account reconciliations have been performed and reviewed, with appropriate adjustments being made to the records. *Note that these tests of control are essentially the same as for the revenue/sales and receivables cycle.*	■ Check invoices and credit notes for accuracy in arithmetic and pricing. ■ Check that inventory records have been correctly updated for receipts of goods from suppliers. ■ Review control account reconciliations. ■ Test purchases cut-off. ■ Apply analytical procedures.

Table continues

Control objectives	Key controls	Tests of control	Substantive tests
	■ Procedures should exist for analysing purchase invoices and recording them in the correct expense or asset accounts. ■ Use of control accounts and batch totals to ensure completeness and accuracy of processing. ■ Accurate records should be kept of purchases returns, and these should be matched with credit notes from the supplier.		Review other audit areas and prior year working papers for evidence of possible unrecorded liabilities.

9.4 Payroll

Control objectives	Key controls	Tests of control	Substantive tests
■ Gross pay is calculated at the correct rates. ■ Employees are paid only for work done.	■ Segregation of duties (establishing pay rates, calculating pay, recording pay). ■ Maintenance of up-to-date personnel records. ■ Authorisation of joiners and leavers, pay rates, overtime, voluntary deductions from pay.	Check: ■ that payroll information is reconciled between periods and any changes between periods are explained ■ entries in the wages control account, if used	Check: ■ the accuracy of the arithmetic in payroll calculations and payroll records ■ postings to ledger accounts ■ that correct pay rates are used

Table continues

Control objectives	Key controls	Tests of control	Substantive tests
■ Gross pay, net pay and deductions are recorded completely and accurately in the payroll, cash records and ledger accounts. ■ The correct employees are paid the correct amounts. ■ The correct amount of deductions are paid to the tax authorities and other authorities.	■ Regular management review of overall cost of payroll. ■ Establishment of standard procedures, timetables and systems for processing payroll. ■ Approval of payroll, once prepared. ■ Use of a control account for payroll expenses/ liabilities. ■ Safe custody of cash, where employees are paid in cash. ■ Verification of the identity of employees, when payment is in cash. ■ Signature received for pay, when payment is in cash. ■ Custody and investigation of unclaimed pay packets, when payment is in cash. ■ Use of a separate bank account for payroll.	■ the accuracy and completeness of ledger account entries ■ the accuracy of the arithmetic in payroll records ■ that the payroll records agree with cash/bank records ■ Agree payroll amounts to bank records. ■ Review payroll for unusual amounts. When employees are paid in cash: ■ check that unclaimed wages are kept safe and reasons for not claiming wages are explained. ■ attend and observe a distribution of pay. ■ compare names on payroll to names on pay packets. ■ examine signed receipts for pay.	■ that correct, authorised rates are used for statutory deductions (such as tax) and voluntary deductions ■ that overtime, bonuses and similar payments have been properly authorised ■ that joiners are properly authorised ■ that employees have not been paid for periods before they join or after they leave ■ the pay for hours worked or output produced should be checked against the authorised documentation ■ that payments of deductions have been made to the appropriate authorities ■ the signed receipts for wages paid in cash

Table continues

Control objectives	Key controls	Tests of control	Substantive tests
	■ Authorisation of cheques/bank transfers, when employees are paid by these methods.	■ check that no employee receives more than one pay packet.	■ that the correct entries have been made in the wages control account *Also:* ■ Verify the existence of a sample of employees on the payroll. ■ When wages are paid in cash, observe the distribution of pay packets. Carry out analytical procedures, such as trend analysis, average pay per employee.

9.5 Bank and cash

Control objectives	Key controls	Tests of control	Substantive tests
Bank			
■ All money belonging to the company is received and is promptly and accurately recorded. ■ All payments are properly authorised and are promptly and accurately recorded.	■ Segregation of duties. ■ Listing and prompt recording and banking of all receipts. ■ Authorisation for all payments. ■ Regular reconciliations are performed and reviewed.	■ Review bank reconciliations for unusual items and evidence of management review of statements. ■ Review cash book for unusual entries. ■ Check additions in cash book and entries in ledgers.	■ Send bank confirmation letter(s). ■ Check or prepare bank reconciliation statement. ■ Assess audit significance of other information in the reply from the bank.

Table continues

Control objectives	Key controls	Tests of control	Substantive tests
Bank			
	■ There are sufficient physical custody controls over cheques and cash.	■ Review payments for evidence of authorisation.	■ Review large or round-sum amounts just before and just after the reporting period. ■ Carry out analytical procedures.
Cash			
As for bank above.	*As for bank above.*	■ Observe that procedures for opening mail and handling cash are being followed. ■ Check amounts recorded as receipts against remittance advices from customers. ■ Check the amounts in receipt books or on till rolls against paying-in slips (paying in cash to the bank), the cash book and bank statements. ■ Check whether cash is banked daily. ■ Check payments out of cash takings, if any. ■ Check petty cash payments for authorisation.	■ Attend/carry out cash counts. ■ Check that postings are made correctly to ledger accounts. ■ Analytical procedures.

Table continues

Control objectives	Key controls	Tests of control	Substantive tests
Cash			
		■ Check the documents that support any cash payments (for example, receipts).	

9.6 Inventories

Many of the points listed above in relation to the purchases cycle (for example, in relation to the receipt of goods) and the sales cycle (for example, in relation to the despatch of goods) should also apply to the inventory system. For example, the requirement for authorisation procedures and segregation of duties are the same. The table below focuses on additional points.

Control objectives	Key controls	Tests of control	Substantive tests
■ Inventory in the inventory records should represent inventory that physically exists. ■ Inventory is valued at the lower of cost and net realisable value (NRV). ■ Inventory quantities are maintained at a level suitable to the business.	■ There should be regular inventory counts, with reconciliations of physical counts to inventory records. Differences should be explained. ■ Reviews of inventory for items where NRV may be below cost. ■ Accurate, up-to-date inventory records are maintained. ■ Inventory cut-off procedures are in place.	■ Review and observe inventory counting procedures. ■ Check that any necessary changes to inventory records are made. ■ Check that NRV reviews are performed. ■ Confirm that cut-off procedures are operating. ■ Review inventory levels for adequacy.	■ Attend inventory count: - observe procedures - record test counts - record cut-off information. ■ Check inventory valuation, at lower of cost and NRV. ■ Check inventory cut-off. ■ Perform appropriate analytical review procedures. ■ Confirm the existence of inventory held at outside locations.

Table continues

Control objectives	Key controls	Tests of control	Substantive tests
	■ Appropriate physical custody procedures should be in place.	■ Check that physical custody procedures are operational (= applied in practice).	■ Check the treatment of inventory held on the client's premises but owned by a third party.

9.7 Non-current assets

Again, some of the controls and tests that are listed above (for example, the requirement that purchases/expenditure should be properly authorised) are also relevant here. The table below lists additional points.

Control objectives	Key controls	Tests of control	Substantive tests
■ Records of non-current assets should be complete and correct. ■ There should be adequate controls for the safe custody of non-current assets. ■ Depreciation, revaluations and disposals must be dealt with correctly.	■ Use of authorised capital expenditure budgets and project evaluation techniques, if appropriate. ■ Use of a non-current asset register, that is regularly checked and reconciled to the non-current asset accounts in the main ledger. ■ Impairment reviews are performed as necessary.	■ Check for the proper authorisation of additions and disposals. ■ Check reconciliations of ledger balances with the non-current asset register.	■ Review the movement in non-current assets for the period. ■ Check additions, and the calculations of depreciation and gain or loss on disposals. ■ Physically verify a sample of additions. ■ Trace proceeds for disposals to cash records. ■ Review for unrecorded disposals. ■ Review evidence relating to any asset revaluations during the period.

CHAPTER 9

Evaluation and review

Contents

The review stage of the audit

- The need for a review
- Evaluation of misstatements: ISA 450
- Other areas for evaluation and review

1 The review stage of the audit

1.1 The need for a review

Having carried out tests of control and an appropriate amount of substantive testing, the auditor has reached the stage in the audit where he should carry out a review and an evaluation of the evidence he has gathered.

- The auditor should back up his detailed testing of controls, transactions and balances with a broader review of other information and events that may have an impact on the information presented in the financial statements.
- **Analytical procedures** are also used at this review stage, as a final check that the information contained in the draft financial statements 'makes sense'.

1.2 Evaluation of misstatements: ISA 450

It is also at this stage of the audit that the auditor will make an overall evaluation of the level of errors he has found in the financial statements. Errors found in individual areas (such as receivables, or inventory) will be summarised and totalled.

The total amount of the errors will be compared with the **materiality thresholds** that were set at the planning stage. This will allow the auditor to reach a conclusion as to whether the financial statements are materially 'correct' – one aspect of whether the financial statements show a true and fair view.

This area is covered by ISA 450 *Evaluation of misstatements identified during the audit.* The **objective** of the auditor in this area, per ISA 450, is to evaluate the effect of**:**

- **identified misstatements** on the **audit**, and
- any **uncorrected misstatements** on the **financial statements**.

A **misstatement** could be in relation to the amount, classification, presentation *or* disclosure of an item.

ISA 450 **requires** the auditor to carry out the following procedures:

- Accumulate all misstatements found during the audit, unless they are clearly trivial.
- If the total of misstatements identified during the audit approach (or could approach) materiality, decide if the overall audit strategy and audit plan need to be revised.

- Communicate all misstatements found during the audit to an appropriate level of management and request that the misstatements be corrected.
- If management refuse to correct the misstatements obtain the reasons for this and take those reasons into account when evaluating whether the financial statements as a whole are free from material misstatement.
- Prior to evaluating the effect of uncorrected misstatements reassess materiality per ISA 320.
- Decide whether uncorrected misstatements are material, individually, or when added together. In making this assessment the auditor should take into account the size, nature and circumstances of the misstatements and the effect of any uncorrected misstatements from prior periods.
- Communicate to those charged with governance the effect that uncorrected misstatements may have on the audit report.
- Request a written representation from management as to whether they believe the effect of uncorrected misstatements are immaterial, individually, or in total (see example letter in the previous chapter).
- Document:
  - the amount below which misstatements would be regarded as clearly trivial
  - all misstatements accumulated during the audit and whether they have been corrected
  - his conclusion as to whether uncorrected misstatements are material, individually, or in total.

1.3 Other areas for evaluation and review

However, there are also a number of other specific areas which form part of the overall evaluation and review process, including the auditor's work on:

- opening balances and comparative figures
- other information published with the audited financial statements
- subsequent events
- going concern basis.

Opening balances and prior period comparatives: ISAs 510 and 710

- Opening balances and comparatives: the potential problem
- ISA 510: Initial audit engagements – opening balances
- ISA 710: Comparative information – corresponding figures and comparative financial statements

2 Opening balances and prior period comparatives: ISAs 510 and 710

2.1 Opening balances and comparatives: the potential problem

The auditor's work on this area is regulated by ISA 510 *Initial audit engagements – opening balances* and ISA 710 *Comparative information – corresponding figures and comparative financial statements* .

In most countries, the financial statements of companies must include comparative figures for the previous year. To reach the conclusion that the financial statements present a true and fair view, the auditor therefore needs to be confident that:

- opening balances brought forward in the accounting records agree with the audited figures reported in the prior year financial statements
- accounting policies have been applied consistently over the current financial year and prior years
- there is consistency of classification and disclosure between the current financial year and prior years.

Where the current auditor performed the audit in the previous year and issued an 'unmodified' opinion, it should be a straightforward exercise for the auditor to confirm that points listed above have all been complied with.

A different situation arises when an audit firm is carrying out an audit of a client for the first time.

For example, an auditor may be appointed to carry out his first audit of the financial statements for the year to 31st December 2006. To do this, the auditor cannot ignore the opening statement of financial position, as at 31st December 2005.

- The figures in the closing statement of financial position for the previous period will be presented as prior period comparative figures in the 2006 financial statements. The new auditor is therefore giving an audit opinion on published financial statements that include the previous year's closing balances.
- Errors in the opening balances may affect the figures for the current financial period. For example, if opening inventory is misstated and is over-valued, the cost of sales in the current period may also be misstated (too high).

2.2 ISA 510: Initial audit engagements – opening balances

ISA 510 provides guidance on the auditor's responsibilities in relation to opening balances where:

- the financial statements for the prior period were not audited, or
- the financial statements for the prior period were audited by another auditor (referred to as the **predecessor auditor**).

The **objective** of the auditor when considering such an initial audit engagement is to obtain sufficient appropriate audit evidence about whether:

- the **opening balances contain misstatements** that materially affect the current period's financial statements, and
- **appropriate accounting policies** reflected in the opening balances have been **consistently applied** in the current period (or a change of accounting policy has been properly accounted for and disclosed).

The following **audit procedures** are **required**:

- Read the most recent financial statements and audit report, if any, for information relevant to opening balances.
- Check that the prior period's closing balances have been correctly brought forward.
- Check that opening balances reflect appropriate accounting policies.
- One or more of the following procedures:
  - Where the prior period financial statements were audited, review the predecessor auditor's working papers to obtain evidence re opening balances.
  - Consider whether audit procedures carried out in the current period provide evidence on some of the opening balances. For example, cash received from customers in the current period gives evidence of the existence of a receivable at the opening date.
  - Carry out specific audit procedures to obtain evidence re opening balances. A review of the audit report on the financial statements for the previous period.
- If evidence is found that opening balances could contain material misstatements affecting the current period's financial statements perform appropriate additional procedures to assess the effect, and
- if such misstatements do exist, communicate this to those charged with governance in accordance with ISA 450.
- Check that the accounting policies reflected in the opening balances have been consistently applied in the current period (or a change of accounting policy has been properly accounted for and disclosed).

2.3 ISA 710: Comparative information – corresponding figures and comparative financial statements

ISA 710 *Comparative information – corresponding figures and comparative financial statements* also relates to a similar area of the audit work. It deals with audit work on corresponding amounts and other comparative information for the preceding financial reporting period. The considerations in ISA 710 apply to all external audit engagements, whereas ISA 510 focuses particularly on new audit engagements and opening balances (comparative statement of financial position figures).

Audit procedures carried out on comparative figures are significantly less than those carried out on the current year figures. They are normally limited to ensuring that comparative figures have been:

- correctly reported as required by the applicable financial reporting framework, and
- appropriately classified.

ISA 710 therefore **requires** the auditor to evaluate whether:

- the **comparative information agrees with the previous period**, or, where appropriate has been restated, and
- **accounting policies have been consistently applied in the two periods**, or, if there have been changes in accounting policies, whether those changes have been properly dealt with.

In addition, he is **required** to:

- perform appropriate additional procedures if he becomes aware of a possible material misstatement in the comparative information whilst performing the current period audit
- obtain written representations which cover all periods referred to in his opinion.

The task set by ISA 710 should not present any problems where the auditor:

- also audited the client's financial statements in the previous financial period, and
- issued an audit report on those financial statements stating that they showed a true and fair view.

If he did not audit the prior period financial statements, then he should also follow the guidance set out in ISA 510 (see above).

The audit opinion should not normally refer to the corresponding figures, unless particular circumstances apply. These circumstances are considered in a later chapter.

Other information published with the audited financial statements: ISA 720

- The nature of 'other information'
- ISA 720: Other information in documents containing audited financial statements

3 Other information published with the audited financial statements: ISA 720

3.1 The nature of 'other information'

The published annual reports of major companies contain a significant amount of information that is not required by statute or by accounting standards.

The annual financial report is often used partly as a 'public relations' document, communicating a wide range of information from the company to shareholders and others, possibly in a report from the chairman or the chief executive officer.

If you have not done so already, you should read the published report and accounts of several public companies that have adopted international accounting standards, and look at the information that they include. Published reports and accounts are normally available from the company's web site (often in the 'investor relations' section).

In doing this, you should note the following:

- the scope and contents of the report (in particular, what 'non-financial' information is published)
- the comments and reports on corporate governance matters.

It would also be helpful, for your auditing studies, to look at:

- the form and content of the audit report.
- the accounting policies applied.
- any accounting or auditing problems that may be evident from the financial statements.

3.2 ISA 720: Other information in documents containing audited financial statements

One of the main benefits of the audit process is that audited information possesses a higher degree of credibility (and reliability) than equivalent information that has not been audited.

There is a possibility that the credibility of audited information may suffer if:

- information that has not been audited is published together with audited information (often in the same printed document) and
- the 'un-audited' information contains errors or is inconsistent with the audited information.

The audit report makes it clear what information has been subject to audit. However, there is a high risk of misunderstanding and a possibility that users of the financial statements will not make the distinction between audited information and other information.

For this reason, ISA 720 requires that auditors should read this 'other' information in order to identify:

- material inconsistencies with the audited financial statements, or
- material misstatements of fact.

An **inconsistency** exists when the other information contradicts information contained in the audited financial statements.

A **misstatement of fact** exists when the other information is incorrectly stated or presented, but the information is not related to matters in the audited financial statements

Action if inconsistencies are not removed

If the auditor judges that **financial statements need to be revised**, and management refuse to do so, then the auditor should qualify his audit opinion.

If the auditor judges that the **other information needs to be revised**, and management refuse to do so, then the auditor should:

- include an emphasis of matter paragraph in his audit report, or
- withhold his audit report, or
- where allowed by law, withdraw from the audit.

If a material inconsistency is identified **after the date of the auditor's report** the auditor should follow the provisions of ISA 560 *Subsequent events*.

Action if misstatements are not removed

If the auditor becomes aware of an apparent material misstatement of fact he should:

- discuss the matter with management, and
- if he considers that there is an apparent material misstatement of fact, request management to take legal advice, and
- consider the legal advice received by the entity.

If the auditor concludes that there is a material misstatement of fact which management **refuses to correct** he should:

- notify those charged with governance, and
- take any further appropriate action (such as taking legal advice about the matter).

Subsequent events: ISA 560

- IAS 10 and ISA 560
- Audit work to check compliance with IAS 10
- Events occurring after the reporting period and up to the date of the audit report
- Facts discovered after the date of the audit report and before the financial statements are issued
- Facts discovered after the financial statements have been issued

4 Subsequent events: ISA 560

4.1 IAS 10 and ISA 560

It is not possible to prepare financial statements that present a true and fair view by considering only those events and transactions that take place before the date at which the statement of financial position is prepared. Material events that occur after the reporting period should also be considered when preparing the financial statements for the year.

Purpose of IAS 10

IAS 10 *Events after the reporting period* has two main objectives:

- to specify when an entity should adjust its financial statements for events that occur after the reporting period, but before the financial statements are authorised for issue, and
- to specify the disclosures that should be given about events that have occurred after the reporting period but before the financial statements were authorised for issue.

Events after the reporting period are defined in IAS 10 as 'those events, favourable and unfavourable that occur between the end of the reporting period and the date when the financial statements are authorised for issue.' There are two types of events after the reporting period:

- Adjusting events. These are events that provide evidence of conditions that already existed at the end of the reporting period.
- Non-adjusting events. These are events that have occurred due to conditions arising after the reporting period.

Accounting for adjusting events after the reporting period

IAS 10 states that if an entity obtains information about an adjusting event after the reporting period, it should update the financial statements to allow for this new information.

'An entity shall adjust the amounts recognised in its financial statements to reflect adjusting events after the reporting period.'

Disclosures for non-adjusting events after the reporting period

Non-adjusting events after the reporting period are treated differently. A non-adjusting event relates to conditions that did not exist at the end of the reporting period; therefore the financial statements must not be updated to include the effects of the event. IAS 10 states quite firmly: 'An entity shall **not** adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period'.

However, IAS 10 goes on to say that if a non-adjusting event is **material**, a failure by the entity to provide a disclosure about it could influence the economic decisions taken by users of the financial statements. For **material non-adjusting events** IAS 10 therefore requires disclosure of:

- the nature of the event, and
- an estimate of its financial effect, or a statement that such an estimate cannot be made.

This information should be disclosed in a note to the financial statements.

The role of the auditor: ISA 560

The work of the external auditor in this area is covered by ISA 560 *Subsequent events*. The objectives of the auditor, per ISA 560, are to:

- obtain sufficient, appropriate evidence about whether events occurring between the date of the financial statements and the date of the audit report are appropriately reflected in those financial statements, and
- respond appropriately to facts that became known to him after the date of the audit report that, had they been known to him at that date, may have caused him to amend his report.

This means that audit procedures must be planned and performed so as to consider all significant transactions occurring after the reporting period. This means that the audit work does not stop with events only up to the end of the reporting period. There are two key dates after the reporting period: the date of the audit report and the date that the financial statements are issued.

- **Before** the issue of the audit report, the auditor should **actively look for** significant subsequent events.
- **After** the issue of the audit report (and up to the time that the financial statements are issued), the auditor has to consider the impact of any significant subsequent events **that come to his attention**. However, he does not have to look for these events actively.

4.2 Audit work to check compliance with IAS 10

Audit work to check compliance with IAS 10 can be divided into three phases:

- from the end of the reporting period to the date of the audit report
- from the date of audit report to the date that the financial statements are issued
- after the financial statements have been issued.

4.3 Events occurring after the reporting period and up to the date of the audit report

Between the end of the reporting period and the date of the audit report, the auditor is required to obtain **sufficient appropriate evidence that all events that require adjustment of or disclosure in the financial statements have been identified**.

Normal audit verification work

The auditor may find sufficient evidence of subsequent events in the course of normal audit verification work. Where this is the case he is not required to perform additional audit procedures. Such normal audit verification work will include looking at sales, invoices and cash transactions after the year-end in order to verify items in the statement of financial position at the year end. For example:

- The audit of receivables will consider whether receivables at the end of the reporting period are collectable. Cash receipts after the year-end may indicate a significant non-payment, suggesting the need to write off a debt as 'bad'.
- The audit of inventory procedures includes a review of the net realisable value of inventory. Sales of inventory after the year-end may indicate that some inventory in the statement of financial position is over-valued (because subsequent events have shown that its NRV was less than cost).
- A search for unrecorded liabilities may discover the existence of some unrecorded liabilities, from invoices received after the reporting period but relating to the period covered by the financial statements.
- A review of the entity's cash position at the end of the reporting period may find that a cheque from a customer, recorded as part of the bank balances, was dishonoured after the reporting period.

Procedures aimed specifically at identifying subsequent events

The auditor should also actively look for 'subsequent events', up to the time that he prepares the audit report. Taking into account his risk assessment of this area, he should:

- obtain an understanding of management's procedures for identifying subsequent events
- enquire of management as to whether any subsequent events have occurred which might affect the financial statements
- read the entity's latest subsequent financial statements
- read minutes of shareholders' meetings, meetings of the board of directors and senior management meetings held after the date of the financial statements and

enquire about matters discussed at any such meetings where minutes are not yet available

- obtain written representations in respect of subsequent events.

4.4 Facts discovered after the date of the audit report and before the financial statements are issued

Even after the date on which the audit report is signed, the auditor retains some degree of responsibility for **events of which he becomes aware**, up to the time that the financial statements are issued. He is not required, during this period, to actively look for subsequent events. His level of responsibility is therefore much reduced compared with the period before the signing of the audit report.

If the auditor becomes aware of a fact that, **had it been known to him at the date of the report, may have caused him to amend his report** then he must:

- discuss the matter with management,
- determine whether the financial statements need amending, and
- enquire how management intend to address the matter in the financial statements.

If the financial statements are amended, the auditor is required to:

- carry out the necessary audit procedures on the amendment(s), and
- extend his review of subsequent events up to the date of the new audit report.

(In some jurisdictions management are not prevented from restricting their amendments to the effects of the subsequent event. In such cases ISA 560 permits the auditor to restrict his extended review of subsequent events to that amendment only. In such a case the auditor must draw attention to this restriction in an **emphasis of matter paragraph** or **other matter paragraph** (covered in a later chapter)).

If management do not amend the financial statements for the subsequent event, but the auditor feels that an amendment should be made, the auditor should take the following action.

- If the audit report has not yet been provided to the entity, modify his opinion as appropriate.
- If the audit report has been provided to the entity:
  - instruct management not to issue the financial statements before the necessary amendments have been made
  - if they do so, take appropriate action to prevent reliance on the audit report, after taking legal advice.

4.5 Facts discovered after the financial statements have been issued

As above, the auditor has no obligation to perform audit procedures or make enquiries regarding the financial statements after they have been issued. However, if he becomes aware of a fact that, **had it been known to him at the date of his audit report**, **may have caused him to amend his report** then he should:

- discuss the matter with management
- determine how the financial statements need amending, and
- enquire how management intend to address the matter in the financial statements.

If the financial statements are amended, the auditor is required to:

- carry out the necessary audit procedures on the amendment
- extend his review of subsequent events up to the date of the new audit report (as above)
- review the steps taken by management to inform anyone who received the original financial statements and audit report of the situation
- issue a new audit report, containing an **emphasis of matter paragraph** or **other matter paragraph** (covered in a later chapter). This should refer to a note in the revised financial statements that explains in more detail the reason for the re-issue of the financial statements.

Going concern: ISA 570

- Introduction
- Going concern: duties of the directors
- Going concern: duties of the auditor (ISA 570)

5 Going concern: ISA 570

5.1 Introduction

The going concern assumption means that the income statement/statement of comprehensive income and statement of financial position are prepared **on the assumption that the entity will continue in operational existence for the foreseeable future**.

If the entity is **not** a going concern, there will be significant implications for the financial statements. For example:

- the distinction between 'current' and 'non-current' for both assets and liabilities ceases to have any meaning: all assets and liabilities become 'current'
- all assets must be carried in the statement of financial position at their net realisable value, and
- there may be additional liabilities.

The auditor needs to be satisfied that the going concern assumption is appropriate to the financial statements under audit. This will involve an investigation of the financial and operating position of the client before the end of the reporting period. If this review indicates that the going concern assumption may not be appropriate, further investigation will be needed.

5.2 Going concern: duties of the directors

In preparing the financial statements, the directors must satisfy themselves (in accordance with IAS 1) that the going concern basis is appropriate. In some countries, there is a requirement for large companies (listed companies) to disclose the fact that, in the opinion of the directors, the company **is** a going concern.

It is therefore the responsibility of management to make the going concern assessment.

5.3 Going concern: duties of the auditor (ISA 570)

The work of the external auditor on the going concern status of an entity is covered by ISA 570 *Going concern*. Key points from ISA 570 are set out below.

The **objectives** of the auditor in this area, according to ISA 570, are to:

- obtain sufficient appropriate evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements
- conclude whether a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern, and
- determine the implications for the audit report (covered a later chapter).

This is a subjective area where judgement is usually required to assess the uncertainties surrounding the assumptions that were made by management in reaching their conclusion about the going concern status of the entity.

ISA 570 requires that the auditor must perform **risk assessment procedures** to consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

If management has already performed such an assessment, the auditor must:

- discuss this assessment with management
- determine whether the assessment identified any relevant events or conditions, and, if so
- determine management's plans to address them.

If management has not yet performed such an assessment, the auditor must:

- discuss with management the basis for the intended use of the going concern assumption, and
- enquire of them whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern.

In evaluating management's assessment the auditor must consider the same time period. If management looked less than 12 months into the future, the auditor should ask management to make a re-assessment looking at least 12 months into the future. The auditor must also enquire if management is aware of any relevant events or conditions beyond this time period.

Factors that raise questions about the going concern assumption

The auditor should remain alert throughout the audit process for factors or events that may indicate that the going concern status could be questionable/doubtful. Factors that may cast doubt on the going concern status of the company include the following:

- Recurring operating losses.
- A heavy dependence on short-term finance for long-term assets.
- Working capital deficiencies (such as a large bank overdraft, or exceptionally low levels of inventory).
- High gearing (a high ratio of debt capital to equity).

- Loan interest payments are in arrears.
- Excessive or obsolete inventory.
- A deterioration in the entity's relationships with its banks (evidenced, perhaps, in written correspondence).
- Increased use of lease and hire purchase finance, in place of purchasing assets.
- Use of out-of-date technology.
- A low level of current sales orders.
- The entity relies very heavily on the success of one product
- There are legal proceedings in progress that may jeopardise the entity's ability to continue in business.
- A loss of key management or staff.
- A loss of a key customer or supplier
- A significant increase in the level of competition in the market.

Going concern assumption: audit procedures

Where events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern the auditor must obtain sufficient appropriate evidence to determine whether in fact a material going concern uncertainty does exist. He does this by performing **additional audit procedures**.

- **Discussion with management**. Management should be asked to explain the reasons why they consider the going concern assumption to be valid. They should also be asked about their future plans for the business. If the entity is expecting to make a loss next year, the possible implications of this for the going concern assumption should be discussed extensively.
- **Obtain a cash flow forecast**. A cash flow forecast should be obtained from the entity and this should also be discussed with management. The assumptions in the forecast should be checked and, if appropriate, challenged. If there is a forecast of a cash shortage, the auditor should discuss with management their plans for obtaining the additional financing that will be required.
- **Review the sales order book**. If this indicates a decline in sales orders, the issue should be discussed with management.
- **Review ageing receivables**. Check a list of ageing receivables and assess the average time to pay. If customers are taking longer to pay, this may have adverse implications for operational cash flow.
- Consider whether planned capital expenditure by the entity may be insufficient to support the business as a going concern in the future.
- If a key senior employee has left the business entity in the recent past, the possible implications (for example, the possibility of losing key customers with the loss of the key employee) should be discussed.
- **Litigation**. If the company is involved in continuing litigation, and faces the possibility of having to pay a large amount of money to settle the dispute, the implications should be discussed.
- **Information from the client entity's bank**. If the client entity is expecting to rely on continuing financial support from its bank (for example, a continuation of its

bank overdraft facility) the bank should be asked to confirm that the finance will remain available.

- After discussing the issues with management, the auditor should obtain a **letter of representation from management** confirming their opinion that the entity is a going concern.

The financial statements are the responsibility of management, and if the auditor considers that the going concern assumption is invalid whereas management consider it to be valid, the options available to the auditor are to:

- discuss the matter with management, having carried out audit procedures to obtain more evidence
- try to persuade management to change their mind and prepare the financial statements on a different basis (a break up basis), and
- if management does not agree to change its view, consider making a qualified audit report.

Unless all those charged with governance are also involved in managing the entity, the auditor must **communicate to those charged with governance** any events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Such communication must include the following:

- Whether the events or conditions constitute a material uncertainty.
- Whether the use of the going concern assumption is appropriate.
- Whether the related disclosures in the financial statements are adequate.

If there is a **significant delay in the approval of the financial statements**, which the auditor believes is due to events or conditions related to the going concern assessment, he must:

- perform the additional audit procedures listed above
- consider the effect of this delay on his conclusions.

The audit work relating to the going concern status is summarised below.

Audit stage	**Audit procedures**
Planning and assessment	■ Consider whether circumstances exist which cast doubt on the going concern status. ■ If management have already carried out their assessment, review and evaluate that assessment. ■ Review management's plans to deal with any problems identified. ■ If the auditor has identified problems not identified by management, ask management to prepare appropriate plans which the auditor then reviews. ■ Seek written representation regarding the plans/going concern status.

- Assess whether there are any material uncertainties relating to the going concern status of the entity.

Detailed audit procedures to assess the going concern status	These might include the following: ■ Reviewing cash flow, profit and funding forecasts, normally for at least one year from the end of the reporting period. ■ Analysing interim or management accounts. ■ Reviewing loan agreements and other relationships with providers of finance. ■ Reviewing minutes of board meetings. ■ Reviewing current and future order levels and relationships with customers. ■ Reviewing operating plans and the availability of future resources.

The impact of the going concern status on the audit report is dealt with in a later chapter.

CHAPTER 10

Group audits

Contents

Introduction to group audits

- Group audits and the audit of individual group companies
- Possible problems with group audits
- Terminology in group audits

1 Introduction to group audits

A group audit is the audit of group financial statements. For this topic, you need to be aware of the requirements of the following accounting standards:

- IFRS 3 *Business combinations*
- IAS 27 *Consolidated and separate financial statements*
- IAS 28 *Investments in associates*
- IAS 31 *Interests in joint ventures*

In addition, IAS 24 *Related party disclosures* is also of particular relevance, because companies within a group are related parties.

1.1 Group audits and the audit of individual group companies

Much of the basic audit work for groups of companies consists of auditing the financial statements of the individual companies in the group. The parent company and subsidiaries are referred to (for audit purposes) as the '**components**' of the group.

The audit work on the financial statements of the components of a group will follow normal auditing principles and practice.

This chapter is concerned with the **additional** audit considerations that arise in connection with the preparation of the group financial statements.

1.2 Possible problems with group audits

The organisation and planning of a group audit is usually more complex than the planning of the audit of a single company, for the following reasons:

- Groups may include a large number of companies. Some group companies may be foreign subsidiaries that report in their own currency and perhaps use their national accounting practices to prepare their financial statements, rather than international financial reporting standards.
- Some companies in the group may have a different year-end accounting date from other companies.
- It will be necessary to make or audit adjustments that are made to the financial statements of individual group companies, for consolidation purposes.
- Some group companies may be audited by an audit firm that is not the auditor of the parent company.

1.3 Terminology in group audits

Some special terms from ISA 600 (see below) are used for group audits.

Group auditor. The group auditor is the audit firm responsible for the audit of the group financial statements (and will usually also be the auditor of the parent company). ISA 600 in fact refers to the '**group audit**', the '**group engagement partner**' and the '**group engagement team**' but the term ' **group auditor**' is useful and well understood.

The group engagement team will:

- establish the overall group audit strategy
- communicate with component auditors (see below)
- perform work on the consolidation process, and
- evaluate the conclusions drawn from the audit evidence obtained in order to form an opinion on the group financial statements.

Each of the above stages is considered in more detail in the remainder of this chapter.

Component auditor. A component auditor is an auditor who, at the request of the group auditor, performs work on the financial information of a component. For example, the audit of an individual subsidiary, associate or joint venture may be performed by Audit firm A, when the group auditor is Audit firm B. Audit firm A is a 'component auditor'.

Component. A component is an entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.

Group audits: preliminaries

- Audits of group financial statements: ISA 600
- The relationship between the group auditor and component auditors
- Accepting an appointment as group auditor
- Understanding the group, its components and component auditors
- Materiality
- Planning and controlling a group audit

2 Group audits: preliminaries

2.1 Audits of group financial statements: ISA 600

ISA 600 *Special considerations – audits of group financial statements (including the work of component auditors)* was issued in October 2007 as a revised and redrafted ISA as part of the IAASB's Clarity Project, but also represented the result of a long consultation process on group audits. The revised ISA 600 contains much more extensive guidance than the original ISA 600.

2.2 The relationship between the group auditor and component auditors

ISA 600 regulates situations where group financial statements include financial information of components that are audited by other audit firms. The group auditor is required to determine how the work of the component auditors will affect the audit of the group financial statements.

The group engagement partner is responsible for:

- the direction, supervision and performance of the group audit, and
- issuing an appropriate group audit report.

The group auditor is **solely responsible** for the audit report on the group financial statements (although ISA 600 does not in fact use this term). The group audit report does **not** therefore refer to any component auditors, unless such a reference is required by local law. If it is required, the group audit report must indicate that such a reference does not reduce the group auditor's responsibility for the opinion on the group financial statements.

Because of this sole responsibility, ISA 600 contains very specific guidance on:

- the direction that the group auditor should give to the group audit, and
- the group auditor's involvement in the work of component auditors.

2.3 Accepting an appointment as group auditor

It is normal practice for the auditor of the parent company to act as the group auditor. However, this is 'technically' a separate appointment. As in the case of all appointments, the audit firm should consider whether it is in a position to accept the appointment as group auditor.

Before accepting appointment as group auditor, the audit firm should ensure that all the procedures relating to acceptance of an engagement per ISA 220 are met and that they have a 'reasonable expectation' of obtaining sufficient appropriate audit evidence about the consolidation process and the financial information of components to reduce audit risk to an acceptable level.

The firm does this by obtaining an understanding of the group and its components and their environment sufficient to determine:

- which components are significant to the group
- which significant components are audited by others, and
- whether, as group auditor, the firm will be able to be sufficiently involved in the audit of significant components to obtain sufficient appropriate evidence about them.

If the group auditor is not able to be involved in the audit of a significant component, then it is unlikely that the group auditor can obtain sufficient appropriate evidence in respect of that component and it should not accept (or should resign from) the engagement. If the auditor is prevented from resigning from the engagement by the law, he should issue a disclaimer of opinion on the group financial statements.

Significant components are those that:

- are of individual significance to the group (ie individually material in a group context), or
- have been identified as likely to include significant risks of material misstatement of the group financial statements.

2.4 Understanding the group, its components and the component auditors

In accordance with ISA 315, the group auditor must identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment. This will mean:

- enhancing the understanding of the group, its components and their environments, obtained at the acceptance or continuation stage, and
- obtaining an understanding of the consolidation process, including the instructions issued by management to its components.

This will enable the group auditor to confirm or revise its initial assessment of components which are likely to be significant.

When the group auditor plans to request a component auditor to perform work on the financial information of a component, he must assess the following.

- Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit (in particular that he is independent).
- The component auditor's professional competence.
- Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence.
- Whether the component auditor operates in a regulatory environment that actively oversees auditors.

The group auditor **cannot simply rely on the work performed by the component auditor without assessing the likely quality of that work**.

If the component auditor is not independent or there are serious concerns about any of the other matters above the group auditor will need to obtain evidence relating to the financial information of the component **without** requesting the component auditor to perform any work.

2.5 Materiality

The group auditor will need to set:

- group materiality for the group financial statements as a whole, and
- component materiality for those components where component auditors will perform an audit or a review for the purposes of the group audit.

Component materiality will usually be lower than group materiality. If a component has been audited in its own right (because of local laws or regulations) and the group auditor decides to use that audit to provide audit evidence for the group audit, the materiality threshold used on that audit will need to be assessed. If the threshold was too high, then additional work may be needed.

2.6 Planning and controlling a group audit

The principles and guidelines for planning and controlling a group audit are similar to those for the audit of an individual company. However, additional considerations arise, in regard to the complexities of a group audit.

These additional considerations will require the group auditor to do the following:

- Familiarise himself with the client's procedures for preparing group financial statements (for example, the client may use standard consolidation schedules).
- Ascertain the client's timetable for the preparation of the group financial statements.

- Establish an audit strategy and audit plan for the entire group audit, including the audit of components. This should include:
  - staffing requirements for the group audit
  - a timetable for the audit of the compamnt financial statemetns and the group financial statements
  - an action plan for possible problem areas (for example, foreign subsidiaries)
  - arrangements for communication and co-operation with component auditors.

Working with component auditors

- Determining the type of work to be performed on components
- Communication with component auditors
- Involvement of the group auditor in work performed by component auditors
- Joint auditors

3 Working with component auditors

3.1 Determining the type of work to be performed on components

Where a component is **of individual financial significance** to the group, the group auditor or a component auditor must perform an audit using component materiality.

Where a component is **significant because of likely significant risk of material misstatement,** the group auditor or a component auditor must perform one or more of the following.

- An audit using component materiality.
- An audit of one or more account balances, classes of transactions or disclosures (depending on where the risk of material misstatement lies).
- Specified audit procedures to address the risk of material misstatement.

For **non-significant components** the group auditor should perform analytical procedures at a group level.

If the group auditor does not consider that sufficient appropriate audit evidence will be obtained from the sum of the above work then additional work should be performed on non-significant components (similar to that for significant components). The selection of such components should be varied from year to year.

3.2 Communication with component auditors

If there is not effective communication between the group auditor and the component auditor, there is a risk that the group auditor may not obtain sufficient appropriate audit evidence on which to base the group audit opinion.

It is therefore vital that there is **clear and timely two-way communication** between the group auditor and the component auditor. The group auditor's requirements are usually communicated in a **letter of instruction**. The component auditor's communication with the group auditor will usually be in the form of a **memorandum** or **report of work performed**.
However, such communication may not necessarily be in writing. For example, the group engagement team may visit the component auditor to discuss identified significant risks or review relevant parts of the component auditor's audit

documentation. In such cases, matters must be properly documented in accordance with ISA 230.

In co-operating with the group auditor, the component auditor will provide the group engagement team with access to relevant audit documentation provided this is not prohibited by law or regulation.

The group auditor's **letter of instruction** to the component auditor should set out:

- the work required
- the use to be made of that work, and
- the form and content of the component auditor's communication with the group engagement team.

It should also include:

- a request for co-operation
- ethical requirements
- component materiality
- identified significant risks
- a list of known related parties.

The component auditor's **report of work performed** should include:

- a statement of compliance with ethical and group auditor requirements
- identification of the financial information on which the component auditor is reporting
- any instances of non-compliance with laws or regulations which could lead to a material misstatement of the group financial statements
- a list of uncorrected misstatements of the financial information of the component
- indicators of possible management bias
- any identified material weaknesses in internal control
- any other significant matters the component auditor expects to communicate to those charged with governance of the component
- any other matters that may be relevant to the group audit
- the component auditor's overall findings, conclusions or opinion.

3.2 Involvement of the group auditor in the work performed by component auditors

It is the group auditor's responsibility to decide what work is to be performed on the financial information of the component by the component auditor.

The group auditor then has to decide the extent of his involvement in that work. For **significant components** he must, as a minimum:

- discuss with component management or the component auditor the business activities of the component that are significant to the group
- discuss with the component auditor the risk of material misstatement of the financial information of the component, and
- review the component auditor's documentation of identified significant risks of material misstatement of the group financial statements.

Where significant risks of material misstatement of the group financial statements have been identified at a component the group auditor should:

- evaluate the further audit procedures to be performed to address such risks, and
- consider whether it is necessary to be involved in those procedures.

Such involvement might include:

- meeting with component management/auditors to obtain an understanding of the component
- reviewing the component auditor's overall audit strategy and plan
- performing risk assessment procedures at the component
- designing and/or performing further audit procedures
- participating in closing/other key meetings between component auditors/management
- reviewing other relevant parts of the component auditor's documentation.

For **other components**, the extent of the group auditor's involvement will depend on his understanding of that component auditor. If he has concerns about that particular component auditor's competence, or a lack of local regulation, he may decide that he needs to be involved in that component auditor's risk assessment.

In all cases the group auditor is required to evaluate the report of the work performed by the other auditor. If, after such evaluation and after discussion with the component auditor/management, the group auditor concludes that the work is insufficient he should:

- determine what additional procedures are needed, and
- whether such procedures should be performed by the component auditor or himself.

3.3 Joint auditors

A joint audit involves two (or more) audit firms being appointed to audit the financial statements of an entity.

Joint audits may occur in other situations, but they are most commonly found in group audits. In particular when a group acquires a new subsidiary, it is not unusual to appoint the group's auditors jointly with the subsidiary's existing auditors, at least for a period of time after the acquisition.

The joint audit provides a joint opinion on the financial statements of the subsidiary.

Advantages of joint audits

The reasons why joint auditors might be appointed include the following:

- The client company may be so large that it requires the services of more than one firm of auditors.
- After the acquisition of a large subsidiary, using joint auditors may help the transition process while the group auditors become familiar with the new subsidiary. The 'old' auditors should be familiar with the business of the subsidiary and should pass their knowledge over to the parent company auditors. For the parent company auditors, this should accelerate the process of getting to know the business of the new subsidiary.
- Joint auditors may provide a higher level of technical expertise than either audit firm could provide individually.
- Improved geographical coverage may be obtained for the audit, where each of the joint auditors on its own does not have offices that cover all the geographical locations of the component companies in the group.
- It has been suggested that two medium-sized audit firms might 'join forces' and tender for the audit of a company for which the auditors would normally be one of the 'Big 4' audit firms. This is possibly a way in which medium-sized firms might try to 'break the monopoly' of the Big 4 on large company audits.

Disadvantages of joint audits

Possible disadvantages of joint audits include the following:

- The extra cost to the client. It is likely to cost more to use two audit firms than to use one.
- Possible inconsistencies between the two joint auditors in the audit methods that they use. If so, there may be problems in reaching agreement on whose audit method to use.
- The possible difficulty the two firms may have in agreeing the division of work.
- Additional problems that will arise in monitoring and controlling the audit work of two different firms.
- The two firms may find it difficult to work well together, and each firm may try to become the leading firm in the joint audit.
- If there is a claim against the auditors for negligence in the conduct of the audit, there may be some difficulty in identifying which of the joint auditors is potentially liable.

The key to a successful joint audit is good communication between the firms, including **joint planning meetings** and **regular discussions** between the firms at all key stages of the audit process. The meetings and discussions should be **fully documented**.

Auditing the consolidation process

- Role of the group auditor with regard to consolidation
- The main audit procedures relating to consolidation
- Subsequent events

4 Auditing the consolidation process

4.1 Role of the group auditor with regard to consolidation

As discussed above, ISA 600 requires the group auditor to obtain an understanding of the consolidation process, including the instructions issued by management to its components. This will allow an assessment of the risks involved in the consolidation process.

The group auditor will want to confirm that the following have been done correctly by the client group.

- There has been a full and accurate transfer of information from the individual financial statements of the components of the group to the final consolidated financial statements.
- Appropriate consolidation adjustments have been made.

However, the amount and type of detailed audit procedures to be carried out will depend on the group auditor's assessment of risk in this area.

4.2 The main audit procedures relating to consolidation

The table below sets out the main audit procedures that could be performed in relation to the consolidation process ie preparing the consolidated financial statements from the financial statements of the individual components in the group.

