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B3 AUDITING PRINCIPLES AND PRACTICE

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STUDY TEXT

B3

Intermediate level

THE NATIONAL BOARD OF ACCOUNTANTS AND AUDITORS TANZANIA (NBAA)

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STUDY TEXT

NBAA

NATIONAL BOARD OF ACCOUNTANTS AND AUDITORS

MSEMA KWELI

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FOREWORD.

The National Board of Accountants and Auditors is a professional body in Tanzania, established under the Auditors and Accountancy Registration Act No 33 of 1972 (CAP 286 R.E.2002). The Board has been charged with among other things, the responsibility to promote, develop and regulate the accountancy profession in the country.

In fulfilling its statutory obligations, NBAA prepares National Accountancy Examination Scheme for students aspiring to sit for Accounting Technician and Professional Examinations. Further, for effective implementation of the examination scheme and improve examination results, the Board provides Study Guides for all subjects to assist both examination candidates and trainers in the course of learning and teaching.

The Study Guides have been prepared in the form of text books with examples and questions to enable the user to have comprehensive understanding of the topics. The Study Guides cover a wide range of topics in the NBAA syllabi and adequately cover the most comprehensive and complete knowledge base that is required by a leaner to pass the respective examination levels.

Furthermore, the Study Guides have been prepared to match with the Competency Based Syllabi to enable the learners to be exposed to practical understanding of issues rather than memorisation of concepts. In this case, the Study Guides are characterized by the following features:-

1. Focus on outcomes – The outcomes shown in every topic provides clear understanding on what to be learnt.

2. Greater workplace relevance – the guides emphasize on the importance of applying knowledge and skills necessary for effectively performance in a work place. This is different from the traditional training where much concern has been expressed in theoretical perspectives.

3. Assessments as judgments of competence – The assessment questions embedded in the Study Guides are adequate measures of understanding of the subject matter.

Study Guides are also useful to trainers specifically those who are teaching in the review classes preparing learners to sit for the professional examinations. They will make use of these Study Guides together with their additional learning materials from other sources in ensuring that the learners are getting sufficient knowledge and skills not only to enable them pass examinations but also make them competent enough to perform effectively in their respectively workplace.

NBAA believes that these standard Study Guides are about assisting candidates to acquire necessary skills and knowledge that will enable them to perform as professionals. The outcomes to be achieved are clearly stated so that learners may know exactly the skills and knowledge they are supposed to acquire in a particular topic.

NBAA wishes all the best to NBAA Examination candidates, trainers in their review classes, lecturers in the higher learning institutions and all other beneficiaries of these learning materials in making good use of the Study Guides towards promoting the accountancy profession in Tanzania.

CPA. Pius A. Maneno
EXECUTIVE DIRECTOR
JUNE, 2019

STUDY TEXT CONTENTS

B3 - Auditing principles and practice

Features of the book

‘The book covers the entire syllabus split into various chapters (referred to as Study Guides in the book). Each chapter discusses the various Learning Outcomes as mentioned in the syllabus.

Contents of each Study Guide

‘Get through Intro’: explains **why** the particular Study Guide is important through real life examples.

‘Learning Outcomes’: on completion of a Study Guide, students will be able to understand all the learning outcomes which are listed under this icon in the Study Guide.

The Learning Outcomes include:

‘Definition’: explains the meaning of important terminologies discussed in the learning Outcome.

‘Example’: makes easy complex concepts.

‘Tip’: helps to understand how to deal with complicated portions.

‘Important’: highlights important concepts, formats, Acts, sections, standards, etc.

‘Summary’: highlights the key points of the Learning Outcomes.

‘Diagram’: facilitates memory retention.

‘Test yourself’: contains questions on the Learning Outcome. It enables students to check whether they have assimilated a particular Learning Outcome.

Self-Examination Questions’: exam standard questions relating to the learning outcomes given at the end of each Study Guide.

EXAMINATION STRUCTURE

The syllabus is assessed by a three hour paper based examination. 5 conventional questions of 20 marks each need to be solved.

The examination will consist of two sections.

Section A	One compulsory question	20 Marks
Section B	Four questions out of Six	80 Marks

SECTION A

OBJECTIVES, PROCESS AND NEED FOR EXTERNAL AUDIT AND ASSURANCE

A1

STUDY GUIDE A1: THE CONCEPT OF AUDIT AND OTHER ASSURANCE ENGAGEMENTS

Get Through Intro

To err is human. Man, in business and accounting, as well as in other aspects of life, is subject to ignorance, incompetence, inefficiency and various temptations. This may lead to the occurrence of errors and fraud. All these errors and fraud may be minimised, if not completely eliminated, when the accounts prepared by one person are checked by another on the basis of well-defined principles, standards and procedures. This idea led to the origin of audit.