Topic	Audit procedures
Clerical accuracy	■ Confirm that figures have been transferred accurately from the financial statements of the components (individual conmpanies in the group) to the consolidation schedules. ■ Check the arithmetical accuracy of all consolidation calculations, such as the consolidation total balances and total transaction values.
Status of investments	■ Confirm that the parent company has correctly classified investments as a subsidiary, associate, joint venture or simple investment, in accordance with standard accounting practice. ■ Confirm that the appropriate accounting treatment has been adopted for each of these classifications of investment in the group accounts.

Table continues

Topic	Audit procedures
Changes in the group	■ For acquisitions: confirm fair values, the calculation of purchased goodwill and accounting treatment in accordance with IFRS 3 and any other relevant standards. ■ Where there has been an acquisition during the year involving deferred consideration as part-payment, check that the amount of the deferred consideration has been included in the cost of the acquisition at discounted present value, using a current pre-tax cost of capital as the discount rate. (Note: The cost of the acquisition affects the amount of the purchased goodwill.) ■ Where there has been an acquisition during the year involving a possible contingent consideration as part-payment, check the reasonableness of the assumption that the resent value of the contingent consideration should be included in the cost of the acquisition. ■ For disposals: confirm the sale proceeds, and the calculation of the gain or loss on sale. ■ Check that the correct accounting treatments of items are applied in the consolidated income statement/statement of comprehensive income and the consolidated . For example, when a subsidiary has been an acquired during the year, check that the calculation of pre-acquisition and post-acquisition profit is correct.
Consolidation adjustments*	■ Reconcile the inter-company transactions and balances (or review the reconciliation of the inter-company transactions and balances that has been made by the client's staff). ■ Confirm the inter-company balances. ■ Check calculations of the adjustments for unrealised profit. ■ Check the calculations and disclosure of non-controlling interests. ■ Check the accounting treatment of inter-company dividends and other dividends.
Loss-making investments	■ Consider whether any goodwill on acquisition has suffered an impairment. ■ Consider whether a write down of the investment in the books of the parent company is needed. ■ If a subsidiary makes losses consistently, its going concern status may be in question. ■ However, the group may take a formal decision to provide financial support to the subsidiary. This decision, in effect, would protect the going concern status of the subsidiary, even if it is making losses. In such a situation, the group auditor will normally request a 'comfort letter' (or 'support letter') to this effect from the directors of the parent company.

Related parties	■ Ensure the provisions of IAS 24 are complied with. ■ (Most components of the group will be 'related' to most other components.)
Reporting	■ Reach a conclusion about whether the group financial statements present a true and fair view. ■ (The principles relating to group audit reports are dealt with in a later chapter.)

*(**Note**: Consolidation adjustments are adjustments that are made after the financial statements of the individual group companies have been prepared. The adjustments are needed to consolidate the financial statements of the individual companies into a single set of group financial statements. Consolidation adjustments may therefore include adjustments to the financial statements of individual group companies, to achieve consistency of accounting policies. There are also adjustments for inter-group balances and closing inventory from intra-group sales, for goodwill impairment, and so on.)

4.3 Subsequent events

The subsequent events review will need to include procedures to identify events at components that occur between the dates of the components' financial information and the date of the **group** audit report. These procedures could be carried out by the group auditor or by component auditors.

Documentation and communication with management and those charged with governance

- Documentation
- Communication with group management
- Communication with those charged with governance of the group

5 Documentation and communication with management and those charged with governance

5.1 Documentation

In addition to meeting the requirements of ISA 230 *Audit documentation* the group auditor must also document the following matters.

- An analysis of components, identifying significant components.
- The type of work performed on the financial information of components.
- The extent of the group auditor's involvement in the work performed by component auditors on significant components.
- Written communications between the group auditor and component auditors concerning the group auditor's requirements.

5.2 Communication with group management

The group auditor should make group management aware, on a timely basis, of the following matters.

- Material weaknesses in the design or operating efficiency of group-wide controls.
- Material weaknesses which are significant to the group that the group auditor has identified at components.
- Material weaknesses which are significant to the group that component auditors have identified at components and have brought to the attention of the group auditor.
- Any fraud or suspected fraud identified by the group or component auditors.

The distinction between management and "those charged with governance" (see below), who could in fact be the same, is covered in a later chapter.

5.3 Communication with those charged with governance of the group

In addition to the matters required to be communicated by ISA 260 *Communication of audit matters with those charged with governance* the group auditor should communicate the following matters to those charged with the governance of the group.

- The type of work to be performed on the financial information of components.
- The group auditor's planned involvement in the work to be performed by component auditors.
- Any concerns over the quality of any component auditor's work.
- Any limitations on the group audit (eg a lack of access to information).
- Any fraud or suspected fraud involving group management, component management, or employees with significant roles in group-wide controls where the fraud resulted in a material misstatement of the group financial statements.

CHAPTER 11

Audit-related services

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Review engagements

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- Due diligence engagements
- International Standard on Review Engagements (ISRE) 2400
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1 Review engagements

1.1 The distinction between audit and audit-related services

An **audit** is a form of **assurance engagement**. The objective of an audit is to enable the auditor to form an opinion as to whether the financial statements of an entity give a 'true and fair view'.

An audit is designed to provide a **high level of assurance to the users of the financial statements**.

In contrast, **audit-related services** do not provide the same high level of assurance, and in some cases do not provide any assurance. Audit-related services include engagements such as:

- **Reviews of data**. Reviews of data are checks carried out on information prepared by another person. They provide a **moderate** level of assurance that the information under review is free of material misstatement.
- **Agreed-upon procedures**. This is an engagement where the party hiring the accountant specifies the procedures that the accountant should follow when performing the assignment.
- **Compilations**. The accountant is engaged to prepare information, rather than to audit information prepared by someone else. For example, an accountancy firm may be engaged to prepare a tax computation for a client.

1.2 Types of review engagement

In a review engagement, the accountant is engaged to review financial information or other information, but not to audit it.

The work performed in a review engagement is less detailed than the work for an audit. As a result, the level of assurance provided is **moderate** rather than high (as in the case of an audit).

A distinction is made between two types of review engagement:

- an attestation engagement, and
- a direct reporting engagement.

Attestation engagement

To **attest** to something means to affirm it or vouch for it. In an attestation engagement, an accountant is engaged to attest to something. For example, an accountant might be engaged to attest to the fact that certain procedures within an entity have been performed in a prescribed way. The accountant will not comment on the quality of the procedures, but will simply attest to the fact that they have been performed.

Direct reporting engagement

In a direct reporting engagement, an accountant is engaged to provide a special report on some aspect of the client's affairs.

- The report will provide an expression of opinion (usually providing **negative assurance**) that is made in accordance with the agreed terms of the engagement
- The report is prepared after the accountant has carried out an independent examination of financial information or other information that has been prepared for use by another party.

1.3 Due diligence engagements

One of the most common forms of direct reporting engagement is '**due diligence**' work. This term refers to any engagement where the accountant is engaged to make enquiries into the accounts, organisation or activities of an entity.

Due diligence work is most commonly referred to in the context of mergers and takeovers. The work involves obtaining information about the target company, prior to the takeover (or merger). The objective should be to find out everything that may be relevant about the target company's operations, financial performance, financial position and future prospects. In addition, information should also be gathered about the business environment in which the target company operates.

The accountant will also interview the senior management of the target company, and also other key employees and possibly external third parties. Due diligence work does **not** involve tests of controls (unless the client specifically asks for this), nor does it involve substantive testing. Due diligence work is **not** a form of audit work.

The main objective of due diligence is therefore often to provide information that will allow the client to:

- decide whether a takeover or merger is actually desirable, and
- if so, whether the proposed cost of the acquisition is reasonable.

An adverse or critical due diligence report may therefore result in:

- abandoning a proposed takeover or merger, or
- reducing the offer price for the acquisition.

Items to investigate in a due diligence exercise

Financial performance and financial position. The accountant will look at the available historical financial information about the target company, such as its financial statements for the past few years. Ratio analysis will often be used to make an assessment. The accountant will also look at the target company's management accounts, budgets and profit/cash flow forecasts, and at any current business plan.

Operational issues. The accountant should also look for any operational issues in the target company that may raise questions about its value. For example, the target company might have important contracts with major customers, and the accountant should try to find out when these contracts reach their termination date and what is the probability that the contracts will be renewed. Other operational problems may be discovered, such as a high rate of labour turnover, or high costs incurred in meeting warranties or guarantees to customers.

Management representations. Management of the takeover target may have provided representations to the potential buyer. For example, they might have given a written assurance that the target company is not subject to any tax investigation or potential litigation. Due diligence work should seek to establish that these representations appear to be correct.

Identification of assets. A takeover usually results in purchased goodwill in the consolidated accounts. However the takeover target may have several intangible assets that do not appear in its statement of financial position (because they were internally-generated assets) but which should be recognised for the purpose of consolidation. Examples are internally-generated patent rights, customer lists and databases and brand names. These should be identified and valued, for inclusion in the consolidated statement of financial position after the acquisition. It is also useful for the management of the potential buyer to be aware of the nature and estimated value of the intangible assets that they would be acquiring.

Benefits and costs of a takeover. Due diligence may also include an attempt to estimate the future benefits of the takeover, such as cost savings from synergies such as economies of scale. Any 'one off' expenses such as redundancy costs and reorganisation costs will have to be estimated – by the potential buyer if not by the due diligence process.

Benefits of using an audit firm for due diligence

There is no reason why an accountancy firm, such as the frm's auditors, shouldbe engaged to carry out due diligence. Management could do some or all the work themselves. However using an accountancy firm to do the work has two potental benefits:

- Hiring an accountancy firm to do the work saves management time for the potential buyer. In additon, the accountants assigned to the due diligence work should have suitable experience in this type of work. For large takeover, the amount of time and resources required to carry out proper due diligence can be substantial.
- Using a professional firm to do due diligence may help to reassure shareholders in the potential buyer (or investors who wil lbe asked to provide loan finance for the takeover) that the acquisition has been properly evaluated

1.4 International Standard on Review Engagements (ISRE) 2400

Objectives of ISRE 2400

ISRE 2400 *Engagements to review financial information* sets out the objective of a review of financial statements as follows. The objective of such a review is:

'…to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework.'

(This quote is © International Federation of Accountants and is reproduced with kind permission.)

Note that a review:

- requires less evidence than an audit, and
- has an opinion that is expressed in negative terms: (it gives '**negative assurance'**).

Because a review engagement provides a lesser form of assurance than an audit, the work for the review will usually be limited to analytical review and other review procedures. Detailed verification work (for example, substantive tests) will not usually be carried out. This will usually mean that fewer accountancy staff, but more experienced staff, will be required for a review engagement than for an audit.

Principles to apply to review engagements

ISRE 2400 set outs the following general principles that should be applied to a review engagement. The accountant should:

- comply with relevant codes of ethics
- plan and perform the work with an attitude of **professional scepticism**, recognising that material misstatements may exist in the information that is subject to review
- obtain **sufficient and appropriate evidence**, primarily through enquiry and analytical procedures.

The actual terms of a review engagement should be agreed with the client, and set out in an **engagement letter**.

Procedures for a review of financial statements

Procedures for the review of financial statements will usually include the following:

- The accountant should obtain an understanding of the entity's business and the industry in which it operates.
- The accountant should make enquiries into:
  - the entity's accounting policies, practices and procedures, including the preparation of financial statements
  - material assertions in the financial statements that are subject to the review
  - decisions taken at board meetings and other meetings of the entity that may affect the financial statements
  - the completeness of the accounting records that were used to prepare the financial statements.
- The accountant will use analytical procedures. These should be designed to identify unusual relationships between items in the financial statements, and individual items that appear unusual. Analytical procedures would include:
  - comparing the financial statements under review with financial statements for prior periods
  - comparing the financial statements with the anticipated results and financial position of the entity
  - a study of the relationships between elements in the financial statements that should be expected to conform to a predictable pattern (based on the entity's past experience or normal ratios/relationships for the industry as a whole).
- Other procedures that will usually be carried out in a review of financial statements include:
  - discussions with the company's auditors (if the audit firm is not the firm of accountants that is performing the review engagement)
  - obtaining representations from management
  - considering the appropriateness of the accounting policies employed by the entity
  - making enquiries into subsequent events (after the date of the statement of financial position)
  - making a review of the statements as a whole.

If the accountant finds information indicating that misstatements might exist in the financial statements, the scope of the work should be extended.

1.5 Reporting at the end of a review engagement

The outcome of a review engagement will be a report from the accountant. The report will be in one of two main forms, depending on whether:

- no matters have come to the attention of the auditor, which indicate that a true and fair view is not presented
- some matters have come to the attention of the auditor, indicating that a true and fair view might not be presented.

No matters have come to the attention of the auditor

In this situation the auditor will issue a report giving a clear expression of negative assurance. An example of such a report, based on ISRE 2400, is given below.

REVIEW REPORT

We have reviewed the accompanying statement of financial position of ABC Company at December 31st 20X6, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Review Engagements 2400. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to enquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view in accordance with International Financial Reporting Standards.

AUDITOR

Date

Address

Note the negative assurance that is given in the report – nothing has come to the attention of the accountant to indicate that a material misstatement exists.

Where such matters have come to the auditor's attention

When matters have come to the accountant's attention, suggesting that a material misstatement exists, the reporting requirements are similar to those in ISA 700 for qualified external audit reports. The auditor will need to:

- describe the matters involved
- assess the impact of the matter, as either material or pervasive/fundamental
- distinguish between 'disagreement' and 'limitation on scope' when presenting the opinion in the report.

The following example of a report dealing with a material disagreement is based on ISRE 2400:

REVIEW REPORT

(First two paragraphs as for the previous unqualified report.)

Management has informed us that inventory has been stated at its cost which is in excess of its net realisable value. Management's computation, which we have reviewed, shows that inventory, if valued at the lower of cost and net realisable value as required by International Financial Reporting Standards would have been decreased by $…, and net income and shareholders' equity would have been decreased by $...

Based on our review, except for the effects of the overstatement of inventory described in the previous paragraph, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view in accordance with International Financial Reporting Standards.

AUDITOR

Date

Address

1.6 International Standard on Review Engagements (ISRE) 2410

ISRE 2410 *Review of interim financial information performed by the independent auditor of the entity* deals with a more specific topic than ISRE 2400. It deals with the review carried out by a company's external auditors of the interim financial statements (mid-year financial statements), where companies are required to produce interim statements. The interim financial statements are not subject to a full audit; however, they are subject to a review.

On the whole general auditing principles apply to this type of review, as set out below.

The auditing firm that reviews **interim financial information (IFI)** is normally the external auditor for the end-of-year accounts. The audit firm should:

- comply with the same ethical requirements as it does for the main audit
- implement appropriate quality control procedures
- plan and perform the review with an attitude of professional scepticism
- agree the terms of engagement with the client in an engagement letter
- prepare documentation sufficient to support the auditor's review conclusions and to provide evidence that the review was conducted in accordance with ISRE 2410.

1.7 Procedures for the review of interim financial information

Procedures for the review of interim financial information (IFI) should include the following:

- The accountant should obtain an understanding of the entity and its environment, including its internal controls, in order to:
  - assess the risk of misstatement in the financial statements
  - select appropriate 'audit' procedures for the review.
- The accountant should make enquiries and perform analytical procedures sufficient to reach a conclusion for the review. This conclusion should be about whether anything has come to the auditor's attention to indicate that the IFI has not been prepared, in all material respects, in accordance with the applicable financial reporting framework. (As with ISRE 2400, the accountant's opinion is expressed in negative terms.)
- If any such matters come to the accountant's attention, the accountant should make additional enquiries or perform other procedures in order to obtain more information.
- The accountant should check that the IFI agrees or reconciles to the underlying accounting records.
- The accountant should discover whether management has:
  - taken subsequent events into account, and
  - made an assessment of the entity's ability to continue as a going concern.
- The accountant should evaluate any uncorrected misstatements in the IFI, both individually and in aggregate. (This is the same as for the annual audit.)
- The accountant should obtain written representations from management that:
  - they acknowledge their responsibility for internal controls
  - the IFI has been prepared and presented in accordance with the applicable financial reporting framework
  - they believe the effect of any uncorrected misstatements are immaterial, both individually and in aggregate
  - there has been full disclosure of all significant facts, risk assessment, possible or actual non-compliance with laws and regulations, and subsequent events.
- The accountant should ensure that any other information issued with the IFI is materially consistent with the IFI.

1.8 Reporting on the review of interim financial information

The auditor should issue a written report on the review of the IFI. This report should consist of the following elements:

- Title: **Review of the IFI**
- Addressee.
- Identification of the IFI that has been reviewed. This should include the title of each of the financial statements in the set of financial statements subject to review, and the end-of-period date and the period covered by the IFI.

- A statement that management is responsible for preparing the IFI in accordance with the applicable financial reporting framework, and for its fair presentation.
- When the IFI consists of a complete set of general-purpose financial statements that should be prepared in accordance with a financial reporting framework, and the statements are **designed to achieve fair presentation**, the review report should include an accountant's conclusion. This conclusion should state whether anything has come to the auditor's attention that causes him to believe that the IFI does not **give a true and fair view** in accordance with the applicable financial reporting framework.
- A statement that the accountant is responsible for expressing a conclusion on the IFI, based on the review that the accountant has carried out.
- A statement that the review of the IFI was conducted in accordance with ISRE 2410, and a statement that that this review consisted of making enquiries and applying analytical procedures and other review procedures.
- A statement that a review is substantially less in scope than an audit conducted in accordance with ISAs. Consequently the review does not enable the accountant to obtain assurance that he would become aware of all significant matters that might be identified in an audit. Accordingly, no audit opinion is expressed (and the accountant expresses a negative opinion rather than a positive opinion).
- Date of the report
- Location in the country or jurisdiction where the accountancy firm practises
- Signature of the accountant/auditor.

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Example

Shown below is an example of an unmodified report, based on ISRE 2410. The report relates to IFI comprising a complete set of general purpose financial statements prepared in accordance with IFRSs. (In other words, the report relates to a review of IFI that uses a financial reporting framework designed to achieve fair presentation.)

REPORT ON REVIEW OF INTERIM FINANCIAL INFORMATION
(Appropriate addressee)

Introduction

We have reviewed the accompanying statement of financial position of ABC Entity as of March 31st, 20X8 and the related statements of income, changes in equity and cash flows for the three-month period then ended, and a summary of significant accounting policies and other explanatory notes.. Management is responsible for the preparation and fair presentation of this interim financial information in accordance with International Financial Reporting Standards. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of review

We conducted our review in accordance with International Standard on Review Engagements 2410. A review of interim financial information consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of the financial position of the entity as at March 31st, 20X8, and of its financial performance and its cash flows for the three-month period then ended in accordance with International Financial Reporting Standards.

Auditor

Date   Address

A **qualified or adverse opinion** should be given where the auditor/accountant believes that the IFI has not been prepared in accordance with the applicable financial reporting framework.

If a **limitation on scope** is imposed, the auditor should:

- communicate to the appropriate level of management, and to those charged with governance, the difficulty the auditor has in reaching an opinion, and
- consider whether he can issue a report.

If there are uncertainties surrounding going concern, then the auditor should modify his report in a manner consistent with ISA 570 *Going concern*.

Agreed-upon procedures

- The nature of agreed-upon procedures
- International Standard on Related Services (ISRS) 4400

2 Agreed-upon procedures

2.1 The nature of agreed-upon procedures

In an agreed-upon procedures engagement, the client that engages also decides the procedures that the accountant will follow.

This is very different from an audit engagement, where the auditor decides the procedures to be followed in order to reach an audit opinion.

- The accountant provides a **report on factual findings** from the procedures performed. **No assurance is provided**.
- It is left to the user to assess the procedures and findings and to draw their own conclusions.

The report issued at the end of an agreed-upon procedure should be made available only to those who have agreed the procedures with the auditor/accountant. This is because other people who are unaware of the agreed-upon procedures may misinterpret the meaning of the report.

2.2 International Standard on Related Services (ISRS) 4400

The conduct of agreed-upon procedures is regulated by ISRS 4400 *Engagements to perform agreed-upon procedures regarding financial information*.

Key points in ISRS 4400 are as follows:

- The terms of engagement for agreed-upon procedures should be set out in an **engagement letter**. The engagement letter should include:
  - the nature and purpose of the engagement, including a specific clarification that it is not an audit and it is not a review
  - the procedures to be carried out by the accountant, and the information to which the accountant is required to apply these agreed-upon procedures
  - the form of the report to be issued at the end of the engagement, and agreed limitations on the distribution of the report.
- The processes undertaken by the accountant to perform agreed-upon procedures may be similar to those involved in an audit:
  - planning and documentation will be required
  - evidence must be collected
  - conclusions must be reached

– a report must be prepared.

However, since there is **no assurance** attached to the assignment, it is likely that the volume of work undertaken by the accountant will be **significantly less than for an audit** of similar financial information.

Example: Report at the end of an engagement with agreed-upon procedures

An example of an appropriate report is set out below.

To: The Board of Directors, C B R Manufacturing Company

Report: Title

At your request, we have applied certain agreed-upon procedures, as detailed below, to the inventory records of G S, as at 31st August 20X6, solely to assist you in connection with the proposed acquisition of that company. Our engagement was conducted in accordance with the International Standard on Related Services applicable to agreed-upon procedures engagements.

The procedures are summarised as follows:

[Insert a list of agreed upon procedures]

We report our findings as follows:

[Insert findings resulting from each of the procedures, with details of ' exceptions' as relevant]

Because the above procedures do not constitute an audit or a review conducted in accordance with International Standards on Auditing, we do not express any assurance on the inventory as at 31st August 20X6.

Had we performed additional procedures or had we conducted an audit or review of the financial statements in accordance with International Standards on Auditing, matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set out in the first paragraph of this report and for your information and is not to be used for any other purpose or to be distributed to any other parties. The report relates only to the items specified above and does not extend to any financial statements of G S, taken as a whole.

Auditor

Date

Address

Compilation engagements

- Nature of a compilation engagement
- International Standard on Related Services (ISRS) 4410

3 Compilation engagements

3.1 Nature of a compilation engagement

In a compilation engagement, the accountant is engaged **to prepare** financial statements or other information, and not to audit or review the financial statements or other information that has been prepared by someone else.

An example is the preparation of financial statements for a sole trader or a club or association.

- The accountancy firm is engaged for its accounting expertise, not its auditing expertise.
- No assurance is provided by the accountant who carries out the work.
- The work normally involves the collection and summarising of information.
- A 'compilation report' may be issued at the end of the assignment, but some compilation assignments (such as doing a tax calculation for the client) do not require a report.

3.2 International Standard on Related Services (ISRS) 4410

ISRS 4410 *Engagements to compile financial information* regulates the conduct of compilation engagements.

No assurance is given by the accountant about the information that has been compiled. However the client gains some assurance from the requirement that the accountant for a compilation assignment must comply with professional codes of conduct. The accountant is therefore obliged to exercise due care and technical competence in carrying out the work.

The key points of ISRS 4410 are as follows:

- An **engagement letter** is required, confirming:
  - that the work to be carried out is not an audit and is not a review
  - that the engagement cannot be relied upon to disclose error, fraud or other irregularities
  - the information on which the assignment will be based (for example, its accuracy) is the responsibility of the client's management
  - the intended use and distribution of the information that will be provided at the end of the engagement.
- Planning and documentation will be required for the engagement.

- The accountant needs to have adequate knowledge of the client's business and its operations.
- If the accountant becomes aware that the information provided is unsatisfactory, he should ask management to correct or improve the information. If management refuses to do this, the accountant should withdraw from the engagement, and inform the entity accordingly.

Example: Compilation report

An example of a compilation report is set out below.

To: The Board of Management of the Manchester Metro Swimming Club

On the basis of the information provided by you, we have compiled, in accordance with the International Standard on Related Services applicable to compilation services, the statement of financial position of the Oxbridge Swimming and Tennis Club as at 31st December 20X7, and the income statement and statement of cash flows for the year ended 31st December 20X7.

Management is responsible for these financial statements. We have not audited or reviewed these financial statements and accordingly express no assurance on them.

ACCOUNTANT

Date

Address

CHAPTER 12

Assurance services

Contents

Introduction and available guidance

1 Introduction and available guidance

1.1 The need for assurance services

Traditionally, the 'assurance' role of the professional accountant has mainly been concerned with provision of audit services within a statutory framework – the audit of published annual financial statements. An audit provides a high level (but not absolute level) of assurance. The requirement for an audit of the annual financial statements therefore has the objective of adding 'assurance' (or 'credibility') to the financial statements under audit.

However, the management of companies and other organisations are required or expected to report to stakeholders on a wide range of information, both financial and non-financial, that is not subject to statutory audit. This might include such matters as:

- corporate governance issues, including risk assessment and internal control systems
- e-commerce and the operation of e-commerce activities
- systems reliability
- performance measurement (both financial and non-financial)
- value for money (VFM).

Although information about these matters may not be subject to a statutory audit, it is often considered important that the information should have credibility. Credibility may be obtained from an assurance report provided by a professionally-qualified accountant.

This chapter deals with:

- the framework for the regulation of assurance reports
- the objectives and key features of an assurance engagement
- specific features of certain specific types of assurance engagement.

1.2 Available guidance on assurance engagements

Guidance on the conduct of assurance engagements is provided by:

- the International Framework for Assurance Engagements, and
- International Standard on Assurance Engagements (ISAE) 3000

1.3 The International Framework for Assurance Engagements

The International Framework for Assurance Engagements is a series of pronouncements that came into effect on 1 January 2005.

The Framework makes a distinction between:

- audits and reviews of historical financial information (regulated by ISAs and ISREs), and
- assurance engagements other than audits and reviews of historical financial information. These engagements are regulated by International Standards on Assurance Engagements (ISAEs).

The Framework also makes a distinction between:

- assurance assignments that give a **reasonable level of assurance**, and
- assurance assignments that give a **limited level of assurance**.

In assurance engagements it is not possible to give an absolute level of assurance as a result of:

- the lack of precision often associated with the subject matter
- the nature of the evidence available
- the timescale involved.

Reasonable level of assurance

Where a reasonable level of assurance is given, the risk attached to the assignment is at a sufficiently low level to enable the practitioner to give **positive assurance**.

Reasonable assurance can only be given in the following circumstances:

- the subject matter of the assurance service engagement is the responsibility of another party, and
- the subject matter is identifiable and can be subjected to evidence-gathering techniques.

In other words, a reasonable level of assurance can be given only if the accountant is carrying out an assignment that looks at information that has not been prepared by the accountant (or relates to some other subject matter that is not the responsibility of the accountant). In addition, the accountant must be able to obtain sufficient evidence for giving a positive opinion.

Limited level of assurance

Where only a limited level of assurance is given:

- the risk is higher than that for an engagement where the accountant is able to give a reasonable assurance, but
- the risk is sufficiently low to allow for a 'negative' expression of the accountant's conclusions (a negative opinion, as in a review report).

1.4 International Standard on Assurance Engagements (ISAE) 3000

ISAE 3000 *Assurance engagements other than audits and reviews of historical financial information* sets out basic principles, key procedures and guidance for professional accountants (referred to as '**practitioners**') when carrying out relevant assurance engagements.

Key general points from ISAE 3000 are set out below.

- **Ethical requirements**. The IFAC ethical code should be followed.
- **Quality control**. Appropriate procedures for quality control of the accountant's work should be applied to each engagement.
- The engagement should be planned and performed with a degree of **professional scepticism**, recognising that the subject matter of the engagement may be materially misstated.
- Before completion of an assurance engagement, the client may ask for the nature of the engagement to be changed to a 'non-assurance' engagement, or for the level of assurance to be reduced. If this happens, the practitioner should consider whether the request is appropriate, and should not agree to the change unless there is a good reason.

The objective and nature of assurance engagements

- Objective of an assurance engagement
- The elements of an assurance relationship and an assurance engagement
- Suitable criteria for assessment
- Reporting on an assurance engagement

2 The objective and nature of assurance engagements

2.1 Objective of an assurance engagement

The objective of an assurance engagement is:

'…to enable a practitioner to evaluate or measure a subject matter that is the responsibility of another party against identified, suitable criteria and to express an opinion that provides the user with a level of assurance about that subject matter.'

(Note: the accountant who carries out an assurance engagement is called a 'practitioner'.)

2.2 The elements of an assurance relationship and an assurance engagement

An assurance relationship is a three-party relationship between:

- the practitioner (the accountant)
- the party responsible for the subject matter of the engagement
- the intended user of the subject matter of the engagement.

There will be:

- a defined subject matter
- suitable criteria for assessment
- a formal engagement process: typically there is an engagement for the work and the accountant gathers evidence and evaluates it

At the end of the engagement, the accountant prepares a report containing a conclusion based on the evidence that has been gathered and evaluated.

2.3 Suitable criteria for assessment

Suitable criteria are the standards against which the subject matter of the assignment is assessed. This can be a difficult aspect of some assurance assignments.

- Establishing suitable criteria is relatively straightforward where regulations are involved (for example, the law or accounting standards).

- The process is more difficult in more subjective assurance engagements, in areas such as customer care or labour relations.

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Example

A firm of accountants takes on an engagement to report on the standards of care provided by a state-owned hospital.

What criteria are used to measure the standards of patient care in the hospital?

Suitable criteria might include the mortality rates of patients treated in the hospital. (This might be expressed as the number of patients who die within a specified period of time after treatment.) However, mortality rates are also affected by factors such as the age of patients and the seriousness of their illnesses.

It is therefore not certain that mortality rates would be a suitable criterion for assessing the performance of the hospital.

2.4 Reporting on an assurance engagement

The report prepared by accountants at the end of an assurance engagement will include the following elements:

- A **title**, indicating that the report is an independent assurance report.
- An **addressee** (= the person or body to which the report is addressed).
- **Subject matter of the report**, including any relevant information relating to the subject matter reviewed, such as the time period for which the information was gathered.
- **Suitable criteria** that have been selected for assessment.
- Where appropriate, a statement that the use of the report must be restricted to certain specified users, or that the use of the report should be restricted to a specific purpose for which it was prepared.
- A **statement that the engagement was carried out in accordance with ISAEs**.
- A **summary of the work performed**.
- The practitioner's **conclusion**.
- The **date, name and address** of the practitioner.

As with a statutory audit report, qualifications may be required in the conclusion provided by an assurance report, where the matter involved may be material. These possible qualifications are set out in the table below.

Situation	Impact on the conclusion
Limitation on scope.	A qualified conclusion or disclaimer of opinion.
The assertion made by the responsible party is not fairly stated.	A qualified or adverse conclusion.

Table continues

Situation	Impact on the conclusion
The subject matter has been materially misstated.	A qualified or adverse conclusion.
The criteria are unsuitable or the subject matter is not appropriate to an assurance engagement.	■ A qualified or adverse conclusion, if users are likely to be misled. ■ Otherwise, a qualified conclusion or disclaimer.

The **level of materiality** that is attached to the matters giving rise to the qualification in the report is important. This will determine whether the report should be qualified, or whether the accountant should give a disclaimer of opinion or an adverse opinion.

Main types of assurance engagement

- Engagements relating to risk assessment
- Engagements relating to performance measurement
- Engagements relating to value for money (VFM)
- Engagements relating to systems reliability
- Engagements relating to e-commerce matters
- Continuous auditing

3 Main types of assurance engagement

Four types of assurance engagement that may be the subject of an examination question are engagements relating to:

- risk assessments
- business performance measurement
- systems reliability, and
- e-commerce matters

3.1 Engagements relating to risk assessment

The concept of business risk assessment was introduced earlier, in the context of auditors using business risk assessments as part of audit approach.

Obviously businesses have systems in place to identify and monitor business risks themselves. Management will distinguish between strategic, operating and information risks. They will analyse risks, considering potential impact on the business and probability of the risk occurring.

When risks have been identified and analysed in this way, management has to come up with strategies to manage risks. There are various strategies.

- If risks are low impact, low probability, then they may well be accepted.
- Higher impact risks must be dealt with, perhaps by taking out insurance against the eventuality (transferring the risk) or by putting in place internal controls to prevent the risk arising (managing the risk).
- If a risk is high impact, high probability it might have to be avoided, for instance, by not taking up the new business opportunity.
- The risks associated with e-commerce particularly are looked at below.

Increasingly large companies are focusing on enterprise-wide risk management, with an overall head of risk management, rather than dealing with it individually on a department by department basis, as has traditionally been the case.

Assurance on risk assessment

Monitoring risk assessment processes is often a task carried out by internal audit but which could equally be carried out by external parties (such as the audit firm) as an assurance engagement.

3.2 Engagements relating to performance measurement

The nature of performance measurement

All entities should have measurement systems for measuring and monitoring the performance of different aspects of the entity's operations and activities. Performance measurement reports indicate to management whether the objectives of the entity are being achieved.

Performance is measured and compared with a 'benchmark', such as a target or budget, or by comparing actual results with results for the previous years, or results achieved by competitors. Examples of performance measurements include sales (and whether sales targets have been achieved), profit (and whether profit targets have been achieved), cost variances and other budget variances, product quality, customer satisfaction, employee efficiency, capacity utilisation, and so on.

There have been significant developments in performance reporting in recent years.

- Many entities publish some or all of their performance measures.
- A wide range of performance measures may be used, including performance relating to non-financial information (such as product quality or customer satisfaction) as well as financial measures. Non-financial measures might be particularly relevant for not-for-profit organisations.
- In some countries, the government sets performance targets for government departments and publicly-owned entities. (For example in the UK, the government publishes performance tables for schools and hospitals.)

Assurance engagements and performance

A client may ask a practitioner to provide assurance about the way in which performance measurements are calculated and presented. The practitioners will need to consider whether the performance measurement system operates as prescribed and intended.

To perform such an engagement, the practitioner will need to:

- understand the performance measurement system in use
- assess and evaluate it, and
- test the effectiveness of its operation.

3.3 Engagements relating to value for money (VFM)

'Value for money' means using resources in the best way in order to achieve intended objectives. There are three aspects to achieving value for money, often known as the '3Es'.

- **Economy**. This means spending money carefully, and not paying more than necessary for resources - materials, labour and other expenses.
- **Efficiency**. Efficiency means using resources in such a way that they produce the greatest possible amount of 'output'. It means getting more from the use of available resources. For example, efficiency in the use of an employee means getting a high rate of output for every hour or day worked.
- **Effectiveness**. Effectiveness means using resources in such a way as to achieve the desired objectives. Efficiency is of little value unless the output from the system is what the entity wishes to achieve.

Entities may use their own internal audit department to carry out value for money (VFM) audits.

Alternatively, an external firm of practitioners may be engaged to carry out a similar task.

Objective of a VFM engagement

The purpose of a VFM engagement is to investigate a particular aspect of an entity's operations, and reach a conclusion about whether the entity is obtaining value for money.

	Meaning	**Measurement**
Economy	'Doing it cheaply'	Compare money spent with inputs acquired
Efficiency	'Doing it well'	Compare inputs used with output achieved
Effectiveness	'Doing the right thing'	Compare output achieved with objectives

The practitioner's approach to a VFM engagement

The approach to performing a VFM engagement is summarised below.

- For the particular aspect of operations that is the subject of the investigation or 'audit', the practitioner should identify and **develop methods of measuring the 3Es** – measurements of economy, efficiency and effectiveness.
- It is often necessary to assess the 3Es by **making comparisons**. The practitioner should therefore establish an appropriate basis for making comparisons (such as economy, efficiency and achievements in previous periods, comparisons with other entities, comparisons with targets, and possibly comparisons with national averages).

- Having gathered and analysed measurements of the 3Es, the practitioner should reach a conclusion. Are the 3Es being achieved for the operations that have been the subject of the investigation?
- If appropriate, the practitioner should identify areas of weakness and make appropriate recommendations to the client about improvements that should be made.

3.4 Engagements relating to systems reliability

Even if an entity is not specifically involved in e-commerce activities, it is likely that a large part of its internal information processing will be computer-based. Major systems failure would therefore make it difficult for many entities to operate effectively, especially if they use on-line systems (network systems) for their transaction processing.

Management and other stakeholders may therefore engage a practitioner to give assurance on the effective and secure operation of their computer systems.

The general approach that the accountant should take for these assurance engagements is similar to the approach to be taken for e-commerce activities which we shall look at below. However, the accountant's work will focus more on identifying, evaluating and testing controls **within** the company's information systems. (The web site aspects that are important for e-commerce engagements are less significant for engagements relating to systems reliability.)

- Computer-assisted audit techniques (CAATs) such as **audit software** and **test data** are likely to be used by the accountant to carry out the work. CAATs were described in an earlier chapter.

3.5 Engagements relating to e-commerce matters

Entities may use information technology to conduct business transactions, using:

- **e-commerce**, or
- **electronic data interchange** (EDI). EDI is the process of transferring documents between the computer systems of different entities. An extension of EDI, known as **SET (secure electronic transmission)** is used to process money transfers electronically for credit cards and debit cards.

E-commerce is a general term that refers to trading electronically, at distances between the buyer and seller. Business transactions take place electronically, rather than face-to-face, or in a paper-based system. Rapid developments in information technology in recent years have led to substantial growth in the volume of e-commerce. Most e-commerce activity is carried out over the Internet, with customers buying goods or services through the web sites of sellers.

An important aspect of e-commerce is that users of an e-commerce system need to have trust in the **integrity** of the system. This means that a customer buying from a remote seller must be confident that the seller is 'genuine' and will deliver the goods that the buyer purchases. Similarly, the seller needs to be confident that the buyer has properly identified himself and can be trusted to pay.

Both the buyer and the seller need to be confident that the details of their transaction will not be 'intercepted' by a third party, because they want the details of the transaction to be kept confidential. For example the name and credit card number of the buyer has to be kept confidential, and there must be no risk of an unauthorised person intercepting and then making use of the buyer's credit card details.

Risk and risk management with e-commerce

Risks arise from the use of e-commerce systems, such as:

- a loss of transaction integrity
- increased security risks with 'remote' trading than with face-to-face trading or paper-based trading transactions
- the use of inappropriate accounting policies (for example, in respect of the capitalisation of website development costs)
- legal and regulatory risks: this is the risk, for example, that e-commerce activities may be breaking the law in some countries.

In addition, the internal controls for an e-commerce system may be efficient, but **there may not be an adequate audit trail** for checking transactions and confirming that the controls are efficient.

Management responsibility for e-commerce risks

As in all risk situations, management should evaluate the risks to which the entity is exposed and take appropriate action to manage those risks. The general approach that should be taken is summarised below.

- Management should carry out risk assessment exercises on a regular basis.
- Management should create an appropriate control environment, including an information systems security policy.
- The entity should make appropriate use of an internal audit function, to obtain assurance that the e-commerce system is functioning properly.
- There should be adequate audit trails for e-commerce transactions.
- The entity should keep up-to-date back-up copies of data files.
- For some systems, it may be appropriate to use encryption for data: encryption involves the electronic conversion of data into a secure coded language for transmission, so that it will be incomprehensible to anyone who intercepts it in transmission.
- The system user should comply with generally-recognised standards and register with the **Web Trust** or a similar organisation.

Note: The **Web Trust** is an organisation established to provide confidence to customers using e-commerce. The Web Trust gives a seal of approval to web sites, and customers who use a web site that has the Trust's seal of approval can have confidence that their transactions are secure. Specially-licensed accountants grant the seal (which has to be renewed every three months), on behalf of the Trust. The accountants confirm that the controls operated by the site comply with the regulations of the Trust.

The e-commerce 'audit'

A firm of accountants may be engaged by a client to provide assurance about the integrity of transactions on the client's web site, and that the client's e-commerce system is suitably protected from risk.

Performing an assurance engagement on electronic processing systems provides additional challenges for auditors. These include:

- the need for specialist knowledge about e-commerce systems
- problems that may arise when some aspects of the e-commerce system (such as the electronic payments system) are outsourced by the client to another entity
- the role of the client's internal auditors in monitoring the integrity of the e-commerce system
- the need for specialist controls (general and application controls) for the system
- possible problems of independence and conflicts of interest, if the audit firm was involved in designing or setting up the e-commerce system that is now subject to 'audit'.

The audit approach to an e-commerce system should include the following elements:

- First of all, the audit firm should decide whether the engagement should be accepted (as in any professional engagement).
- The firm should then plan the engagement: an important aspect of planning may be to make available audit staff with appropriate expertise in e-commerce systems.
- The firm should obtain a detailed knowledge of the client's business.
- It should consider liaison with the internal auditors of the client, if there have been internal audit investigations into the client's e-commerce transactions or system.
- The firm should identify and evaluate the risks in the system.
- It should ascertain and evaluate the control environment and the specific internal controls that are in operation.
- It may also be appropriate to perform a going concern review, particularly in the case of entities that rely mainly on e-commerce activities for their income.

3.6 Continuous auditing

Continuous auditing is a process which allows auditors to give assurance on a subject matter concurrently or shortly after the occurrence of the event on which assurance is being given and therefore give assurance more frequently, by using automated procedures.

Continuous auditing requires using automated procedures which are embedded in a client's system, so they require technical skills as well as 'auditing' skills. They will require strict controls and secure communications links to operate effectively.

Prospective financial information

- The nature of prospective financial information (PFI)
- ISAE 3400: The examination of prospective financial information
- Reporting on PFI

4 Prospective financial information

4.1 The nature of prospective financial information (PFI)

Traditionally, the role of the auditor has focused on providing assurance on 'historical' events, for example on financial statements relating to a period of time in the past.

When an auditor examines historical data, there is usually factual evidence to support the reported figures. This evidence will often come from events that have taken place since the financial statements were produced. For example, receivables may subsequently have been paid, inventories may subsequently have been sold, providing evidence that trade receivables were correctly valued in the statement of financial position, and that inventory was also correctly valued. This evidence is critical to the audit process.

As business and economic environments have changed, demand has grown for professional accountants to provide **assurance on information relating to the future.**

Such information is known as **prospective financial information** (PFI).

PFI is widely used both within an entity (internally) and externally.

- **Internally**, forecasts and projections are widely used as a form of management information. Examples include forecasts and projections relating to:
  - revenue
  - capital expenditure
  - revenue expenditure
  - profits
  - cash flows
  - working capital

- **External** uses include:
  - profit forecasts, for providing to the stock market
  - forecasts of cash flows, to support an application for a loan from a bank
  - profit forecasts to support or defend take-over bids.

The auditing profession has traditionally been cautious about expressing a firm opinion on financial information relating to a future period.

However, when an audit firm undertakes this type of work, the work (on PFI) is closely regulated. For example, accountants are required to use very careful wording in their reports on PFI.

Definitions

Prospective financial information (PFI). PFI is financial information based on assumptions:

- about events that may occur in the future, and
- possible actions by an entity.

Forecast: A forecast is PFI prepared on the basis of assumptions about:

- future events that management expect to take place, and
- the actions that management expect to take.

The assumptions that are used by management to prepare a forecast are called '**best estimate assumptions**'.

Projection: A projection is PFI prepared on the basis of:

- **hypothetical assumptions** about future events and management actions that are not necessarily expected to take place, or
- a mix of best estimate and hypothetical assumptions.

A **forecast** is therefore a best estimate of what is expected to happen, and a **projection** is an estimate of what is likely to happen if certain conditions or events were to happen. Both are distinguished from a 'target', which is what management want to happen.

4.2 ISAE 3400: The examination of prospective financial information

ISAE 3400 *The examination of prospective financial information* is the main source of regulation in this area. It provides guidance on:

- the examination of PFI, and
- reporting on PFI

It focuses mainly on **numerical information** and numerical forecasts or predictions.

Accepting a PFI assurance engagement

Many of the points relevant to deciding whether to accept any audit or assurance engagement will apply to accepting a PFI assurance engagement. Issues to consider will include, for example:

- the availability of resources and staff with the necessary expertise, and

- the timescale for the completion of the engagement
- agreeing a fee for the work with the client.

The accountant should also establish with the client the form that the assurance report should take. It is particularly important that the client should understand that in a review of forward-looking information, only negative assurance can be provided.

The client should also be informed that the audit firm will comply with the requirements of ISAE 3400 when reviewing the prospective financial information.

An **engagement letter** should be agreed and signed by both parties before the work is actually started.

Procedures in a PFI assurance engagement

There are several specific points that might apply to PFI engagements:

- understanding the nature of the information to be examined
- establishing the intended use of the information (and the intended recipients of the final report)
- establishing whether the information will be for general distribution or limited distribution to a small number of users
- the nature of the assumptions that have been made by management (whether they are best estimate assumptions for a forecast, or hypothetical assumptions for the purpose of making a projection)
- the time period covered by this information.

When deciding the nature, timing and extent of the procedures required to complete a PFI assurance engagement, the auditor should consider the following issues:

- The likelihood of material misstatement in the forecast or projection.
- The knowledge that the auditor has obtained during any previous similar engagements.
- The competence of the client's management with regard to the preparation of PFI.
- The extent to which the PFI is affected by management's judgement (in other words, to what extent does the PFI depend on judgement about best estimates or hypotheses).
- The adequacy and reliability of the underlying data and assumptions that have been used as the basis for preparing the prospective financial information.

The general approach to the assurance work should be similar to the approach for audit work or other assurance work, but with some modifications to allow for the specific nature of the work.

Procedures will include the following:

- Where the audit firm has no previous knowledge of the entity, it should obtain sufficient knowledge of the entity and its environment.
- If best estimate assumptions have been used in preparing the PFI (a forecast), the auditor should seek evidence to support these estimates.
- If hypothetical assumptions have been used (to prepare a projection), the auditor should assess whether they are realistic and sensible, and whether the full implications of the hypothetical assumptions have been properly reflected in the PFI.
- The auditor should assess whether the PFI contains all the relevant material items and that nothing of significance has been omitted.
- If part of the 'future period' in the forecast or projection has already passed, the auditor should review the actual results for that part of the period, and compare actual results with the forecast or projection. The differences will help the auditor to assess the reliability of the forecast or accuracy of the projection.
- The auditor should also check the arithmetical accuracy and consistency of the projected financial information that has been prepared.
- The auditor should obtain representations from management on:
  - management's acceptance of responsibility for the information
  - the intended use of the information
  - the completeness of the assumptions that were made to prepare the PFI.

Example: Profit forecast

Procedures relating to a profit forecast that the entity will use in support of a bank loan application might be as follows:

- Understand the basis of the forecast (by asking the person who prepared it). Then test the calculation of the forecast according to its method (for example, if it has been extrapolated from previous results, re-perform the arithmetic of the extrapolation).
- Consider whether the assumptions in the forecast are consistent with each other (for example, will sales grow at that rate without additional marketing costs?).
- Consider whether the forecast is reasonable in the light of known facts such as:
  - Current economic circumstances
  - Past trading history
- Discuss the key variables and sensitivities with management. Often, key assumptions will be estimates of sales demand and sales price, and the gross profit ratio. The auditor should establish the basis on which these estimates have been made.
- Review internal consistency of forecast (for example, has the same interest rate been used throughout the forecast, has the same growth rate been applied to sales and purchases?)
- Compare assumptions and bases for forecasting with information used internally (for example, by the marketing department)

- Compare figures with other forecasts to ensure consistency (for example, depreciation should appear in both profit forecast and capital expenditure forecast)
- Compare figures with any available evidence – for example, costs may be compared to quotations for work to be done. Assess costs for reasonableness. For example if the profit forecast includes estimates of advertising and marketing costs, do these seem reasonable in comparison with the value of sales turnover and other operating costs?
- Consider whether all items of cost have been included. For example if the profit forecast involves the launch of a new product, have all the initial running costs been included, such as initial marketing costs and set-up costs for operations.
- Consider whether the forecast of the amount of finance required allows for working capital.
- Check that the forecast of profit and cash flows includes the cost of borrowed finance.
- Check that forecasts of costs and revenues allow for estimated inflation.
- It would also be appropriate to carry out some sensitivity analysis of the forecasts of revenues, cost sand profits, to establish the extent to which estimates in the forecast would need to differ before the forecast profit turns into a forecast of loss.

Tutorial note: If you are asked in your examination to list procedures in relation to a particular forecast, you should think what that forecast will contain and what it will not contain. For example, a cash flow forecast will not include amounts for depreciation.

4.3 Reporting on PFI

A report from the audit/accountancy firm on PFI should contain the following elements:

- Title
- Addressee
- Identification of the PFI (for example by page references to pages in same document as the report, where the PFI can be found).
- A reference to the ISAE.
- A statement that management is responsible for the PFI, including the assumptions on which it is based.
- A reference to the purpose of the PFI and/or the restricted distribution of the report (and the PFI) to a limited number of users.
- A statement of negative assurance as to whether the assumptions that management have made provide a reasonable basis for the PFI.
- An opinion as to whether the PFI is properly prepared on the basis of these assumptions, and whether the PFI is presented in accordance with the relevant financial reporting framework.
- The report should also contain warnings that the PFI is a forecast or projection, and the results indicated by the PFI might not be achieved.

- Date, address and signature of the accountant/auditor.

Example: report on PFI

An audit firm has been the auditor of Entity AZ for a number of years.

REPORT ON A FINANCIAL FORECAST

To the Board of Directors of The Penguin Company

We have **examined** the profit forecast for the year to 31st December 20X6 set out on pages… to… **Our examination was made in accordance with International Standard on Assurance Engagements 3400**.

Management is responsible for the forecast, including the assumptions set out in Note XX on which the forecast is based.

Based on our examination of the evidence supporting the assumptions, **nothing has come to our attention that causes us to believe that these assumptions do not provide a reasonable basis for the forecast. Further, in our opinion, the forecast is properly prepared on the basis of the assumptions**.

Actual results are likely to be different from the forecast, since anticipated events frequently do not occur as expected and the variation may be material.

Auditor
Address
Date

The auditor may not be in a position to issue an unqualified report. In these circumstances, and after due consideration, the auditor may issue:

- a qualified report, or
- an adverse report, or
- he may decide to withdraw from the engagement.

Example: qualified report on PFI

REPORT ON A FINANCIAL PROJECTION

To the Board of Directors of The Pen and Pencil Supply Company

We have **examined** the projection of the profits of the Pen and Pencil Supply Company for the five years ended 31st December 20X9 set out on pages… to… of this document in accordance with International Standards on Assurance Engagements applicable to the examination of prospective financial information. **Management is responsible for the projection, including the assumptions set out in Note XX on which the projection is based**.

The projection has been prepared for the purpose of a loan application to the XYZ National Bank.

As the loan is to be used to finance a new international venture to be undertaken by the company in an emerging market, the **projection has been made using a set of assumptions, including hypothetical assumptions** about future events and management actions that are not necessarily expected to occur. As a result, **readers are warned that the projections may not be appropriate for purposes other than that described above**.

Based on our examination of the evidence supporting the assumptions, **nothing has come to our attention that causes us to believe that these assumptions do not provide a reasonable basis for the projection**, assuming that market share of 3% per annum is gained over the five year period. **Further, in our opinion, the projection is properly prepared on the basis of the assumptions and is presented in accordance with generally accepted accounting principles**.

Even if the events anticipated under the hypothetical assumptions described above occur, **actual results are likely to be different from the projection, since other anticipated events frequently do not occur as expected and the variation may be material**.

Auditor
Address
Date

Forensic audits

- Forensic accounting, forensic investigations and forensic auditing
- The nature of forensic investigations and audits
- Application of ethical principles to forensic investigations
- Procedures in forensic investigations
- Reporting on forensic audits

5 Forensic audits

5.1 Forensic accounting, forensic investigations and forensic auditing

In general terms, 'forensic' means used in connection with courts of law. In accounting, the term 'forensic' therefore refers to the use of accounting information for legal purposes, in the resolution of legal disputes or in disputes that are resolved by a court of law. It may be used in both criminal cases (for example fraud cases) and civil cases.

Forensic accounting

Forensic accounting involves preparing financial information for use as evidence by a court of law. Examples include the provision of financial information relating to:

- loss of earnings
- settlement of a legal dispute involving the valuation of a business
- losses relating to an insurance claim
- a divorce settlement.

There are two aspects to forensic accounting:

- forensic investigations
- forensic audits.

Forensic investigations

A forensic investigation is a forensic audit carried out in response to a suspicion of wrong-doing, usually to prove or disprove certain assumptions, for example, 'X person is carrying out a fraud' or 'Y person was negligent in carrying out that piece of work'.

The objective of a forensic investigation is to obtain evidence that might be used in legal proceedings to resolve a dispute or prove innocence/guilt in a criminal case, such as providing evidence of money laundering.

Often forensic investigations are usually reactive, meaning that they seek to prove or disprove suspicions of wrongdoing and provide evidence for legal proceedings.

However, investigations can also be proactive or preventative. Techniques of forensic auditing can be used to identify risks of wrongdoing and then steps can be taken to improve the situation.

Forensic audit

Forensic audit is an element in forensic investigations. It refers to the methods and procedures used to obtain audit evidence in a forensic investigation. Forensic auditing may be defined as the process of:

- gathering, analysing and reporting on data, much of it financial in nature, in the pre-defined context of legal dispute or investigation into suspected irregularities and
- in some cases, giving preventative advice in this area..

The terms 'forensic accounting', 'forensic investigations' and 'forensic audits' are closely connected, and an exam question may refer to any of these three terms.

5.2 The nature of forensic investigations and audits

Forensic investigations and audits are associated with situations where disputes arise or wrongdoing has occurred such that criminal or civil action is being taken in a court of law. The following general areas may give rise to forensic auditing:

- Fraud investigation
- Negligence investigation
- Insurance claims, and the assessment of losses.

In any of the above examples, a forensic accountant might be called on by the court to act in the capacity of expert witness, providing evidence to that court on the financial implications of a situation, or on whether there is evidence to substantiate claims of fraud or negligence.

Example: fraud investigation

In the case of a fraud investigation, a forensic accountant may be engaged to:

- investigate whether fraud has actually occurred, and if so to obtain evidence to support that assertion in a court of law
- identify the individual or individuals who have committed the fraud, and obtain evidence that can be used in a court of law to link them to the fraud: this work will also involve obtaining evidence to show how the individual or individuals had an opportunity to commit the fraud
- estimate the financial loss that has occurred because of the fraud.

The forensic accountant is not a policemen and it is not his job to prosecute individuals for alleged fraud. However, he will be engaged by the criminal investigation authorities to obtain evidence that can be used to pursue a criminal prosecution (or to conclude that sufficient evidence cannot be obtained).

5.3 Application of ethical principles to forensic investigations

The ethical principles set out earlier apply to accountants carrying out forensic work as they do to accountants in every situation.

- **Integrity**. In legal disputes and criminal investigations, individuals may be dishonest and tell lies. However the forensic accountant must act with integrity and honesty at all times.
- **Objectivity**. The forensic accountant is paid by a client to carry out an investigation, and the client will presumably be hoping for a particular outcome to the investigation. For example in a fraud investigation, the criminal investigators who use a forensic accountant may be hoping for evidence of guilt. However the forensic accountant must remain independent (in spite of the advocacy threat) and should seek to obtain evidence to reach a fair opinion.
- **Professional competence and due care**. Forensic accounting is a specialised area of work, and individuals should be sufficiently competent to do the work.
- **Confidentiality**. The normal ethical rule is that accountants should maintain client confidentiality, and should not disclose information without the client's consent. An exception is that the duty of confidentiality is overridden by the requirement to provide evidence when requested to a court of law. Legal requirements for disclosure override the rules of client confidentiality.
- **Professional behaviour**. Forensic accountants often appear as witnesses in court, ad in the public eye they should display professional behaviour and act in a way that is not detrimental to the image of the accounting profession.

There are some particular considerations that accountants will have to bear in mind when carrying out forensic work:

- to whom a duty of confidentiality is owed (particularly when acting as an expert witness in relation to both sides of a legal claim)
- duties to the court
- legal privilege in the context of money laundering.

This last area is a particularly important one for forensic accountants. Most accountancy work, for example, auditing or accounts preparation, gives rise to the duties to report suspicions of money laundering.

However, when an accountant is working in a legal capacity, it may be that information obtained during the course of that work is subject to legal privilege. If so the accountant would be wrong to make a report of suspicion of money laundering. Whether or not legal privilege applies in a particular situation is a complicated question, and the accountant should take legal advice on his position.

5.3 Procedures in forensic investigations

The procedures that a forensic accountant will carry out will depend on the terms and the objectives of the engagement.

In many cases, procedures will be similar to auditing procedures and will depend on exactly what is being proved or disproved. In others, the accountant may be preparing financial information from a number of sources to substantiate a claim.

In the exam you may be asked to describe the procedures in a forensic investigation. In answering a question on this topic, it may be useful to think about the elements in a normal audit investigation:

- Establish the objectives of the investigation.
- Plan the investigation with a view to achieving the objectives. For example in an investigation into suspected fraud, the auditor should plan how to establish whether fraud has occurred, how it could have happened and how long has it been going on – as well as who has committed the fraud and how much has been lost.
- The audit work should therefore be planned in a way that will provide sufficient appropriate evidence to achieve the objectives of the audit. The evidence should be strong enough to 'stand up' in court if required: in fraud cases, audit evidence should therefore try to establish a motive for the alleged fraudster, identify the opportunity that the fraudster had to commit the fraud and also any evidence of measures by the fraudster to conceal his crime.
- Note that audit evidence may be gathered in various ways – similar to the methods used in a normal audit. This includes interviewing individuals (including individuals suspected of fraud).
- The auditor should use the evidence obtained to reach an opinion. If the evidence is insufficient, he should try to obtain additional evidence.
- At the end of the investigation a report is prepared for the client.

Examples

If an accountant is asked to give evidence of whether an audit file has been prepared negligently, he will review the file comparing the procedures carried out with the requirements of auditing standards.

If an accountant is asked to give evidence of whether inventory has been misappropriated, he may carry out analytical review (comparing margins year on year), he may carry out tests on cut-off and inventory counting to ensure that the figures are not misstated (giving the impression of a fraud), he may carry out tests of controls to establish whether they are capable of preventing frauds and whether they have been applied.

5.4 Reporting on forensic audits

Key issues in reporting will be:

- Whom the report is intended for and restriction of liability to other parties
- The type of assurance required (as for any assurance engagement, this will affect the level of evidence obtained)
- What purpose the report is required for, for example, to substantiate an insurance claim or to provide evidence to a court of law

CHAPTER 13

Internal audit and outsourcing

Contents

The nature and development of internal auditing

- Definition of internal audit
- Reasons for the development of internal auditing
- Typical functions of internal audit
- Comparison of external and internal audit

1 The nature and development of internal auditing

1.1 Definition of internal audit

The role of the internal audit function has been defined as:

'….an appraisal system established by management for the review of the accounting and internal control systems as a service to the entity.'

There are several parts to this definition:

- Internal auditing is an appraisal system.
- It is established by management as a service to the entity.
- It involves the review of accounting systems.
- It also involves the review of internal control systems, which are systems for financial controls, operational controls and compliance controls.

Internal auditing is a separate and distinct branch of the accounting profession. The role of internal auditing has become more significant in larger entities and is now seen as an important management tool.

1.2 Reasons for the development of internal auditing

The main reasons for the importance of the internal audit function are as follows:

- Internal audit helps management to monitor the controls within their entity. As entities increase in size and complexity, and become global in nature, the task of monitoring controls becomes more difficult. An internal audit function helps management to monitor these controls.
- Similarly, as markets become increasingly competitive, it is important that entities should be very competitive themselves. This means using resources efficiently and effectively. An internal audit function can be used to monitor the efficiency of operations.
- In many countries there is a large amount of statutory and accounting regulation, including corporate governance regulation. An internal audit function can be used by management to check on compliance with laws and regulations.

- Many entities use complex IT systems. Specialist internal auditors can help management to review the effectiveness of controls within IT systems (by means of IT audits).
- The increasing cost of the external auditor's services means that it may be cheaper to use internal auditors to perform audit tasks whenever possible. (The reliance of external auditors on work done by internal auditors is considered later. However, an internal audit department may be used for work not related to the external audit that might otherwise be given to an external firm of accountants as non-audit work.)

There is no legal requirement for an entity to establish an internal audit function. The fact that many organisations do so indicates that there are significant benefits to be gained.

For companies that operate over multiple sites, internal audit may be an essential tool for effective management. Senior management can use an internal audit department to carry out 'external' checks on its operational departments. Random visits or surprise visits by internal auditors may be used to confirm that all locations are applying internal controls properly, and are complying with relevant laws and regulations. The largest locations, or locations where there is a high risk of control failure, may be visited more frequently by the internal auditors.

1.3 Typical functions of internal audit

The scope and objectives of internal audit vary widely, and depend on:

- the size and structure of the entity, and
- the requirements of its management.

However, internal audit activities usually include one or more of the following:

- **Monitoring of internal control**. Senior management need to reassure themselves that internal controls are functioning effectively. In a large organisation, they do not have the time to carry out this task personally, for example through observation. Monitoring controls, and making sure that the controls are working properly, needs attention on a continuous basis. An internal audit department is usually given the specific responsibility by management for reviewing controls, monitoring their operation and recommending improvements.
- **Examination of financial and operating information**. An internal audit department might be given the responsibility for a detailed examination of financial and operating information, and in particular, its reliability and usefulness. Internal auditors may investigate how information is identified, measured, classified and reported, and recommend improvements where appropriate. The audit work may involve investigations into specific items of information, including the detailed testing of transactions, balances and procedures.
- **Review of the economy, efficiency and effectiveness of operations**, including non-financial controls of an entity. Audits of economy, efficiency and effectiveness can be carried out on any aspect of operations, and are usually called value for money (VFM) audits.

- **Review of compliance**. Senior management may ask the internal auditors to check that operational departments are complying properly with certain laws, regulations and other external requirements, or with management policies and directives and other internal requirements. These investigations are often called 'compliance audits'.

1.4 Comparison of external and internal audit

Internal and external auditors will often carry out their work using similar procedures. However, there are a number of fundamental differences between the two audit roles. These are summarised in the following table:

Factor	External audit	Internal audit
Role	To express an opinion on the truth and fairness of the annual financial statements	To examine systems and controls and assess risks in order to make recommendations to management for improvement.
Qualification to act	Set out by statute.	No statutory requirements – management select a suitably competent person.
Appointed by	The shareholders	Management
Duties set out by	Statute	Management
Report to	The shareholders	Management

Types of internal audit

- Introduction
- Financial audits
- Operational audits
- Compliance audits

2 Types of internal audit

2.1 Introduction

Internal auditors may be involved in 'financial' audits, focusing on the audit of items in the income statement/statement of comprehensive income and statement of financial position. When the internal auditors perform this type of work, they may duplicate work that the external auditors might otherwise be expected to do. The external auditors might therefore be able to rely on the work of the internal auditors in reaching their audit conclusion. This was considered in Chapter 8.

However, the internal audit function often has a much wider role than simply performing financial audits, and in many entities (particularly large entities) the internal auditors are involved in other aspects of auditing, such as:

- **energy audits**: these are checks on how the entity is making use of energy and whether its operations are energy-efficient
- **social audits**: these are checks on the impact of the entity on the society in which it operates
- **environmental audits**: these are checks on the effect the entity is having on its natural environment, and considers issues such as the use of sustainable materials, re-cycling, reducing pollution, and so on
- **human resource audits**: these are audits into the work force of an entity, to check whether the entity has adequate systems for the recruitment, training and development of employees to meet its current and future needs.

2.2 Financial audits

Performing financial audits is the traditional role of the internal auditor. Internal auditors may be asked by management to review accounting records and other records to substantiate figures appearing in financial statements and management accounts.

This work overlaps with the work of the external auditor. Consequently, this aspect of internal audit work is now seen as a relatively minor part of the total work of an internal audit department.

However, it is important to remember that by performing financial audits, the internal auditor is able to look at the internal controls that are in place to minimise risks, to identify weaknesses and to recommend improvements in the internal control system.

2.3 Operational audits

Operational audits examine the entity's internal control procedures and whether or not the control systems that have been established by management are operating effectively. As a result of the audit, the internal audit department will make recommendations to management for improvements to the system or the way in which it is operated.

The **value for money** (or VFM) audit was described in an earlier chapter as an assurance service that might be performed for a client by an external accountancy firm. VFM audits may be carried out instead by the internal audit department.

Finding the best possible **combination** of the 3Es is seen as a strategy for maximising profit performance. It is not usually possible to achieve objectives (effectiveness) by using the cheapest resources (economy) in the most productive way possible (efficiency). Sometimes, greater efficiency can only be achieved by spending more, so a balance must be found between economy and efficiency. Sometimes, the benefits of greater effectiveness are not justified by the extra cost, so a balance must be found between economy and effectiveness.

One of the purposes of a VFM audit should be to check whether the most appropriate balance between economy, efficiency and effectiveness is being achieved.

2.4 Compliance audits

Entities are subject to a large number of laws and regulations, and they may be exposed to the risk of regulatory action by the authorities if they fail to comply with the regulations. The nature of important regulations varies from one industry to another. Controls over health and hygiene are important for the food manufacturing industry, for example. Controls over pollution are important for companies involved in oil and gas exploration. Controls over money laundering are important for financial services; and controls over safety are important for companies in the public transport industry.

Internal audit can be used by management as a tool to confirm that significant laws and regulations are being **complied with** by the company.

Outsourcing

- Financial operations that might be outsourced
- Advantages and disadvantages of outsourcing
- Outsourcing the internal audit function
- Outsourcing other finance or accounting functions
- ISA 402: Audit considerations relating to entities using service organisations

3 Outsourcing

3.1 Financial operations that might be outsourced

'Outsourcing' by a company means arranging for an external entity to perform a task that would otherwise be performed by the company's own staff. It usually refers to routine and repetitive procedures and operations.

Outsourcing of work to 'external suppliers' and service organisations is a common practice. Examples of work that may be outsourced include:

- payroll operations
- internal auditing
- financial and management accounting activities (for example data processing or pensions)
- IT services
- work relating to taxation compliance and tax consultancy
- due diligence procedures for acquisitions and mergers
- non-financial services, such as catering, cleaning, motor vehicle fleet management, and staff recruitment and selection.

Entire functions may be outsourced. For example, an entity may outsource all the financial accounting function, from book-keeping through to the preparation of final financial statements.

Alternatively, only parts of functions may be outsourced, with the remainder of the function being retained 'in house'. For example, an entity may outsource its payroll function, but perform the rest of the accounting and finance function itself.

A problem for the auditors (internal and external) is that when work is outsourced, they need to satisfy themselves that the external agencies are performing their work properly. It may be necessary to check that the information provided by the external agency is correct (and not subject to misstatement) and that the internal controls applied by these external agencies are effective.

3.2 Advantages and disadvantages of outsourcing

Advantages

There are several reasons why entities outsource their operations.

- Cost savings. It may be cheaper to outsource work to an external service provider than to do the work in-house.
- The skills of the external agency or service provider. An external service provider may have skills and expertise for doing the work, that the entity itself does not have 'in house'.
- Access to the most up-to-date techniques and technology might not be readily available within the entity, but the external agency may have them.
- The management of the entity are able to focus their time and effort on 'core activities', and do not have to spend as much time monitoring the out-sourced activities.

Disadvantages

There are also disadvantages with outsourcing.

- The management of the entity needs to make sure that the service provider understands the requirements of the entity in respect of the service that it is providing. If the work is not properly specified, the service provider may fail to do everything that the entity requires it to do.
- The entity relies on the service provider to do its work on time and have it ready at the time that the entity requires it. This is particularly important, for example, when payroll operations are outsourced.
- There may be problems with negotiating an appropriate fee for the work with the service provider.
- Management need to ensure that the service provider gives the organisation an appropriate level of priority and 'customer care'. This means that management must carry out regular reviews of the service level and service quality provided.

In general, the outsourcing arrangement needs to be effectively managed and controlled by the organisation.

3.3 Outsourcing the internal audit function

Some entities outsource the work of the internal audit function. When this happens, the service provider is often the accountancy firm that provides the entity with its external audit services.

Several factors need to be considered when an entity outsources its internal audit function.

- The audit firm must have a greater level of independence than the entity's own internal audit staff. If the external audit firm is not properly independent from the executive management of the entity, it should not be given any internal audit work.

- The audit firm may have access to more highly trained, specialist employees.
- The audit firm will have greater numbers of employees available for any urgent internal audit assignments.
- Professional codes of conduct and standards of behaviour will regulate the audit firm. This **might not** be the case with an in-house internal audit department.
- The audit firm may be sued for breach of contract or for negligent work and should have professional indemnity insurance to meet claims for losses due to negligent work.

However, there are a number of disadvantages with outsourcing the internal audit function to the external audit firm.

- Professional firms are not under the control of the entity in the same way as their 'in house' internal audit employees.
- Fees for internal audit work can be high.
- Professional firms may not have the same level of detailed knowledge of the entity and its operations that 'in house' internal auditors (working in the organisation on a daily basis) should have.
- There may be threats to the independence of the external audit where the firm acts as both internal auditors and external auditors.

3.4 Outsourcing other finance or accounting functions

A list of examples of other functions that could be outsourced was given at the start of this section. In the exam, you may be required to comment on the specific advantages and disadvantages of outsourcing any of these.

An important aspect of outsourcing accounting functions may be that the external supplier controls the accounting records from which figures for the financial statements are obtained. For example if payroll work is outsourced, the data for employee costs and any liabilities for payroll (such as tax liabilities) may be held by the service provider, not by the audit client.

The audit client may hold none of this information. The auditor is engaged by the audit client and has no contractual relationship with the service organisation. However the auditor may need to obtain audit evidence from the service organisation. Clearly it is important that if the service organisation controls any accounting information for the audit client, the contractual arrangement between the audit client and the service organisation should include an obligation for the service organisation to provide the auditor with access to the information required.

Issues for the auditor to consider in this type of situation are as follows.

- **Materiality**. The auditor should decide whether the outsourced operation is material in terms of the financial statements. If payroll work is outsourced, this is likely to be a material item and the auditor will have to consider how to obtain sufficient appropriate evidence about payroll costs.
- **Accessibility to the records**. This point was considered earlier. It is important that access to the relevant records is available for the auditor, and the auditor

should discuss with the service organisation the arrangements for obtaining the information required.

- **Control risk**. The auditor will need to make an assessment of control risk in the outsourced operation. A systems audit will be possible only if the auditor is satisfied with the control system in the service organisation. Otherwise substantive auditing procedures will be needed.
- **Compliance**. Where the outsourced work is subject to regulatory requirements, the auditor will need to consider how to gather evidence about compliance with the regulations. An example is the need to check compliance with tax regulations for deductions from tax, in the case of outsourced payroll activities.
- **Transfer of information**. It may also be necessary to check the procedures for the transfer of information between the service organisation and the audit client, to establish how information is transferred, how often it is transferred and whether the method of transfer is reliable.

If you are asked in an exam question to comment on outsourcing any function, remember to think specifically about the relevant function you are being asked about, and think through factors such as:

- the logistics/practical issues of the outsourced operation
- the confidentiality associated with the source information (for example, in respect of payroll, pension details are considered highly confidential by staff)
- the speed of technological advancement in the area
- the responsibility for the function: for example, directors will still be legally responsible to ensure that proper accounting records are kept, even if they outsource them.

3.5 ISA 402: Audit considerations relating to an entity using a service organisation

ISA 402 provides guidance to external auditors where clients outsource some of their operations to service organisations. The services provided by a service organisation are relevant to the audit when those services, and the controls over them, **are part of the entity's information system**. Such controls are most likely to relate to financial reporting but other controls could also be relevant to the audit – such as controls over the safeguarding of assets.

When the client uses the services of a service organisation, the **objectives** of the auditor, per ISA 402, are:

- to obtain an understanding of the nature and significance of those services and their effect on his client's internal controls, sufficient to identify and assess the risks of material misstatement, and
- to design and perform audit procedures in response to the assessed risks.

Obtaining an understanding of the services provided

In obtaining an understanding of the services provided the auditor is applying ISA 315, which was discussed in a previous chapter. The auditor is **required** to:

- understand how his client uses the services provided, and
- evaluate the controls at his client which relate to the services provided.

For example, a client may have outsourced its payroll transactions, and have established controls over the submission and receipt of payroll information that would prevent or detect material misstatements. Testing these controls may enable the auditor to conclude that payroll is not materially misstated, *regardless of the controls in place at the service organisation.*

If the auditor is **unable to obtain a sufficient understanding from the client** then he should use one or more of the following procedures:

- Obtain a Type 1 or Type 2 report (see below).
- Contact the service organisation, via the client, to obtain specific information.
- Visit the service organisation and perform appropriate procedures to give the necessary information.
- Use another auditor to perform such procedures.

Type 1 and Type 2 reports

A **Type 1 report** comprises:

- A **description** of the service organisation's system, control objectives and controls as at a specified date (prepared by the management of the service organisation), and
- A "**reasonable assurance**" report on the above description and the suitability of the controls to achieve the specified control objectives (prepared an auditor instructed by the service organisation).

A **Type 2 report** is a more detailed report, covering not only the theoretical controls in place, but also whether, in practice, **the controls have achieved their objectives**. The description may now cover a specified period, and may also report on the operating effectiveness of the controls over that period. The report will now also give:

- the "service auditor's" opinion on the operating effectiveness of the controls, and
- a description and the results of his tests of controls.

In common with earlier theory in this chapter, before relying on a Type 1 or Type 2 report the "user auditor" must be satisfied as to:

- the service auditor's professional competence and independence from the service organisation, and
- the standards under which the report was issued.

Responding to the assessed risks of material misstatement

In responding to the assessed risks, the auditor is applying ISA 330, which was discussed in a previous chapter. The auditor is **required** to:

- determine whether sufficient appropriate audit evidence is available from records held at the client, and, if not
- perform further audit procedures to obtain such evidence or use another auditor to perform those procedures at the service organisation on his behalf.

If the auditor wishes to perform **tests of controls** he should use one or more of the following procedures:

- Obtain a Type 2 report.
- Perform appropriate tests of controls at the service organisation.
- Use another auditor to perform such procedures on his behalf.

Other requirements

The auditor should enquire of management as to whether the service organisation has reported any fraud, non-compliance or uncorrected misstatements to them.

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation he should express a modified opinion in his audit report. (The different types of audit opinions are discussed in a later chapter.)

The auditor should **not refer in his report to the work of a service auditor** unless that is required by law or regulation. Even then, or if the auditor refers to the expert's work in his report because it is relevant to an understanding of a modified opinion, then he must make it clear that such a reference does not reduce his responsibility for that opinion in any way.

CHAPTER 14

Reporting

Contents

The audit report and the meaning of 'a true and fair view'

- The audit report
- The meaning of a 'true and fair view'

1 The audit report and the meaning of a 'true and fair view'

1.1 The audit report

The auditor's report on the financial statements is the only direct communication between the auditor and the owners of the company (to whom the auditor normally reports).

In the past, the auditor's report was criticised for being too brief to allow the general reader to understand the nature of an audit and the meaning of the auditor's report. This was seen to be a major cause of the 'expectation gap' – the problem that users of financial statements expect more from the audit than statutory and other regulations require.

The expectation gap

The term 'expectation gap' refers to the fact that the public perception of the role and responsibilities of the external auditor is different from his statutory role and responsibilities. The expectations of the public are often set at a level higher than that at which the external auditor actually operates.

Some examples of the misunderstandings inherent in the public's expectations are as follows:

- The public believes that the audit opinion in the audit report amounts to a 'certificate' that the financial statements are correct and can be relied upon for all decision-making purposes, including decisions about takeovers.
- The public also believes that the auditor has a duty to prevent and detect fraud and that this is a purpose of the audit.
- The public assumes that in carrying out his audit work, the auditor tests 100% of the transactions undertaken during the accounting period.

One consequence of these misunderstandings has been an increasing tendency in some countries to undertake legal action against the auditors, sometimes on a 'frivolous' basis, in the belief that the auditor should have prevented misstatements in the financial statements or should have prevented fraud.

Responses to the problem of the expectation gap have varied between countries. In some countries, corporate governance codes have been changed to strengthen the role and responsibilities of directors for sound internal control and accounting systems.

The auditor's report is addressed to the owners of the company, not to other users of the financial statements. In the context of auditor liability, some of the larger auditing practices now include an additional paragraph in the audit report, after the opinion paragraph, disclaiming any liability that may arise from the use of the report by persons other than those to whom it is addressed.

Electronic reporting

Many companies now publish their annual reports on their websites. This method of 'electronic reporting' has implications for the auditor. It is considered good practice for the auditor to check that the electronic form of the financial statements and auditor's report are identical to the paper copy.

1.2 The meaning of a 'true and fair view'

In most countries, auditors performing an audit in accordance with statutory requirements are required to produce a report that makes reference to whether the financial statements give 'a true and fair view'. In some countries, the audit report is required to give an opinion whether the financial statements 'present fairly, in all material respects'. The terms 'true and fair view' and 'fair presentation' have an equivalent meaning.

The meaning of the term 'a true and fair view' has not been rigorously defined, either by law or by the auditing profession. Many legal authorities and writers on auditing have developed their own definitions of the term. The main points to note are as follows:

- Assessing whether financial information is true and fair is more an art than a science. The assessment relies heavily on the judgement of the auditor.
- It is appropriate to think of 'true and fair' as a combined phrase. Do not try to define 'true' and 'fair' as separate concepts.
- True and fair will normally imply:
  - compliance with any relevant legislation and accounting standards
  - the use of accurate figures or best possible estimates
  - meaningful presentation and disclosure of information
  - the avoidance of bias, distortion, and manipulation of figures,
  - no concealment of material information.

The unmodified audit report: ISA 700

- Definition of an unmodified audit report
- Reaching the audit opinion
- Basic elements of the audit report
- Audit report prescribed by law or regulation
- Audits conducted in accordance with both ISAs and local auditing standards
- Unaudited supplementary information presented with the audited financial statements
- IAPS 1014 Reporting by auditors on compliance with International Financial Reporting Standards

2 The unmodified audit report: ISAs 700

2.1 Definition of an unmodified audit report

An **unmodified audit report** is an audit report containing an audit opinion not modified in any way by a 'qualified' opinion, and containing no other modifications or additional paragraphs such as might be added by an 'emphasis of matter' paragraph. These are discussed in a later section.

An **unmodified opinion** should be expressed when the auditor concludes that the financial statements:

- have been prepared in accordance with the identified financial reporting framework, including the requirements of applicable law, and
- give a true and fair view.

An unmodified opinion provides a high level of assurance that a professional, independent examination of the financial statements has not revealed any actual or possible material misstatements in those financial statements.

The general format of the report is regulated by the revised ISA 700 *Forming an opinion and reporting on financial statements* However, the precise wording of an audit report may be varied at the discretion of the auditor.

Unlike the original ISA 700, the revised ISA 700 does not deal with modifications to audit reports. Modified reports are the subject of ISA 705 *Modifications to the opinion in the independent auditor's report* and by ISA 706 *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report.* Both of these ISAs are described later.

2.2 Reaching the audit opinion

In reaching his audit opinion, the auditor is **required** to evaluate whether:

- he has obtained sufficient appropriate audit evidence as to whether the financials statements are free from material misstatement

- uncorrected misstatements are material, individually or in aggregate
- the financial statements give a true and fair view
- the financial statements have been prepared in accordance with the relevant financial reporting framework

and, in particular, whether

- the financial statements adequately describe the relevant financial reporting framework
- the financial statements adequately disclose the entity's significant accounting policies
- the significant accounting policies are appropriate and consistent with the relevant financial reporting framework
- accounting estimates are reasonable
- the information in the financial statements is relevant, reliable, comparable and understandable
- the financial statements provide adequate disclosures
- the terminology used in the financial statements is appropriate.

2.3 Basic elements of the audit report

The basic elements of an unmodified auditor's report, as given in ISA 700, are as follows:

1. Title
2. Addressee
3. Introductory paragraph
4. Statement of management's responsibility for the financial statements
5. Auditor's responsibility
6. Auditor's opinion
7. Other reporting responsibilities (possibly)
8. Auditor's signature
9. Date of the audit report
10. Auditor's address.

These elements are designed to achieve the **objectives** of ISA 700, which are for the auditor to:

- form an opinion on the financial statements, based on the conclusions drawn from his audit evidence, and
- express that opinion clearly through a written report that also describes the basis for that opinion.

In addition, an unmodified report may include an 'emphasis of matter' paragraph or an 'other matters' paragraph'. These are covered by ISA 706 and are explained later.

Title

The auditor's report should have a title that clearly indicates that it is the report of an independent auditor. This is to distinguish this type of auditor's report from other reports that might be issued by other auditors (who may not have to abide by the same ethical requirements and requirement for independence as the independent auditor - for example, internal auditors).

Addressee

The report should be appropriately addressed, as required by national law and the circumstances of the engagement. The report is usually addressed to either:

- the shareholders of the entity whose financial statements are being audited, or
- the board of directors of the entity.

Introductory paragraph

The introductory paragraph in the report should:

- identify the entity whose financial statements have been audited
- state that the financial statements have been audited
- identify the title of each statement that makes up the complete set of financial statements (income statement/statement of comprehensive income, statement of financial position, and so on)
- refer to the summary of significant accounting polices and other explanatory information
- specify the date or period covered by each statement.

Management's responsibility for the financial statements

This section of the report should describe the responsibilities of those responsible for the preparation and presentation of the financial statements. It should include an explanation that management is responsible for:

- the preparation of the financial statements in accordance with the applicable financial reporting framework, and
- for such internal controls as deemed necessary to enable the preparation of financial statements which are free from material misstatement.

Auditor's responsibility

This section of the report states that:

- the responsibility of the auditor is to express an opinion on the financial statements based on his audit
- the audit was conducted in accordance with ISAs, explaining that those standards require the auditor to:
  - comply with ethical requirements, and
  - plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

The latter gives the reader of the report assurance that the audit has been carried out in accordance with established standards and practices.

This section also describes the 'scope of the audit' It refers to the auditor's ability to perform the audit procedures which he deemed necessary in the circumstances. Any restriction on the scope of the audit can lead to a 'modified' audit report (which is explained later).

This section also therefore describes an audit by stating that:

- an audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements
- the procedures selected depend on the auditor's judgment, including his assessment of the risks of material misstatement of the financial statements. As part of this assessment, the auditor considers relevant internal controls. He does not consider internal controls for the purpose of expressing an opinion on their effectiveness
- an audit also includes evaluating the appropriateness of the accounting policies used, the reasonableness of accounting estimates made by management, and the presentation of the overall financial statements

This part of the (unmodified) report should end with a statement that the auditor believes that the audit evidence he has obtained is sufficient and appropriate to provide a basis for his opinion.

Auditor's opinion

When the financial statements have been prepared in accordance with a **"fair presentation" framework** an unmodified opinion should be expressed when the auditor concludes that the financial statements **give a true and fair view** or are **presented fairly**, in all material respects, in accordance with the applicable financial reporting framework.

When the financial statements have been prepared in accordance with a **"compliance" framework** an unmodified opinion should be expressed when the auditor concludes that the financial statements **have been prepared**, in all material respects, in accordance with the applicable financial reporting framework.

This can lead to a two-fold opinion. For example, in the UK, an opinion will be expressed on whether the financial statements:

- give a true and fair view (UK accounting standards) or present fairly (IFRSs), and
- have been properly prepared in accordance with the Companies Act 2006.

Where IFRSs are not used as the financial reporting framework, the reference to the financial reporting framework in the wording of the opinion should identify the jurisdiction of the financial reporting framework.

Further guidance on this point is given by IAPS 1014. This point is dealt with in more detail later.

Other reporting responsibilities

In some countries, the auditor may have additional reporting responsibilities. For example, he may be required by local legislation to report certain matters if they come to his attention during the course of the audit, or he may be required to report on specific matters such as the adequacy of accounting records.

Such other reporting responsibilities should be addressed in a separate section of the report, following the opinion paragraph, sub-titled "Report on Other Legal and Regulatory Requirements".

Auditor's signature

The report should be signed:

- in the name of the audit firm, or
- in the personal name of the auditor, or
- both.

The report is usually signed in the name of the firm because the firm assumes responsibility for the audit. However, in the UK, the report has to be signed by the 'senior statutory auditor' (the engagement partner) for and on behalf of the firm.

Date of the auditor's report

The report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base his opinion on the financial statements.

This will not be earlier than the date on which the financial statements are signed or approved by the directors/management of the client company.

The date of the report informs the reader that the auditor has considered the effect on the financial statements (and on his audit report) of subsequent events which occurred after the reporting period and up to that date.

Auditor's address

The report should give a specific location for the auditor. This will usually be the city where the office responsible for the audit is located.

Example

An example of an unmodified audit report is set out below.

INDEPENDENT AUDITOR'S REPORT

(Appropriate addressee)

Report on the financial statements

We have audited the accompanying financial statements of ABC Company, which comprise the statement of financial position as at December 31st, 20X7, and the statement of comprehensive income, statement of changes in equity, and statement of cash flows for the year then ended, and a summary of significant accounting polices and other explanatory information.

Management's responsibility for the financial statements

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

Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence that we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view (or present fairly, in all material respects,) of the financial position of ABC Company as of December 31, Year 7, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Report on other legal and regulatory requirements

(Form and content of this section of the report will vary depending on the nature of the auditor's other reporting responsibilities.)

(Auditor's signature)

(Date of the report)

(Auditor's address)

2.4 Audit report prescibed by law or regulation

If the auditor is required by law or regulation (eg a national auditing standard) to use a specific layout or wording of the audit report, rather than the wording in ISA 700, then the audit report may only refer to ISAs if it includes, as a minimum, the following elements:

- Title
- Addressee
- An introductory paragraph identifying the financial statements audited
- A description of management's responsibility for the preparation of the financial statements
- A description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit: this should include a reference to ISAs and local auditing standards and a description of an audit in accordance with those standards
- An opinion paragraph containing an expression of opinion on the financial statements, and a reference to the applicable financial reporting framework used
- Auditor's signature
- Date of the report
- Auditor's address.

These headings correspond with those specified by ISA 700 as headings to be included in an unmodified audit report.

2.5 Audits conducted in accordance with both ISAs and local auditing standards

An auditor may be required to conduct an audit in accordance with particular national auditing standards (e.g. in the UK, with ISAs (UK and Ireland)) but in doing so may have also complied with "pure" ISAs. This will be the case in the UK, where, ISAs (UK and Ireland) are based on the "pure" ISAs.

In this case the audit report may refer to ISAs in addition to the national auditing standards but only where:

- there is no conflict between the national auditing standards and ISAs which would have led the auditor to form a different opinion or not to include an emphasis of matter paragraph (see later) that would have been required by ISAs, and
- if the report follows the wording of national auditing standards, it includes, as a minimum, the elements as specified above.

When the report refers to both national auditing standards and ISAs it should clearly identify the jurisdiction of origin of the national standards.

2.6 Unaudited supplementary information presented with the audited financial statements

The report and accounts issued by a company often contain supplementary information that is not covered by the auditor's opinion, such as a chairman's statement, employment report or business review.

The auditor should be satisfied that any unaudited supplementary information that is presented together with the audited financial statements is clearly differentiated from the audited financial statements. This is because unaudited items are not covered by the auditor's opinion.

If the auditor concludes that the unaudited information is **not** clearly differentiated, then he should ask management to change how that information is presented. If management refuse to do so then the auditor should explain in his report that the supplementary information has not been audited.

The auditor's responsibilities in respect of unaudited supplementary information are covered by ISA 720 (which is described later).

2.7 IAPS 1014: Reporting by auditors on compliance with International Financial Reporting Standards

ISA 700 requires that the audit report should clearly indicate the financial reporting framework that has been used to prepare the financial statements (for example, International Financial Reporting Standards). IAPS 1014 was issued to provide guidance on this area.

Financial statements might comply:

- exclusively with International Financial Reporting Standards, or
- with International Financial Reporting Standards and a national financial reporting framework, or
- exclusively with a national financial reporting framework, but with disclosure of the extent of compliance with International Financial Reporting Standards.

An unmodified opinion can only be given where the relevant framework(s) have been complied with. A company that complies with IFRSs should disclose the extent of the compliance with International Financial Reporting Standards, in a note to the financial statements.

The auditor will therefore need to consider the accuracy of this note in the same way as he would consider the accuracy of any other notes to the financial statements. If he disagrees with the note he will need to modify his audit report.

The modified audit report: ISAs 705 and 706

3 The modified audit report: ISAs 705 and 706

3.1 The nature of a modified audit report

Before issuing a modified report, the auditor should discuss with management the reason for the modification. The reason should be explained and the auditor should ask the client entity's management to amend the financial statements.

- If management make the necessary adjustments, the auditor will not need to issue a modified report.
- If management refuse to make the amendments, a modified report may be the only course of action available to the auditor.

An audit report is said to be **modified** where either:

- a matter arises which **does not affect the opinion** given by the auditor, but which gives rise to an '**emphasis of matter paragraph**' or an '**other matter paragraph**' in the audit report (covered by ISA 706)
- a matter arises which **does affect the opinion** issued on the financial statements. This will give rise to a **qualified opinion**, a **disclaimer of opinion** or an **adverse opinion** (covered by ISA 705).

A modified audit report can therefore either have an unmodified audit opinion or a modified audit opinion.

3.2 Emphasis of matter paragraphs and other matter paragraphs: ISA 706

As discussed above, an audit report may be modified to include an 'emphasis of matter' paragraph and/or an 'other matter' paragraph. These types of paragraph are the subject of ISA 706 *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report*.

The purpose of these paragraphs is to provide additional communication in the audit report when the auditor wishes to draw the attention of users to a particular matter in the financial statements. They do not modify the audit opinion.

- An **emphasis of matter paragraph** draws the attention of users to an item (or 'matter') that is **included** in the financial statements and which the auditor considers **fundamental** to an **understanding of the financial statements**.
- An **other matter paragraph** deals with a matter which is **not included** in the financial statements but which is **relevant** to an **understanding of the audit, the auditor's responsibilities or the audit report.**

3.3 Emphasis of matter paragraphs

An 'emphasis of matter' paragraph is used to draw the reader's attention to a matter presented or disclosed in the financial statements **which is fundamental to an understanding of those financial statements.**

When an audit report contains an emphasis of matter paragraph, **the opinion is not modified**. It can therefore only be used where the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. (If the matter is materially misstated, a modified opinion is required.)

When the auditor includes as emphasis of matter paragraph in the audit report the auditor is **required** to:

- include it immediately after the opinion paragraph
- use the heading 'emphasis of matter' for the paragraph (or another appropriate heading)
- include a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements
- indicate that his opinion is not modified in respect of the matter being emphasised.