The most common definition of an audit is an evaluation of an organisation, system, process, project or product. Audits are performed to ascertain the validity and reliability of information, and also to provide an assessment of a system's internal control. Traditionally, audits were mainly associated with gaining information about the financial systems and financial records of a company or a business. However, recently, auditing has begun to cover other areas such as information about environmental performance. As a result, there is a growing need for professionals whose job is to conduct audits.

Audits are performed by a competent, independent and objective person or persons, known as auditors, who then issue a report on the results of the audit. These auditors must adhere to generally accepted standards set by governing bodies that regulate businesses. In the case of financial statements, external users of those statements may be domestic or spread all over the world, and may or may not have adequate accounting knowledge. An audit gives assurance to these users that the financial statements of the company 'fairly' present the company's financial position and the results of its operations.

Learning Outcomes

a) Define and explain the concepts of audit and assurance.
b) State and explain the meaning of reasonable assurance.
c) Identify and explain using suitable comparisons the different levels of assurance that may be obtained from assignments.
d) State and explain the meaning of an opinion and an assurance report.
e) State and explain the reasons for and the benefits gained from the different types of audit and assurance assignments including those relating to financial statements, internal controls, corporate social responsibility and sustainability reports.
f) State and explain the parties and their roles, duties and rights in an assurance engagement including the members of the assurance team.

1. Define and explain the concepts of audit and assurance.
State and explain the parties and their roles, duties and rights in an assurance engagement including the members of the assurance team.

[Learning Outcomes a and f]

1.1 Concepts of Audit and Assurance

1. Audit

Extract of auditor's report

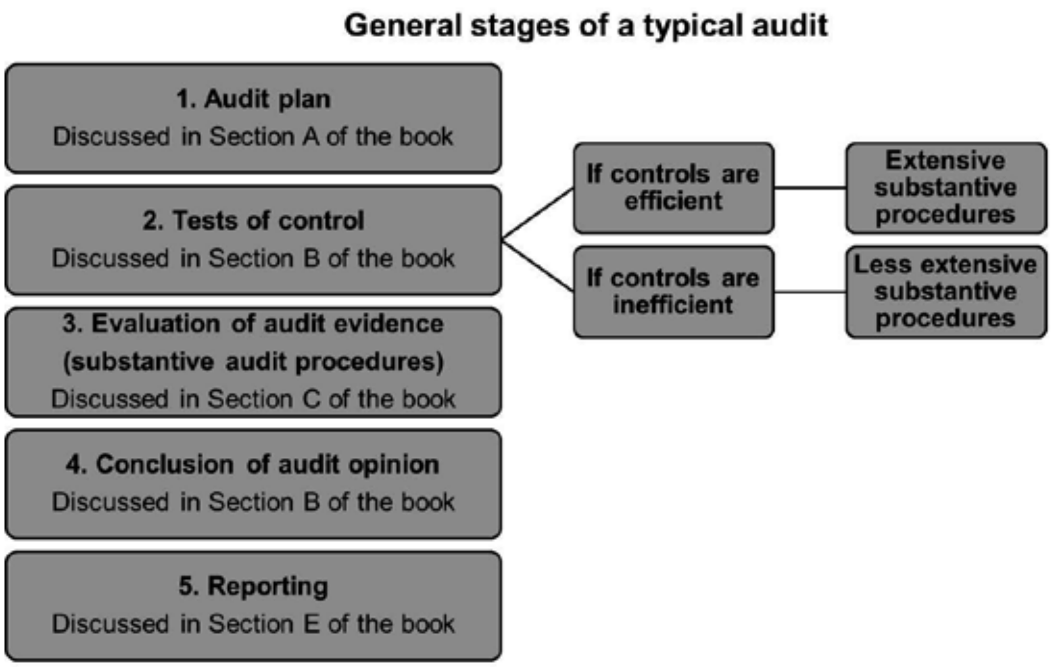
Example

Opinion on the Financial Position

In our opinion, the statement of financial position presents fairly, in all material respects (or gives a true and fair view of), the financial position of ABC Company as at December 31, 20X1 in accordance with International Financial Reporting Standards.

An **external audit** can be defined, in simple terms, as an independent examination of financial information, with a view to expressing an opinion on this information. The basic objective of auditing is the expression of an opinion on the financial statements, is constant irrespective of the nature, size or form of the entity. The opinion will be in relation to whether the financial statements are prepared in all material respects in accordance with the applicable reporting standards. In short, the auditor expresses whether the financial statements prepared are true and fair.