Circumstances in which an emphasis of matter paragraph may be necessary

ISA 706 gives the following examples of circumstances in which an emphasis of matter paragraph may be necessary:

- Where there is an uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- Where the entity has adopted a new IFRS early and that has had a pervasive effect on the financial statements.
- To draw attention to a major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

e

Example: Emphasis of matter paragraph

The following illustrative wording is given in ISA 706.

> **Emphasis of matter**
>
> We draw attention to Note X to the financial statements which describes the uncertainty related to the outcome of the lawsuit filed against the company by XYZ company. Our opinion is not qualified in respect of this matter.

ISAs requiring emphasis of matter paragraphs

There are currently two ISAs which **require** the auditor to use an emphasis of matter paragraph in certain circumstances.

ISA 560 *Subsequent events* requires an emphasis of matter paragraph to be used in two specific circumstances. These were set out in a previous chapter.

ISA 570 *Going concern* requires an emphasis of matter paragraph to be used to highlight the existence of a **material uncertainty** relating to a **going concern problem**. The following illustrative wording for this type of emphasis of matter paragraph is from ISA 570.

(Note that this is only appropriate where the issues relating to the going concern of the entity are not such that a modified audit report should be given. Such matters are considered later in this chapter.)

> **Emphasis of matter**
>
> Without qualifying our opinion, we draw attention to Note X to the financial statements which indicates that the company incurred a net loss of $… during the year ended 31 December 20X1 and, as of that date, the company's current liabilities exceeded its total assets by $…. These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty which may cast significant doubt about the company's ability to continue as a going concern.

3.4 Other matter paragraphs

As stated above, an 'other matter' paragraph is used if the auditor considers it necessary to communicate a matter other than those included in the financial statements that, in his opinion, is relevant to users' understanding of the audit, the auditor's responsibilities or the audit report. In this case the auditor is **required** to:

- include the other matter paragraph immediately after the opinion paragraph (and any emphasis of matter paragraph), or
- elsewhere in the report if its content is relevant to the other reporting responsibilities section.

Circumstances in which an other matter paragraph may be necessary

ISA 706 gives the following examples of circumstances in which an 'other matter' paragraph may be necessary:

- Where the auditor is unable to resign from the engagement even though the possible effect of a limitation of scope imposed by management is pervasive (relevant to users' understanding of the audit). This should be rare in practice.
- Where local law or custom allows the auditor to elaborate on his responsibilities in his report (relevant to users' understanding of the auditor's responsibilities or audit report).

3.5 The modified opinion: ISA 705

When the auditor must issue a modified opinion

ISA 705 *Modifications to the opinion in the independent auditor's report* **requires** the audit to **modify** his opinion in the audit report in two situations:

- **Material misstatement**. This occurs when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are 'not free from material misstatement'. In other words the auditor considers that there is a material misstatement in the financial statements.
- **Limitation on scope.** This occurs when the auditor is unable to obtain sufficient appropriate evidence to conclude that the financial statements as a whole are free from material misstatement. In other words, the auditor has been unable to obtain sufficient appropriate audit evidence to reach an opinion that the financial statements give a true and fair view; therefore the financial statements may contain a material misstatement.

ISA 705 lists three types of **modified opinions:**

- a qualified opinion
- an adverse opinion, and
- a disclaimer of opinion.

Each of these types of modifications are explained below.

Deciding the type of modified opinion required

The following table from ISA 705 provides a useful summary of when each type of modified opinion is **required** to be given in the audit report:

	Auditor's judgement about the pervasiveness of the effects (or possible effects) on the financial statements	
Nature of matter giving rise to the modification	**Material but not pervasive**	**Material and pervasive**
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence (limitation on scope)	Qualified opinion	Disclaimer of opinion

Qualified opinions

A qualified audit opinion should be given when, in the opinion of the auditor, there is a material misstatement or a limitation on scope, and the effect on the financial statements is material but not pervasive.

Qualified audit opinions are sometimes called 'except for' opinions, because the audit report should state that in the auditor's opinion the financial statements give a true and fair view **except for** the matter or matters described in the report.

The meaning of pervasive: disclaimer of opinion or adverse opinion

Generally, a matter will be **material but not pervasive** when the auditor encounters a material problem with one or more **specific items** in the financial statements (such as a problem with inventory or revenue), but the remaining items and the financial statements as a whole provide a true and fair view.

'**Pervasive**' effects on the financial statements are defined by ISA 705 as those that, in the auditor's judgement:

- are not confined to specific elements, accounts or items of the financial statements, or
- are confined to specific elements in the financial statements, but these represent (or could represent) a substantial proportion of the financial statements, or
- in relation to disclosures in the financial statements, are fundamental to users' understanding of those statements.

The difference between a 'material' and a 'pervasive' modification is a matter of judgement. There are no absolute cut-off points or dividing lines that separate one from the other.

Limitations on scope

ISA 705 suggests that a limitation on scope may occur as a result of:

- circumstances beyond the control of the entity, such as when the entity's accounting records have been destroyed
- circumstances relating to the nature or timing of the auditors work: an example is when the auditor is appointed too late to enable him to attend the physical inventory count
- limitations imposed by management. The management of the client entity may prevent the auditor from obtaining the audit evidence required, for example by:
  - preventing the auditor from observing the physical inventory count
  - preventing the auditor from asking for confirmation of specific account balances (for example, a receivables circularisation).

Management imposed limitations on scope

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit which is likely to result in a qualified or disclaimer of opinion, the auditor is **required** to ask management to remove the limitation. If management refuse to do this, the auditor must:

- communicate the matter to those charged with governance
- consider whether it is possible to perform alternative audit procedures in order to obtain sufficient appropriate audit evidence.

If it is not possible to obtain audit evidence in another way and the matter is **material but not pervasive** the auditor must give a **qualified opinion.**

If it is not possible to obtain audit evidence in another way and the matter is **material and pervasive** the auditor must:

- **resign** from the audit where practicable and not prohibited by law or regulation, or
- if not practicable or possible, issue a **disclaimer of opinion**.

3.6 Form and content of a modified opinion

The form and content of a modified audit report with a modified opinion differs from an unmodified audit report in several ways. ISA 705 includes the following **requirements**.

Basis for modified opinion paragraph

When a modified opinion is issued, the audit report must include a 'basis for opinion' paragraph, which should appear just before the audit opinion in the report.

The paragraph is headed '**Basis for qualified opinion**', '**Basis for adverse opinion**', or '**Basis for disclaimer of opinion**', as appropriate. Examples of these types of opinion are shown later.

This 'basis for opinion' paragraph must include the following:

- For a material misstatement relating to **specific amounts** – a description and quantification of the impact on the financial statements (or a statement that quantification is not possible).
- For a material misstatement relating to **narrative disclosures** – an explanation of how the disclosures are misstated.
- For a material misstatement relating to the **non-disclosure** of information that should have been disclosed – the nature of the omitted information and, unless prohibited by law or regulation, the omitted disclosures.
- If the modification results from **an inability to obtain sufficient appropriate audit evidence** – the reasons for that inability.

Opinion paragraph

This paragraph in the audit report must be headed '**Qualified opinion**', '**Adverse opinion**', or '**Disclaimer of opinion**', as appropriate.

Specific wording is prescribed for the different types of modified opinions which is best illustrated by the examples shown later.

Auditor's responsibility paragraph

The auditor's responsibility paragraph appears earlier in the audit report, after the statement about management responsibilities for the financial statements. For a **qualified or adverse opinion** this paragraph is amended to state that the auditor believes that the audit evidence obtained is sufficient and appropriate to provide a basis for the modified opinion.

Where there auditor gives a **disclaimer of opinion**, more extensive amendments are required by ISA 705.

3.7 Examples of modified opinions

Illustrative examples of the different types of modified opinion are shown below. They are all taken from ISA 705. Where paragraphs in the examples are incomplete, the wording of the report commences or concludes in the same way as in the example of the unmodified report, shown in an earlier section of this chapter.

Example 1: Qualified opinion – limitation on scope

This is an example of a qualified opinion, arising from the auditor's inability to obtain sufficient appropriate audit evidence. The only paragraphs from the report that are shown here are those that are relevant to the modified opinion.

Auditor's responsibility

… We believe that the audit evidence that we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for qualified opinion

ABC Company's investment in XYZ company, a foreign associate acquired during the year and accounted for by the equity method, is carried at $XXX on the statement of financial position at 31 December 20X1, and ABC's share of XYZ's net income is included in ABC's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ at 31 December 20X1 and ABC's share of XYZ's net income for the year because we were denied access to the financial information, management and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

Qualified opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view….

Example 2: Qualified opinion – material misstatement

This is an example of a qualified opinion, arising from a material misstatement of the financial statements:

> **Auditor's responsibility**
>
> … We believe that the audit evidence that we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.
>
> **Basis for qualified opinion**
>
> The company's inventories are carried in the statement of financial position at $XXX. Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from International Financial Reporting Standards. The company's records indicate that had management stated the inventories at the lower of cost and net realisable value, an amount of $XXX would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by $XXX, and income tax, net income and shareholders' equity would have been reduced by $XXX, $XXX and $XXX, respectively.
>
> **Qualified opinion**
>
> In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view….

Example 3: Disclaimer of opinion – limitation on scope

This is an example of a disclaimer of opinion where the auditor has been unable to obtain sufficient appropriate audit evidence about a **single element** of the financial statements:

This is an example of a disclaimer of opinion where the auditor has been unable to obtain sufficient appropriate audit evidence about **multiple elements** of the financial statements:

> We were engaged to audit the accompanying financial statements of ABC Company….
>
> Management is responsible for…..
>
> **Auditor's responsibility**
>
> Our responsibility… International Standards on Auditing. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.
>
> **Basis for disclaimer of opinion**
>
> We were not appointed as auditors of the company until after 31 December 20X1 and thus did not observe the counting of physicals inventories at the beginning

and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at31 December 20X0 and 20X1 which are stated in the statement of financial position at $XXX and $XXX, respectively. IN addition, the introduction of a new computerised accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our audit report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the statement of financial position at a total amount of $XXX as at 31 December 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found to be necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the income statement, statement of changes in equity and statement of cash flows.

Disclaimer of opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

Example 4: Adverse opinion – material misstatements

This is an example of an adverse opinion is of a group audit report. Although group audit reports are not examinable in this paper, it still provides a useful illustration:

Auditor's responsibility

… We believe that the audit evidence that we have obtained is sufficient and appropriate to provide a basis for our adverse audit opinion.

Basis for adverse opinion

As explained in Note X, the company has not consolidated the financial statements of subsidiary XYZ Company it acquired during 20X1 because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under International Financial Reporting Standards, the subsidiary should have been consolidated because it is controlled by the company. Had XYZ been consolidated, many elements in the accompanying financial statements would have been materially affected. The effects on the financial statements of the failure to consolidate have not been determined.

Adverse opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the consolidated financial statements do not give a true and fair view….

3.8 Deciding to give a modified opinion

The auditor will give a modified opinion only if he is satisfied that:

- the reasons for giving a modified opinion are justified, and
- the management of the client entity are unable or unwilling to take action to remove the necessity for a modified opinion.

For example, suppose that the management of a client entity decides that a material non-current asset should not be depreciated. The auditor should first of all satisfy himself that there is no acceptable reason for the management's view, and that the asset should be depreciated.

- The auditor should review the audit file and check for any information about this matter from previous audits.
- He should consider whether there might be an acceptable reason for a departure from the requirements of international financial reporting standards and GAAP, in order to give a true and fair view.
- If the auditor is still satisfied that management is incorrect in their opinion, he should meet with the management and:
- Discuss their reasons for not depreciating the asset
- Obtain a representation from them confirming that the asset will not be depreciated
- Decide whether the effect of this action by management on the financial statements is material or 'material and pervasive' and so what form of modified opinion is necessary
- Warn management that the audit opinion will be modified unless management change their view
- If management still refuse to change their view, issue a modified opinion, which will be either a qualified opinion or an adverse opinion.

3.9 Audit reports and the exam

For the exam, you may be expected to study an audit report that contains errors and identify and explain what those errors are. Alternatively, you may be asked to discuss what audit opinion would be appropriate.

The key issues to consider are as follows.

- Do the financial statements give a true and fair view? (Misstatements do not affect the true and fair view if they are immaterial.)
- If they do, the audit opinion will be unmodified.
- If the draft financial statements give a true and fair view, is there any item that justifies an 'emphasis of matter' paragraph? Usually, an emphasis of matter paragraph is something that could affect the going concern assumption.
- If the financial statements do not give a true and fair view, what is the item of contention? Is it something that involves a disagreement with management (a misstatement) or is there inadequate audit evidence (a limitation on scope)?

- Is the matter material but not pervasive? If so, a qualified audit opinion is appropriate ('except for…').
- If the matter is material and pervasive, either an adverse opinion or a disclaimer of opinion is appropriate. (These are rare in practice, but of course they could feature in an exam question!)

Here are some examples.

Example 1

You are the manager in charge of the audit of Colorosso, a limited liability company. Your auditors' report for the previous financial year to 31 December Year 7 was signed, without modification, in February Year 8.

The scope of the audit for the year to 31 December Year 8 has been limited. This is because the company's chief executive officer fled the country in April Year 8, taking the accounting records with him.

You have identified a valuable training opportunity for Robin, one of your audit team. As a training exercise, you have asked Robin to draft the extracts for the basis of opinion and opinion paragraphs that would **not** be standard wording in an unmodified auditor's report.'

Robin's draft extracts were produced as follows:

'**Basis of opinion** (extract)
However, the evidence available to us was limited because accounting records were missing at the beginning of the year and it was not possible to reconstruct them completely.

Opinion (extract)
Because of the possible effect of the limitations in the information available to us, we do not express an opinion on the financial statements.'

Requirement

(a) Identify and comment on the principal matters relevant to forming an appropriate opinion on the financial statements of Colorosso for the year ended 31 December Year 8.

(b) Discuss the suitability of Robin's draft extracts.

Answer

Tutorial note
To answer this requirement, you need to:

- identify the principal matters relevant to forming an appropriate opinion
- comment on these matters
- identify whether Robin's report indicates that Robin has identified and considered these matters

- reach a conclusion about whether Robin's report is suitable. This may involve setting out what would have been suitable if Robin's report is not suitable.

Matters relevant to forming an opinion

The following matters are relevant to forming an appropriate opinion.

(1) The accounting records for the opening three or four months of the year are missing.

(2) The accounting records are missing because the former CEO absconded with them. There must be some reason why he took the accounting records: fraud is a possible reason.

(3) The audit opinion for the previous financial year was unmodified. This would imply that the opening balances for the current year and comparative figures for the previous year are correct. However, this might not be the case.

(4) If there is a possibility of fraud, this would raise doubts about the correctness of the audit report for the previous year. There may have been fraud last year that was undetected fraud. And this might have caused material misstatement to that audit report.

(5) There is an inability to obtain sufficient appropriate audit evidence (limitation on scope) for the year to 31 December Year 8.

Comments on these matters

Matter listed above	Comment
(1)	This constitutes a limitation on the scope of the audit (item 5 above). The auditors will not be able to obtain sufficient appropriate audit evidence about the relevant period. Therefore the audit opinion will be modified. The modification should (a) give details of what records are missing and why, or (b) cross-refer to where this information is given in the financial statements. The extent of the modification will depend on which records are missing and where the auditors' scope is limited. It is likely that the information with regard to the income statement/statement of comprehensive income is limited, but possibly not the statement of financial position. A modification might be limited to a qualification ('except for') over the statement of comprehensive income for the first few months of the year.
(2)	However, there is an indication in the manner in which the CEO has taken the accounting records that there may have been a fraud. It is therefore probable that the auditors will have to modify the

opinion even if they are able to reconstruct the financial records as it will not be possible to gain sufficient appropriate evidence about the possible fraud.

(3) and (4) The previous audit report cannot be withdrawn but the auditors are not precluded from modifying their opinion for the current year on the basis of the comparative figures for the previous year. It is probable that any fraud in progress at the start of this financial year could have affected the previous financial year, unknown to the auditors at the time.

Conclusion about Robin's draft

Robin is correct to modify the opinion on the grounds of limitation of scope. However, the draft should:

- make reference to the exact nature of the problem/possible fraud
- take account of a possible modification in relation to the comparative figures for the previous financial year
- take account of the fact that the problem may be limited to the statement of comprehensive income.

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Example 2

A client company has recently prepared draft financial statements for the year to 31 December Year 2. During the year, the company closed a factory that made a loss-making product which contributed 14% to total sales revenue in the previous year and 10% in the current year.

The closure is permanent. It is mentioned in the directors' report and in the annual business review, but not in the financial statements themselves.

Required

What should be the auditor's view of this situation?

a

Answer

The factory appears to have been a separate component of the company's business, making a separate product that contributed materially to total sales income.

The closure represents a discontinued operation, and failure to disclose the details is a failure to comply with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. It is also in breach of the requirements of IAS 7 *Statements of Cash Flow* and IFRS 8 *Operating Segments* which also require disclosures relating to discontinued operations.

The matter is material, but is not pervasive. If management do not amend the financial statements to provide the required disclosures, a qualified audit opinion (for a misstatement) would be appropriate.

e

Example 3

A client company has prepared draft financial statements for the year to 31 December Year 3. In February Year 4 a legal claim was made against the company, claiming substantial damages. The company's lawyers have advised that the claim has less than 50% chance of success. If it did succeed, the company would have sufficient cash resources to meet the claim in full.

The matter is disclosed in the draft financial statements in a note, as a material contingent liability.

Required

Should the audit opinion be unmodified, and if so, should the report contain an 'emphasis of matter' paragraph?

a

Answer

The claim was made after the end of the reporting period, and is a non-adjusting event. The probability that the claim will be successful is less than 50% (on the assumption that the lawyers have given a reasonable opinion).

It is therefore appropriate to disclose the item as a contingent liability (in this case, a material non-adjusting event after the reporting period). The auditor should therefore give an unmodified opinion.

An 'emphasis of matter' paragraph is normally only used when the matter involves considerable uncertainty. 'Considerable uncertainty' usually exists only when there is some concern about the going concern status of the entity or about a matter that could have a major impact on the financial statements. In this case, we are told that the company has sufficient cash resources to meet the legal claim in full, in the event that it is successful.

It therefore appears that considerable uncertainty does not exist, and an 'emphasis of matter' paragraph would be inappropriate.

The impact on the audit report of opening balances and comparatives
■ ISA 510: Initial engagements – opening balances ■ ISA 710: Comparatives

4 The impact on the audit report of opening balances and comparatives

The audit work needed on opening balances and comparatives (ISAs 510 and 710) was described in an earlier chapter. The auditor must consider the possible impact of this work on the audit report.

4.1 ISA 510: Initial audit engagements – opening balances

The audit report is **required** by ISA 510 to be **modified** where the auditor:

- is unable to obtain sufficient appropriate audit evidence re the opening balances (qualified ("except for") or a disclaimer of opinion)
- concludes that there is a misstatement in the opening balances that materially affects the current period's financial statements and the misstatement is not properly accounted for/disclosed (qualified ("except for") or adverse opinion)
- concludes that accounting policies have not been consistently applied (or a change of accounting policy has not been properly accounted for/disclosed) (qualified ("except for") or adverse opinion)

or where

- the prior period's audit report was modified, and the matter is still relevant and material to the current period's financial statements (modify as appropriate).

4.2 ISA 710: Comparative information – corresponding figures and comparative financial statements

Financial statements include audited figures for the current financial year (just ended) and for the previous financial year, which are presented as comparative information.

The audit opinion should not normally refer to the corresponding figures, unless the following circumstances apply:

Circumstance	ISA 710 requirement
The auditor gave a qualified opinion for the previous financial period and the problem remains unresolved.	Modify this year's audit report.

Circumstance	**ISA 710 requirement**
The auditor finds a material misstatement in the prior period financial statements, on which an unmodified opinion was previously given, and the corresponding figures have not been appropriately restated.	Give a qualified or adverse opinion on the current period financial statements, in respect of the corresponding figures included.
The prior period financial statements were audited by another auditor	Use an "other matter" paragraph to explain this fact and the type of opinion given.
The prior period financial statements were not audited.	Use an "other matter" paragraph to state this fact. (However, the auditor remains responsible, per ISA 510, for obtaining sufficient appropriate evidence on opening balances.)

The impact of going concern on the audit report: ISA 570

- Where the use of the going concern assumption is appropriate but a material uncertainty exists
- Management's attitude to disclosure of material uncertainty
- Where the use of the going concern assumption is inappropriate

5 The impact of going concern on the audit report: ISA 570

If indications are found which suggest that the going concern basis might not be appropriate for preparing the financial statements, the auditor is **required** by ISA 570 to consider the implications for his audit report.

The form of the report will depend on the auditor's judgement. There are two possible views he could take:

- the use of the going concern assumption is appropriate but a material uncertainty exists, or
- the use of the going concern assumption is inappropriate.

If management is unwilling to make or extend a going concern assessment (see previous chapter on ISA 570) the auditor is also **required** to consider the implications of this for his audit report.

5.1 Where the use of the going concern assumption is appropriate but a material uncertainty exists

Where the auditor considers that the going concern assumption is **appropriate, but a material uncertainty exists,** he must consider whether the financial statements:

- adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with those events or conditions, and
- disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern .

If there is **adequate disclosure**, then the auditor should express an unmodified opinion. However, he should use an emphasis of matter paragraph to:

- highlight the uncertainty, and to
- draw attention to the relevant note in the financial statements.

An example of such an emphasis of matter paragraph was given above.

If there **is not adequate disclosure,** the auditor should express a qualified or adverse opinion.

5.2 Management's attitude to disclosure of material uncertainty

The management of a client company will probably be reluctant to include a disclosure about material uncertainty in relation to the going concern assumption. There are several reasons for this.

- Admitting that there is material uncertainty about whether the company can continue as a going concern for the next 12 months can be seen as a sign of management failure. Management will probably be reluctant to admit their responsibility for failure to the company's shareholders.
- A statement that there is material uncertainty about the ability of the company to continue in business will make the situation even worse for the company. Banks will be reluctant to lend more money and may withdraw existing lending facilities. Suppliers may be reluctant to supply more goods without a credit guarantee (which the company would have to buy from an insurance company). Customers may stop buying the company's products due to concern that the company will not be in existence to provide after-sales service.
- Employees will become more concerned for job security, and many might look for jobs with other employers. Staff turnover would therefore increase.

It is also possible that management do not accept that there is material uncertainty about the ability of the company to continue in business. There could therefore be genuine disagreement between management and the auditor on this issue.

As indicated above, if management refuse to provide suitable disclosure the audit opinion should be modified.

5.3 Where the use of the going concern assumption is inappropriate

Where the financial statements have been prepared on the going concern basis, but the auditor considers the going concern assumption is inappropriate, the auditor should express an adverse opinion.

The auditor may give an unmodified opinion if the financial statements have been prepared on an alternative acceptable basis (for example, a break-up basis) and there is adequate disclosure of this basis. An emphasis of matter paragraph may be required in the audit report.

Communicating with those charged with governance: ISA 260

- Introduction
- Matters to be communicated
- The communication process

6 Communicating with those charged with governance: ISA 260

6.1 Introduction

In most countries, the auditor communicates to the shareholders, as owners of the company, by means of his audit report. ISA 260 *Communication with those charged with governance* requires in addition that the external auditor should communicate formally to those charged with governance to provide useful feedback about the audit.

In the case of a company those charged with governance are the board of directors or the audit committee (which is a sub-committee of the board of directors). In your exam it will usually mean the directors of the company.

The auditor's **objectives** in respect of ISA 260 are to:

- communicate his responsibilities and give an overview of the planned scope and timing of the audit
- obtain information relevant to the audit
- provide timely observations arising from the audit which are significant to management's responsibility to oversee the financial reporting process
- promote effective communication between the auditor and those charged with governance.

As a result of the communication, the auditor should be satisfied that there is sufficient documentation of all the significant matters in the audit and that these have been brought to the attention of the individuals in the client entity who are accountable to its owners.

6.2 Matters to be communicated

The auditor is required by ISA 260 to communicate the following matters.

- **His responsibilities** in relation to the audit, including notification that:
  - he is responsible for forming and giving an opinion on the financial statements prepared by management, and
  - the audit does not relieve management or those charged with governance of their responsibilities.
- An overview of the **planned scope and timing** of the audit.

- Any significant findings from the audit. These are often called the **management letter points** and are usually communicated along with any deficiencies in internal control as required by ISA 265 (see below). They include:
  - the auditor's views on the entity's accounting policies, estimates and financial statement disclosures
  - any significant difficulties encountered during the audit
  - any significant matters arising from the audit already brought to the attention of management and written representations requested*
  - any other matters arising from the audit that are significant to the oversight of the financial reporting process.
- For **listed entities** a statement (which must be made in writing):
  - that the audit team/firm have complied with relevant ethical requirements in respect of independence
  - of all matters relevant to independence (such as relationships and non-audit fees) and the safeguards applied.

*This requirement does not apply if those charged with governance are involved in managing the entity as they will already be aware of these issues. The significant matters do not include material weaknesses in internal controls as such a report is a requirement of ISA 265, not ISA 260 (see next section).

6.3 The communication process

The communication with those charged with governance may be provided **either in writing or orally**. It could take place as a discussion between the auditor and an appropriate level of management, perhaps with the audit committee in the case of a larger company.

However, where oral communication would not be adequate, ISA 260 requires that communication is in writing, in the form of a letter or report. If communication is oral then the matters communicated, to whom and when must be documented.

Communication must be made on a **timely basis**. The appropriate timing will vary depending on the matter to be communicated. Communication in respect of planning matters will be likely to be made early in the engagement. Any significant difficulties encountered during the audit should be communicated as soon as practicable, especially if likely to lead to a modified opinion.

Communicating deficiencies in internal control: ISA 265

- Introduction and requirements of ISA 265
- The management letter

7 Communicating deficiencies in internal control: ISA 265

7.1 Introduction and requirements of ISA 265

ISA 315, covered largely in an earlier chapter, requires the auditor to **communicate material weaknesses in internal control identified during the audit to management**. This requirement is embodied in ISA 265 *Communicating deficiencies in internal control to those charged with governance and management*.

A **deficiency** is defined by ISA 265 as where:
- a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis, or
- a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

A **significant deficiency** is one which merits the attention of those charged with governance.

ISA 265 **requires** the auditor to:
- Communicate significant deficiencies identified during the audit to those charged with governance in writing on a timely basis.
- Communicate any other deficiencies to an appropriate level of management

The communication of significant deficiencies must be **in writing** and is **required** to cover:
- A description of the deficiencies and an explanation of their potential effects.
- Sufficient information to allow those charged with governance and management to understand the context of the communication, including an explanation that:
  - the purpose of the audit was to express an opinion on the financial statements
  - whilst the audit did include consideration of internal controls in order to design appropriate audit procedures, this was not done for the purpose of expressing an opinion on the effectiveness of internal control, and
  - the matters being reported are limited to those deficiencies identified during the audit and considered of sufficient importance to be reported.

The above should make it clear that the report covers only those weaknesses that have been discovered as a result of the audit work that has been undertaken. It is a by-product of a statutory audit, and is not the result of a full review of systems and controls. As a consequence, other weaknesses may exist that are not mentioned in the report.

The auditor will also usually state that such communication has been provided for the purposes of those charged with governance, and that it may not be suitable for other purposes.

7.2 The management letter

Although now a requirement of both ISA 315 and ISA 265, the **management letter** or **letter of weakness** has long been seen as an extra service provided to the client by the external auditor. If management address the points in the letter, the controls in place will be improved. This may enable future audits to focus on the more efficient systems-based approach. This in turn may reduce the cost of the audit to the client.

The report is prepared and sent after the results of the tests of control are known – usually after the **interim audit**.

The report may later be updated after the **final audit**, if further weaknesses have been found, or if weaknesses that were reported to previously have not yet been dealt with.

In line with ISA 265's requirement to give a description of the deficiencies and an explanation of their potential effects, the report will usually identify the following information for each weakness reported:

- The nature of the weakness in the present system, in terms of both design and operation. (In other words, is there a control weakness 'on paper'? If there is no control weakness 'on paper', are the controls applied effectively in practice?)
- The implication of this weakness in controls.
- Recommendations for improvement.

The auditor should ask management to provide a response and action plan for each weakness identified in the report. He should also mention that the contents of the report will be followed up in future audits.

Special purpose audit reports

8 Special purpose audit reports

8.1 Introduction

The external auditor may be called upon to report on the contents of documents other than the annual financial statements of an entity. For the purposes of your examination, you need to be aware of the reporting principles in relation to:

- summary financial statements
- revised accounts
- distributions following an audit qualification.

The relevant ISAs are:

- ISA 800 *Special considerations – audits of financial statements prepared in accordance with special purpose frameworks*
- ISA 810 *Engagements to report on summary financial statements*

although only ISA 800 is listed as examinable.

8.2 The summary financial statement

Many local jurisdictions allow entities to provide certain users, perhaps employees, with financial statements in a summarised form. These summarised statements present only the main aspects of the entity's financial performance and financial position. The entity may ask its auditors to issue a report on these statements to add credibility to the information contained in the document. ISA 810 *Engagements to report on summary financial statements* provides guidance on this area.

The **objectives** of the auditor, per ISA 810 are to:

- **determine whether it is appropriate to accept the engagement** to report on summary financial statements (SFS)
- and, if engaged to:
  - **form an opinion** on the SFS based on evidence obtained, and
  - express that opinion clearly in a written report that also describes the basis for that opinion.

Requirements of ISA 810

The auditor should not report on the SFS **unless he has already issued an opinion on the full financial statements** from which the SFS are derived.

Before accepting an engagement to report on SFS the auditor should:

- decide whether the criteria applied by management in the preparation of the SFS are acceptable
- obtain management's agreement that it is responsible for:
  - preparing the SFS in accordance with the above criteria
  - making the "full" (i.e. audited) financial statements available to the users of the SFS
  - including the auditor's report on the SFS in any document which contains the SFS.

The "**applied criteria**" may be established by law or regulation. For example, in the UK the criteria would be the relevant sections of the Companies Act 2006.

The auditor should perform the following **procedures** as a basis for his opinion on the SFS:

- Evaluate whether the SFS adequately disclose:
  - their summarised nature and identify the full financial statements
  - the criteria applied in the preparation of the SFS.
- When the SFS are not accompanied by the full financial statements, consider whether the SFS describe clearly where the full financial statements are available or the law or regulation which states that they need not be.
- Compare the SFS to the full financial statements to ensure they agree with or can be derived from the latter.
- Evaluate whether:
  - the SFS have been prepared in accordance with the applied criteria
  - the SFS contain sufficient information so as not to be misleading
  - the full financial statements are readily available (unless not required to be).

Where the auditor is able to give an **unmodified opinion** on the SFS one of the following phrases should be used:

- "The SFS are consistent, in all material respects, with the audited financial statements, in accordance with [applied criteria]", or
- "The SFS are a fair summary of the audited financial statements, in accordance with [applied criteria]".

The term 'true and fair' (or its equivalent) is not used in the report, because the SFS will not contain all the information required by a recognised financial reporting framework.

The **auditor's report on the SFS** should include the following elements:

- Title
- Addressee
- An introductory paragraph that:
  - identifies the SFS on which the auditor is reporting
  - identifies the full financial statements
  - refers to the auditor's report on the above, its date and the type of opinion given in that report (e.g. unmodified)
  - (if the report on the SFS is dated later than the audit report on the full financial statements – note that it cannot be dated earlier) states that nether set of financial statements reflects the effect of events that occurred after the date of the audit report on the full financial statements
  - states that the SFS do not contain all the disclosures required by the financial reporting framework applied in the preparation of the full financial statements and that reading the SFS is no substitute for reading the full financial statements.
- A description of management's responsibility for the SFS (the preparation of the SFS in accordance with the applied criteria).
- A statement that the auditor is responsible for expressing an opinion on the SFS based on the procedures required by this ISA.
- An opinion.
- Date of the report.
- Auditor's address.
- Auditor's signature.

Note that the auditor might have issued a **qualified opinion on the full financial statements** or used an **emphasis of matter or other matter paragraph** but may nevertheless be satisfied with that the SFS are properly derived from those full financial statements. In this situation, the auditor's report should also describe:

- the basis for the opinion
- any effect of the opinion on the SFS.

If the opinion was an **adverse or disclaimer of opinion** the auditor's report on the SFS should state that it is **inappropriate to express an opinion on the SFS**.

Example

An example of a report on SFS is set out below. This example is based on circumstances where an unmodified opinion was expressed on the full financial statements and the auditor's report on the SFS is dated later than the "full" auditor's report.

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS
[Appropriate Addressee]
The accompanying summary financial statements, which comprise the summary statement of financial position as at 31st December 20X1, the summary statement of comprehensive income, summary statement of changes in equity and summary statement of cash flows for the year then ended, and related notes, are derived from the audited financial statements of ABC Company for the year ended 31st December 20X1. We expressed an unmodified audit opinion on those financial statements in our report dared 15th February 20X2. Those financial statements, and the summary financial statements, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements.
The summary financial statements do not contain all the disclosures required by [describe financial reporting framework applied in the preparartion of the audited financial statements]. Reading the summary financial statement, therefore, is not a substitute for reading the audited financial statements of ABC Company.
Management's responsibility for the summary financial statements
Management is responsible for the preparation of a summary of the audited financial statements in accordance with [decribe established criteria].
Auditor's responsibility
Our responsibility is to express an opinion on the summary financial statements based on our procedures, which were conducted in accordance with International Standard on Auditing 810 "Engagements to report on summary financial statements".
Opinion
In our opinion, the summary financial statements derived from the audited financial statements of ABC Company for the year ended 31st December 20X1.are consistent, in all material respects, with those financial statements. [Auditor's signature] [Date]
Auditor's address

8.3 Revised accounts

On rare occasions, it may be discovered that there are defects in audited financial statements which have already been presented to the shareholders of the company. When this happens, national laws or regulations may or may not allow the incorrect financial statements to be revised.

Revisions should relate to:

- matters arising **before** the original accounts were approved
- that result from fundamental errors of fact.

Any revision that is made may take the form of:

- withdrawing the original financial statements and issuing a revised version, **or**
- making the necessary revision in a supplementary note to the financial statements.

The duties of the auditor in respect of revised accounts are to ensure that:

- the revisions comply with the appropriate accounting framework, and
- there is good reason for the revision, and
- the revised accounts show a true and fair view.

Audit procedures in relation to checking revised accounts might include the following:

- The auditor should assess the nature of the revision, and the audit work necessary to reach an audit conclusion.
- The auditor should obtain audit evidence relating to the adjustments that have been necessary to make the revision.
- The auditor should perform a final review of the revised financial statements.
- The auditor should also consider any legal implications or other implications of the revision.

Revisions to financial statements require a revision to the opinion paragraph in the audit report, as illustrated below.

> In our opinion, the revised financial statements give a true and fair view as at the date the original financial statements were approved, of the financial position of the company as of ……………………

8.4 Distributions following an audit qualification

Although national laws vary in detail, there is a general principle that companies may only distribute as dividends 'profits available for distribution'.

'Profits available for distribution' will generally consist of the excess of accumulated realised profits over accumulated realised losses. They will normally be determined by reference to the latest audited accounts. If there is a modification to the audit opinion on those accounts, local law will often require the directors to ask the auditors to state whether, in their opinion, the modification is material for deciding whether the proposed distribution is lawful.

Example

A company has distributable profits of $2 million

The directors have refused to write off trade receivables of $0.3 million.

As a result the auditor has given a qualified opinion.

The directors wish to pay a dividend of $1.5 million.

Although the opinion was qualified, the matter is not material for deciding whether the proposed dividend is lawful. Even if the directors had written off these receivables, there would still be sufficient profits for the dividend to be paid.

A report would therefore be issued as set out below.

AUDITORS' STATEMENT TO THE MEMBERS OF ………

We have audited the financial statements of ……………………..….. for the year ended 31st December 20X6 in accordance with International Standards on Auditing …………………. and have expressed a qualified opinion thereon in our report dated …….

Basis of opinion
We have carried out such procedures as we consider necessary to evaluate the effect the qualified opinion has for the determination of profits available for distribution.

Opinion
In our opinion, this qualification is not material for the purpose of determining whether the distribution of $….…… proposed by the company is permitted under (reference to local law).

Auditor
Address
Date

8.5 ISA 800 Audits of financial statements prepared in accordance with special purpose frameworks

ISAs in the 100 to 700 series apply to an audit of financial statements. ISA 800 deals with special considerations **in the application of those ISAs** to an audit of financial statements prepared in accordance with a special purpose framework.

Although such special considerations cover:

- acceptance of the engagement
- planning and performance of the engagement, and
- forming an opinion and reporting on the engagement

the bulk of the ISA is concerned with reporting. An audit report on such financial statements will add credibility to those financial statements.

Considerations when accepting the engagement

The auditor is **required** to determine the acceptability of the financial reporting framework applied by obtaining an understanding of:

- the purpose for which the financial statements have been prepared
- the intended users of those financial statements
- the steps taken by management to determine that the framework is acceptable in the circumstances.

The special purpose framework could be a fair presentation framework or a compliance framework, as discussed under ISA 700 above.

Considerations when planning and performing the audit

ISA 200 requires the auditor to comply with all ISAs relevant to the audit. ISA 800 **requires** the auditor to determine whether any special consideration is needed.

ISA 315 requires the auditor to obtain an understanding of the entity's selection and application of accounting policies. If the special purpose financial statements have been prepared **in accordance with the provisions of a contract** then ISA 800 **requires** him to obtain an understanding of any significant interpretation of the contract that management has made in the preparation of those financial statements.

Forming an opinion and reporting considerations

When forming an opinion and reporting on special purpose financial statements the auditor is **required to follow ISA 700 and other relevant reporting ISAs**. The table below shows how the requirements of ISA 700 (and ISA 706) are applied by ISA 800.

ISA 700/706 requirements	**How applied by ISA 800**
The auditor must evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework (ISA 700).	For financial statements prepared in accordance with the provisions of a contract the auditor must evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.
Provisions covering the form and content of audit reports (ISA 700)	The report must also describe the purpose for which the financial statements are prepared and, if necessary, the intended user (or refer to a note which gives that information). If management has a choice of financial reporting frameworks in this instance, the section on management's responsibilities must refer to its responsibility for making an acceptable choice.

ISA 700/706 requirements	How applied by ISA 800
Use of an emphasis of matter paragraph (ISA 706)	The report must include an emphasis of matter paragraph alerting users to the fact that the financial statements have been prepared in accordance with a special purpose framework and that, as a result, they might not be suitable for another purpose.

The example report below shows how the usual ISA 700 report would be adapted for a report on special purpose financial statements.

Example

An example of an audit report on special purpose financial statements prepared in accordance with the financial reporting provisions established by a regulator (in this example a fair presentation framework) is set out below. The additional wording, per ISA 800, is shown in square brackets.

INDEPENDENT AUDITOR'S REPORT

(Appropriate addressee)

Report on the financial statements

We have audited the accompanying financial statements of ABC Company, which comprise the statement of financial position as at December 31st, 20X7, and the statement of comprehensive income, statement of changes in equity, and statement of cash flows for the year then ended, and a summary of significant accounting polices and other explanatory information. [The financial statements have been prepared by management based on the financial reporting provisions of Section Y of Regulation Z.

Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with [the financial reporting provisions of Section Y or Regulation Z], and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence that we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view (or present fairly, in all material respects,) of the financial position of ABC Company as of December 31^{st}, 20X7, and of its financial performance and its cash flows for the year then ended in accordance with [the financial reporting provisions of Section Y of Regulation Z].

[Basis of accounting

Without modifying our opinion, we draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist ABC Company to meet the requirements of Regulator DEF. As a result, the financial statements may not be suitable for another purpose.

Other matter

ABC Company has prepared a separate set of financial statements for the year ended December 31^{st}, 20X7 in accordance with International Financial Reporting Standards on which we issued a separate auditor's report to the shareholders of ABC Company dated March 31^{st}, 20X7.]

(Auditor's signature)

(Date of the report)

(Auditor's address)

CHAPTER 15

Current issues I

Contents

Ethical issues

- Introduction
- Regulation of auditing: an ethical framework or a rulebook?
- Auditor independence
- The provision of non-audit services to audit clients
- Auditor rotation

1 Ethical issues

1.1 Introduction

You need to be aware of current issues in auditing. These issues include ethical issues and the problem of auditing and exemption from audit of small companies.

You should monitor the professional press for further developments over the course of your studies.

1.2 Regulation of auditing: an ethical framework or a rulebook?

There are generally recognised to be two methods of regulating the behaviour of individuals:

- a **rulebook approach**: this sets out the rules about what must and what must not be done - 'you must not do that'
- a **framework approach**: this sets out principles that should govern behaviour, with reasoned arguments to support the principles - 'you should understand why it is not acceptable to do that'.

Both approaches may be enforced by sanctions against individuals who do not comply.

There are a number of **advantages** of adopting a framework approach as opposed to a rulebook approach for regulating the behaviour of accountants and auditors.

- It is impossible to develop rules that will deal with all situations.
- In a rules-based system, the rules may be interpreted too narrowly. If so, the rules cease to be of practical value, because they cannot be applied with confidence in practice (unless there is a very detailed set of rules).
- An ethical framework is therefore more flexible. It sets out general principles, and requires accountants to apply the general principles to the circumstances of each case that arises.
- It may also be argued that accountants are professionals with an ethical code of conduct: consequently they do not need to have their behaviour regulated by detailed and strict rules and regulations.

1.3 Auditor independence

It is well established that independence is fundamental to the credibility of the audit process. Much of the current thinking on independence has been developed by the Securities and Exchange Commission (SEC) in the USA. The work of the SEC has followed on from the corporate scandals in the US in 2001 and 2002, such as Enron and WorldCom. Similar proposals have been put forward in the UK and in other countries.

In January 2003, the SEC adopted rules to implement the **Sarbanes-Oxley Act 2002** on corporate governance. The rules aim to strengthen auditor independence and require additional disclosures to investors about the services provided to corporations by an independent accountant.

The SEC approved the following measures:

- The rules relating to non-audit services were revised, in cases where the independence of the audit firm would be impaired if it provided the non-audit services to the audit client.
- Rules for the rotation of audit partners. Certain partners on the audit engagement team should be 'rotated' (= changed) after no more than five or seven consecutive years, depending on the partner's involvement in the audit. However, some small accounting firms may be exempt from this requirement.
- Establish rules that an accounting firm would not be considered to be independent if certain members of management of the clients had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of the audit.
- An audit firm should not be considered to be independent from an audit client if any audit partner involved in the audit has obtained payment (for the firm) for services relating to engagements with the client for services other than audit, review and attestation services.
- The auditors should be required to report certain matters to the client's audit committee, including reports on any 'critical' accounting policies that are being used by the client.
- The audit committee of the client should be required to approve in advance all audit and non-audit services provided to the client by the auditor.
- There should be disclosure to shareholders of information about audit and non-audit services provided to the client by the auditor, and the fees for those services.

1.4 The provision of non-audit services to audit clients

Non-audit services that might impair the firm's independence

The **Sarbanes-Oxley Act** (mentioned above) lists nine non-audit services that are considered to impair the audit firm's independence if they are provided to the client by the audit firm. These are set out below.

(1) Book-keeping or other services related to the accounting records or financial statements of the audit client

The rules prohibit an accountant from auditing the book-keeping work performed by his or her accounting firm on behalf of a client.

(2) Financial information systems design and implementation

The rules prohibit an audit firm from providing any service related to the information systems of the audit client, unless it is reasonable to conclude that the results of these services will not be audited.

These rules do not prevent an audit firm from working on the hardware or software systems of an audit client, if these are unrelated to the client's financial statements or accounting records and provided that the provision of these services by the audit firm is approved in advance by the audit committee.

(3) Appraisal or valuation services, fairness opinions, or contribution-in-kind reports

All these activities are essentially services involving a report from an accountancy firm on the valuation used in a transaction.

The rules prohibit an audit firm from providing such services, unless the results of these services will not be audited as part of the audit of the financial statements.

(4) Actuarial services

The rules prohibit an audit firm from providing any actuarial advisory service to an audit client that involves a decision about amounts to be recorded in the financial statements (and related accounts) of the audit client.

Such a service may apply, for example, to the valuation of pension funds (which is connected to the valuation of pension fund liabilities).

An audit firm may, however, assist a client in understanding the methods, models, assumptions and inputs used in computing an amount.

(5) Internal audit outsourcing services

The rules prohibit the audit firm from providing any internal audit service that has been outsourced by the audit client, where the internal audit work relates to the audit client's internal accounting controls, financial systems or financial statements.

This means that internal audit work relating to operational controls and compliance (operational audits, VFM audits and compliance audits) by the audit firm are permissible.

(6) Management functions or human resources

The rules prohibit an audit firm from:

- acting (even in a temporary capacity) as a director, officer or employee of an audit client, or
- performing any decision-making, supervisory, or ongoing monitoring function for the audit client.

The independence of an audit firm will also be impaired if the firm provides assistance to the client in connection with any senior level management appointment. An accountant's independence is impaired with respect to an audit client when the accountant:

- seeks out prospective candidates for managerial, executive or director positions within the client company, or
- acts as negotiator, on the audit client's behalf, with any person who has applied for a senior management position, or
- undertakes reference checks of prospective candidates for a senior management position.

Under this rule, an accountant's independence will also be impaired when the accountant:

- engages in psychological testing or other formal testing or evaluation programmes, or
- recommends or advises the audit client to hire a specific candidate for a specific job.

(7) Broker or dealer, investment adviser, or investment banking services

Acting as a broker-dealer, promoter or underwriter on behalf of an audit client will make the accountant an advocate for the audit client and will impair his independence.

(8) Legal services

A firm is prohibited from providing to an audit client any service that could be provided only by someone qualified to practise law in the jurisdiction in which the service is provided.

(9) Expert services unrelated to the audit

The rules prohibit an audit firm from providing expert opinions to an audit client, for the purpose of advocating that audit client's interests in litigation or in any regulatory or administrative proceeding or investigation.

Advantages and disadvantages of the auditor providing non-audit services

Advantages

The audit firm is in an excellent position to provide its client with non-audit services. This is because:

- it already has an extensive knowledge of its client, the client's business and its systems, and
- it should therefore be able to provide the additional non-audit services to the client at a lower cost than other accountancy firms, and with less disruption to the client.

Non-audit work also makes audit firms more attractive in the recruitment market, because a wider range of work experience can be offered to trainees.

Disadvantages

However, there are some obvious disadvantages to providing non-audit services.

- The audit firm may be seen by the world at large to lack independence from the client, because of the large fees it receives for audit and non-audit work. (This was a criticism levelled at the Houston office of audit firm Andersens, following the collapse of Enron.)
- Accountants from the audit firm may find themselves in a position where they are making management decisions. (If so, their independence is impaired.)

1.5 Auditor rotation

The need for auditor rotation has been a topic of discussion, following various major corporate failures in recent years. There has been a general perception that in many cases of corporate collapse, the audit firm was 'too close' to the audit client, and had failed to detect the warning signs of collapse.

It has therefore been suggested that there should be a regular change in the individuals who perform the audit of a client company. This should prevent the auditor from becoming too familiar with the client and key members of the client's staff as a result of developing a long and 'comfortable' relationship.

There are two different suggestions about how auditor rotation should be achieved.

- **Audit partner rotation.**. The audit firm may remain as auditors of the same client company for an unlimited number of years (or until the company decides to change its auditors). However the 'lead' engagement partner and other key members of the audit team should be 'rotated' regularly.
- **Audit firm rotation**. Alternatively the audit firm itself should remain as auditor of a client company for no longer than a specified maximum number of years, say five years or seven years.

Audit partner rotation has been adopted in most countries. However, audit partner rotation is not visible to the world at large. In contrast, audit firm rotation would provide a public demonstration of auditor independence.

Arguments in favour of audit firm rotation

There are several arguments in favour of the rotation of audit firms.

- In a long-term audit relationship, the auditors may become too close to management of the client company. This may weaken their professional scepticism and independence. They may be more likely to compromise when disagreements with management occur, in order to preserve the relationship – and the audit, and their fees.
- Even if audit firm rotation would not protect the independence of the audit firm, it improves the public **perception** of independence, and so may increase confidence in the quality of external audits.

Arguments against audit firm rotation

However, there are also a number of arguments against the rotation of audit firms.

- There may be negative effects on audit quality and effectiveness in the first years following a change. This is because the new auditors may take several years to familiarise themselves with their new client and its procedures. There is some evidence to suggest that there may be a higher instance of audit failures in the first years following a change of auditors. If this evidence is valid, the connection between company failures and a change of auditors might reflect an inability of the newly-appointed auditor to identify problems in the client company.
- There are also substantial costs from changing auditors regularly, as the auditor attempts to familiarise himself with the new client. More management time is also needed to assist the new auditor to learn about the client company, its operations and its systems.
- There is no evidence that compulsory audit firm rotation has a positive impact on auditor independence and audit quality.
- The market for auditing listed companies is dominated by the 'Big Four' accountancy firms. If this domination of the audit market continues (which is probable), it may be difficult to change auditors easily. The other large firms may not have available resources to take on the audit, or may not be 'independent' because of other non-audit services that they already provide.

The accountancy and auditing profession

- The current structure of the auditing profession
- Incorporation and the problem of auditors' liability

2 The accountancy and auditing profession

2.1 The current structure of the auditing profession

Because of increasing globalisation of companies, the auditing profession now has three tiers:

- the 'Big Four' international firms (Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers (PwC)
- the second tier – smaller firms but still with numerous offices and international resources
- the small firms.

The 'Big Four' came about from mergers and take-overs within the profession. They have the resources, expertise and geographical coverage to be able to audit the largest global entities. However, this level of amalgamation has left little choice for the largest clients and little competition for those firms.

2.2 Incorporation and the problem of auditors' liability

In most countries, accountancy and auditing practices were originally established as sole practitioners or (where permitted by local law) partnerships.

With these business structures (sole practitioner and partnership) the owner or owners have unlimited liability for the liabilities of the practice. This would include liabilities arising from legal claims against the firm for negligent audit work. The owners' personal assets as well as business assets are at risk if the firm itself cannot pay claims against it.

This principle of unlimited liability was intended to promote public confidence in the auditing profession and to encourage auditors to carry out their work with due care.

However, problems began to emerge as businesses grew and the size of claims against auditors increased.

One response to this was the introduction of requirements for practising accountants to carry **professional indemnity insurance**, so that liabilities arising from legal claims against a practitioner or partners can be met through an insurance policy. However the premiums for professional indemnity insurance began to rise as the size of claims increased. This has imposed an increasing financial burden on accountancy firms, particularly on smaller firms.

A more recent development for giving financial protection to accountants has been a movement towards **removing 'unlimited liability' status of auditors**. A number of approaches are available to achieve this. They include the following:

- accountancy practices may be permitted by law to trade as limited liability companies
- accountancy practices may be permitted by law to trade as limited liability partnerships (this is permitted, for example, under UK law)
- statute law may place a maximum limit on the size of legal claims against the auditor
- the auditor may be able to agree with the audit client a maximum limit on legal claims (by the client company), as a formal term in the written contract under which the audit is performed.

Transnational audits

- Definition
- Transnational Audit Committee

3 Transnational audits

3.1 Definition

A transnational audit is an audit of financial statements which are or may be relied upon outside the audited entity's home jurisdiction for the purposes of significant lending, investment or regulatory decisions; this will include audits of all financial statements of companies with listed equities or debt and other public interest companies which attract particular public attention due to their size, products or services provided.

IFAC's Transnational Audit Committee (TAC) gives the following illustrations of transnational audits:

Example 1: US Company raising debt finance in Canada.

This will qualify as a transnational audit as it is reasonable to assume that providers of debt finance in Canada will use the financial statements of the company, prepared and audited by American standards, in making decisions.

Example 2: International charity taking donations through various national branches and making grants around the world.

This will qualify as a transnational audit as it is operating across national boundaries and is public interest (being a charity). There is a reasonable expectation that the financial statements of this charity will be used by someone, perhaps donors, in countries other than the one it is domiciled in.

As companies subject to transnational auditing are generally listed, they will have a large amount of regulation in terms of listing requirements and corporate governance requirements which the auditors must be aware of.

Their listed status may also affect the standards by which their financial statements are prepared and audited, for example, if they are listed on a European stock market, the financial statements will have to be prepared according to international financial reporting standards and audited in accordance with international standards on auditing.

Such audits demonstrate the need for harmonised global standards in accounting and auditing.

3.2 Transnational Audit Committee

TAC is a committee of IFAC. It represents and meets the needs of the Forum of Firms, which are firms which participate in transnational auditing.

Specific responsibilities of the TAC include:

- Identifying audit practice issues. When the issues suggest changes in auditing or assurance standards may be required, recommend to the appropriate IFAC standard setting boards that the issue be reviewed.
- Providing a forum to discuss 'best practices' in areas including quality control, auditing practices, independence, and training and development.
- Proposing members to the IFAC Regulatory Liaison Group and identifying qualified candidates to serve on IFAC standard setting boards.
- Acting as a formal conduit for interaction among transnational firms and international regulators and financial institutions with regard to audit quality, systems of quality control, and transparency of international networks.

Small companies

- An audit is an audit
- Audit exemption for small companies
- The audit of smaller entities

4 Small companies

4.1 An audit is an audit

'An audit is an audit' is a phrase that may be used to argue that the essential features of all audits are the same, regardless of the nature or size of the entity under audit.

There is some truth in this view. For example, all audits are regulated by ISAs, and all audits result in an opinion from the auditor about whether the financial statements give a 'true and fair view'.

However, the **audit process** itself differs significantly between clients, depending on:

- the key characteristics of the client (such as the size of the client and its operations), and
- the audit strategy adopted for that client.

The entity's size is a key feature of an entity that has a significant impact on the audit approach. Smaller entities may require a very different audit approach from large entities.

4.2 Audit exemption for small companies

Many countries do not require 'small' companies to undergo a statutory annual audit. However, the definition of 'small company' varies between countries. For example:

- in the UK legislation currently exempts from audit all companies with annual revenue not exceeding £6.5 million.
- in the US, only companies listed with the SEC are required to have an annual audit.

It is worth noting that small companies which are exempt from the statutory audit requirement may choose voluntarily to have an audit of their financial statements.

There has been much debate surrounding the issue of audit exemption for small entities. You should be aware of the arguments for and against exemption.

Arguments for audit exemption for small entities

There are various arguments in favour of the view that small companies should have an exemption from statutory external audits.

- Audit costs are high: the resources could be spent by smaller entities to obtain more useful financial services.
- Providers of loan finance (for example, banks) will normally attach their own specific conditions to borrowings. These conditions are often independent of the content of the borrower's financial statements.
- Filing deadlines for the accounts of smaller companies are often long after the reporting date. The audited financial statements are therefore often 'out of date' and of limited use, by the time they become available for inspection.
- Many countries allow smaller companies to publish 'abbreviated' financial statements. Consequently only a limited amount of audited information is available to users of the statements.

Arguments against audit exemption

There are also various arguments against the view that small companies should have an exemption from statutory external audits. Some of these arguments emphasise the potential benefits of annual audits.

- If the financial statements have been prepared by a part-qualified accountant, an audit provides some assurance that they provide a true and fair view and do not contain material misstatements.
- The audit is valuable, especially to user groups other than the shareholders (such as trade suppliers, tax authorities), by giving them some reassurance about the financial statements of small entities.
- Shareholders, especially minority shareholders, should be entitled to receive financial statements from the entity that have been independently audited.
- The external audit imposes a level of discipline on companies, in matters relating to accounting and internal control. The auditors can advise management on ways of improving internal control.
- The audit may identify areas where efficiency and cost savings can be made by the entity. These savings would have the effect of reducing the overall cost of the audit.
- If a small company expects to approach its bank in the future to ask for loan finance, the bank may demand to see audited financial statements (for the purpose of assessing the loan application).
- The tax authorities are more likely to accept audited financial statements as a valid basis for computing the company's tax liability.
- If the small company expects to grow, it will become large enough at some time in the future to require a statutory annual audit. If there are material errors in its financial statements, the cost of its first statutory audit could be high.

4.3 The audit of smaller entities

Standard audit practice requires the auditor to gain an understanding of the business and its environment in developing an audit strategy. Applying this principle to the audit of smaller entities will allow the auditor to focus attention on the main features of the client, which will affect the audit approach.

The key issue in deciding the audit approach is likely to be internal control, and the limited nature of the control system.

- Segregation of duties is likely to be weak, due to the restricted numbers of staff employed by smaller entities.
- Owners or senior management are likely to dominate all major aspects of the business activities. This is useful as a form of supervisory control, but the internal controls over management themselves are likely to be very weak and ineffective.
- In an expanding business, senior management may be closely involved in developing the business, leaving them with little time for supervisory controls or for implementing and monitoring other controls.
- Record-keeping and documentation of system and controls may be informal and inadequate. This further weakens the internal control system.

Audit approach to smaller entities

The table below summarises the main additional points for the auditor to consider when dealing with a smaller entity.

Area	Comment
Acceptance of the audit appointment	The auditor should be aware of the possible risks to independence, resulting from: ▪ close involvement with management ▪ pressure by management to reduce the audit fee.
Engagement letter	This formalises the relationship between the auditor and the client. If necessary, it separates the accounts preparation function from the auditing function.
Planning and recording	This process will be similar to the audit engagement for larger entities, but is likely to be simpler. The audit team may be very small so communication and co-ordination should be easier. A brief memorandum prepared at the completion of the previous audit, updated in the current period based on discussion with the owner-manager, may be sufficient as the documented audit strategy for the current audit.
Accounting systems	The accounting systems may not be adequate for audit purposes, and the auditor may not be able to rely on the controls in place. As a result, control risk is likely to be high.

Substantive procedures	Substantive procedures are likely to form the basis of the audit work, if controls are weak. However, it is difficult to reach a conclusion on the **completeness** of accounting records, where the audit is based only on substantive procedures.
Audit evidence	High-quality evidence may be more difficult to find than in a larger entity.
Materiality	A smaller entity's profit before tax may be consistently negligible, as the bulk of any profit may be taken out by the owner-manager as remuneration. A benchmark such as profit before remuneration and tax might therefore be more relevant.
Analytical procedures	Smaller entities may not have interim or monthly financial statements which can be used for analytical review purposes. ISA 315 suggests that the auditor may be able to use an early draft of the entity's year-end financial statements.
Management representations	These are often more important in smaller entities than large entities. However, the auditor must look for evidence to **support** the management representations.
Going concern	A smaller entity may be more able to quickly respond to opportunities, but it may also be more vulnerable to a bank withdrawing support. The continued financial support of the owner-manager may be vital to the survival of the entity and the auditor will need to assess the risk of that support failing.
Audit report	There may be insufficient evidence as to the completeness and accuracy of the records, which may lead to a qualified audit opinion.
Review of financial statements	This is the same as for the audit of any other company, except that smaller entities may be exempt from certain reporting requirements (for example, from the application of certain requirements of International Financial Reporting Standards).

CHAPTER 16

Current issues II

Contents

The impact of social and environmental matters on the statutory audit

- ISA 250: Consideration of laws and regulations in an audit of financial statements
- Other relevant ISAs
- IAPS 1010: The consideration of environmental matters in the audit of financial statements
- Substantive procedures to detect a material misstatement due to environmental matters

1 The impact of social and environmental matters on the statutory audit

1.1 ISA 250: Consideration of laws and regulations in an audit of financial statements

As discussed in a previous chapter, ISA 250 requires the auditor to obtain sufficient appropriate evidence in respect of non-compliance with laws and regulations which might be expected to have a direct effect on material amounts and disclosures in the financial statements. Non-compliance could be over a variety of social or environmental matters such as:

- health and safety legislation
- equal opportunities legislation, or
- anti-pollution legislation.

Social or environmental matters can have a direct impact on the statutory audit. This is because a breach of social or environmental legislation may have a material impact on the financial statements. For example, if an entity is in breach of social or environmental legislation (or other regulations):

- it may need to include a provision for fines or penalties in its financial statements
- it may need to disclose a contingent liability for a possible settlement in a court case, where the entity is facing a civil lawsuit for damages arising from a breach of environmental or social regulations
- it may be required by law to improve working conditions or rates of pay, which will affect labour costs
- it may be necessary to write down the value of certain assets due to impairment.

1.2 Other relevant ISAs

There are some other ISAs that include a reference to social or environmental aspects of the external audit.

ISA 315: Identifying and assessing the risks of material misstatement through understanding the entity and its environment

The auditor should evaluate the environmental risks facing a client entity, and the controls that are in place to manage those risks. ISA 315 therefore requires the auditor to be aware of:

- relevant environmental legislation
- the nature of the production processes used by the entity, and
- the general impact of the entity's activities on its physical environment.

Environmental risks will include:

- contingent liabilities arising from legal claims against the entity, as a result of environmental damage or a breach of environmental protection regulations
- provisions that may be required for restoration costs
- expenditure that may be required to modify or clean the production processes and re-design products, in order to meet environmental regulations.

ISA 330: The auditor's responses to assessed risks

ISA 330 requires the auditor to design audit procedures that take into consideration the environmental risk assessment. Designing suitable audit procedures to assess environmental risk will probably require a high level of professional judgement from the auditor. In particular, judgement may be required as to whether a liability exists, and if so, how it should be measured. As a result:

- the auditors may need to take advice from external experts, and
- written management representations should be obtained about the environmental risks.

ISA 540: Audit of accounting estimates

ISA 540 includes a requirement that the auditor should review the approach taken by management to making estimates that relate to environmental risks.

1.3 IAPS 1010: The consideration of environmental matters in the audit of financial statements

Environmental matters are defined by IAPS 1010 as:

- initiatives to prevent, reduce or repair damage to the environment or to conserve resources
- consequences of violating environmental laws or regulations, and
- consequences of environmental damage.

For many companies, environmental matters are not significant. However, where environmental matters **are** significant there may be a risk of material misstatement in the financial statements. For example, environmental risks may be significant for an oil exploration company, a chemical production company or a provider of energy from nuclear power.

The following examples are given of environmental matters that might affect the financial statements:

- The introduction of new environmental laws and regulations may lead to an **impairment of assets**. For example, new laws may be introduced relating to assets containing dangerous substances such as asbestos. When this happens, entities may be required to recognise the impairment of non-current assets that contain the substance.
- An entity may be guilty of non-compliance with legal requirements concerning environmental matters, such as emissions or waste disposal. In some cases, there may be new environmental legislation with retrospective effect. In all these circumstances, the entity may be required to make **accruals** for remediation work, and for paying compensation or legal costs.
- Some entities incur **environmental obligations** as a direct by-product of their core businesses. This applies, for example, to companies in the extraction industries (oil and gas exploration or mining), chemical manufacturers and waste management companies.
- A **provision** may be required as a result of **constructive obligations** that the entity incurs from a voluntary initiative. For example, an entity may have identified contamination of land. Although under no legal obligation, it may have decided to remedy the contamination (or it may be expected to remedy the contamination, because of its past actions), because of its concern for its long-term reputation and its relationship with the community.
- An entity may need to disclose in the financial statements the existence of a **contingent liability** where the expense relating to environmental matters cannot be reasonably estimated.
- In extreme situations, non-compliance with certain environmental laws and regulations may affect the ability of an entity to continue as a **going concern**. This may affect the disclosures and the basis of preparation of the financial statements.

Risk assessment and internal control

IAPS 1010 states that in order to obtain a general understanding of relevant environmental laws and regulations, the auditor should carry out the following procedures:

- The auditor should use his existing knowledge of the entity's industry and business.
- The auditor should ask the management of the entity questions about the environmental laws and regulations that may be expected to have a fundamental effect on the operations of the entity.
- The auditor should also ask the management of the entity questions about the entity's policies and procedures regarding compliance with relevant environmental laws and regulations. Managers with responsibility for environmental matters should be questioned, as well as senior management.
- The auditor should discuss with management the policies or procedures that the entity has adopted for identifying, evaluating and accounting for litigation claims and assessments.

The auditor may find evidence of a risk of a material misstatement in the financial statements due to environmental matters. For example, evidence of such a risk may be discovered in the following circumstances:

- The auditor might discover the existence of a report about material environmental problems, prepared by environmental experts, internal auditors or environmental auditors.
- The auditor might discover evidence of a violation of environmental laws and regulations, which is mentioned in correspondence with regulatory agencies, or a report issued by a regulatory agency.
- The auditor may find that the name of the entity is included in a public register, or plan, for the restoration of soil contamination.
- There may be reports or comments in the press or other media about the entity and its involvement or responsibility for major environmental problems.
- The auditors may find comments relating to environmental matters made in solicitors' letters to the entity.
- The auditors might suspect environmental risks when they find large or unusual fees charged by environmental consultants, or large payments of penalties as a result of a violation of environmental laws and regulations.

1.4 Substantive procedures to detect a material misstatement due to environmental matters

The external auditors may design substantive tests for detecting a material misstatement in the financial statements due to environmental matters. The substantive tests may consist of the following checks:

- A review of documents such as:
  - minutes of meetings (board meetings, audit committee meetings, environmental committee meetings)
  - industry information
  - media comment
  - environmental reports and audits
  - internal audit reports
  - due diligence reports
  - reports from regulators
  - correspondence with environment agencies
  - correspondence with solicitors.
- The auditors may use an external expert to provide advice (in accordance with ISA 620).
- The auditors may use the work done by the internal audit department to investigate environmental risks and controls within the entity.
- The auditor may make some enquiries about the insurance cover obtained by the entity for its environmental risks.

- The auditors should obtain written representations from management that they have considered the effects of environmental matters on the financial statements, and that:
  - they are not aware of any material liabilities or contingencies arising from environmental matters, including those resulting from illegal or possibly illegal acts
  - they are not aware of environmental matters that may result in a material impairment of assets, or
  - if they are aware of such matters, they have disclosed all the relevant facts to the auditor.
- The auditor should ask about the policies and procedures of management for assessing the need to write-down the carrying amount of assets, in situations where any impairment of assets has occurred due to environmental matters. The auditor should also consider the adequacy of any write down of assets that the entity has made.
- The auditor should ask about the policies and procedures that are used by the entity to help identify liabilities, provisions or contingencies arising from environmental matters.
- The auditor should ask about events or conditions that may give rise to liabilities, provisions or contingencies arising from environmental matters. For example, the auditor should ask whether there have been:
  - violations of environmental laws and regulations
  - penalties arising from violations of environmental laws and regulations, or
  - claims and possible claims for environmental damage.
- If the entity has identified a need for site clean-up costs, restoration costs or penalties arising from non-compliance with environmental laws and regulations, the auditors should enquire about any related legal claims or possible legal claims.
- The auditor should ask whether there is any correspondence from regulatory authorities relating to environmental matters. When such correspondence exists, the auditor should consider whether the correspondence indicates the existence of a liability, provision or contingent liability.
- When property (land or buildings) has been abandoned, purchased, or closed during the period, the auditor should ask about regulatory requirements for cleaning up the site, or about the intentions of the entity with regard to clean-up, future removal of the building and site restoration at the end of the asset's life.
- The auditor should perform analytical procedures and consider, as far as practicable, the relationships between financial information and quantitative environmental information. For example, the auditor might analyse the entity's environmental records and establish whether there is a relationship between raw materials consumed and waste production/emissions.
- The auditor should review and test the process used by management to develop accounting estimates and disclosures relating to environmental matters. A review might consist of obtaining an estimate from an independent expert to corroborate the estimates of management. Alternatively, the auditor might be

able to verify the estimates of management from subsequent events after the reporting period.

- For all liabilities, provisions, or contingencies related to environmental matters, the auditor should consider whether the assumptions underlying the estimates are appropriate, and whether the amount of the liability, provision or contingency is reasonable.
- The auditor should review the adequacy of the disclosures in the financial statements about the effects of environmental matters.

Social and environmental reports and audits

- The significance of social and environmental reporting
- Environmental reports
- Environmental audits
- Social reports and audits
- Audit evidence for social and environmental reports

2 Social and environmental reports and audits

2.1 The significance of social and environmental reporting

Under pressure from public opinion, many entities are now aware of social and environmental issues, and the effect that the entity has on social and environmental matters in the countries where it operates. If it fails to recognise social and environmental problems, and is not seen to be doing something about them, an entity's reputation may be at risk. Reputational risk can have consequences for customer demand for the entity's products. Many members of the public may refuse to buy goods from companies, or invest in the shares of companies, unless those companies have 'healthy' social and environmental policies.

The senior management of some major entities would argue that they show more concern for social and environmental matters than governments.

It has therefore become increasingly important for companies to demonstrate their social and environmental policies, by publishing social and environmental reports, or through their web sites, advertising and media reports.

In most countries, reporting on social and environmental issues is voluntary. However, the EU has recently issued an accounts modernisation directive, requiring quoted companies to publish a business review each year. This review should include information about a range of issues, including social and environmental matters.

Environmental policies

An entity's environmental policies might cover such matters as:

- energy consumption
- pollution
- the use of natural resources and sustainability of the business
- use of re-cycled materials.

Social policies

Social policies might cover such areas as:

- employee rights (for example, rights to trade union membership)
- employee training and development
- human rights
- child labour in developing countries
- equal opportunities
- health and safety matters
- relationship with the local community
- supporting local, national and international good causes.

Many large companies now publish a social and environmental report, sometimes called a sustainability report. The aim of such reports is to demonstrate that the company has a strong social and environmental conscience, and is actively engaged in improving social and environmental conditions.

Credibility can be added to these reports by an **independent verification statement** from a firm of accountants or similar firm of independent external experts.

2.2 Environmental reports

Many larger entities whose activities have an environmental impact now publish an annual environmental report or sustainability report. This may be published as part of the company's annual report. More often, it is published as a separate document.

The contents of environmental reports are not regulated, and although the external auditors may review the reports, they are not included within the scope of the statutory audit opinion. However, some entities engage external 'environmental experts' to review and report on their environmental reports.

An environmental report is seen as an important indicator of the commitment that the entity is giving to its impact on the physical environment and the future of the planet and its peoples.

An environmental report may cover such matters as:

- environmental performance targets and the extent to which they have been achieved (for example, in its 2005 sustainability report, Shell reported on whether it had met targets with respect to oil spills and greenhouse gas emissions)
- relevant environmental regulations imposed on the entity, and the extent to which they are complied with
- compliance with industry standards or other environmental standards
- the entity's policy on 'sustainable development'. Sustainability refers to the ability of the entity to meet the needs of the present generation of customers without adversely affecting future generations. For example, a supplier of timber

may have a policy of re-forestation of large geographical areas, to replace timber that they cut down

2.3 Environmental audits

An environmental audit can be defined as:

'…a management tool, comprising a systematic, objective assessment of how well an entity is performing with the aim of safeguarding the environment by enhancing management control of environmental practices including compliance with appropriate legislation and regulations.'

An environmental audit may be performed by:

- the entity's external auditors, or
- the internal auditors, or
- external environmental experts.

Environmental audits are not subject to the same high level of regulation as financial audits. However, if an environmental audit is performed by professionally qualified accountants, it would be subject to the usual requirements of codes of professional practice for accountants.

Typically, an environmental audit involves an assessment of all impacts of the entity's activities on the environment, including:

- compliance with environmental regulations, for example on pollution of land, water and air
- waste disposal
- recycling policies
- sourcing of raw materials.

The accountant performing an environmental audit will determine the environmental policies that the organisation has in place, and assess the entity's performance based on measurable performance criteria. For example, actual performance measures for pollution might be compared with pre-established targets.

2.4 Social reports and audits

Many entities now publish a 'social report' or social information, often together with an environmental report. These reports may be subject to an audit or review process, by the entity's external auditors, internal auditors or external experts.

An extract from the social report section of Shell's 2005 Sustainability Report gives some indication of the topics that these reports might cover.

Example

Extracts from Shell's 2005 Sustainability Report

Living consistently by the Shell General Business Principles remains an important part of our culture. It requires concerted effort, particularly as the search for more oil and natural gas continues to take us to difficult locations and sensitive countries.

Human rights

We turn our commitment to human rights into action in many ways. One is by providing employees with a safe and healthy workplace, and access to unions, grievance procedures and staff councils. Another is avoiding the use of child labour. A third is taking security measures that do not compromise the rights of the communities in which we operate.

We use independent Country Risk Assessments from a leading international human rights institute to help us understand human rights risks when we enter a new location…. Risk areas are highlighted, such as labour rights of migrant workers or behaviour of security forces. We then develop a set of actions to help us avoid violating rights in these risk areas.

Contractors

Contractors must manage HSE in line with our Health, Safety and Environment standard and are expected to follow our, or equivalent, business principles. In many countries, we work with contractors to help them understand and comply with these requirements. If they cannot, we are required to review the relationship.

In 2005, we cancelled 63 contracts because of such concerns.

Our people

We are committed to preventing incidents – such as spills, fires and accidents – that are a risk to people, the environment and our facilities. All Shell companies, contractors and joint ventures we control are obliged to operate in line with our Health, Safety and Environment (HSE) standard.

It requires them to take a systematic approach to managing their HSE risks. All our major facilities must be certified to the international ISO 14001 environmental standard. Sites must have emergency response plans and test them regularly, so that damage can be minimised in the event of an incident. We investigate serious incidents and near misses so we can learn from them and help prevent similar incidents happening in the future.

Labour rights and child labour

We have made a specific commitment not to exploit children, through direct employment or indirectly through joint ventures, contractors or suppliers. By the end of 2005, Shell companies in nearly 90% of the countries where we operate had procedures to prevent the use of child labour…. Shell companies in nearly 70% of countries where we operate screened their contractors for child labour and nearly two-thirds screened their suppliers, up from less than a third five years ago.

Shell in society: our contribution

Our biggest contribution to society is through our products – the energy and petrochemicals that modern economies need. But our operations can also make a strong, positive contribution to development.

Turning payments to governments into social benefits

In 2005, we paid over $19 billion in corporate taxes and $2 billion in royalties. We collected more than $72 billion in sales taxes and excise duties….

In energy-producing countries, oil and natural gas revenues can bring widespread benefits. Managed well, the money can fund services such as schools and hospitals and diversify the economy. Managed badly, it can stimulate corruption, breed conflict and hurt the country's competitiveness. We encourage and support host governments' efforts to use energy revenues wisely. We enforce our policy of zero tolerance of bribes and facilitation payments….

2.5 Audit evidence for social and environmental reports

In most countries there are currently only limited statutory requirements, or no statutory requirements at all, about social and environmental reporting. For example in the European Union, quoted companies are required to include some information about social and environmental risks in their annual business review, but there are no rules about what these disclosures should contain.

Since companies decide what to include in their social and environmental report, the report may contain very few verifiable numbers and may consist largely of narrative ('words, not numbers').

However some companies have chosen to include quantified performance measurements in their social and environmental report. (Some companies publish 'sustainability reports'. These report figures for financial performance, social performance and environmental performance. Sustainability reports are sometimes referred to as 'triple bottom line reporting', because they present performance reports for each of these three areas.)

When social and environmental reports include quantified performance figures, performance is often reported by comparing actual performance against target for a number of different 'key performance indicators' or KPIs. The KPIs vary according to the nature of the company and its business.

To make these reports more convincing and believable to users, the figures may be audited to verify that they are reliable. In the past a P7 exam question has asked candidates to suggest:

- a number of different KPIs for a social and environmental report and
- suggestions about how an auditor might obtain evidence to verify the reliability of the performance measurements in the report for each KPI.

Example: KPIs

The KPIs and sources of audit evidence in the table below are illustrative only. They provide an indication of the nature of performance measurements for social and environmental issues. The selection of KPIs is a matter of choice for the company itself, and the performance measurements used therefore vary widely. (Remember that social issues include matters relating ot employment and employees as well as matters relating to society as a whole and the 'corporate citizenship' of the company.)

Key performance indicator	Possible source of audit evidence
Social indicators: employees	
% of employees who are women, or from particular ethnic groups or in particular age groups (as evidence of non-discrimination)	Personnel file
Staff turnover ratio	Personnel files
Spending on employee training	Cash book or training account in the main ledger
Absentee levels	Payroll records, records of medical evidence of 'sick leave'
Injuries at work: number or expressed as a% of the work force	Health and safety records
Social indicators: customers and general public	
Customer satisfaction measurements: number of complaints as a % of sales orders	Records in sales administration
Spending on charitable causes, or investment in particular communities	Cash book or relevant expenditure account in the main ledger.
Environmental indicators	
Increase or reduction in consumption of natural resources (water) and energy	Invoices from utility companies
Pollution levels	Official regulatory measurements
% of waste re-cycled	Observation
Investment in environmentally-friendly materials (such as re-cycled paper)	Observation, purchase orders

Q&A

Practice questions

Contents

1 Audit and assurance

(a) Explain the meaning of assurance.

(b) Explain the difference between an audit and a review.

2 Corporate governance

(a) Explain what is meant by corporate governance.

(b) Explain the roles of the following in achieving sound corporate governance.

(i) The directors

(ii) The audit committee

(iii) The external auditors

(iv) The internal auditors

3 Maloney and Co

You are a manager in the audit firm of Maloney and Co. One of the firm's partners has read in the press about the increasing responsibilities placed on professional firms for the detection and reporting of money laundering activities.

He has asked you to prepare a paper for the partners covering the meaning of money laundering, the firm's obligations in respect of money laundering, and the steps that the firm should take in order to meet those obligations.

Required

Set out the points to be included in your paper for the partners.

4 Ethics

The ACCA has an ethical guide, its *Code of Ethics and Conduct*. These rules are applicable to all members and students. If these rules are not complied with disciplinary action may result which could lead to reprimand, fine or exclusion.

Required

(a) Explain why you think the ACCA's fundamental principles are so fundamental to auditing.

(b) Explain how a member can demonstrate that he is truly independent in carrying out the work he performs, and why it is important that he should do so.

(c) Set out the circumstances in which it is permissible to disclose confidential client information.

5 Frame-it

You are a manager in a four partner firm. The directors of Frame-it, a listed company, wish to dismiss their auditors. The directors of Frame-it have approached your firm to act as auditors and have stated that they are prepared to pay $100,000 as an audit fee, plus a bonus of 1% of the profits after taxation.

Frame-it manufactures and retails window frames. The directors have a poor reputation as regards employee welfare and there is a high turnover of employees. The company's business practices have previously been investigated by the authorities but no action was in fact taken against the directors or the company.

Required

Comment on the ethical and other professional issues you would take into account before deciding whether or not your firm should indicate its willingness to accept nomination as auditors of Frame-it.

6 Bloodhound Investigations

Bloodhound Investigations is an entity specialising in conducting investigations for corporate clients. It employs ex-police officers, security consultants, IT and fraud specialists. Bloodhound Investigations has recently parted company with its firm of auditors and has approached your firm to undertake the audit. You have been provided with the following information:

Bloodhound Investigations is a major service provider to your firm, particularly in the provision of IT and fraud consultancy.

Bloodhound Investigations has parted acrimoniously with their previous auditors and are withholding fees, pending the resolution of a number of issues in particular relating to their accusations on the competence of the auditors provided.

Bloodhound Investigations is facing a hostile take-over at present from the Technical Investigations Group, a company you also audit.

Required

(a) Explain the impact of each of the three pieces of information provided above and how these would influence your decision to accept the nomination of auditor for Bloodhound Investigations.

(b) Describe the other factors that you would consider in making a decision as to the acceptance of Bloodhound Investigations as a client.

(c) Describe the steps you would take if you decided to accept the nomination as auditors for Bloodhound Investigations.

7 SeaSun Yachting and Marina

SeaSun Yachting and Marina (SYM) have a marina on the South Coast and a large sales operation dealing in yachts and speedboats. You are responsible for the audit of SYM and have found some potential causes of concern that could indicate fraudulent activity or financial misconduct within the company. In particular:

- 30% of the yachts on sale by SYM are supplied through one of the major international boating companies with a special finance arrangement deal.

However, SYM have also obtained separate finance on these yachts, which are therefore in effect being 'double financed'.

- Ten yachts shown as assets by SYM cannot be located, with no explanation other than that they have not been sold. These yachts together are worth approximately $5 million.
- Long delays have occurred in performing reconciliations with the last four months of reconciliations still not completed. At the time of the last reconciliation, material differences had been identified upon which no action appears to have been undertaken.
- Sales have been overstated by $10 million in the current financial statements.

The finance director has been off sick with stress for the last five months and therefore has not been available to discuss any of the issues identified.

Required

(a) Explain the difference between fraud and error and how the issues shown here could be categorised as fraud or error.

(b) Discuss the role of management and the role of the auditor in the prevention and detection of fraud and error.

(c) Describe what steps you would take to further investigate and then report on the matters referred to above.

8 Palomer Publications

Palomer Publications (Palomer) is a long-established publishing company. In the last two years, it has made significant losses as a result of its investment in technology and in particular, the high-tech environment of e-commerce. This investment and the company's sound future prospects have led to a good Stock Exchange rating since they are generally seen as leading edge in this field, with good preliminary sales and strong feedback on the ease of use and marketability of their web site.

Palomer's investments have been funded through use of their reserves built up over many years. However, two weeks ago, Palomer's shares were suspended, having fallen by 90% on rumours that reserves had been significantly overstated and that they were no longer financially viable. Your firm, as the auditors, has come in for significant criticism and is being accused of negligence. Your firm is also being threatened with legal action in relation to the lack of due care in preparation of the accounts.

Required

Explain the legal position of your firm, the requirements for due care and the steps and procedures the firm could have taken to prevent such a situation occurring.

9 Evans Engineering

Your firm was the auditor of Evans Engineering, a civil engineering contractor, until it was taken over by the Diamond Corporation in October 20X5. The audit opinion on Evans Engineering for the year ended 30th April 20X5 was unmodified, and was signed in August 20X5.

Your firm has recently received a letter from the firm of solicitors which represents both Evans Engineering and the Diamond Corporation. The letter is as follows:

> 'It has come to our clients' attention that an employee of Evans Engineering has been defrauding the company over a period of many years.
>
> Evidence has also emerged that the existence or value of certain assets at 30th April 20X5 may not have been able to be substantiated and that liabilities at that date may have been understated.
>
> Our clients are continuing to investigate the matter and we will advise you in due course if it is decided to commence proceedings against your firm.'

The senior partner of your firm has asked you to review the files on Evans Engineering and to report whether there could be any grounds for a claim against the firm.

Required

(a) Identify to whom your firm could be liable in these circumstances, on what grounds such a liability could arise, and what any plaintiff would have to establish in order for their claim to succeed.

(b) Set out the principal concerns that you would address in your review of the files on Evans Engineering for the senior partner.

10 Quality control documentation

Set out possible examples of documentary evidence which should indicate that the auditor has adhered to ISA 220 *Quality control for an audit of financial statements*.

11 Tower Accountants

You have just joined the partnership of a small firm of Certified Accountants 'Tower Accountants & Partners', and have been asked to prepare a communication brief for distribution to all staff which will then be followed by a presentation with a question and answer session. The communication brief required is regarding quality control procedures and audit working papers.

ISA 220 requires quality control procedures to be implemented at the engagement level, and ISQC 1 requires them to be implemented at the level of the audit firm. The partners are concerned that the firm's quality control procedures may not be satisfactory, as they have never been reviewed since they were first implemented five years ago. In addition, although staff are able to read the policies and procedures in the staff manual, there are currently no other ways in which the information is communicated to them.

Required

(a) Prepare a communication brief for distribution to all staff which sets out:

  (i) why quality control policies and procedures are necessary

  (ii) the areas that should be covered by quality control policies

  (iii) procedures that would be required to ensure that the policies are met.

(b) Answer the following queries which were asked at the question and answer session.

  (i) What is the difference between a hot review and a cold review and why are both necessary?

  (ii) Why is it so important that all audit reasons and justifications are documented in the working papers when it should be obvious from test results what the key issues are?

  (iii) Why do audit working papers have to be standardised; surely this inhibits auditors exercising their skills and experience in the most effective way?

12 Lancaster Leisure

You are the senior audit manager for a medium sized firm of accountants. Your firm has just lost two clients which have gone into receivership and has now been invited to tender for the audit of Lancaster Leisure. The audit fees have been initially estimated at $20,000.

Lancaster Leisure is a medium sized manufacturing organisation which has existed for 45 years and has generally made consistent profits. However, in the last two years, profits have fallen by approximately 10% in each year, although the market sector in which Lancaster Leisure operates is expanding. The company has also stated that they would like some consultancy support regarding business strategy in order to try and reverse the current profit downturn, and have set aside $100,000 for this.

You have ascertained the following from a brief discussion with the managing director:

- There has been no investment in non-current assets in the last 10 years. The company was intending to start a program of investment two years ago but this was cancelled due to the reduced profits, and maintenance and repair costs have increased significantly over the last year.
- Staff wages have been frozen, and there has been some discussion with unions as staff morale is very low and several staff have already left. So far, industrial action has been avoided.
- The financial director was dismissed three months ago, and hasn't been replaced; he is currently suing Lancaster Leisure for unfair dismissal.
- The managing director is due to retire next year; a replacement has not yet been considered.

- There is an outstanding litigation case as an employee is suing Lancaster Leisure due to an accident whilst in the workplace, and the authorities have written a detailed report about the case.

Your firm's total fee income last year was $700,000, including $50,000 from the lost clients.

Required

Prepare a document for discussion with the partners covering the following:

(a) The advantages and disadvantages of tendering for the audit of Lancaster Leisure, highlighting any key risks to your firm.

(b) Although the initial estimate of the audit fee was $20,000, further work needs to be done before a figure could be included in the tender document. List the factors which should be taken into account when calculating this fee.

(c) An outline of the matters which should be included in the tender document if the firm does decide to tender.

13 Audit approaches

(a) Outline the circumstances when it is appropriate to use only a substantive approach in an audit and when a combination of a systems-based approach and substantive procedures should be used.

(b) Explain what is meant by the business risk approach to an audit and describe the advantages and limitations of this approach.

14 Artemis Aviation

You are the manager in charge of the audit of Artemis Aviation, a small airfield which provides fuel, maintenance services, long and short term tie down, hangar facilities and flying tuition in the company's five light aircraft.

Artemis Aviation is a family owned company. The two principal shareholders/directors are mainly involved in flying tuition. Other employees are a part-time bookkeeper, a receptionist, two full-time mechanics and other part-time flying instructors.

Required

(a) Set out the principal control risks for Artemis Aviation and suggest internal controls which would mitigate those risks.

(b) Justify an appropriate audit strategy.

15 Systematic Stores

Your firm has been invited to tender for the audit of Systematic Stores, a chain of twenty stores operating a sophisticated computerised inventory control and re-ordering system. Four other firms have also been invited to tender. As part of the tendering process, you have been asked to produce a written presentation.

Given the complex systems within its business, Systematic Stores is particularly anxious to establish the ability of your audit procedures to deal with the business risks and has asked you to set out as part of your presentation, your approach concerning the following:

(1) Audit risk, and how your procedures would seek to address it to their business.

(2) Materiality, and how this might be applied.

Required

Draft the sections of the written presentation to Sunshine Stores which deal with these two aspects of the audit approach.

16 Top Toys

Top Toys is a prestigious toy retailer trading from a single city centre location. The accounts and administration offices are above the shop. The company is the wholly-owned subsidiary of a major department store chain. Top Toys is headed by its dynamic managing director, John Smith, aged 70.

At John Smith's insistence, your firm, as local to Top Toys, has recently been appointed as the auditor. Top Toys is now the only group company not to be audited by the group auditors.

The following matters have come to light during the preliminary discussions with John Smith and those members of his staff to whom he has allowed you access:

(1) The parent company wishes Top Toys to develop operations in a number of out-of-town shopping centres. John Smith regards this as unacceptable because it would destroy the goodwill and prestige built up over 150 years of quality retailing.

(2) The company has approximately 30,000 lines of inventory. Contrary to group accounting instructions, no physical count is planned for the year end. The company intends to rely on the continuous inventory system which commenced operation in March 20X5.

Two major problems have occurred with the system to date. Firstly, a trainee failed to enter all the inventory lines before the system went live. Secondly, due to a dispute with the software house, there has been no maintenance service for five months.

(1) John Smith has just returned from a toy fair at which he placed an order for 50,000 dolls produced by a little known student co-operative led by his only granddaughter. The chief buyer is said to be fuming over the incident.

(2) In the year to 31st January 20X5, John Smith received a bonus of $200,000, but you were unable to obtain any information in respect of the calculation and authorisation of the bonus. No other director of Top Toys received a bonus in that year and the next highest paid director received a total emoluments package of $30,000.

(3) There is a dispute with a major supplier over the credit facilities offered to Top Toys. The supplier manufactures and supplies 30% of the Top Toys' purchases and claims that Top Toys has continually exceeded its credit period and that its accounting staff are impatient and incompetent.

(4) The company's overdraft limit of $250,000 is due for renegotiation in April 20X6.

Required

Identify the potentially high risk areas of the audit.

17 Red Recruitment

Your firm has recently been appointed auditor of Red Recruitment, a small company set up two years ago by the managing director, Roy Red, who was previously an investment banker. The initial capital was provided equally by Roy and the bank. The bank loan and the current overdraft facility are secured on the company's assets. The overdraft is running just under its limit.

The company places highly qualified personnel in management positions. Roy employs the following staff:

- A senior recruitment consultant, Greta Green.
- Three other recruitment consultants.
- An office manager, Bob Blue.
- A bookkeeper, Paula Pink.

Greta places clients in employment and supervises and trains the other recruitment consultants.

Bob is in charge of all office administration. He raises invoices for fees when Roy instructs him to do so and pays invoices when Roy tells him to. Roy is the sole cheque signatory.

Paula maintains the accounting records on a PC located in the general office. The PC is regularly backed up and copies retained in a drawer under the desk on which the PC stands.

Required

Identify, from the situation outlined above, circumstances that should be taken into account when planning the audit. Explain why these matters should be taken into account.

18 PJ's Powertools

PJ's Powertools is a company which assembles a range of power tools from bought-in components.

Required

(a) For each of the following issues state the enquiries you would make and the procedures you would perform in order to reach a conclusion as to whether the items are fairly stated in the financial statements.

(1) A provision against warranty claims.

(2) The annual depreciation charge on a compressed air system purchased by the company during the year for its assembly department.

(b) Explain why the audit of provisions is a difficult area for the auditor.

19 Ready Removals

Ready Removals is a removals company. In the year ended 31st March 20X7 the company made a trading profit of $80,000. You are the manager in charge of the audit. The following issues have arisen:

(1) A customer is suing the company for $100,000 for damage caused to antique furniture. The company is defending the claim and believes that the furniture was reproduction as opposed to antique and therefore worth only $10,000.

(2) A balance due from Speedy Storage in respect of sub-contract work, of $30,000, has been outstanding for over six months. Your firm has been asked by Ready Removals' accountant not to write to Speedy Storage for direct confirmation of this amount as the latter company objects to such letters. You have been assured by the accountant that the relationship between the two companies is good and that the outstanding balance will be paid.

(3) Ready Removals has recently invested in four new removal vans and is currently carrying out extensive refurbishment of its premises. As a result of this expenditure the company has reached its overdraft limit of $50,000.

Required

For each of the above issues:

(a) state, with reasons, the audit work that you would expect to find in undertaking your review of the audit working papers for the year ended 31st March 20X7

(b) draft the relevant sections dealing with these issues of the management representation letter you would wish the directors to sign.

20 Fine Feathers

Fine Feathers retails women's clothes through a chain of over 30 stores. Each of these stores is located in prime city-centre sites. The company is growing rapidly.

You are the audit manager in the firm that has recently been appointed as auditor to Fine Feathers. The audit partner has asked you to review a number of the company's accounting policies and practices. These are set out below.

(1) The majority of the company's sites are acquired on short leases (typically 10 to 25 years), with rent reviews usually every five years. A premium is usually paid to secure the lease, although this is normally associated with a period of reduced rent. Such premiums are capitalised and amortised over the life of the lease on a straight line basis.

(2) Before a new site can be opened for business it undergoes extensive refurbishment. During the refurbishment period, costs incurred (including rates and services as well as contractors' fees) are debited to a holding account. On completion of the refurbishment, the costs are transferred to short leaseholds.

(3) Fine Feathers is very aware of the importance of image in the retail fashion industry. Following a survey by independent consultants, all the existing shops are to be restyled to project a new image. These costs will be capitalised.

Required

(a) Identify and comment on the accounting and auditing issues raised by the above.

(b) List the further information that you require in order to be able to form an opinion on the above practices.

21 Marvellous Manufacturing

You are the manager in charge of the audit of Marvellous Manufacturing. Your subsequent events review for the year ended 31 March 20X7 has identified the following events, all of which took place after the reporting period:

(1) A third of the sales force was made redundant. Provision has been made in the financial statements for the year ended 31 March 20X7 for redundancy payments of $500,000.

(2) One of Marvellous Manufacturing's largest customers, Rafters Retail, notified its intention to go into liquidation with an outstanding debt of $250,000. The directors consider that the current general provision for bad debts will cover any potential loss.

(3) A writ has been issued against the company by a former sales director who is claiming $120,000 for breach of his service agreement following his dismissal during the year ended 31 March 20X7. No provision has been made in the financial statements for the year ended 31 March 20X7 in respect of this claim.

(4) A fire at the company's warehouse destroyed its entire inventory. The inventories had a book value of $2 million. This loss has not been included in the financial statements for the year ended 31 March 20X7.

Required

State the enquiries you would make and the evidence you would seek in order to reach a conclusion on the accounting treatment of the above in the financial statements for the year ended 31 March 20X7.

22 Wally's Wines

You are the audit manager in charge of the audit of Wally's Wines, a company which imports and distributes wine. In recent years the company has become less profitable due to the large range of wines now carried by supermarkets. The draft financial statements for the year ended 31 March 20X7 show that current liabilities exceed current assets by $200,000.

The company's major source of finance is a bank loan of $500,000 which is due for repayment in full on 31 October this year. The company is currently negotiating with its bankers for a replacement long-term loan of $1 million. They intend to use some of the loan to reposition themselves in the marketplace to establish the superiority of their wines over those sold in supermarkets.

The directors submitted a profit forecast with their loan application and are optimistic that their application will be successful. However, they do not expect negotiations to be completed before the annual general meeting in September. Your firm has been asked not to approach the bank directly.

Required

(a) Set out the audit procedures you would perform in order to establish the status of Wally's Wines as a going concern.

(b) Discuss the alternative audit opinions that might be relevant to the financial statements of Wally's Wines together with the circumstances in which each would be appropriate.

23 The Pepper Group

The Pepper Group is an international business, made up of ten subsidiaries and a head office. You are the manager in charge at the firm undertaking the group audit, but there are separate local auditors for the Cayenne subsidiary in the United States, the Habenaro subsidiary in Mexico and the Hybrid subsidiary in Columbia. You are aware of the following information:

(1) Hybrid is a loss-making subsidiary, with losses at the current year end totalling $2.7 million. There are significant control problems, high levels of bad debts and 25% staff turnover. The local auditors have already stated their intention to give a qualified opinion for the year just ended because of the material issues found.

(2) Cayenne is operating to a different financial year to that of the group as a whole, being October 20X1 rather than December 20X1.

(3) Shortly after the year end, in January 20X2, the Pepper Group announced the sale of Habenaro for $25 million and this disposal is currently underway.

(4) The Pepper Group is guaranteeing loans of approximately $10 million for its subsidiaries.

Required

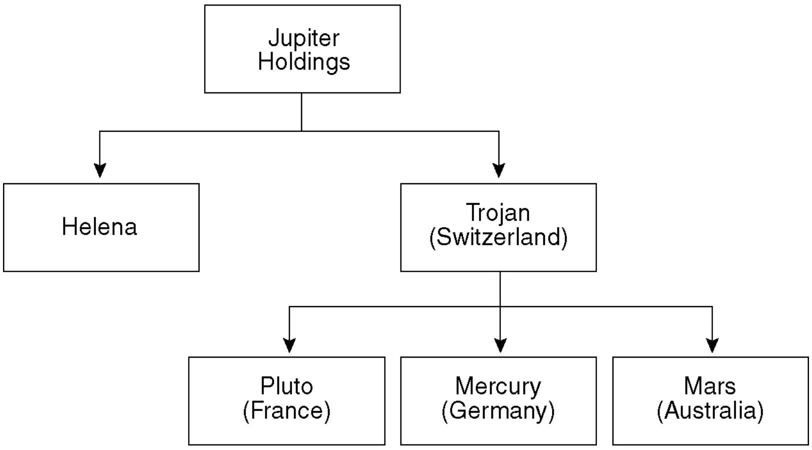
(a) Set out how you would plan and control the group audit of the Pepper Group.

(b) Consider the impact of each of the above issues on the group audit.

(c) Explain the nature of the relationship between your firm and the auditors of the subsidiaries, making particular reference to the extent to which your firm may rely on the component auditors' work and to the considerations involved where joint audits are conducted.

24 Jupiter Holdings

The following diagram shows the structure of the Jupiter Holdings group, a listed company with subsidiaries both locally and overseas. All subsidiaries are wholly-owned. All of Jupiter Holdings' overseas operations are run via Trojan.



During the year ended 31 December 20X4 the board of Jupiter Holdings decided to restructure the group and the following events took place:

(1) Mars was sold on 1 August 20X4 to an Australian competitor, Venus. The consideration was in the form of shares in Venus, such that Trojan now owns 30% of Venus.

(2) Pluto was sold on 30 November 20X4 to Helena. The consideration was $1 million settled in cash.

(3) To stimulate the operations of Helena and Pluto, 26% of the Helena group was sold to Interesting Investments on 1 December 20X4.

You are the audit manager on the Jupiter Holdings audit. In addition to the main group financial statements, Helena is also required by Interesting Investments to prepare group financial statements. Your office audits the Jupiter Holdings group, Helena and Pluto. Your Swiss associate audits Trojan. Mercury (which is not material to the group) is not audited, and Venus and Mars are audited by a small

Australian practice. With the exception of Mercury, all members of the group are material.

Required

Prepare notes for a planning meeting with the engagement partner setting out the significant matters which need to be considered at this stage in respect of:

(a) the Helena audit

(b) the Jupiter Holdings audit.

25 Audit-related services

Explain the key characteristics of the following audit-related services:

(a) A review engagement

(b) Agreed-upon procedures

(c) A compilation engagement

26 Assurance work

'The growth in assurance-type work provides a great money spinning opportunity for audit firms to provide a lower level of assurance, involving less work and reduced engagement risks, compared to the standard audit.'

Required

Discuss this statement.

27 Elleander Designs

You are one of three audit managers working for a medium-sized firm of accountants which has just taken on the audit of Elleander Designs. Elleander Designs retails designer clothes through its two shops located in busy towns 30 kilometres apart.

The clothes sold are very exclusive. They are designed by the company's owner, Mrs Catur, who is also the managing director. 50% of the company's clothes are made to order, with the remainder being produced as inventory for the two shops. Each hand made piece can take up to three months from commencement of design to finishing and can sell for up to $10,000.

Mrs Catur splits her time equally between the two shops. She employs two shop managers, two assistants, and other staff who make up her designs in workrooms above each shop. There are two other directors: Mr Catur, her husband, the finance director, and Ms Craft, her sister, who is the marketing director.

The following is an extract from the financial statements:

	Year ended 30 September 20X2 (draft)	Year ended 30 September 20X1 (actual)
Non-current assets	$	$
Intangible (goodwill)	67,500	75,000
Property, plant and equipment	40,000	45,000
Current assets		
Inventories		
Finished goods	150,000	210,000
Work in progress	45,000	75,000

Note to the draft accounts

There is a legal claim pending. However, the directors consider that it is so unlikely to succeed that no provision has been made for it in the financial statements.

The goodwill figure arose when Elleander Designs, which was originally a partnership, incorporated to become a limited company in July 20X1.

Required

(a) State the evidence you would require from Elleander Designs in order to verify the year end inventories figures and justify your answer.

(b) Briefly describe what audit work you would perform to verify the figure for goodwill in the financial statements.

(c) Explain what is meant by an 'accounting estimate' and describe what work you would perform to verify whether or not the figure for the legal claim pending should be included in the financial statements.

(d) Elleander Designs has approached its bank to discuss raising finance for a new exciting 12 month partnership venture with a major clothes designer. The bank has asked for a five year forecast to be examined and reported on by an accountant. Briefly describe what work you would carry out in connection with the forecast, including the contents of your firm's report.

28 Cranford Communications

Cranford Communications operates via a head office and several branches. The company has a mainframe computer at its head office, which is linked via a communications network to terminals at its branches.

You are a manager at a firm which has been asked to carry out a systems reliability review over the general controls operating in Cranford Communications' computer system. Your initial work has identified the following weaknesses:

(1) There is no physical restriction at every site to the rooms in which the terminals are kept.

(2) Staff can change passwords at their discretion.

(3) In the computer room at the head office there are no fire extinguishers or air conditioning.

(4) There is no formal disaster recover plan.

(5) Back up media is held on site.

Required

Identify the possible consequences of the above weaknesses and suggest recommendations to remedy them, clearly describing how the control procedures should operate.

29 Internal and external audit

(a) Explain the difference between the internal and external audit functions.

(b) List the advantages and disadvantages of a company outsourcing its internal audit function to its external auditors.

30 Holiday Snacks

You are the audit manager in charge of the audit of Holiday Snacks, a company which runs a chain of snack bars operating in a number of seaside holiday resorts. Your firm has been the auditor for a number of years and has always had to substantively test cash sales because of a lack of control over the recording of takings. The audit reports to date have been unmodified.

You have recently been informed that the company has taken on a newly qualified certified accountant as chief internal auditor and an unqualified assistant internal auditor. Since their appointment half way through the year ended 31st December 20X5 the two have spent most of their time carrying out substantive tests on cash sales.

The directors are hopeful that your audit fee this year will decrease because you will be able to rely on the work carried out by the internal auditors.

Required

Explain the issues that will be relevant to your firm in deciding:

(a) whether you can rely on the work performed by the internal auditors

(b) how much reliance to place on that work.

31 Aaron Automotives and Bling Bonnets

You are the manager responsible for the audit of two, unrelated, audit clients. In each case you are currently reviewing the audit working papers and the audit seniors' recommendations for the type of audit report to be issued. Details are as follows:

(1) Aaron Automotives is a subsidiary of Verity Vehicles. Serious going concern problems have been noted during this year's audit. Aaron Automotives will

be unable to trade for the foreseeable future unless it continues to receive financial support from Verity Vehicles. A letter of support has been received and a copy is filed on the current audit file.

The audit senior has suggested that, due to the seriousness of the situation, the audit opinion should be modified.

(2) During the year, Bling Bonnets has made a small loan to one of its directors but this has not been disclosed in the financial statements. Such disclosure is required by local legislation. Your audit report gives an opinion on compliance with such legislation.

The audit senior has suggested that, as the amount involved is small, an unmodified opinion should be issued.

Required

For each client, comment on the suitability or otherwise of the seniors' proposals for the audit reports. Where you disagree, indicate what kind of modification (if any) should be given instead.

32 Gorgeous Goods and Conrads Contracts

Described below are situations which have arisen in two unrelated audits and which are considered material.

(1) Gorgeous Goods

Although you are satisfied that closing inventories this year are fairly stated, the audit report on the previous year's financial statements was modified due to a restriction on the scope of the audit work in respect of the closing inventory figure. This led to a qualified opinion.

(2) Conrads Contracts

The financial statements disclose the fact that a provision may be required to reduce inventories to their net realisable value if a contract with a major customer, representing 60% of the company's revenue, is not renewed. A decision on this by the customer is not expected until after the accounts are due to be signed.

Required

(a) State what is meant by, and explain the relationship between, the concepts of materiality and true and fair.

(b) State, with reasons, the effect on the audit reports of the situations described above.

33 Polar Publishing

You are the manager in charge of the audit of Polar Publishing which publishes a number of specialist monthly magazines. Most readers take out an annual subscription, which can commence in any month of the year. The company's revenue is made up of 40% from sales of magazines and 60% from advertising revenue.

On review of the audit working papers, you have come across the following file note points:

(1) Details of readers and their subscription renewal dates are stored on the computerised database. The client has allowed routine database maintenance work to slip badly behind schedule. At the final audit there is a backlog of new subscriptions and notification of cancelled subscriptions and changes of addresses which have not been input onto the database.

(2) The advertising manager has been under considerable pressure due to staff shortages in the advertising department. In order to sell sufficient advertising space he has been offering a variety of special deals to advertisers. The negotiations all take place over the phone and the manager keeps notes of the conversations in his desk drawer. Towards the year end, the manager was so busy that he had no time to send out the usual confirmation letters. The confirmation letters are used as the basis for allocating advertising space.

Required

Set out, in a manner suitable for inclusion in a report to management, the weaknesses arising from the above, the consequences of those weaknesses and recommendations for improvement.

34 Non-audit services

The current practice of many audit firms offering substantial non-audit services to their audit clients compromises the integrity of the auditing profession and is not in the interests of management.

Required

Discuss the above, indicating whether factors such as client size and listed status would make any difference to your opinion.

35 Auditor's liability

Increasingly, the auditing profession is finding itself on the receiving end of large negligence suits.

Required

Discuss what measures could be taken within individual firms, by the profession as a whole, or by governments to reduce the size or incidence of such claims.

36 The audit of small businesses

There is a view held by some, that small businesses are unauditable by their very nature. However, others would say that because the auditor of a small business is much more closely involved with his client, his knowledge of that client is extensive and he is therefore better placed to audit it, whereas larger audits are much more mechanical.

Required

Discuss.

37 QP Supermarkets

QP Supermarkets (QPS) has 200 stores throughout the country, with around 20 stores in Europe. QPS have been trying to compete with the large out of town supermarkets for the last five years but have recently taken the decision to move into the smaller stores in towns. Their aim is to be specialist in the type of value for money 'quality' products that cannot normally be obtained in local shops. QPS has also moved into sales via the internet. They receive orders through the internet and arrange for the closest local store to distribute the shopping to the customer.

You have been assigned to the audit of QPS this year. You have obtained the following information:

(1) The internet sales service has proved very successful with a 100% increase in sales on last year. However, there have been complaints about the quality of deliveries and that customers are failing to receive all items ordered.

(2) There have been interruptions to the internet sales service caused by the higher than expected levels of sales. There have also been concerns over the confidentiality and security of information accessed via the internet.

(3) Problems have arisen with two of the new sites selected by QPS for expansion.

- In respect of Site A, there has been substantial local opposition accompanied by environmental concerns over potential contamination of the site.
- In respect of Site B, planning permission has not yet been obtained and has been deferred due to an alternative application in the locality by a major competitor. This looks likely to delay planning decisions for a significant period of time.

(4) QPS acquired Lopay Supermarkets last year as part of their business strategy. Initially, the decision was taken to continue to operate Lopay separately and integrate the stores on a phased basis over a two year period. This would involve rebranding Lopay, investing and upgrading stores and ensuring the same quality of staff as QPS. Lopay managers were retained to continue managing stores and to ensure continuity. As the integration has commenced, a number of problems have now become apparent with Lopay operations. These include the following:

- Lopay employees have not been receiving the legal minimum wage.
- No records have been maintained of the number of hours worked by employees, although anecdotal evidence has been received that in some areas they have been regularly working 60 hour weeks.
- There are three ongoing complaints for unfair dismissal.
- Staff retention has been a major difficulty.
- Investigations are underway by the authorities over allegations of false labelling of sales items.
- An investigation is underway over the sale of meat products in one store that appear to have resulted in a local outbreak of food poisoning. The most likely cause for this outbreak is the poor refrigeration and maintenance of the products and sales beyond 'sell by' dates. Some local press comment has already arisen.

Required

Explain the risks facing QP Supermarkets in respect of the above, the controls you would expect to operate in the scenario, the further work you would undertake and the potential impact on the financial statements and the audit.

38 Environmental issues

In recent years, many commentators have been placing increasing emphasis on the importance of the environment. Perhaps as a consequence of this, companies have begun to recognise their environmental responsibilities and environmental issues now often have important implications for companies. Such implications cannot be ignored by company auditors. The profession needs to show an awareness of the possible impact of environmental issues on clients' financial statements.

Required

Discuss.

Q&A

Answers

Contents

1 Audit and assurance

(a) The meaning of assurance

In an assurance engagement an assurance firm is engaged by one party to give an opinion on a piece of information which has been prepared by another party.

The most common example of assurance is the statutory audit. Rather than the shareholders merely accepting the information provided by the financial statements as being sufficiently accurate and reliable, the statutory audit provides assurance as to the quality of that information. This makes the information more reliable and therefore more useful to the user.

Because of the amount of work carried out, a statutory audit will provide a high level of assurance. The level of assurance given by other assurance engagements will depend on various factors.

Examples of 'non-audit' assurance engagements might include reports on such matters as:

- corporate social responsibility
- environmental policy
- employment policies
- non-financial performance indicators.

(b) The difference between an audit and a review

The objective of an audit (as a form of assurance engagement) is to enable the auditor to form an opinion on whether the financial statements of an entity comply in all material respects with an identified financial reporting framework, established by country-specific legislation, and accounting standards (for example, International Financial Reporting Standards).

The audit opinion typically makes reference to whether the financial statements give a 'true and fair view' or 'present fairly'.

Audits are long-established formalised processes, tightly regulated by law and professional practice. Audits were developed because of the separation between ownership (by the shareholders) and stewardship (by the directors) in the corporate form of business organisation. In order to protect the shareholders, an audit is designed to provide a high level of assurance to the user of the financial statements.

A review is an audit-related service as opposed to an audit. Whereas an audit provides a high level of assurance, a review provides a moderate level of assurance that the information under review is free of material misstatement. The resultant opinion is usually expressed in the form of negative assurance i.e. 'nothing has come to our attention to suggest that the information is misstated'.

The higher level of assurance provided by an audit will enhance the credibility provided by the assurance process, but is likely to be more time-consuming (and therefore more costly) than a review.

2 Corporate governance

(a) **The meaning of corporate governance**

Corporate governance is the way in which companies are managed and controlled. In particular, it focuses on the role of directors and their responsibilities to shareholders and other stakeholders.

(b) **Roles in achieving sound corporate governance**

(i) **The directors**

The directors should guide the company strategically, monitor management, and be accountable to the company and its shareholders. In particular, the board of directors should:

- act on a fully informed basis, in good faith, with due diligence and care, and in the best interests of the company and the shareholders
- treat all shareholders fairly
- apply high ethical standards taking into account the interests of stakeholders
- fulfil certain key functions, including:
  - reviewing and guiding corporate strategy, risk policy, annual budgets and business plans; setting performance objectives; monitoring performance; overseeing major capital expenditures, acquisitions and divestments
  - monitoring the effectiveness of the company's governance practices and making changes as needed
  - selecting, compensating, monitoring and replacing key executives and overseeing succession planning
  - aligning key remuneration with the longer term interests of the company and its shareholders
  - ensuring a formal and transparent board nomination and election process
  - monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions
  - ensuring the integrity of the accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards
  - overseeing the process of disclosure and communications.

(ii) **The audit committee**

In many countries the establishment of an audit committee has become a major feature, or even a requirement, of corporate governance regimes.

The audit committee establishes a 'buffer' between the auditors and the executive directors in order to minimise the risk of the auditors coming under undue pressure from the executive members of the board. In this way the audit committee will:

- strengthen the independence of the external auditors
- increase public confidence as to the credibility of the auditing and reporting process
- assist the directors in meeting their responsibilities, including those arising under corporate governance regulations.

(iii) **The external auditors**

It is the directors who are responsible for the preparation of financial statements which comply with the relevant regulation. The external auditors are responsible for reviewing that information and, in some cases, reporting on the extent to which the directors have complied with their responsibilities.

(iv) **The internal auditors**

As was seen above with regard to the role of the directors, it is the directors who are responsible for setting up, implementing and monitoring control systems. Part of their responsibility in this area is often satisfied by the establishment of an effective internal audit function.

3 Maloney and Co

Points to be included in paper for partners re money laundering

- Money laundering can be defined as the process by which criminals attempt to conceal the true origin and ownership of the proceeds of their criminal activities.
- Such activities might include drug trafficking, terrorism, theft, fraud and tax evasion.
- The proceeds of any crime will come within the scope of the regulations if funds are laundered and detected here, irrespective of where in the world the criminal activity took place.
- It is an offence to provide assistance to a criminal to obtain, conceal, retain or invest funds if an individual knows or suspects that such funds are the product of a criminal activity.
- The specific obligations placed on firms include the following:
  - Putting into place systems, controls and procedures to ensure that the firm is not used for money laundering purposes.
  - The appointment of a Money Laundering Reporting Officer (although the responsibility for having appropriate systems in place to prevent and detect money laundering rests collectively with the firm's partners. They cannot claim that the responsibility for compliance with the money laundering regulations rests solely with the nominated individual.)
  - Establishing/enhancing the record keeping systems for all transactions and for verifying the identity of clients.
  - Establishing suspicion reporting procedures within the firm.

- Training and educating staff so that they are fully aware of the extent of their obligations.

- The ACCA's Monitoring Unit will check to see if practitioners have understood their obligations by asking a series of questions at visits.
- In addition to any disciplinary action which may be taken by the ACCA, penalties for not complying with money laundering obligations can render a firm liable to unlimited fines and its partners to possible imprisonment.
- The accountant's normal professional duty of confidentiality to clients is not an adequate defence where money laundering is concerned unless there is a legal privilege (rare).
- In the case of reporting suspicions of money laundering, practitioners will be afforded statutory protection against claims for breach of confidence where reports are made in good faith and to the appropriate authority. This will be so even where suspicions later prove to be groundless.

4 Ethics

(a) **Importance of the fundamental principles of professional conduct**

These principles are considered to be so fundamental because they underpin the way in which ACCA members should act during the course of their professional work, and they specify behaviour expected from members during the course of their work. ACCA is a professional body and has a high reputation which can only be maintained if its members also adhere to the high standards that are set by it.

Furthermore, any individual or organisation who employs the services of an ACCA member should be able to expect a certain level of service from that member. By stating the fundamental principles of professional conduct within their rules of professional conduct, the ACCA are requiring their members to adhere to those standards. If those standards are subsequently breached then disciplinary action followed by a reprimand, fine or exclusion can follow.

These principles are therefore clearly fundamental to auditing as a profession as ACCA members who are acting as auditors have certain responsibilities to their clients and third parties when conducting their work. These principles further demand high standards of conduct from such a person acting as auditor.

(b) **Importance of independence and how it can be demonstrated**

Independence of auditors is a key area within the ACCA rules of professional conduct. It is vital that not only is a member independent but he must be seen to be independent if he is to act as an auditor – his objectivity must be beyond question.

There are a many situations which may give the appearance that a member is not independent. Such situations should be safeguarded against as avoided by the auditor if he is to be seen as truly independent. Examples include:

- Fee income from one client (or group of connected clients) should be less than 15% of the gross practice income (10% for a public company). An audit firm should have procedures in place to ensure that existing clients do not go over this threshold.

- An audit firm should avoid auditing clients where a 'close connection' exists with that client firm as a whole or with an officer or employee of the client. In addition, if an officer or employee is closely connected with a partner or member of staff then audits of that client should be avoided. Also, a person in an audit firm should not be involved in the audit of a client if he has been an officer or employee of that client up to two years previous to the audit.
- An audit firm should not audit a company in which it has a financial interest. Similarly, if a member of staff at the firm has a financial interest then he should not be involved in the audit.
- An audit firm (or anyone closely connected with it) should not, either directly or indirectly, make a loan to or guarantee borrowings by an audit client, or accept a loan from such a client or have borrowings or other obligations guaranteed by such a client.
- Accepting goods, services or hospitality from a client can threaten or appear to threaten independence, and these should be avoided unless clearly insignificant.
- An audit firm may provide other services (such as taxation, consultancy) as well as audit services to a client, and although ACCA does not object to this in principle, it is stressed that the auditor should not participate in executive decisions, or perform management functions. Care should always be taken by any firm which is providing additional services to clients to ensure that it maintains (and shows) its independence. Many of the larger auditing firms do this by having different departments with different staff who work on the different types of work.
- Independence could be put at risk where there is actual or potential litigation between the auditor and his client. It could be difficult for the auditor to report fairly and impartially on the client's financial statements, and the client's management may be unwilling to disclose all relevant information.
- If an audit firm has an associated firm supplying other services e.g. insurance services, management consultancy, then it could be considered to influence the audit firm's actions when auditing a particular firm with a view to obtaining additional work for the associated firm. The audit firm should be aware of this threat to its independence and ensure that the situation is regularly reviewed to maintain objectivity. Factors that need to be considered include the closeness of the association and the degree to which the associate firm wants the audit firm to retain the client.
- If an auditor has to perform a specialist asset valuation for a client then they should ensure that they maintain their independence.
- If a member's view is requested on the appropriateness of an accounting standard he should ensure that he has all the information that is necessary, as the opinion may influence the auditor's judgement. Furthermore, if a member is asked for a second opinion on the accounting treatment of items then he should ensure that he contacts the present auditor to obtain all necessary information and facts.

(c) **Circumstances in which confidential client information may be disclosed**

The general rule is that client information is confidential and may not be disclosed unless the client gives his permission. However, there are some exceptions to this rule.

The auditor may be obliged to disclose client information in the following circumstances:

- Where he is ordered to do so by a court order.
- Where he suspects his client to be undertaking activities such as drug trafficking, terrorism or money laundering.
- If, according to the Banking, Insurance, Insolvency and Financial Services legislation, the auditor considers that the client has been acting recklessly or is not a fit and proper person to be managing a business.
- If the auditor becomes aware of a suspected or actual non-compliance with laws and regulations, which gives rise to a statutory right or duty to report, he should report this to the proper authority immediately.

Even if the auditor is wrong in his suspicions, he will be protected against defamation claims by the client under the legal principle of 'general privilege'. In such cases he would have to prove that his suspicions were justified, and should be able to provide relevant evidence to support his case.

The auditor may *voluntarily disclose* relevant information in order to protect himself in legal proceedings, if authorised by statute, to sue for fees or when he considers it appropriate to report in the public interest in which case the following circumstances should apply:

- He must report to an appropriate authority.
- Members of the public are likely to be affected.
- The matter is serious, and likely to be repeated.

In such circumstances the auditor should also consider:

- the relative size of the amounts involved
- the extent of the likely financial damage
- the client's reasons for being unwilling to disclose the matters to the appropriate authority.

If a member is approached by any authority where prosecution is the main intention, he should act very carefully. He should seek legal advice before disclosing any client information and ascertain whether the authority has sufficient authority for requesting such information.

If the auditor discloses client information recklessly then he will be in breach of his contractual duty of confidentiality and could be sued by the client.

5 Frame-it

Integrity of the client

The reason for the proposed change in auditors should be ascertained via discussion with the directors. It is possible that the reason may prevent acceptance of the nomination (e.g. the existing auditors intend to qualify their opinion and your firm agrees with their view).

The permission of Frame-it must be sought in order to communicate with the existing auditors to assess any reasons for not accepting the nomination. If permission is not granted, the nomination should be declined.

The response of the existing auditors should be carefully considered, especially in the light of the reasons given by the directors. If the reasons differ, this will reflect upon the directors' integrity and, again, the nomination should be declined.

Frame-it's reputation (employee relations, investigation by the authorities and any other adverse opinions) will also impact on the assessment of the directors' integrity.

Auditor independence

Auditor independence should not be in any doubt. For example, there should be no family or personal relationships with key staff at Frame-it, or beneficial shareholdings in Frame-it held by audit staff.

If existing audit clients have any relationships with Frame-it (e.g. competitor, supplier, customer) a conflict of interest could arise. As a small firm (only four partners) appropriate safeguards may not be feasible.

The firm must also be careful not to become unduly dependent on one client. As a listed company, Frame-it's audit fee should not exceed 10% of practice income.

Furthermore, an audit fee based on a percentage of profits would seem to detract from objectivity as it would be in the auditors' interests to allow profits to be overstated. Even if the auditors would not allow this to happen, the acceptance of an appointment with such a bonus would detract from the *appearance* of objectivity.

Practical considerations

Sufficient staff at the right time of year will be required to undertake the audit.

Audit staff must be sufficiently competent to deal with a listed company manufacturer and retailer. If the firm's expertise lies in other market sectors this may not be the case.

If a flat fee is to be accepted, it should be fair and reasonable with regards to the level of staff needed on the audit and time spent by them. If the fee is likely to be insufficient to cover such costs then this may give the appearance to the outside world that a poor quality audit is being performed. The flat fee should also leave the directors in no doubt as to the range of services being offered (i.e. statutory audit only).

Regardless of the integrity of the directors, Frame-it's poor reputation may affect the auditors' reputation and they might therefore not wish to be associated with such a company, as existing and potential clients might be influenced by such adverse publicity.

6 Bloodhound Investigations

(a) **Impact of the three pieces of information**

Major service provider to your firm

Bloodhound Investigations (BI) is therefore potentially an important element of the firm's business. In deciding whether to accept the nomination as BI's auditors, a decision needs to be made as to how this current business relationship could impair objectivity and business judgements.

If BI provided a material level of income to the firm, this could be seen as a clear case in which the independence of the auditor may be in question. However, the situation here is different in that the income is being derived by BI, who is employed by the firm. It is important to understand how close and important this connection is. If the firm is heavily reliant on BI for the provision of such services, that could be said to have an influence in the way that the audit is conducted and must be a factor in deciding on whether or not to accept the appointment.

Acrimonious parting with the previous auditors

It is important to understand the situation relating to this because it will impact on the decision as to whether or not to accept the nomination. The suggestion is that BI was unhappy with the competence of the auditors concerned. However, more detailed evaluation may show that there were underlying problems such as the auditors challenging accounting policies.

Where the previous auditors feel aggrieved by proposed removal, they have a statutory right to make representations to the shareholders.

BI are also withholding fees from the previous firm – this will be a factor in agreeing to take on the appointment, since this suggests an issue over payment for professional services received and may be an indication of other issues relating to recovery of fees.

The firm already represents the Technical Investigations Group (TIG), a company involved in a hostile take-over of BI.

This could give rise to a conflict of interest if the firm were to undertake the audits for both entities. It may also lead to concerns over confidentiality since information relevant to one audit could be identified from the other entity's audit process.

(b) **Other factors to consider in making a decision as to whether to accept BI as a client**

- Whether a partner or anyone closely connected with a partner has a beneficial interest in BI. This may be particularly relevant in view of the existing relationship with BI.
- Whether there are any other factors that together mean that the firm would have undue dependence on BI. This would mean looking at the expected fees from the audit relative to other fee income.
- Practical considerations such as the relative size of the firm and client, expertise required and geographical issues.
- Consideration of any relevant legal requirements.
- Whether the prospective client is one that the firm would wish to deal with. The implication in the question is that since the firm already use BI to provide services it must consider BI to be reputable. However, if BI had a poor reputation and image within the industry, the firm may be less willing to take on the audit.
- Fit with current business, for example, if the firm has chosen to specialise in certain types of audit. The firm already represents TIG which may mean that this is a niche that it is keen to represent.
- The level of risk associated with the client, in particular, the level of potential audit risk. Since BI has parted company from its previous auditors, this may be an indicator of a level of risk to the audit with potential concerns over fee recoverability. The current uncertainty relating to BI (i.e. the takeover bid) may also represent an audit risk.
- There may be opportunities for other services to be provided to BI, particularly since the firm already has an effective business connection.

(c) **Steps to take in accepting nomination**

- Request BI's permission to communicate with the current auditors by way of a professional etiquette letter. This would be to inform the auditors of the firm's nomination as a matter of professional courtesy and to ascertain whether there are any circumstances concerning the change of auditor that might affect the firm's decision. The firm would also need to obtain reasonable handover information from the previous auditors including a trial balance reconciled to the last set of financial statements.
- Send a letter of engagement in accordance with ISA 210. The contents of this letter should already have been agreed with BI and receipt of the letter should be acknowledged by BI.
- Accept the nomination and be appointed by resolution of shareholders or directors.
- Meet with the client to agree the scope of the audit and basis for fees.
- In taking on the client, the firm needs to have established the risks associated with BI and to have confirmed the planning approach and skills required. In accepting the appointment, the firm has taken the decision that the issues raised did not present an insurmountable barrier. The firm therefore has to ensure that mechanisms are in place to avoid conflicts of

interest and breaches of confidentiality in the conduct of audit. This will include ensuring that the same partner and staff are not involved in the audit of the two rival firms (TIG and BI) and that 'Chinese walls' operate between the two areas. Both firms should have been made aware of the potential conflict.

- The firms will also ensure that the auditor relationship did not impact on the consultancy services relationship and, again, that conflicts of interest were avoided, with no undue pressure on the auditors arising from the heavy use of BI services.
- In accepting the appointment the firm should encourage payment of the fees to the previous auditor.

7 SeaSun Yachting and Marina

(a) **Difference between fraud and error and how the given issues could be categorised**

ISA 240 is concerned with the issues of fraud and error. Fraud relates to *intentional* acts that may involve falsification of documents and records, misappropriation of assets or misapplication of accounting policies. Error relates to *unintentional* acts that may result in misapplication of accounting policies, oversights or misinterpretations of fact and clerical errors. Failure to correct an identified material error results in an unintentional act becoming an intentional one. The audit procedures for fraud or error may be the same but fraudulent activity may result in the need to disclose illegal acts to the regulatory authorities.

(1) Double financing of yachts

There may be a significant issue with SYM's procedures resulting from this. The auditor will need to ascertain whether this was an unintentional act caused by poor record keeping or a lack of understanding of the financing arrangements. However, with the amount of money involved, this could be a major fraudulent activity or a mechanism to disguise the seriousness of the company's financial position.

(2) Missing yachts

The missing yachts may be a clear case of deliberate misappropriation of assets and therefore fraud. However, they could also arise from erroneous accounting and asset records and due to the poor arrangements for capturing sales.

(3) Reconciliation differences

These may have arisen through error rather than fraud, but failure to act on such differences could mean that the situation becomes more in the nature of an irregularity.

(4) Overstatement of sales

This could arise from unintentional application of policies or poor records. However, it may also arise from fraudulent activity.

The reasons behind the absence of the financial director need to be considered. His absence could indicate guilt (with the stress being caused by the worry of being caught or the pressure he has been placed under to commit fraud). However, his absence could be unrelated to fraud and these issues could have arisen in his absence as staff struggle to deal with the accounting system and controls.

(b) **Roles in the prevention and detection of fraud and error**

Management is responsible for the prevention and detection of fraud and error through the implementation and operation of effective control systems and accounting policies.

The auditor has no responsibility for the prevention and detection of fraud and error although the annual audit may act as a deterrent.

The auditor's role is to assess the potential for financial misstatement and to establish with management whether there are any factors such as fraud that may result in such a misstatement. To do this requires effective planning and control, assessing risks associated with the company and directing audit attention to the areas of risk. Audit procedures should be designed to obtain reasonable assurance that material errors have not occurred or that where they have occurred they have been corrected or properly disclosed in the financial statements.

(c) **Further steps for investigation**

(1) Double financing of yachts

Clearly, this could have a material effect on the financial statements, since it involves double financing of around 30% of yachts. The auditor will need to perform additional procedures to establish how and why this occurred, and whether it was a one-off intentional situation. These problems should be factored into the risk assessment process and consideration given to the reliability of management evidence. The timing of the problems will be important, in particular, in establishing whether there is a link with the absence of the finance director on sickness leave for the last five months. The full scale and impact of the problem needs to be established and whether this problem leads to a question mark over the company's future viability.

(2) Missing yachts

The level of assets missing is $5 million, which is likely to be material to the financial statements. The auditor will need to carry out further audit procedures and in particular, understand how assets are controlled and whether missing yachts are an isolated occurrence.

The auditor will need to understand whether these are 'missing' because of poor accounting, poor inventory control or fraudulent activity. It may be that the yachts were sold but not correctly reflected in the accounts. It will be important to establish the true facts as far as possible. It will also be important to understand what controls should normally operate to prevent such occurrence, how these controls have been operating (particularly in the absence of the financial director) and the length of time since the problems have occurred. Yachts are large assets – not ones that would be easy to mislay or miscount.

(3) Reconciliations

Reconciliations have not been performed for four months – so may be linked to the finance director going on sick leave. The lack of control over reconciliations including the failure to investigate and address differences that have occurred suggests poor management of risk in the company. The auditor needs to:

- establish responsibilities within SYM for undertaking reconciliations
- ensure that reconciliations are completed and that the full differences are identified
- review whether the other problems identified with inventories and financing are linked to these reconciliation problems
- establish whether the lack of reconciliations provides further evidence of fraud
- fully understand the impact on the financial statements.

(4) Overstatement of sales

Again, the auditor needs to conduct additional audit procedures to understand the impact of this situation. Sales are overstated by $10 million in the current financial statements, which is likely to be material. The auditor needs to:

- confirm when and how this problem has occurred
- ascertain the reasons for the overstatement
- confirm what prior year investigations were undertaken and whether there were any earlier indications
- establish what controls exist over sales and to what extent these are in operation.

Overall impact on the financial statements

For all of the items referred to, the auditor will need to consider the overall impact on the financial statements. The significant nature and size of the problems may impact on the going concern status of the company and added together, may be an indication of lack of control, poor risk management or fraudulent activity. It is important that the auditor discusses the issues with management to keep them informed of his concerns and to ascertain:

- whether they were aware of the problems
- how they have addressed their concerns
- what other issues may have arisen
- the impact of these issues and the likelihood of other risks materialising
- what reports they have received on the management of risk and the operation of internal controls
- how the role of the finance director has been managed since his absence on sick leave

- what explanations have been received for the absence of the finance director and what contact has been maintained in the five months of absence
- whether the absence is linked to fraudulent activity or to stress arising from the control issues that have subsequently been discovered.

8 Palomer Publications

The audit firm has statutory responsibilities under company law including a duty to report on whether financial statements show a 'true and fair view' or 'present fairly' the financial position. If the firm is shown to be negligent in this process, they could be subject to various types of action (civil and/or criminal).

In the specific case of Palomer, the problems relate to investments from reserves and the collapse in share price resulting from the 'rumours' of a lack of reserves and lack of financial viability. The suspension of the Palomer shares allows time to investigate the true position and deal with fact rather than rumour.

During the audit of Palomer, the firm would have considered the going concern basis of the company and would have examined the financial statements for material error. This would include consideration of the level of reserves. Therefore if there are substantiated problems, the firm would have been expected to identify the situation. The audit process should have been carried out with a due level of skill, care and diligence and with regard to the required professional standards. If the firm can demonstrate that the audit was performed in accordance with professional standards, then it will be difficult to demonstrate negligence. However, if the firm had any suspicions of problems with the company's financial position, it should have fully pursued this to establish the facts and, if it has not done so, could be accused of negligence.

The question does not identify the possible source of legal action. There is a possibility of liability in tort, under which a third party could sue the firm for damages. However, such a third party would have to prove that:

- the auditors owe a duty of care to the third party
- that appropriate standards of care have been breached, and
- that the third party has suffered loss as a direct result of this breach of standards.

A duty of care exists where the auditors knew (or reasonably should have foreseen at the time of auditing the financial statements) that those financial statements might be relied on for that particular purpose and that it would be reasonable for such reliance to be placed for that purpose.

To avoid successful allegations of negligence, there are a number of key mechanisms that the auditors of Palomer should have followed:

- Ensure that evidence is available to demonstrate that best practice procedures were being followed, including effective quality control and supervision of work undertaken on the client.

- Effective planning of assignments, including the assignment of staff with the appropriate skills and training, as well as effective direction of resources during the assignment.
- The use of appropriate audit programmes and checklists to ensure appropriate focus and effective documentation and capture of evidence.
- Review of business and audit risks. This may have indicated a longer term viability problem, with both the heavy investment in e-commerce and the reliance on reserves in making this investment being important business risks that should have been managed.
- Regular technical training and updating of all staff and proper briefing.
- Supervision of audit work, including review of working papers.
- Monitoring of quality control procedures.
- Final review of the financial statements.
- Professional indemnity insurance would provide an insurance protection should the company be faced with successful legal action.

9 Evans Engineering

(a) **Potential liability**

To whom

- Evans Engineering – the company with whom there was an audit 'contract'.
- The individual shareholders of Evans Engineering – to whom the audit report is addressed.
- The Diamond Corporation – if the auditors knew that the Diamond Corporation would rely on the 30^{th} April 20X5 financial statements in deciding whether and how much to bid for Evans Engineering.

Grounds for liability

- The firm will be liable under contract law to Evans Engineering if it has been negligent in the standard of work carried out.
- The firm may be liable under the tort of negligence to the shareholders of Evans Engineering or to the Diamond Corporation if the plaintiff can establish the following.

Plaintiff to establish

- **Duty of care owed** – case law would indicate that the auditor is unlikely to be held as owing a duty of care to third parties (the Caparo case), but it is possible in the particular circumstances that a duty would be held to be owed. For example, in the BBH v ADT case, one of the audit partners had verbally confirmed the accuracy of the accounts on which ADT relied to be accurate during a meeting. At this point the firm took on a verbal contract with ADT.

- **Breach of that duty** – the plaintiff would have to show that the auditor did not exercise a reasonable degree of care in carrying out his work.
- **Resultant financial loss suffered** – third parties must show that loss was caused by reliance on the audited financial statements and that it was reasonable to place reliance thereon. The plaintiff must show that they would have taken different action had the financial statements shown the true position.

(b) **Principal concerns in file review**

Planning memorandum – this should set out the audit approach and document the evaluation of risk and materiality levels. There should be evidence of a team briefing.

Review procedures – there should be clear evidence that all files and audit work have been subject to adequate review. All significant/contentious matters scheduled for partner/manager review should have been cleared. All schedules should show evidence of review by more senior persons.

Verification of non-current assets – the extent to which the existence of non-current assets was verified should be evaluated. Particular attention should be paid to the procedures used to inspect assets transferred between sites.

Construction contracts in progress – the degree of reliance placed on the evidence of an expert should have been appropriate. Consideration must have been given to the degree of completion of contracts in progress, to estimates of profits/losses and to the vouching of costs and estimates of expected future costs.

Liabilities – the existence of unrecorded liabilities should have been tested via post statement of financial position review and cut-off tests. Appropriate tests should have been performed to test the adequacy of provisions for warranty work.

Internal control evaluation – the accounting systems and internal controls should have been adequately documented and evaluated. Particular attention should be paid to segregation of duties, the lack of which could have helped the fraud to be perpetrated.

Management letter – this should include all weaknesses identified and a response from management should have been obtained.

Potential adjustments – a summary of all errors discovered and potential adjustments should be on file with a note as to how they were dealt with.

Audit programmes – there should be a completed audit programme for all material areas of the audit on file. Where standardised programmes are used these should have been tailored to a construction company.

Audit administration – records of work done and a comparison to budget and prior years should be on file to show that an appropriate amount of time was devoted to the audit. The degree of supervision of the audit should have been appropriate to the experience and proficiency of the audit staff.

Accounting policies – the accounting policies adopted should have been appropriate to the industry, in particular, with regard to the recognition of revenue and profits.

10 Quality control documentation

Communication of procedures

- Memoranda to all partners and staff.
- Quality control manual.

Appointment/reappointment

- Minutes of a meeting to discuss.
- File note re engagement partner's decision with appropriate justification.

Ethics

- Staff manual containing guidance.
- Annual declarations by staff re share interests in clients, personal relationships with clients etc

Skills and competence

- Documentation of recruitment procedures including job specification, curriculum vitaes, record of interviews etc.
- Existence of technical library.
- Technical circulars and memoranda.
- Record of attendance at professional courses with evidence of review for which courses were attended by which staff at which particular levels.
- Training/CPE records with evidence of review.
- Staff planning schedules with consideration of:
  - exposure to different types of audit
  - mix of staff to give experienced staff the chance to supervise and junior staff the opportunity to learn from their supervisors.

Consultation

- Evidence of a structured approach to file review (e.g. lead schedules signed off by senior, then manager, then partner).
- Letters/memoranda/minutes showing discussion of technical problems or matters of judgement at an appropriate level.

Monitoring

- Records of 'cold' file review by persons independent of audits being reviewed.
- Evidence of consideration of required level of competence of designated reviewers.
- Proof that recommendations for improvement are implemented (e.g. may be noted at the planning stage of a subsequent audit).

11 Tower Accountants

(a) **Communication brief**

To: All employees of Tower Accountants
From: New partner
Date:
Subject: **Quality control**

Please find details below regarding the subject of quality control policies and procedures. I will shortly be arranging a time for a presentation to be followed by a staff question and answer session.

(i) **Why quality control policies and procedures are necessary**

ISA 220 *Quality control for an audit of financial statements* requires that all firms implement quality control policies and procedures at the engagement level. ISQC 1 *Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements* requires all firms to implement quality control policies and at the firm level. It is therefore clear that the audit profession as a whole perceives such policies and procedures to be necessary. The key reasons for this are set out below.

Whenever an audit assignment is performed by a firm there are several risks which they are exposed to such as performing work negligently such that the client or indeed a third party suffers loss as a result. This could have an adverse effect on the audit firm – its reputation could suffer, and therefore both the income from that client and potential clients may be lost due to the loss of one client.

Another risk that could materialise if there were insufficient/inadequate quality control procedures is that an audit report may be unmodified when in fact it should be modified or vice versa e.g. it could be unnecessarily qualified.

Such risks are clearly ones that should be avoided by any firm and therefore proper management of quality control within our firm is vital.

(ii) **Areas that should be covered by quality control policies**

- Professional requirements for all personnel – it should be ensured that all staff adhere to the ACCA's principles of independence, integrity, confidentiality and professional behaviour.
- Skills and competence of all staff – all staff should be either fully qualified or trained for the work that they are performing, and a system should be in place to ensure that knowledge is kept up to date.
- Acceptance and retention of clients – the firm should ensure that it is able to perform the audit i.e. that it has the necessary capacity and skills, would be able to remain independent, and that the client's directors and management are trustworthy and have integrity.

- Assignment of personnel to the audit – appropriate staff must be assigned to each audit i.e. they must have the relevant skills and experience to perform the work.
- Delegation of work to staff undertaking the audit – all work that is delegated must be performed to satisfactory standards and meet quality control criteria. Adequate direction, supervision and review should exist throughout all stages of the audit.
- Consultation – there should be consultation within the firm with other audit managers or partners on subjective audit issues; in addition, where necessary, consultation with external bodies/individuals on specialist issues should also be conducted.
- Monitoring quality control policies – an important part of any quality control system to ensure that such policies stay relevant and are sufficient; an effective and appropriate system should be in place. For audits of listed companies an engagement quality control review must also be carried out by a reviewer independent of that engagement.

(iii) **Procedures required to ensure that quality control policies are met**

An outline of the procedures that would be required within Tower Accountants to ensure that quality control policies are met is detailed below. These will be expanded and refined following discussions within the firm:

- Division of staff – current job titles will be reviewed for all staff to ensure that these are still meaningful and accurate, and properly represent the duties undertaken by each individual. The organisation chart will be updated and copies issued to all staff and included within the staff manual. This will ensure that there are no misunderstandings regarding any individual's reporting lines.
- Training of staff – a training course will be devised to ensure that all staff understand and are familiar with the firm's quality control procedures. These procedures will be documented and will form part of the induction process for all new members of staff. Ongoing training methods will also be devised to ensure that all staff are kept up to date with current issues.
- Ethical requirements – independence requirements should be communicated to all staff and they should be required to notify the firm of any circumstances or relationships that might cause a breach.
- Acceptance and retention of clients – there should be a system in place which ensures that prior to accepting any new client, and when reviewing all existing clients' circumstances, all such relevant factors are considered.
- Working papers – these will be standardised to ensure that all the work that is required for each part of the audit is complete and documented. It should also ensure that work is properly reviewed at the appropriate level at the required stages in the audit.
- Consultation – any issues that arise during the course of the audit which are subjective and/or contentious should be discussed with a

senior member of Tower Accountants, or, where necessary, discussed with an approved specialist outside of the firm.

- Proper/effective recruitment and retention policies and procedures – to ensure that the right personnel are selected for the right job, and that such staff are retained within the firm.
- Monitoring of quality control policies – a monitoring process should be established to check that the quality control system is operating effectively. This should include inspecting, on a cyclical basis, at least one completed engagement for each engagement partner.

(b) **Queries from the question and answer session**

(i) **Difference between a hot review and a cold review**

A **hot review** is a review of working papers that is performed by a more senior member of staff during the course of the audit, and is usually performed soon after the work is completed. The reviewer will indicate that he has performed the review by dating and initialling the piece of work. The review should ensure that the work has been performed in line with the audit programme and that the conclusions are consistent with the results obtained.

A **cold review** is one that is performed at the end of the audit – usually by the audit manager or partner. This will be done before the audit report is signed off and will comprise a review of the whole file together with the financial statements. The purpose of this review is to ensure that the audit work has been fully completed and that the results and conclusions for the entire audit are consistent.

(ii) **Why all audit reasons and justifications need to be documented in the audit working papers**

All audit reasons and justifications need to be documented in the audit working papers because those working papers need to be sufficiently detailed and complete to enable an auditor with no previous experience of the audit to establish what work has been completed and how the conclusions were reached. This would become especially important if the auditors had to give evidence in a court of law regarding the audit. It should also be clear from the documentation in the file that the auditors' conclusions are reasonable.

(iii) **Reasons for standardised audit working papers**

The standardisation of audit working papers ensures that work is performed consistently across audits, and that the evidence that is necessary for each piece of work is always obtained. However, the working papers should not be so rigid that they inhibit the auditors' skills and flair, as these are the factors that make the difference between a good and a bad auditor. Auditors should always be looking for anything unusual when performing their work and if any such issues are identified then they should be put on notice and 'dig deeper'. Any such instances should never be ignored just because such work is not part of the standard programme. Auditors must be flexible in their approach, and use their initiative.

12 Lancaster Leisure

(a) **Advantages and disadvantages of tendering for the audit**

A number of issues require careful consideration before deciding whether or not to tender for the audit.

Advantages

- Increased fees – this would be especially advantageous as the audit firm has recently lost two clients.
- There is the possibility of additional work (i.e. management consultancy) as well as the audit which would significantly increase the firm's overall fee income.

Disadvantages (and risks)

- Lancaster Leisure (Lancaster) is currently experiencing difficulties in respect of sales.
- Lancaster has had staff morale problems which could make the audit more difficult as staff may be unwilling to co-operate with the auditors or may present an unbalanced view of circumstances due to their low morale.
- Lancaster has not invested in non-current assets recently. This has only compounded its current financial problems and will not help in improving the outlook for the future and the company's long term viability, especially taking into account the other mitigating factors such as the retirement of the managing director, staff issues and pending litigation.
- There is a litigation case currently outstanding from an employee regarding an accident in the workplace – the audit firm would have to ensure that this is correctly treated. Furthermore, the finance director is suing Lancaster for unfair dismissal. Both of these litigation cases should put the audit firm on notice that the situation within Lancaster is one which is far from ideal for taking over an audit.
- The audit firm should ascertain what has happened to the previous auditors i.e. did they resign, or were they removed from office – reasons for either of these situations should be ascertained. The previous auditors should be contacted for relevant information.
- Although the audit fee represents increased total fee income for the firm, this, together with the potential amount for the consultancy support, would mean that the total income from Lancaster represented 18.5% of the firm's total fee income. The audit fees on their own represent 3% so clearly this is well within the recommended limit of 15%. However, because of the potential additional income, the audit firm would have to be aware of any independence issues, and take appropriate action.
- A company search should be undertaken to confirm who is involved in the running of Lancaster, and a copy of the filed financial statements should be obtained. Credit references should also be obtained.
- Discussions should be held with management and their lawyers regarding the litigation case, as the outcome of the cases could have a significant impact on the profit for the year.

- If the tender is unsuccessful then all the work involved will have been wasted and this clearly has a cost implication to the audit firm.
- Background information regarding the industry as a whole and for Lancaster specifically should also be obtained to ascertain whether or not expert assistance would be required, and whether the audit firm has the relevant skills and experience to perform the audit.

(b) **Factors to be taken into account when calculating the audit fee for inclusion in the tender document**

- What work will be required to be performed for the audit – this depends on how complex Lancaster's financial affairs are and whether or not the audit firm will be able to rely on the controls in existence. Although the latter will not be known until the audit work is started, the firm may be able to get a feel for this from the initial information obtained. The tender should state this and make allowance for this in the price.
- What the fee is for similar companies audited in respect of size, complexity, degree of risk.
- What the set up costs would be for the audit and then subsequent annual costs. The first audit will obviously take more time due to the systems documentation required.
- The level and number of staff that will need to be involved in the audit.
- The fee charged must be able to be clearly explained and analysed.
- Whether or not the fee can be easily renegotiated at a later date.
- Ensure that the client is clear as to what is included in the audit fee and what would have to be paid for in addition if required.

(c) **An outline of what should be included in the tender document if the audit firm decided to tender**

- The fee and how it has been calculated.
- The nature, purpose and legal requirements of an audit.
- An assessment of Lancaster's requirements for the audit and the management consultancy support.
- Details of how the audit firm will satisfy Lancaster's requirements in respect of the audit and the management consultancy support.
- Any assumptions made by the audit firm in preparing the tender e.g. work to be done by Lancaster's staff.
- The audit methodology/approach to be used for the audit, together with how the management consultancy work would be approached.
- Details of the firm and its personnel who are likely to be used on the audit and for the management consultancy work (organisation charts may also be included).
- The other services that the audit firm can offer in addition to management consultancy.

13 Audit approaches

(a) **Substantive approach versus combined approach**

Substantive approach only

Where internal controls are initially assessed as weak, there is no point in testing them as this will only confirm that control risk is high and that a systems-based approach is therefore not appropriate.

Internal controls will be weak in small organisations where there are too few staff for proper segregation of duties. Also, in a small organisation where the owner-manager operates the system of internal controls, he can easily override controls which he himself has set up. Even where controls exist, there may be no evidence that those controls have been operated.

In addition, for smaller organisations, it is not appropriate to perform tests of controls if it is quicker (and therefore more efficient) to check all (or a substantial proportion of) transactions during the year. Performing tests of controls involves a fixed time (to ascertain and record the systems and evaluate controls as well as testing them) which cannot be recouped in the relatively short time needed to substantively test transactions.

As an extension of a purely substantive approach, a statement of financial position approach may be suited to small companies. In the statement of financial position approach, the auditor concentrates primarily on testing balances as opposed to balances and transactions. It is also an approach suited to companies where assets and liabilities are substantial in relation to transactions (e.g. investment companies). This approach is based on the accounting equation whereby opening net assets plus profit for the year equals closing net assets. The theory is that if opening net assets were correct and closing net assets are also correct then the profit for the year must be correct.

Combination of a systems-based approach and substantive procedures

On larger audits, the auditor will usually seek to place reliance on internal controls as this will allow him to perform reduced substantive procedures. This approach is preferable where audit testing time will be less than that needed for (extensive) substantive testing alone.

Generally a combined approach will result in a more cost-effective audit where there are:

- sufficient staff to allow the operation of an effective system of internal control, and
- a large number of transactions.

To take a wholly substantive approach in this situation would require a large number of transactions to be vouched, whereas testing internal controls produces a lower control risk which requires fewer substantive procedures.

(b) **Business risk approach**

The meaning of the business risk approach

The business risk approach involves the auditor looking at the business as a whole and carrying out an evaluation of the risks to which it may be exposed.

The general approach will be to:

- identify the key business risks
- evaluate their possible impact on the financial statements
- plan the approach to the audit around the key business risks identified.

In order for this approach to work effectively, the auditor must have a good understanding of the client's business and of the environment in which it operates. The auditor is interested in business risk not for its own sake, but in the light of its possible impact on the financial statements.

The business risk approach is sometimes referred to as a 'top down' approach to an audit. The approach starts with the business, which generates the financial transactions. It ends with the financial statements which record the outcome of the business transactions. It is the business which 'drives' the financial statements.

Advantages

- The business risk approach starts at an earlier stage than the conventional audit risk model, based on inherent and control risks. By looking at the nature of the business itself, the auditor should get a more complete picture of the events which may affect the entity's ability to meet its objectives. By doing so the auditor will better understand the inherent and control risks to which the business may be subject.
- It provides a framework for the audit, helping to identify areas where most work should be performed. This will be linked to the auditors' assessment of the materiality of the risk and the likelihood of the risk crystallising.
- The business environment is changing rapidly – a business risk approach keeps the auditor up-to-date.
- Evidence suggests that major audit problems are more likely to result from business related problems than from control weaknesses.
- This approach may allow the auditor to 'add value' by making effective recommendations to improve the performance of the client's business.
- Audit costs may be reduced as a result of the use of less detailed audit testing.
- The approach may benefit the auditor's own business as it indicates the use of a modern approach, which may differentiate the firm's product from that of its competitors.

Limitations

- The approach requires the use of more experienced audit staff, including partners and managers. This may serve to cancel some of the cost savings mentioned above.
- The closer involvement that the approach requires from the auditor may raise questions about auditor independence.

- Some auditors feel uneasy about the 'broad' view taken by the business risk approach.
- The approach may be effective only in the case of audits of larger entities by larger firms.

14 Artemis Aviation

(a) **Principal control risks and internal controls to mitigate**

Fuel

Risks

- Fuel could be lost or misappropriated.
- Fuel could be used without being charged to an external customer.
- Fuel could be stored inadequately leaving the company exposed to breaches of environmental/health and safety regulations.

Controls

- Fuel should be stored in accordance with environmental/health and safety regulations.
- Receipts of fuel should be logged.
- Receipt and issue of fuel should only be made by one of the mechanics.
- Internal issues of fuel (to the flying school) should be authorised, by one of the two directors on a fuel requisition form.
- External issues of fuel should only be made to credit-checked clients, within their credit limits, and should result in a form, signed by the client, acknowledging receipt of that quantity of fuel.
- Regular fuel reconciliations should be carried out agreeing a fuel dip to the record of theoretical fuel. Discrepancies outside a certain range should be investigated.

Maintenance

Risks

- The company's aircraft may not be properly maintained, leading to safety/regulatory risks.
- Parts and mechanics' time may not be properly charged to clients' accounts.
- Parts could be lost/misappropriated.

Controls

- An adequate timesheet system should be operated to ensure that all hours worked are properly authorised, all chargeable hours are properly charged and that mechanics are properly employed on the company's or its clients' aircraft.

- An adequate stores control system should be set up to ensure that parts ordered and issued are authorised, checked on receipt and charged to clients.
- A periodic physical inventory count should be carried out and any discrepancies between book and physical inventory investigated.

Flying school

Risks

- Tuition charged on a credit basis could lead to bad debts.
- Outside instructors could be paid for hours not worked.

Controls

- Tuition should only be offered on a credit basis to credit-checked clients, within their credit limits.
- All other clients should purchase pre-paid vouchers.
- Charges for outside instructors should be authorised to ensure that only tuition provided is paid for and at an agreed rate (e.g. agreed rate × number of hourly lessons taken).

Tie down and hangar services

Risks

- Unauthorised aircraft could be tied down/stored in hangars.
- Charges for authorised aircraft may not be billed.

Controls

- Physical controls over access to hangars/tie down lots with only authorised aircraft allowed access.
- Daily log taken of aircraft stored in hangars/tied down with monthly bills drawn up on this basis.

Regulations

Risks

- If the company does not adhere to local aviation authority regulations (e.g. over safety, fuel storage, flight records, maintenance and testing of aircraft) it could lose its operating licence.

Controls

- The directors should ensure that regulations are followed and monitor any changes in regulations.

(b) **Appropriate audit strategy**

Even with the controls suggested above, Artemis Aviation remains a small family-owned company. As such, it carries the internal risks of domination by individual family members. The risk of misstatement or otherwise depends on the compliance and integrity of those family members.

The company has very few employees amongst whom it can achieve effective segregation of duties. Any computerisation of systems may improve efficiency but controls over such systems in small companies are rarely adequate. Therefore the audit approach is likely to be wholly substitutive.

The auditor will also need to consider the laws and regulations surrounding this business sector. In order to properly assess risk he will need a detailed knowledge of such regulations.

15 Systematic Stores

(1) **Audit risk**

Our firm's audit approach is designed to allow us to form an opinion on the financial statements as efficiently as possible.

The identification of risk of misstatement is the key to this approach since we will direct particular audit attention to areas where we have perceived that misstatements are likely, but will not waste time checking for errors or irregularity where we are satisfied the chance of misstatement is so low as to be immaterial or insignificant.

Risk at the overall entity level

In assessing the possibility of error in the financial statements there are two aspects to be considered.

(a) Inherent (or business) risk

This first aspect involves an assessment of the inherent risk of misstatements attaching to your particular business.

This will be affected by such considerations as the nature of the business, management philosophy, staff numbers and experience, timetables for accounts production, recent trends in results and the current financial position within the retail sector.

We would obviously need to discuss many of these matters with you in more detail before reaching any conclusions. However, our experience of audits in the retail sector will, we believe, be a considerable advantage in interpreting and using the information obtained.

In addition, this inherent risk is affected by the computerised nature of the systems.

Computers process systematically in accordance with the programming instructions. There is, therefore, a reduction in risk of random errors in the day-to-day transactions.

The key risks will be in systems development and the prevention of technical errors and breakdowns in the hardware and software.

Our considerable experience of computer audits allows us to adopt an approach which takes advantage of this fundamental nature of computerised systems, and which uses, rather than ignores, the computer.

(b) *Control risk*

This second aspect involves us assessing the control risk, i.e. the risk that errors are not being prevented or detected and corrected by the company's own systems.

Key factors we would consider here might be as follows:

General computer controls

Clearly, the computerised nature of the systems has a fundamental effect on the audit risk, but may overall reduce the risk dramatically if there are good general controls over the environment within which the computer operates.

In particular, we would be concerned with the following:

- Development controls which ensure that the programs are properly designed, documented and tested before implementation.
- Operational controls which prevent misuse of the system. These would include not only personnel controls such as adequate training, but also software and hardware error protection.
- Continuity controls such as back-up procedures to ensure recovery from a technical breakdown or error without permanent corruption of files.
- Access or file security controls to prevent unauthorised access to or amendment of data or program files.

Management control over branches

In particular we will consider the extent to which budgeting and review systems and the company's own internal analytical review of results would identify significant errors or irregularities in branch figures.

Internal audit

If there is an effective internal audit department it will be possible to place reliance on the work it does to provide evidence as to the accuracy of the records, either by direct testing or by testing of the operation of other detailed internal controls.

Risk at the individual account area level

Again, there are areas we might deem inherently high or low risk simply due to their nature. For example, stock is inherently liable to misstatement due to:

- shoplifting ('shrinkage')
- short shelf lives of perishable goods
- losses arising from any bad press surrounding particular products.

However, we will also consider the particular internal controls, and hence specific control risk, relating to each area. This will involve assessment of both manual controls (user controls) and computer controls (programmed application controls).

Where possible, we will seek to take advantage of the additional controls it will have been possible for you to set up in the computer system, particularly in relation to stock.

(2) **Materiality**

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

Our audit approach plans to allow us to detect material misstatements and we will decide in advance of detailed planning, an approximate materiality threshold (i.e. the threshold below which an error would not be considered material) based on the size of key account areas in the financial statements.

There is obviously a direct link between risk and the materiality of any area. The smaller the area the less likely it can be materially misstated.

Thus we will not direct attention to immaterial areas such as petty cash in the office, unless this is specific work you would like us to carry out as an additional routine.

There will of course be certain areas which despite their small size are particularly important, such as disclosure of directors' transactions.

16 Top Toys

New client

Inherent risk is increased by the lack of cumulative audit knowledge and experience which means that the new auditors are not aware of error incidence in prior years.

It is possible that the group auditors would have been appointed had they been locally represented. In insisting on a local firm, the managing director may well have been asserting his independence from the parent company. He may think he is owed a favour in this respect – which may colour initial relationships with the auditors.

The business

As a prestigious toy retailer, business risk is not unduly high. However, sales will be seasonal and there is a high risk of stock obsolescence when toys are no longer fashionable.

Management

Inherent risk is increased because the financial statements are subject to the dominant influence of John Smith. There may be management bias to overstate results, for example, to:

- justify the parent company's retention of the company
- justify the $200,000 bonus or a repeat of it
- 'empire build' this location and prevent out-of-town development

- increase the purchase consideration if the parent company decides to sell Top Toys.

John Smith is in a position to override controls and abuse his authority. This will lead to high control risk as suggested by:

- his undermining of the buyer's authority in ordering 50,000 dolls
- the lack of information about his bonus
- a lack of compliance with parent company's directives (to develop operations out-of-town and conduct a year end inventory count).

Limitation of scope

John Smith may attempt to dominate the conduct of the audit and seek to limit access to staff and accounting records. There is a risk that some disclosable transactions may not be identified. The known purchase of the 50,000 dolls may be a related party transaction but there may be other such transactions.

Staff

There is a high risk of errors and even irregularities arising due to:

- lack of training and supervision of trainees
- poor morale (as John Smith appears to consistently undermine the authority of others).

Going concern

There may be some doubts about the appropriateness of the going concern assumption. In particular:

- if John Smith retires, he may not be replaced
- proceeding with the out-of-town development may impact on goodwill
- consistently exceeding the major supplier's credit limit may indicate cash flow problems
- if supplies are subsequently withheld, another supplier may not be found
- if the bank does not renew the overdraft, continued trading may depend on the support of the parent company.

Inventories

Specific risks include:

- obsolescence of toys which lose their popularity
- understatement of inventory quantities due to omissions on changeover
- misstatement of inventory quantities due to the lack of system maintenance
- possible overvaluation (e.g. of the 50,000 dolls).

17 Red Recruitment

Circumstance	Why taken into account
This is a new audit appointment.	Inherent risk is increased as there is a lack of cumulative audit knowledge and experience.
The company is relatively new.	The consequent lack of historic financial information will make it difficult to use analytical procedures and margins will be largely irrelevant in this type of business.
The managing director has no experience of this industry.	This will increase inherent risk as the business is less likely to succeed.
The managing director has a vested interest in the success of the business.	There may be bias to overstate results. Expenses may be suppressed (particularly given the way the system operates) and revenue may be recognised before it has been earned.
There is an apparent lack of internal controls.	There is high control risk, particularly as Roy is likely to be more interested in developing the business than developing control systems.
The company is still in its infancy and is only just operating within its overdraft facility.	Again, the risk of business failure is high and the managing director may be motivated to overstate results.
Bob can initiate and execute transactions and has access to documents and assets (e.g. cash) and there is no formal supervision over the accounting function.	The lack of segregation of duties and supervision means that errors by Bob may not be detected, thereby increasing control risk.
Accounting records are maintained on a PC.	The PC environment increases both inherent and control risk. There seem to be no access controls and files may be corrupted by unauthorised access. The lack of general controls could result in a significant accounting breakdown (e.g. in the event of a fire).

18 PJ's Powertools

(a) **Enquiries and procedures**

(1) **Provision against warranty claims**

Enquiries

- What is the company policy in respect of warranty claims (e.g. repair, replacement, credit note, refund) and over what timescale?
- What basis/assumptions have been adopted in order to arrive at the amount provided?
- What changes in the provision have been made compared to the previous year (e.g. to allow for new/discontinued products)?
- Have any mitigating factors been taken into account (e.g. insurance, recourse to suppliers of components)?
- Are repairs carried out in-house or sent away?

Procedures

- Read the terms and conditions on sales invoices to identify circumstances which might make the warranty agreement void (e.g. servicing must be carried out by authorised third parties).
- Review the company's schedule of claims received after the reporting period, identifying those claims rejected.
- Vouch a sample of related labour costs to payroll/time sheet analyses showing the cost of service labour.
- Reperform the company's calculations (e.g. extrapolation of legitimate claims as a percentage of sales).
- Consider management expertise and previous accuracy in respect of determining provisions.
- Review correspondence with customers requesting work to be carried out under warranty or identifying defects.
- Review the terms and conditions of the suppliers of the bought-in components (e.g. counter claims).
- Review consumer reports of the company's products.

(2) **Depreciation charge**

Enquiries

- On what dates was the compressed air system delivered, installed and made operational?
- Was the system installed by the supplier, a sub-contractor, or by PJ's Powertools?
- On what basis have costs other than the purchase price been capitalised?
- What is management's policy for setting, reviewing and revising estimated useful lives/residual values?

Procedures

- Agree purchase price and date to supplier's invoice.
- Physically inspect the asset and observe its operation.
- If the asset replaced a similar system, ascertain the actual useful life of the previous system and any residual value.
- Compare estimated useful life and depreciation method applied (straight line, reducing balance etc) to similar items of equipment used in the assembly process.
- Reperform the calculation of depreciation in accordance with the stated policy.
- Assess management's previous accuracy in estimating the useful lives of assets, e.g. whether any fully depreciated assets are still in use, the amount of profits/losses arising on disposal.

(b) **Why the audit of provisions is a difficult area for the auditor**

By definition, provisions are liabilities of uncertain timing or amount. Auditors are therefore far more likely to have to exercise their professional judgement in assessing the adequacy of a provision.

Provisions may be estimates based on forecast information rather than historic information (e.g. forecast sales returns for a warranty provision) and are therefore subject to a range of possible outcomes.

Auditors may also find that sufficient independent audit evidence may not be available to confirm the need for/amount of a provision. Some reliance is likely to have to be placed on written representations.

In addition, subjective areas such as provisions provide scope for manipulation making them higher risk areas for the auditor. Management may be motivated to understate provisions if:

- their remuneration is linked to profit
- a takeover or sale is pending
- lenders may foreclose on loans.

Conversely, overstated provisions create hidden 'reserves' which can be utilised to increase profits in a bad year.

19 Ready Removals

(a)

Audit work	Reasons
(1) Damages claim	
■ Ask the directors how they propose to treat the claim in the financial statements (and on what grounds).	■ The matter is potentially material – even a claim of just $10,000 represents 12.5 % of trading profit.
■ Inspect the invoice/contract with the customer to ascertain the terms and conditions and whether the antiques collection is identified.	■ The customer's claim may be invalid if they were responsible for insurance or if high-value items should have been specified.
■ Review correspondence with the customer and with solicitors and the accident report/damage record.	■ In order to obtain consistent third party evidence to support internal evidence.
■ Examine Ready Removals' own insurance cover documentation.	■ Ready Removals may have its own insurance cover to cover such claims from customers.
■ Enquire whether the damage was an isolated incident.	■ To ascertain whether there may be other similar claims for which provision is needed.
(2) Bad/doubtful debt	
■ Ask Ready Removals' directors for their views on the recoverability of the debt.	■ The matter is material as full provision would reduce trading profit by 37.5%.
■ Analyse Speedy Storage's account to ascertain whether it is still active and whether any cash has been received.	■ This may highlight specific matters for investigation. If current invoices are being settled, this could indicate that the $30,000 is being disputed or is invalid (and therefore irrecoverable).
■ Select a small sample of transactions and vouch to supporting documentation (e.g. invoices and remittance advices).	■ To ensure that a bona fide debt exists.
■ Inspect Ready Removals' contract with Speedy Storage and the correspondence file.	■ Special credit terms may exist (though these are unlikely to extend to six months). Correspondence may reveal disputed amounts and steps taken to recover them (e.g. warning letters).
■ Conduct a company search on Speedy Storage.	■ To confirm that the company exists and appears solvent. To ascertain whether the two companies are related parties.

■ Review the equivalent balance (if any) in last year's working papers.	■ If Speedy Storage's balance has previously been circularised (without any repercussions), permission to confirm the balance directly with Speedy Storage may be sought from a higher authority (than the financial accountant).

(3) Overdraft limit

■ Ask the directors why they consider Ready Removals to be a going concern.	■ If it is not possible to determine that the going concern presumption is appropriate then there will be an impact on the audit report.
■ Review the current refurbishment programme and related finance arrangements.	■ The going concern presumption may not be appropriate if finance is not forthcoming to finish the refurbishment project (e.g. if the company is unable to trade).
■ Review correspondence with the bank and prospective lenders seeking additional borrowing facilities.	■ The company should take steps to increase its borrowing facilities as long-term investment cannot be sustained on an overdraft facility.
■ Discuss with directors any alternative courses of action to alleviate the cash flow problem.	■ If the recent investment in new removal vans was for outright purchase, sale and leaseback may be arranged to raise funds.

(b) **Letter of representation (extracts)**

(1) No provision is considered necessary in respect of a legal claim by Mr X for damage to reproduction furniture. No amounts are expected to be paid, and no similar claims have been received or are expected to be received.

(2) We confirm our considered view that the company has adequate resources to continue operations for the foreseeable future (i.e. is a going concern). This conclusion has been reached based on forecast expenditure and current and future borrowing arrangements.

Tutorial note

In part (b), the representation for the legal claim assumes that audit work will validate the assertion that the collection is not antique.

Written representations on the debt from Speedy Storage are not appropriate. If sufficient evidence cannot be obtained to confirm the recoverability or otherwise of this debt, the limitation on scope will result in a qualified audit opinion.

20 Fine Feathers

(a) Accounting and auditing issues

(1) Amortisation of lease premiums

Accounting issues

Per IAS 16 *Property, plant and equipment* the depreciable amount of an asset should be allocated on a systematic basis over its useful life.

If the premiums are associated with periods of reduced rent then it may be appropriate to charge all/a greater part of the premium to these periods. The reduced rent charges in the income statement/statement of comprehensive income would then be matched with the increased amortisation charge in those periods.

The depreciable amount of an asset is calculated after deducting its realisable value from its initial cost. If the site is unlikely to be retained for the whole period of the lease then the company will need to consider the realisable value.

Unless the premiums are associated with a period of reduced rent, a straight line basis of amortisation is most likely to be appropriate, matching the lease cost to the period over which it will generate revenue.

If the company decides to sublet the site, impairment reviews under IAS 36 *Impairment of assets* may be necessary towards the end of each lease when rents able to be negotiated are likely to be lower.

Auditing issues

Given the company's continued growth the area will be material.

The terms of each lease are likely to differ, given that they are all in different cities. It may be difficult to assess for each site:

- whether any premium is associated with a period of reduced rent
- whether the site will be held for the whole of the lease term (i.e. whether that site will continue to be profitable/prime), and
- if not, what the realisable value of the lease might be.

It may be necessary to use the work of a property expert.

(2) Refurbishment of new sites

Accounting issues

Per IAS 16 cost comprises purchase price plus any costs directly attributable to bringing the asset to the condition necessary for it to be capable of operating in the manner intended by management.

Consultants' costs, labour and material costs etc would all be likely to meet this definition but rates are non-incremental costs and so should not be capitalised. Service costs (gas and electricity?) might be considered incremental provided they relate to the period of refurbishment but it may be more prudent to write these off.

A depreciation policy needs to be formulated to write off the cost of the refurbishment over its 'useful life'. In order to establish this, a decision will need to be made as to how long the refurbishment will accrue benefits before more refurbishment (e.g. the refit in point (3)) is needed.

Given that this life may not be as long as that of the leases themselves, it would seem appropriate to categorise these costs separately in non-current assets, i.e. not as part of the short leaseholds.

Auditing issues

Again, this area is likely to remain material given the planned expansion.

Although it should be relatively straightforward to vouch the costs included, it will be difficult to assess the 'useful life' of the refurbishments.

However, it does seem likely (especially given the refit described in point (3)) that a facelift will be needed every so many years, making it unlikely that these costs should be amortised over the same period as the leases themselves.

(3) **Image survey/refit**

Accounting issues

Again, there is the problem of whether a clear future economic benefit (i.e. an asset) arises from these costs and if so for how long.

If the independent survey supports increased revenue because of the refit then the costs could be carried forward over the periods expected to benefit from this image.

If future benefits are not 'probable' then the costs should be written off immediately.

Auditing issues

The audit firm will need to consider the materiality of these costs though it seems likely that they will be material this year.

In any case, in the first year of audit, the firm should establish a precedent for such costs for the future.

Even if future benefits are 'probable' it will be very difficult to establish the period which may benefit.

(b) **Further information**

(1) **Amortisation of lease premiums**

- The size of the lease premiums.
- The frequency of such premiums being associated with a period of reduced rent.
- The length of the period of reduced rent.
- Dates of the rent reviews.

- The likely increase in rents.
- The likelihood of the company selling the site before the end of the lease term.
- History of selling sites during the lease term.

(2) **Refurbishment of new sites**

- The frequency of refurbishment after the initial refurbishment.
- Whether future plans include such refurbishments.
- The materiality of the rates/services capitalised.

(3) **Image survey/refit**

- The date and success of the last major refit.
- Frequency and success of similar refits in similar companies.
- A copy of the survey.
- Whether there are documented plans for any more such refits.

21 Marvellous Manufacturing

(1) **Redundancy payments**

Enquiries

- Are additional redundancies likely in the foreseeable future?
- What are the reasons for the redundancies (e.g. reorganisation of operations)?
- Are the redundancies associated with the discontinuance of a business segment?
- When were the directors' plans re the redundancies announced to the workforce/made public?

Evidence

- Client schedule showing the make-up of the provision for agreement to payroll and personnel records.
- Post year end cash book payments to confirm amounts provided.
- Redundancy notices/board minutes to confirm the date on which the decision was made.
- Sales order books to establish the impact on sales levels arising from the redundancies.

(2) **Bad debt**

Enquiries

- What steps are being taken to find new customers to lessen the impact of the loss of Rafters Retail?
- Were any inventories manufactured to order for Rafters Retail?
- Have such goods been separately identified in year end inventories?

- What steps are being taken to recover the debt (e.g. attending meetings arranged by the liquidator)?
- How much of the debt is likely to be recoverable?

Evidence

- Correspondence with the liquidator to establish the likelihood/amount of debt recovery.
- Schedule of inventory provision to establish if any provision was made against goods manufactured to order for Rafters Retail.
- Insurance policy documents (if insured for such losses).
- The make-up of the current balance (i.e. year end balance and/or post year end transactions).

(3) **Claim by former sales director**

Enquiries

- Why was the director dismissed?
- What is the nature of the alleged breach?
- What are the company's intentions? (e.g. out of court settlement)

Evidence

- The service agreement, in order to establish whether the director's action is in accordance with its terms.
- Legal correspondence/board minutes to assess the most likely course of action/outcome and the amounts involved.
- The director's personnel records including dismissal notice etc.
- Post year end cash book payments to the former director.

(4) **Fire destroying inventories**

Enquiries

- To what extent have inventories been replaced since the fire?
- To what extent were manufacturing processes disrupted by the loss of raw materials inventories?
- Have orders/customer goodwill been lost due to delays in despatching goods to customers?
- What was the cause of the fire?

Evidence

- Insurance policy, to establish extent to which the loss of inventories (and any consequential loss) is recoverable.
- Correspondence with insurers to ascertain whether claim will be settled in full.
- Sales order books to establish any significant loss in customer goodwill.

- Cash book payments to suppliers for 'emergency' purchases of raw materials.

22 Wally's Wines

(a) **Audit procedures**

Re profit forecast

- Check the validity of the assumptions on which it was based.
- Check that accounting policies used are valid in the circumstances and consistent with the company's usual policies.
- Check the calculations.
- Consider the likelihood of the forecast being achieved, i.e. the likely success of the repositioning.
- Consider whether Wally's Wines has the marketing/selling expertise to achieve this or, if not, whether they are planning to buy such expertise in.
- Check that the costs of the above have been built into the forecast.
- Check that future interest charges on the new borrowings have been built into the forecast.
- Consider the accuracy of any previous forecasts.
- Consider the reliability of any external advice taken.

Re cash flow projection for the year to 31st March 20X8

- Ensure that after settling liabilities the new loan will be sufficient.
- Ensure all cash requirements have been taken into account.
- Compare the cash flow forecast for the first month(s) with actual results to assess accuracy.

Other

- Consider the likelihood of obtaining the new loan, including any indications given by the bank to date and any interim correspondence.
- Ask the directors whether there are any alternative sources of finance which may be available if the bank does not grant the loan. If there is, obtain confirmation from the likely source that this would be available.
- Inform the directors that unless your firm is satisfied that the required finance can be obtained, you will modify your audit opinion – therefore some confirmation from the bank (or other lender) must be obtained.
- Consider whether even if the bank will not get a new loan it might extend the existing loan.
- Discuss with the directors whether the annual general meeting (and therefore the signing of the audit report) could be postponed until the bank has made their decision.
- Consider the position of the company if new finance is not obtained. Could the company sell surplus non-current assets? Is the existing loan secured

over any of the company's assets or by personal guarantees of the directors?

- Consider seeking advice from an insolvency practitioner.
- Consider the company's previous experience and success in renewing finance.
- Review board minutes.

(b) **Alternative audit opinions**

Unmodified opinion

If the audit firm can satisfy itself that the going concern assumption is appropriate.

Modified report with an emphasis of matter paragraph

Where the going concern assumption is appropriate but a material uncertainty exists *and* the financial statements:

- adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with those events or conditions , and
- disclose clearly that there is a material uncertainty related to those events or conditions.

Qualified or adverse opinion

Where there is not adequate disclosure of the above then the audit firm should express a qualified or adverse opinion on the grounds of a material misstatement (in respect of disclosure).

Where the going concern assumption is inappropriate

Where the going concern assumption is inappropriate, the audit firm should express:

- an **adverse opinion** if the financial statements have been prepared on a going concern basis
- an **unmodified opinion** if the financial statements have been prepared on an alternative acceptable basis (e.g. break-up basis) and there is adequate disclosure of this basis. An emphasis of matter paragraph may be required.

23 The Pepper Group

(a) **Approach to planning and controlling the group audit**

Planning

- Obtain the instructions issued by head office for the preparation of the group's financial statements.
- Obtain the timetable for the production of the individual financial statements and the group financial statements.
- Ensure that there is a standard format and layout of subsidiary financial statements to facilitate consolidation.

- Consider audit staffing and skills required.
- Liaise with component auditors of subsidiaries.
- Consider potential problems that may arise, for example with Hybrid.
- Consider the risks arising from the group relative to the subsidiaries.
- Consider any additional procedures that may be required for subsidiaries being audited by component auditors.
- Consider whether materiality levels are acceptable.
- Use questionnaires for the subsidiaries to establish accounting policies, accounting details needed for consolidation but not available from the accounts and information relevant for group accounts but not for subsidiaries' own accounts.

Controlling

The group audit will be subject to the same control and quality checks as any other audit, including maintenance of documented files with auditors' decisions documented, file review, supervision and discussion with management. Effective planning, allocation of staff and review procedures for group audits are all important elements of control.

(b) **Impact of each issue on the group audit**

(1) **Hybrid**

If Hybrid continues to make losses, the directors of Pepper may consider there to have been an impairment in the value of the holding company's investments. If that is the case, the auditor will need to confirm that any write-down is adequate by examining:

- the extent of support to Hybrid by Pepper/what element of the $10 million guarantees relates to Hybrid
- Hybrid's cash flow projections
- the extent of disclosure of guarantees in Pepper's financial statements.

There are clearly material problems for the subsidiary itself but consideration needs to be made as to whether these issues are also material to the group as a whole and whether the subsidiary control problems are symptomatic of a wider problem.

If the issues are material to the group, then the impact on the audit report will need to be considered.

(2) **Cayenne**

Cayenne's year-end precedes that of the group by two months and therefore figures used for this subsidiary will either be estimated or out-of date in the group financial statements.

IAS 27 *Consolidated and separate financial statements* requires the consolidated financial statements to be prepared as at the same reporting date. Therefore, Cayenne should be made to prepare additional financial statements as at the group year end – unless it is impracticable to do so.

If it is impracticable, provided the difference is no more than three months (as is the case here), the October 20X1 financial statements may be used provided adjustments are made for any significant transactions or events occurring in November and December. The auditor will need to consider whether any such adjustments need to be and have been made.

(3) **Habenaro**

As the announcement was not made until after the year end, this is a non-adjusting subsequent event that will have a significant impact on the group statement of financial position. The auditor will need to ensure adequate disclosure in the financial statements.

(4) **Guarantees**

These loans are an important liability for Pepper Group and the auditor will need to ensure that there is appropriate disclosure in the financial statements.

(c) **Relationship with component auditors**

The group auditor has overall responsibility for expressing an opinion on the group financial statements and therefore needs to confirm that he is satisfied with the work undertaken by the subsidiary auditors (referred to by ISA 600 as ' component auditors' where they are not also the group auditor).

In reviewing the work of the component auditors, the group auditor needs to confirm the following:

- That all significant risks of material misstatement of the group financial statements have been addressed in the audit of the components.
- Whether there are any reasons why he cannot rely on the work of the component auditors (for example, a lack of competence, independence, or local regulation of auditors).
- The materiality of the issues raised in the component financial statements in relation to the group materiality level (in particular Hybrid, which seems to be of most significant concern).

If a joint audit is to be undertaken, then it is important that the scope and responsibilities are agreed and documented. This will involve a preliminary meeting to agree approach, timing, staffing, responsibilities and working papers.

24 Jupiter Holdings

Planning notes: year ended 31st December 20X4

(a) **The Helena audit**

- Engagement letter for Helena will need revising now that group financial statements are to be prepared.
- In respect of the acquisition of Pluto from Trojan.
  - Method of finance used to raise the $1 million and any impact thereof.

  - Whether special accounts were prepared at 30th November 20X4. If so, these may be of use for the audit.
  - Whether a fair value exercise was carried out.
  - Check that Helena is applying the Jupiter group accounting policies re goodwill, foreign exchange etc.
- The timetable for the Helena audit and consolidation needs to be linked into the Jupiter consolidation/audit.
- Consider the level of assistance/information required by the auditors of Interesting Investments (Helena may be classified as an associate of Interesting Investments).
- The results of Pluto need to be consolidated by Helena from 30th November 20X4 and disclosed appropriately in the Helena group income statement/statement of comprehensive income.
- Discussion of the effect on group structure and operations of Interesting Investments taking a non-controlling interest in Helena.

(b) **The Jupiter Holdings audit**

General

- Agreement of year-end timetable with client.
- Given the various events during the year, discussions need to be held with the board of the reasons behind each change, as there may be further (going concern?) implications for the group.
- This year's audit is likely to be higher risk than last year's. We need to assess the implications for audit approach/staffing.
- Ensure usual information re intra-group trading/balances is available in order to eliminate on consolidation.
- Everything that follows suggests that the work will need to be budgeted very carefully. A fee increase would seem likely to be necessary.

Helena

- Authorisation of disposal of shares by shareholders of Jupiter.
- Correct calculation of any profit/loss on disposal.
- Disclosure of that profit/loss.
- Correct calculation of non-controlling interests.

Trojan

- Contact Swiss office re audit approach/deadlines.
- Confirm Swiss office still following firm's world-wide audit/ethical standards.
- Require usual proforma accounts for consolidation.
- Correct calculation of any profit/loss on disposal of Pluto.
- Any profit/loss on sale of Pluto will need to be eliminated on consolidation.
- Enquire re use of cash from sale of Pluto by Trojan.

- Consider what involvement we need in the work performed by the Swiss office. As a minimum:
  - prepare a letter of instruction and organise a review of the Swiss office's report of work performed
  - discuss the business activities of Trojan that are significant to the group
  - discuss the risk of material misstatement of Trojan's financial statements with the Swiss office, and
  - review the Swiss office's documentation of identified significant risks of misstatement.

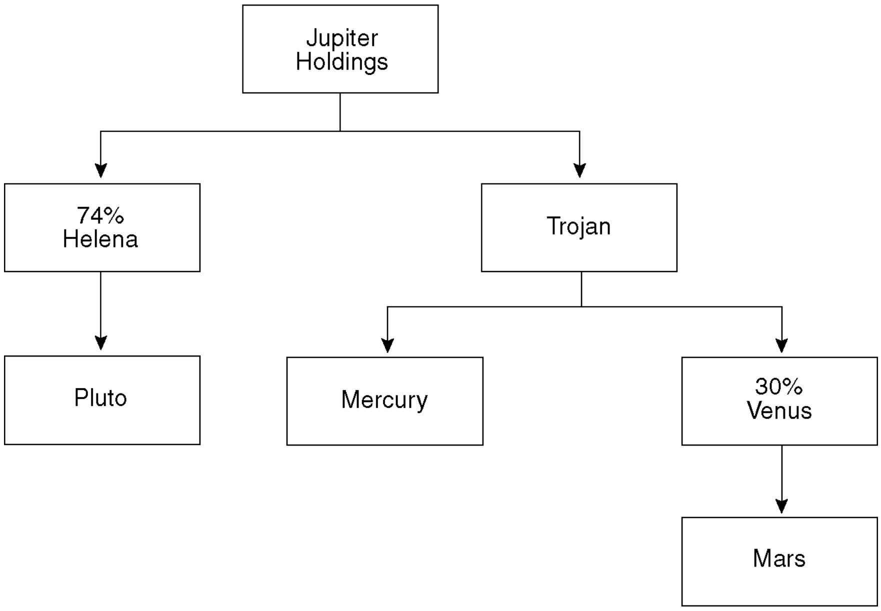
Mercury

- Although Mercury has not previously been material, we need to confirm this is still the case.
- In any case we should encourage the board to appoint auditors.
- If a firm other than our associate is appointed, and we decide we need to be involved in the audit, as a minimum, prepare a letter of instruction and organise a review of the auditor's report of work performed.

Venus and Mars

- Need to establish the degree of influence that Trojan can exert over the Venus group. If significant the group will need to equity account for the Venus group from 1st August.
- The results of Mars will need to be consolidated up until 1st August and may need to be classified as discontinued, together with any profit/loss on disposal.
- We will need to be satisfied that the work of the (small) Australian firm can be relied upon. Assuming that it can be, then, as a minimum, perform the work listed under Trojan above. If further audit procedures are considered necessary, decide whether that work can be carried out by the Australian firm or should be carried out by ourselves.
- If their work cannot be relied upon consider what procedures we need to perform ourselves in order to obtain sufficient appropriate evidence and reach an opinion on the group financial statements.

Working



25 Audit-related services

(a) **A review engagement**

In a review engagement the accountant is engaged to review *but not audit* financial or other information.

The work performed is less detailed than for an audit. As a result, the level of assurance provided is seen to be moderate as opposed to the high assurance given by an audit.

A review engagement could be:

- an attestation engagement, or
- a direct reporting engagement.

In an attestation engagement, an accountant might be engaged to attest to (vouch for) the fact that certain procedures within an entity have been performed. He will not comment on the quality of the procedures, merely that they have been performed.

In a direct reporting engagement, an accountant will carry out an independent examination of financial or other information prepared by his client for use by a third party. The resultant special report will be on some aspect of his client's affairs and will usually provide negative assurance.

One of the most common forms of direct reporting engagement is 'due diligence' work.

In the context of mergers and takeovers, Entity X, taking over Entity Y, is likely to require a due diligence report into the valuation of the assets and liabilities of Entity Y.

(b) **Agreed-upon procedures**

In an agreed-upon procedures engagement, the client, as opposed to the accountant, determines the procedures to be followed.

The accountant provides a report on factual findings from the procedures performed. No assurance is provided.

It is left to the user to assess the procedures and findings and to draw their own conclusions.

(c) **A compilation engagement**

In a compilation engagement the accountant is engaged to prepare (but not review or audit) financial statements or other information. A typical example is the preparation of financial statements for a sole trader or a club.

The accountant is engaged for his accounting, not auditing, expertise. No assurance is provided. The work normally involves the collection and summarising of information.

A 'compilation report' may be issued at the end of the assignment.

26 Assurance work

Introduction

The statement makes a number of assumptions with regard to assurance type engagements compared to the standard audit process, which are that such assignments:

- are financially lucrative
- involve less risk
- involve less work
- provide a lower level of assurance

Assurance engagements may be for a number of different purposes, involve different approaches, attract flexible levels of fees and provide varied levels of assurance.

To fully discuss the statement, it is important to look at the objective and types of assurance engagement, then the levels of risk, type of work and types of assurance provided.

Objective and types of assurance engagement

The objective of an assurance engagement is to evaluate or measure a subject matter that is the responsibility of another party against identified suitable criteria, and to express a conclusion that provides the intended user with a level of assurance about the subject matter. Assurance engagements involve a third party relationship, where the service may provide assurance to an intended user about a subject matter that is the responsibility of another party. The key elements of the service relate to the subject matter, suitable criteria, an engagement process and a conclusion and report.

Types of assurance engagements include: performance measurement; internal controls, risks, systems reliability, e-commerce, social matters, environmental issues and corporate governance and compliance. Following an assurance engagement process and producing a report at the end can lead to increased credibility. The assurance report may involve a report that expresses a conclusion on the assertion by the responsible party on the subject matter.

Comparison to an audit – less work and a lower level of assurance?

An assurance engagement may involve the same challenges as for an audit in that concerns may arise which could impact on the conclusions drawn. For example, identified criteria might not be met, an inappropriate assertion may have been made, evidence may not be sufficient. In this case, a reservation of conclusion (disagreement) or a denial of conclusion (limitation on scope) may be expressed and the report must include all significant facts and reasons supporting the conclusions. As with any engagement, the firm must give consideration to the significance and materiality of its findings.

A traditional audit service involves conducting an audit and providing a report as to whether the financial statements provide a true and fair view and that accounting standards have been complied with. This is a long established practice, with published professional standards and outputs that are generally seen as credible and reliable by clients and users of reports provided. An audit may provide a high (but not absolute) level of assurance and result in a report providing a positive assurance on assertions.

Different levels of assurance can be provided for other assurance engagements, ranging from a high level of assurance to a very low level. Usually, a non-audit assurance engagement provides a high or moderate level as follows:

- A high level of assurance refers to the firm having obtained sufficient, appropriate evidence to conclude that the subject matter conforms to identified suitable criteria in all material respects.
- A moderate level of assurance is provided when sufficient, appropriate evidence is obtained to be satisfied that the subject matter is plausible in the circumstances.

An absolute level of assurance cannot be provided because of the nature of any assurance engagement. The subject matter is not necessarily clear cut, the nature, timing and extent of procedures may be limited, there may be difficulties in establishing sufficient evidence and the types of approach and testing procedures used vary from the standard audit approach.

A high level of assurance can only be given if the subject matter is the responsibility of another party, is identifiable and can be subject to evidence procedures and there are suitable criteria against which a conclusion can be expressed.

Guidance on and difficulties of assurance engagements – less risk?

There are fewer published standards on assurance engagements although International Standard on Assurance Engagements 3000 establishes the basic principles and essential procedures for the performance of engagements intended to provide a high level of assurance.

It is often difficult to identify appropriate criteria for measurement of assurance assignments. This involves engagement risk when inappropriate criteria are selected. Engagement risk also arises where inappropriate conclusions are being drawn, or from loss arising from litigation or adverse publicity.

Assurance services can be provided in a number of emerging areas, for example e-commerce, which may be risky by nature both to the company and the firm. If assurance is linked to a key strategic platform of the company, this can involve a high degree of risk to the firm, with pressure on providing staff with the appropriate skills, knowledge and expertise to perform the assignment effectively and draw out the necessary recommendations and conclusions.

A money spinning opportunity?

Fee income will vary depending on the nature, scope and length of time involved on the assignment. An assurance engagement may involve greater technical skills and experience (e.g. IT, e-commerce and project skills) that will add to the cost to the firm and fee income. However, such skills are difficult to acquire and maintain, impacting on the cost to the firm in retaining and using such skills.

Conclusion

All audit work involves a professional commitment and obligation, whether an assurance or audit-type engagement. Levels of assurance, extent of activity, fees and engagement risk will all vary depending on the size and nature of the work undertaken.

27 Elleander Designs

(a) **Year-end inventories**

As the inventories figures are a material item and their valuation will clearly have a direct effect on reported profits the testing of year end inventories needs to be extensive. The year end valuation is clearly subjective as there is no certainty that the figures at which the items are valued will be realised. In the fashion industry, tastes change frequently, therefore the items that are made for inventories rather than to order are clearly high risk valuations.

The following audit procedures should be carried out:

- Ensure that inventories are valued at the lower of cost and net realisable value.
- Vouch costs to costing records.
- Vouch raw materials and labour costs to invoices and time sheet/labour rates.
- Consider to what extent design costs and overheads are included in inventories and whether this is reasonable.

- Where inventories are carried at net realisable value:
  - review the previous year's valuations and assess how accurate these were, based on current year sales
  - examine sales after the current year end to assess whether the prices obtained were in line with the valuations.
- Use an independent expert who has skills and experience of the fashion industry to ensure that the inventories stated as being included in the year end figures are clearly identifiable as such and that any net realisable values are reasonable.

(b) **Audit work re goodwill**

- Review the methods used by Elleander Designs to determine the fair value of the consideration given to purchase the partnership, and the fair value of the net assets at the date of acquisition.
- Ascertain who performed the valuations and consider whether or not they were suitably qualified.
- If this was the finance director consider his possible lack of independence and consequential impact on the figures.
- Consider the use of an independent expert due to the significance of the amount of goodwill, and if there is the above connection.
- Check that the goodwill is being correctly treated and amortised in accordance with IFRS3 *Business combinations*.
- Check to ensure that the proper disclosures have been made per IFRS3.

(c) **Accounting estimates and legal claim pending**

An accounting estimate as defined by ISA 540 *Audit of accounting estimates* is 'an approximation of the amount of an item in the absence of a precise means of measurement'. Other examples of accounting estimates (in addition to the legal claim pending) are losses on construction contracts, accumulated depreciation and deferred tax.

The legal claim pending is a contingent liability. The work that would need to be performed to verify whether or not it should be included in the financial statements would be as follows:

- Discuss the matter with directors to obtain more information about the background and details of the case. Obtain appropriate written representations.
- Examine the board meeting minutes (and any other relevant meetings) for details of the case to ascertain that all facts about the case are known.
- Examine correspondence with lawyers and contact the lawyers to ascertain whether they are also of the opinion that the case is very unlikely to succeed. If necessary, a meeting should be arranged with the lawyers if the case is considered to be particularly complex.

(d) **Work on forecast**

- Prepare and agree a letter of engagement with Elleander Designs.
- Determine what assumptions have been made in the preparation of the forecast and the rationale behind the assumptions.
- Discuss the company's future plans in respect of the new venture and other potential developments.
- Identify what evidence is available and the reliability of such evidence. All evidence produced by the client should be based on realistic information that can be justified and should be supported by relevant documentation.
- Ensure that all necessary elements have been taken into account e.g. capital expenditure, working capital, cash flow requirements etc.
- Perform arithmetic checks on the forecasts and supporting information to ensure that they appear reasonable and that all information and any assumptions are consistent.
- Pay particular attention to items that are highly variable, e.g. sales figures as these are very dependent on demand and also fashion changes. Costs should also be examined closely to ensure that these are in line with current costs – although allowance should be made for any future changes.
- Check that the accounting policies used to produce the forecasted figures are in line with those currently used or where these are changed, then an explanation should be provided.
- Obtain written representations for the forecast figures to ensure that management accept responsibility for the figures; representation should also be obtained for the use of the financial information.
- Once the work has been completed produce a report which:
  - clearly identifies the forecast information that has been examined
  - specifies the work that has been done in auditing the information
  - includes a statement from management indicating that they accept responsibility for the forecast and any assumptions made
  - includes a statement of opinion and a warning to any readers of the prospective financial information stating that 'actual results are likely to be different from the forecast since anticipated events frequently do not occur as expected and the variation may be material'.

28 Cranford Communications

(1) **No access restriction to terminal rooms**

Consequences

- Unauthorised personnel may gain access to the terminals, resulting in loss of hardware or corruption of software (deliberate or otherwise).
- This could cause financial loss and/or other costs arising from disruption to the business.

Recommendations

- Terminals should be kept in locked rooms, preferably with keypad or swipecard access limited to authorised persons only.
- Where only key access is feasible, keys should be held by authorised officials and a record of their issue to staff maintained.
- Any security codes should be changed regularly by a senior official.

(2) **Passwords changed by staff**

Consequences

- If passwords are changed infrequently unauthorised members of staff may learn the passwords of their colleagues.
- This could allow unauthorised members of staff access to parts of the system to which they should not have access.
- This could lead to confidential information being accessed or unwanted changes being made.

Recommendations

- The system should be programmed to force users to change their passwords on a monthly basis.

(3) **No fire extinguishers/air conditioning for main computer**

Consequences

- This may lead to hardware overheating, resulting in systems failure, damage to equipment and loss of data.
- The lack of fire extinguishers could mean that damage to equipment could not be lessened in the event of a fire.
- It may also mean that insurance cover/hardware manufacturer's warranties are invalid and that Health and Safety Regulations are being breached.

Recommendations

- Air conditioning should be installed in the computer room, in accordance with the hardware manufacturer's recommendations.
- The authorities should be contacted to inspect the offices to ensure they comply with regulations. This is likely to lead to the installation of fire extinguishers.

(4) **No disaster recovery plan**

Consequences

- In the event of a systems failure, continuity of operations may not be possible.
- The disruption may cause financial loss if:
  - extra costs are incurred in recovering data
  - customer goodwill is lost

- asset records may be lost, making insurance claims difficult.

Recommendations

- A formal disaster recovery plan should be approved by the board covering interim processing arrangements and steps to be taken to resume normal operations.
- The plan should be:
  - documented
  - set out responsibilities
  - stored at multiple locations
  - periodically tested.

(5) **Back up media held off site**

Consequences

- Back-up media must be available for use in case the original data is lost/damaged.
- If the only copy is kept on site then if there was a fire/flood/theft of such media the business would not be able to use the back up copy and would incur substantial costs to recreate/recover the data.

Recommendations

- Regular back-ups should be taken and stored off site in a secure and appropriate location.

29 Internal and external audit

(a) **Difference between internal and external audit**

The external auditors are appointed under statute, by the shareholders of the company. Their *statutory* duty is to report to those shareholders on whether the financial statements give a 'true and fair view' or 'present fairly' the operations of the company.

The external auditors' scope is unlimited – they have the right to carry out whatever work they deem appropriate in order to reach their opinion. They have to meet statutory criteria in terms of qualifications and independence.

The internal auditors are appointed by the directors of the company as a tool to help the directors manage the company. The internal auditors are thus part of the system of corporate governance/internal control.

Their work will be set by management, but will usually involve examining systems and controls in order to make recommendations to management for improvement. There are no legal requirements covering qualifications and independence – management will select suitable qualified persons and will take steps to secure their independence within the company.

(b) **Advantages and disadvantages of outsourcing internal audit to external auditors**

Advantages

- Cost/time savings e.g. freeing up management time and other resources for more 'productive' uses.
- The audit firm is likely to have:
  - specialist skills and knowledge which are not available 'in house'
  - access to the most up-to-date techniques and technology which may not be readily available within the organisation
  - access to more highly trained, specialist employees
- The audit firm will have a higher level of independence than the entity's own internal audit staff.
- The audit firm will have greater numbers of employees available for any urgent assignments.
- The audit firm is governed by professional codes of conduct and standards of behaviour.
- The audit firm may be sued for breach of contract or for negligent work and carries professional indemnity insurance.

Disadvantages

- The company will need to ensure that the audit firm gives the organisation an appropriate level of priority and 'customer care' – though a firm which also acts as external auditor arguably has a vested interest in doing so.
- Professional firms are not under the control of the entity in the same way as their employees are so the outsourcing arrangement needs to be effectively managed and controlled by the organisation.
- Fees will need to be agreed and may be high.
- The audit firm may not have the detailed knowledge of the entity which internal auditors working in the organisation on a daily basis would have – although the external auditor is likely to be the next best placed.
- There may be threats to independence where a professional firm acts as both internal and external auditors.

30 Holiday Snacks

(a) **Issues relevant to deciding whether the firm can rely on the work performed by the internal auditors**

Objectivity

The chief internal auditor is a newly qualified certified accountant, so he will be bound by ethical guidance which requires him to carry out his work with independence and objectivity. He should also be expected to have briefed his assistant on the importance of an objective approach.

The internal audit function will have greater independence if the chief internal auditor reports directly to the board.

The scope of the internal audit function should be unrestricted. If put upon enquiry, the internal auditors should be able to conduct non-routine investigations.

It is more likely that reliance can be placed on the internal audit work if findings are reported directly to the board and management make a positive response to those findings.

Technical competence and due professional care

Although the function has accounting experience its experience of internal auditing and the snacks industry may be limited. The audit firm will need to assess the effectiveness of the internal audit function via discussion and a review of working papers.

The internal audit work should be properly planned, reviewed, supervised and recorded. In particular, the substantive procedures on the cash sales system should adequately cover the different locations. Working papers should set out audit objectives, tests performed, results and conclusions. The work of the assistant should show evidence of monitoring and review.

Effective communication

It is more likely that reliance can be placed on the internal audit work if the function is allowed to communicate freely with the external auditors. There should be regular meetings between the two and one should notify the other of any significant matters discovered which might affect the other's work.

(b) **Issues relevant to deciding how much reliance can be placed on that work**

Responsibility

Although the work of the audit firm may be reduced by placing reliance on the work of the internal auditors the responsibility of the firm is not reduced by such reliance. The audit firm must be able to draw its own conclusions.

If it is decided that the work of the internal auditors can be relied on, the audit firm should consider the following in determining the extent of its use of the internal auditors' work in the area of substantive testing of cash sales.

Materiality and information available

Although cash sales are a material area, some reliance can be placed on the work of internal audit.

It may be possible for the firm to reduce the amount of substantive testing on cash sales because of the extensive testing carried out by the internal auditors. However, in doing so the firm is not really relying on the internal audit function as a part of the internal control system – more using them to provide assistance.

Risk

There is a high risk that cash sales are understated. Although some reliance can be placed on the work of internal audit the audit firm's involvement must be sufficient to allow them to reach their own conclusions.

Judgement

The area is not a particularly judgemental one so reliance would not be precluded on these grounds.

Availability of other audit evidence

The availability of complementary evidence (e.g. from analytical procedures) may increase the extent of reliance.

31 Aaron Automotives and Bling Bonnets

(1) **Aaron Automotives**

Although the situation is indeed serious, this does not automatically mean that the opinion should be modified.

If a letter of support had not been received then a qualified or adverse opinion on the grounds of a material misstatement (disagreement about the appropriateness of the going concern assumption) would be required.

However, the company has received a letter of support from its parent company to the effect that it will enable Aaron Automotives to continue trading. If this evidence (together with other evidence, such as directors' representations) is considered sufficient to support the appropriateness of the going concern assumption, no modification to the opinion will be necessary (provided that the support is adequately disclosed in a note to the financial statements). If the evidence is sufficient but the disclosure inadequate, a qualified ('except for') or adverse opinion will be needed.

If the letter of support does not provide sufficient evidence (e.g. there are doubts about Verity Vehicles' ability to provide the necessary finance) the report (but not the opinion) should be modified via the inclusion of an emphasis of matter paragraph, drawing attention to the significant uncertainty and the relevant note in the financial statements describing that uncertainty.

Conclusion

The audit senior's proposal is unsuitable. Assuming that disclosures are adequate and evidence is sufficient, the opinion should be unmodified.

(2) **Bling Bonnets**

In this situation, local legislation requires any such loans to be disclosed (however small the amounts involved). If such disclosure is not made then the auditor will need to qualify his audit opinion on the grounds of a material misstatement (disagreement – the financial statements comply with local legislation 'except for' the non-disclosure of a loan to a director).

Whether the non-disclosure also affects the true and fair view is more difficult. On the one hand, the amount is immaterial by size, but it could be considered to be material by nature – i.e. however small, the amount the users of the financial statements would want to know about such a loan and therefore the report should also be qualified on the grounds of true and fair.

Conclusion

The audit senior's proposal is unsuitable. Unless the appropriate disclosures are made, the opinion should be qualified – at the very least on the grounds of non-compliance with local legislation.

32 Gorgeous Goods and Conrads Contracts

(a) **Meaning of and relationship between**

Materiality

- 'Materiality' is an expression of the relative significance or importance of a particular matter in the context of financial statements as a whole. A matter is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.
- Materiality may also be considered in the context of any individual statement within the financial statements or of individual items included in them (performance materiality).
- Materiality is not capable of general mathematical definition as it has both qualitative and quantitative aspects.

True and fair

- The term 'a true and fair view' is not defined in statute and it has therefore fallen to the auditing profession to reach a reasoned and consistent interpretation of the term. Accounts should be true and fair if prepared in accordance with recommended accounting policies.
- Truth relates to factual accuracy and correctness of the financial statements. For example, the statement of financial position should be an 'accurate' reflection (within acceptable limits) of the company's assets and liabilities at the year end.
- Fairness relates to the presentation of information and the view conveyed to the reader. It is important that information in the financial statements is presented in a manner that is free from bias and does not lead the reader to any view that is not a reasonable reflection of the company's financial situation.

Relationship between materiality and true and fair

'True and fair' is a matter for professional judgement. 'Materiality' is just one of the factors considered in making such a judgement.

For example, if a company's actual revenue for a year of $220,000 was inaccurately stated (e.g. at $220,100) the financial statements could still be judged 'true and fair' as knowledge of the error would not cause a reader of the financial statements to change his opinion of them (i.e. the misstatement is not material).

Conversely, if a misstatement is judged to be material, the true and fair view is impaired.

Accounting standards are intended to give a true and fair view and need not be applied to immaterial items. Where material, compliance with accounting standards will normally be necessary for financial statements to give a true and fair view.

(b) **Effect on audit reports and reasons**

(1) **Gorgeous Goods**

Effect on audit report

- The audit opinion on the current year income statement/statement of comprehensive income and comparative income statement/statement of comprehensive income (closing inventories) and statement of financial position (inventories) will be qualified ('except for').
- The qualification arises because of the auditor's inability to obtain sufficient appropriate evidence (limitation on scope). It will not be a disclaimer of opinion as the item is not likely to be pervasive as well as material.
- The report will refer to how the scope of work has been limited.
- The opinion paragraph will state that 'except for' adjustments that might be necessary to opening inventories and/or closing inventory comparatives; the financial statements show a true and fair view and have been properly prepared.

Reasons

- Comparatives are part of the audited financial statements.
- In addition, last year's closing inventories become the current year's opening inventories and this affects current year profits.

(2) **Conrads Contracts**

Effect on audit report

- If the auditor assesses that the contract is unlikely to be renewed and that, as a result, the company will no longer be a going concern, a modified opinion is likely on the grounds of a material misstatement (disagreement with the application of the going concern concept). A qualified or adverse opinion would be given.
- If the auditor assesses that the going concern assumption is appropriate but a material uncertainty exists and the directors have adequately disclosed the situation, an unmodified opinion would be given but an emphasis of matter paragraph should be used to highlight the uncertainty and the note in the financial statements disclosing it.

- If the auditor assesses that disclosures are inadequate for a true and fair view, an 'except for' qualification would be required on the grounds of a material misstatement (disagreement with disclosure).
- If the auditors believe that the directors have not provided sufficient information and explanations on the matter a qualified opinion (limitation on scope) may be required.

Reasons

- Inventories may not be stated at the lower of cost or net realisable value, as required by IAS 2.
- There is some uncertainty as to whether Conrads Contracts is a going concern, given the potential loss of over half their trade.

33 Polar Publishing

(1) **Database maintenance**

Weakness

Routine maintenance work is behind schedule resulting in a backlog of input for new subscriptions, cancellations and changes of addresses.

Consequences

- Accounting errors and loss of revenue could arise through
  - not invoicing new subscribers
  - invoicing cancellations
  - sending invoices to incorrect addresses.
- Customer goodwill may be lost if subscribers no longer receive their magazine through it being sent to the wrong address.
- New subscribers, failing to receive their magazine promptly, may cancel their subscription.

Recommendations

- Extra staff should be employed to bring the database up to date as soon as possible. Thereafter it could be kept up to date by a part-time employee. The cost of this should be outweighed by the benefit gained through avoiding lost revenue and customer goodwill.

(2) **Advertising deals**

Weakness

As a result of staff shortages, some deals with advertisers are not being recorded and order confirmations are not being sent out.

Consequences

- A loss of revenue and customer goodwill could result, as order confirmation letters are used as the basis for allocating advertising space.

- Advertisers may be unable to place adverts because no space has been allocated.
- Advertising space may be allocated in error and then left without an advertisement.
- The lack of written confirmation of the terms may lead to incorrect invoicing, resulting in a loss of revenue or customer goodwill.
- There may be delays in receiving monies from advertisers whist invoicing disputes are being dealt with.

Recommendations

- A pre-printed, pre-numbered document should be used for recording all deals. These should be filed and referenced to the order confirmation letters and reviewed on a regular basis.
- Alternatively, a suitable multi-part document could provide a copy to replace the confirmation letter.
- Additional staff should be allocated to the department to record and confirm all deals are still current.

34 Non-audit services

Introduction

The provision of non-audit services by external auditors to their clients has become increasingly common over the years. For larger firms and their (large) clients such services include a wide rage of consulting services. For other firms with smaller clients, non-audit services are more likely to include services such as basic bookkeeping and accounts preparation.

Do such services compromise the integrity of the auditing profession?

The provision of other services can lead to a stronger relationship with the client and increased knowledge about its business and its problems. This increased knowledge will indirectly improve the quality of the audit but there may also be direct audit efficiencies if the audit department can rely on work performed by other departments within the firm.

On the other hand, if the auditor pushes too far with his cross-selling, the client may wonder whether the auditor is raising real issues or is trying to sell additional services. In addition, the outside world may perceive that the auditor lacks true independence and whether he has taken on the audit merely in order to benefit from fees for (often) lucrative non-audit services. It must be remembered that ethical guidance requires the auditor not only to *be* but also *be seen to be* independent.

Providing other services to audit clients can also lead to actual (as opposed to perceived) conflicts of interest or a loss of independence/objectivity.

For example, the audit firm might advise both the company and individual directors or shareholders, in areas such as personal tax, financial planning or incentive schemes. In such circumstances it will be impossible to give the best advice to both parties. A different type of conflict arises where the auditor ends up assessing his own work, for example, where the firm has implemented a major systems change and now that system needs to be audited. Some accountancy bodies have now tightened up in this area such that firms may no longer take on such systems work where that work would subsequently need to be relied upon during the course of the audit.

An actual or perceived loss of independence could arise for the following reasons:

- The importance of the client, i.e. undue reliance on one client which could affect (or be seen to affect) objectivity or the willingness to argue a point. This situation is perhaps most likely to occur where the audit fee is relatively small compared to the fees for other services. The ACCA's ethical rules seek to avoid this by restricting the recurring fees from one client (or group of connected clients) to 15% of practice income (10% for a listed client). However, there is no restriction in terms of a ratio between the audit and non-audit fees.
- The closeness of the personal relationship with a small client who relies on the audit partner for general advice. However, if this small client is owner-managed then this will be less of an issue.
- The participation in outsourcing or other arrangements which mean that the same firm is responsible for both preparing and auditing financial information.

Although there are rules in respect of independence/conflicts of interest in the ACCA's ethical rules which must be adhered to, there are situations which do not breach the rules but could be seen to affect the auditor's independence.

Are such services in the interests of management?

For management, the attraction of using the already appointed statutory auditor for these other services may lie in the 'one-stop shop', whereby the company has access to a range of specialists who are already familiar with the entity through their ongoing audit work.

In addition, the information gained by one department of the (audit) firm can be used by others in the firm, thereby eliminating the need for management to give multiple briefings and thus saving them time.

However, going to a *different* firm for these other services may provide management with a new view/perspective on their problems which may, in itself, be valuable.

Should client size/listed company status make a difference?

There seems to be no clear reason for the rules to be different for different sizes of client. Smaller companies will generally use smaller firms for auditors and larger ones will use the larger firms. Different types of other work and therefore different types of conflict may arise but the issue is still there.

However, there may be a reason for differentiating between owner-managed businesses and those with outside shareholders. In listed companies, shareholders often have no real influence over day-to-day management and rely on the auditors for an independent view of performance. In the owner-managed entity, the directors are arguably at liberty to use the auditors in any way they see fit (though there may be other users of accounts such as banks which are interested in auditor independence from management).

Conclusion

Due to recent events, the reputation of the auditor has been severely damaged in the eyes of the user. Although arguably many of the advantages that apply to management for engaging the auditor to perform non-audit services have a knock-on effect to the user, it seems unlikely at the moment, that users will see it this way. Most users now view the auditor/client relationship as potentially a very cosy one, with auditors earning huge fees from other services and directors, in turn, having a blind eye turned to their creative accounting practices. However untrue this may be for the majority of auditor/client relationships, further action is necessary to undo this damage.

It may be possible that in the future, audit firms will be appointed for fixed periods and/or will be banned from carrying out any sort of non-audit work. The latter could be achieved either by allowing audit firms to perform non-audit work but only for a non-audit client, or by not allowing audit firms to do anything but audit work.

35 Auditor's liability

Introduction

There are several ways in which claims against the auditor for negligent auditing could be reduced, or, once a claim is made, its size mitigated. Some of these remedies are available to individual firms, some need the input of the profession and some require governmental action.

Individual firms

Clearly, it is preferable to avoid claims arising for negligent auditing in the first place. Firms can minimise the risks of being sued by ensuring that high quality audit work is performed. Auditors should therefore:

- follow appropriate auditing standards
- employ sound quality control procedures
- train staff effectively
- ensure that the firm is up to date with modern auditing methods.

However, if successful claims are made (or if out of court settlements are reached) the auditor will have to pay damages. If the damages are beyond the means of the audit firm, in some countries, the law may also allow claims to be made against the personal assets of partners. As a result, the ACCA and other professional bodies *require* members in practice to carry professional indemnity insurance. Such insurance will pay out *if* the firm itself is unable to pay.

On the other hand, some take the view that the very existence of professional indemnity insurance may itself increase the frequency and size of claims made against firms, which are seen to have large amounts of funds at their disposal to meet claims. The sceptical might say that it may encourage more careless auditing. In any event, it imposes a high cost on practices, which has risen as the general level of claims has risen.

Governments

In the light of the above criticisms of professional indemnity insurance, a number of suggestions have been made of ways in which claims against auditors could be limited. All of these could require government action.

Governments could allow auditors to agree a 'cap' on their liability with their clients or they could set a statutory limit on claims, based on the size of the audit fee or on a simple fixed amount. In the UK, the recent Companies Act 2006 allows auditors to agree a cap on liability with their clients.

Alternatively, in some countries there is still some way to go in overhauling the way in which audit firms are constituted. Conventionally, in most countries, accountancy and auditing practices were established as sole practitioners or, where permitted by local law, partnerships.

The implications of this structure were that the owner or owners had unlimited liability for the debts of the practice. This would include claims made against the firm for negligent audit work. As discussed above, in some countries, the owners' personal as well as business assets were at risk if the firm itself could not pay claims against it.

This principle was originally designed to promote public confidence in the auditing profession and to encourage auditors to carry out their work with due care. Problems began to emerge as businesses grew and the size of claims against auditors increased.

Governments could respond to the issue by moving towards removing auditors 'unlimited liability' status. Accountancy practices could then be allowed to trade either as limited liability companies or as limited liability partnerships (which is, for example, now allowed under UK law). However, in the current climate, the public may perceive this as just another way in which auditors are attempting to wriggle out of their responsibilities/liabilities.

The auditing profession

Another route may lie in work the profession could do to improve public confidence in the auditing process. This could include the tightening up of ethical rules, for example, to make the rotation of audit firms (as opposed to partners) mandatory and to restrict the amount of non-audit services which an audit firm could carry out for its clients.

Conclusion

Undoubtedly, there are measures which could be taken to reduce or mitigate the incidence or size of negligence claims. Unfortunately, some of these measures may be perceived negatively by the public. The most important measure probably lies in improving the public perception of auditors and ensuring that their work is carried out to high standards with no hint of any unethical practices.

36 The audit of small businesses

Introduction

There are three separate assertions made here.

(1) That small businesses are unauditable.

(2) That preparing the accounts of a small business gives the auditor an insight into that business which is advantageous to his subsequent audit.

(3) That audits of large entities can be rather mechanical.

What is small?

Companies may be defined as small by local legislation using limits based on monetary amounts of revenue or assets. However, the most useful approach is to define what makes a small business not by its absolute size but by its characteristics. Such criteria might be based on owner management, limited formal controls and situations where the auditor is engaged to carry out a significant amount of accountancy work in addition to the statutory audit. These criteria form the basis of the following discussion.

Are small businesses unauditable?

Only small businesses which are incorporated are required by law to have an audit. Others may have one, either voluntarily or under pressure from lenders.

When auditing a small company, the auditor is still required to obtain sufficient appropriate audit evidence (ISA 500). Given the above characteristics of a small company the auditor may be faced with poor or non-existent documentation, doubts about the completeness of income (especially in a cash-based business) and the need to place reliance on written representations.

In order to get around these issues the auditor is likely to take a substantive approach to his work, vouching a high number of transactions and using third party verification wherever possible. He cannot, however, rely on uncorroborated written representations but must look for evidence to support those representations. If the auditor is also preparing the accounts then he is more likely to be able to gain sufficient comfort that they are true and fair.

Ultimately, although small businesses are auditable, if sufficient audit evidence cannot be obtained, the auditor will have no option but to modify his opinion (most commonly on an inability to verify completeness of income).

Does preparing the accounts of a small business gives the auditor an advantageous insight?

The need to understand the client is a fundamental requirement whenever an audit is performed (ISA 315) and whatever the size of business.

If the auditor is also engaged to prepare the accounts he should gain an increased understanding of his client during the process of preparation. In addition, some verification work will have been performed during this process as the auditor refers to source documentation.

However, the auditor must be careful not to lose such advantages by failing to audit other areas, merely because he has put the accounts together himself. Although not all parts of a 'standard' audit programme will be appropriate, the auditor will need to use his increased knowledge of the client to tailor such a programme to the smaller client (indeed many firms have specific small company audit programmes).

Are audits of large entities rather mechanical?

The inference of this part of the question is that auditors of larger clients do not have to be as concerned with understanding their client as they can more easily use a standard set of audit programmes and working papers.

This is of course wrong. The approach to any client must be tailored to that client's needs, based on the auditor's experience and judgement. The audit team must be properly briefed and controlled and all work must be reviewed. Without such an approach the team might perform a 'standard' audit and miss a material error due to a lack of understanding.

The planning process must therefore include the preparation of a detailed audit planning memorandum. Staff should be briefed to ensure they understand how their assigned tasks fit into the audit as a whole and they should be encouraged to refer problems to more senior staff.

In summary, a properly performed audit of a large entity should not be mechanical although undoubtedly, it can benefit from some standardisation, for example, via the thoughtful use of pre-prepared working papers, tailored to that client.

Conclusion

When audits are performed properly, small businesses are not completely unauditable and the approach to large audits is not mechanical.

37 QP Supermarkets

Risks and expected controls

(1) Internet operation – quality/non-delivery

Risks	Expected controls
Rapid growth of the internet service could cause a strain on QPS's resources, with difficulty in responding to demand and meeting customer needs. There may be a lack of technical skills to support the rapid growth.	■ Risk assessment established by management, with details of how rapid growth will be managed. ■ Forecast levels of growth of QPS internet sales, accompanied by an agreed strategy for managing that growth and responding to demands.

(1) Internet operation – quality/non-delivery

Risks	Expected controls
	■ Employment of appropriate skilled technical resource.
Failure to deliver all requested items could result in customer dissatisfaction and a switch away from using the internet service.	■ Checks on deliveries. ■ Reconciliation of orders and against payments. ■ Inventories checks and controls.
Poor quality of deliveries could arise from a lack of commitment to the internet service by the local supermarkets responsible for delivery or delays in delivery. This could result in: ■ customer dissatisfaction, customer complaints and unwillingness of customers to continue with the service ■ a need to compensate customers for poor quality/delayed goods	■ Clear, documented procedures for deliveries. ■ Quality standards and control for goods deliveries. ■ Monitoring of complaints received. ■ Monitoring of trends in use and identification and review of potential problem stores.

(2) Internet operation – systems problems

Risks	Expected controls
System breakdown resulting in poor customer service, loss of sales and financial loss.	■ System logs. ■ Regular back-up of data. ■ Disaster recovery and business continuity plans in place and subject to regular testing and review. ■ Service standards for system maintenance. ■ IT expertise.
If the internet ordering continues to grow at a rapid rate, then continued interruption of services could ultimately affect profitability and viability of the company.	■ Forecast of levels of ordering with plans for maintenance of service to achieve desired levels of service.
QPS sensitive information may be obtainable by hackers through the internet capability.	■ Data encryption. ■ Access controls.
Unauthorised access to customer information obtained through the internet resulting in customer dissatisfaction, complaint and 'lack of trust'. Potential to lose customers.	■ Access and security controls – restriction of access, access logs. ■ Access reporting and monitoring.
Data may become corrupted or lost,	■ System maintenance controls.

(1) Internet operation – quality/non-delivery

Risks	Expected controls
resulting in loss of customer orders or records, or failure to obtain payment for goods received.	■ IT service standards.
Breach of Data Protection legislation.	■ Nominated Data Protection Officer. ■ Data protection procedures and checks to ensure compliance.

(3) Environmental issues re new sites

Risks	Expected controls
Delay in availability of new sites will impact profitability of the company	■ Plans showing environmental analysis and development assumptions.
Financial capital tied up in new sites that cannot be built on.	■ Cash flow forecasts. ■ Budgets and plans.
If there has been contamination of the site, there may be a number of associated risks including: ■ Costs of clean up ■ Impairment in the value of assets Environmental laws or regulations may have been breached.	■ Environmental analysis prior to purchase of sites. ■ Planning applications.
Local opposition and environmental cases may affect the reputation of QPS and also cause problems in achieving our planned customer base.	■ Liaison with local residents and environmental officers.

(4) Social issues re acquisition of Lopay Supermarkets

Risks	Expected controls
Negative publicity and damage to QPS's reputation through breaches of employment and health and safety regulation.	■ Procedures to ensure adherence to all required legislation. ■ Nominated responsibility for compliance.
Financial risk of compensation required to customers hit by food poisoning from Lopay products.	■ Environmental and health and safety controls and procedures documented and monitored. ■ Escalation of Health and Safety concerns.
QPS could be fined for breach of trading standards and other legislation.	■ Health and Safety procedures. ■ Staff training.
Poor practices in Lopay could damage QPS as a whole and lead to loss of	■ Clear common procedures for Lopay and QPS staff.

(1) Internet operation – quality/non-delivery

Risks	Expected controls
customers and financial loss.	■ Monitoring, supervision and regular checks of compliance with procedures. ■ Training of staff. ■ Use of QPS staff in Lopay stores to bring about common practices.
Breach of laws on minimum wages and of working time directives may result in the need for provision of back pay and fines.	■ Skills of HR staff. ■ Monitoring of adherence to minimum wages and working time directives and review of reports produced on compliance.
Inability to meet stores standards arising from high turnover of staff.	■ Recruitment and retention policies, with common standards across QPS. ■ Monitoring and reporting of staff turnover levels and explanations for high levels.

Further investigations and impact on financial statements/the audit

(1) Internet operation – quality/non-delivery

Further investigations	Impact on financial statements/audit
■ Review plans for internet use against actual internet use. ■ Confirm what investigations management have carried out on the delivery problems and level of complaints. Check whether there are key areas of concern. ■ Confirm how inventories are being controlled for internet distribution and what measures have been taken to ensure the quality and accuracy of deliveries. ■ Review the impact of complaints and financial compensation that has been undertaken and is in the pipeline.	Problems with deliveries and inventories may impair profitability. Significant levels of compensation required against complaints will also impact on profitability. Need to quantify the impact of these problems and decide how best to reflect these in the financial statements.

(2) Internet operation – systems problems

Further investigations	Impact on financial statements/audit
■ Confirm the technical expertise available for support of the system. ■ Check whether there is any outsourcing of the system. If the system is outsourced, confirm the service levels and maintenance contracts. ■ Review the performance levels of the system against planned performance levels.	The poor systems service may have an impact on the financial statements depending on the scale of the problem. The internet is a key strategy for QPS and systems problems may result in the failure of this strategy with customers moving away from this service. Need to discuss with management, in particular, whether the problems will impact the future provisions for compensation to customers for problems in service and security. Also, review whether there is potential impact on the going concern basis.
■ Check whether actual breaches in confidentiality and security have been experienced and review any compensation required for this.	

(3) Environmental issues re new sites

Further investigations	Impact on financial statements/audit
Site A	
■ Obtain a full understanding of the environmental issues associated with the site, including obtaining written representations from management. Need to fully understand the business (ISA 315) and understand the risks and controls. ■ Evaluate whether there is a risk of misstatement in the accounts. This will include confirming the length of time that the site has been owned by QPS, the checks carried out before acquisition of the site including any evidence of environmental concerns, records of planning and local discussions undertaken. ■ Review minutes of meetings including board committees, directors meetings, discussions with environmental and planning officers.	There could be misstatements arising because of the environmental issues. The value of assets may need to be written down. If there are serious contamination problems for which the company is liable this could have an impact on the going concern basis. Refer to relevant accounting standards for environmental issues.

■ Consider whether the environmental issues could impact on the going concern status.	
Site B	
■ Investigate the potential timescale and financial impact of the delay and whether this affects the financial viability of the new store. ■ Hold discussions with planning officers. ■ Consider strategy and planning assumptions and future cash flow forecasts.	The problems may affect the valuation of assets and future cash flow of QPS and therefore the auditor needs to understand the impact so that the financial statements can be reviewed.

(4) Social issues re acquisition of Lopay Supermarkets

Further investigations	Impact on financial statements/audit
■ Need to comply with ISA 250 *Consideration of laws and regulations in an audit of financial statements.* ■ Identify what action management have already taken to address the legal concerns, including notification to the relevant legal authorities and measures to ensure future compliance.	Need for provision for back pay and fines relating to minimum wage and working time directives.

38 Environmental issues

Introduction

In many countries, legislation and regulation now encompasses environmental protection as a response by law makers to increasing public pressure for environmental protection. Such protection might include aspects such as water industry control, clean air, town and country planning and pollution prevention and control.

Although there is widespread publicity relating to environmental issues concerning large multinationals, the financial statements of small and medium-sized enterprises (SMEs) are not exempt from the potential impact of such issues. The size of an entity has no direct bearing on whether environmental matters are likely to be significant to its operations. Small operations are, in principle, as likely to cause environmental damage as large operations. The issues involved are relevant to entities of all sizes.

Increasing pressures on commercial activities to tackle environmental issues have arisen from many sources, including:

- lobby groups (e.g. Greenpeace)

- financial institutions (e.g. banks are more cautious about risking their reputation by paying insufficient attention to environmental issues in making lending decisions and many now pursue so called 'ethical investment policies')
- supply chain greening (i.e. larger organisations implementing environmental standards and expecting their suppliers to do likewise)
- government action (e.g. taxes on emissions and landfilling)
- the accounting, auditing and legal professions (e.g. in the UK the auditing standards body has issued a discussion paper *Environmental issues in the audit of financial statements*).

Implications for businesses

The significance of environmental matters to the financial statements normally depends on the nature of the reporting entity's operations.

Some entities may incur environmental obligations as a direct result of their core business (e.g. mining and extractive industries, chemical manufacturers and waste management companies). For such organisations, compliance with environmental laws and regulations should be central to the business.

Other entities may be affected by market issues such as compliance of products with environmental legislation and customer perception of environmental friendliness. Examples here include those products containing chemicals or packaging which may damage the environment.

Businesses may also be affected by the location of their operations (e.g. if they are holding an interest in land or buildings that have been contaminated by previous occupants, or if they are considering building on out of town 'greenfield' sites).

Organisations may incur the costs of clean-up operations even though they are not responsible for environmental pollution.

Businesses may also be affected indirectly by environmental issues if they are dependent on a major customer or supplier whose business is under threat from environmental pressures. As it is a principle of corporate governance that management should maintain a sound system of internal control (to safeguard the shareholders' investment and the company's assets), a company exposed to significant environmental risks might be expected to operate an environmental management system (EMS).

Why environmental issues cannot be ignored by auditors

The auditor's duties with regard to the growing body of environmental laws and regulations are the same as for any other laws and regulations where non-compliance may materially affect the financial statements of their clients.

In particular, auditors must be alert to the possibility of the nature of a client's business having potentially harmful environmental impacts. As part of their assessment of risk and internal controls, auditors will also require information concerning existing and proposed regulations and fines or penalties incurred. For example, the auditor of a company engaged in waste disposal must be familiar with the terms of licences under which the company is permitted to dispose of hazardous substances.

Where an organisation has been subjected to an environmental audit, the statutory auditor should review the findings of the environmental audit (e.g. as published in an environmental performance report) and consider whether the risk of material error in the financial statements is increased.

Impact on the financial statements

At the financial statement level, environmental risks encompass:

- the risk of non-compliance with laws/regulations
- the risk of compliance costs arising
- the possible effects of customers' views (as they may reject a company's products because of the environmental impact of those products).

Environmental issues may have a direct impact on the following:

- Provisions (e.g. for site restoration).
- Contingent liabilities (e.g. arising from pending legal action).
- Actual liabilities (e.g. fines and penalties imposed).
- Non-current asset values (e.g. property situated on or near a contaminated site).
- The valuation of inventories (where inventories may be slow-moving because of public attitudes).
- Capital or revenue expenditure on clean-up operations.
- Product redesign costs.
- Going concern, for example, where new or more stringent environmental legislation (such as that on emissions) threatens product viability, or where the withdrawal of an operating licence is 'life threatening' to the business.

Conclusion

Clearly, auditors cannot ignore the impact of environmental issues on the financial statements of their audit clients. A 'general awareness' of the risks is, however, a minimum requirement.

Where financial statements embody management assertions concerning environmental matters (e.g. the existence of an environmental liability, the occurrence of environmental expenditure, the valuation of an environmentally impaired asset, the completeness of fines and penalties) the auditor must go much further in order to obtain sufficient appropriate evidence to corroborate these matters.

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