Diagram 1: General stages of a typical audit



2. True and fair presentation

The term "**true and fair**" is not defined in the Companies Act, but if the accounts of an entity are prepared in accordance with the facts, correct principles and applicable / accepted standards, the accounts are said to be true and fair.

In simple terms, we can say that truth means something factually correct and fair means just, equitable and not misleading. So, the auditor needs to ensure that the financial statements are not only factually correct but are also just, equitable presented so as to be open and understandable, and in accordance with accounting principles and standards.

Example

Mafinga Tea Company has had its accounts audited by its auditor. The truck has been depreciated over a period of ten years. Mathematically, the auditor has made the calculations correctly but the life of the truck has not been estimated correctly. The life of the truck cannot be more than five years. Therefore, the financial statements are true but are not fair: though arithmetically accurate they mislead users about the state of the trucks.

3. Assurance engagement

Definition

An assurance engagement is where a professional accountant in public practice expresses a conclusion designed to enhance the degree of confidence of the intended users, other than the responsible party, about the outcome of the evaluation or measurement of a subject matter against criteria.

As defined by Code of Ethics for Professional Accountants

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Example

Jane is choosing a dress for a party that she plans to attend. She will probably ask her friend's opinion on how the dress looks before purchasing it. Jane wants to be assured that her dress is suitable before she decides to buy it.

Another example will help to clarify the concept of assurance.

Example

Pwani Builders Limited want to purchase a plot, where they intend to construct a shopping mall. Before they commit to buying the plot, Pwani Builders Limited will need to do some research on the site and its accessibility. They will certainly need to employ a surveyor to give them some more confidence and reduce the risk involved. They may ask the surveyor to look into different sites: their title, their location and whether or not the site is dispute-free. The surveyor will be providing Pwani Builders Limited with some assurance.

Elements of an assurance engagement

The following are the key elements of an assurance engagement:

(a) A three party relationship involving a practitioner, a responsible party, and intended users.

(b) A suitable subject matter is the data that the responsible party has prepared, and which requires verification: for example, historical financial information, prospective financial information, corporate social responsibility reports etc. However, the subject matter would be appropriate only if it is measurable and is supported by evidence.

(c) Suitable criteria are required in an assurance engagement. The subject matter is compared to the criteria in order for it to be assessed and an opinion provided.

This is the criteria against which the subject matter is evaluated or measured t he intended users can understand the basis for the practitioner's conclusion. The practitioner considers whether it is relevant to the circumstances, to disclose.

- the sources of the criteria,
- Measurement methods used when the criteria allow for choice between a numbers of methods,
- Any significant interpretations made in applying the criteria in the engagement circumstances and
- Whether there have been any changes in the measurement methods used.

Factors determining suitability of the criteria are as follow:
- Relevancy
- Reliability
- Understandability
- Neutrality

The following example of criteria may be used by CPA –PP in the provision of assurance services:
i. IFRS, IPSA or an approved national framework
ii. Commission of Sponsoring Organisation (COSO)

(d) Appropriate evidence has to be obtained by the practitioner in order to give the required level of assurance.

(e) An assurance report in appropriate form is the opinion that is given by the practitioner to the intended user and the responsible party.

In both the examples considered above, a few similar elements can be found. They are:

- Jane and White Builders – the **potential users.**
- The friend of Jane and the surveyor whom they want to rely upon – the **practitioner or expert.**
- The **responsible party** that will supply the goods or services.
- The dress and the plot that they want to buy – the **subject matter** of the transaction.
- The **appropriate evidence** such as the real estate agent's details of inspecting the property or the fact that Jane's friend has seen her wearing the dress.
- The expectations or **criteria** which help the potential user to decide whether to purchase or not.

Criteria are the benchmarks used to evaluate or measure the subject matter. Criteria can be formal such as International Financial Reporting Standards, i.e. IFRSs, or International Public Sector Accounting Standards. Criteria can also be informal such as an internally developed code of conduct or an agreed level of performance e.g. the time limit set for the use of a common machine to be used by different departments.

Example

Chunya Company, an iron and steel company, has its accounts audited by Elite Associates. There is a lot of emission of fumes and smoke during the manufacture of iron and steel. According to the rules on pollution, only 50,000 cubic metres of exhaust gases are permitted. In other words, the criterion is for exhaust gases emitted by Chunya Company should not exceed 50,000 cubic metres.

There are **three separate parties** involved in the assurance agreement. They are:

- The **intended users:** the person, persons or class of persons who want to purchase or for whom the practitioner prepares the assurance report e.g. the shareholders of an entity.
- The **responsible party,** who is responsible for the subject matter information and the subject matter e.g. the board of directors of a company.
- The **practitioner,** who gives assurance or who can be relied upon e.g. a professional accountant.

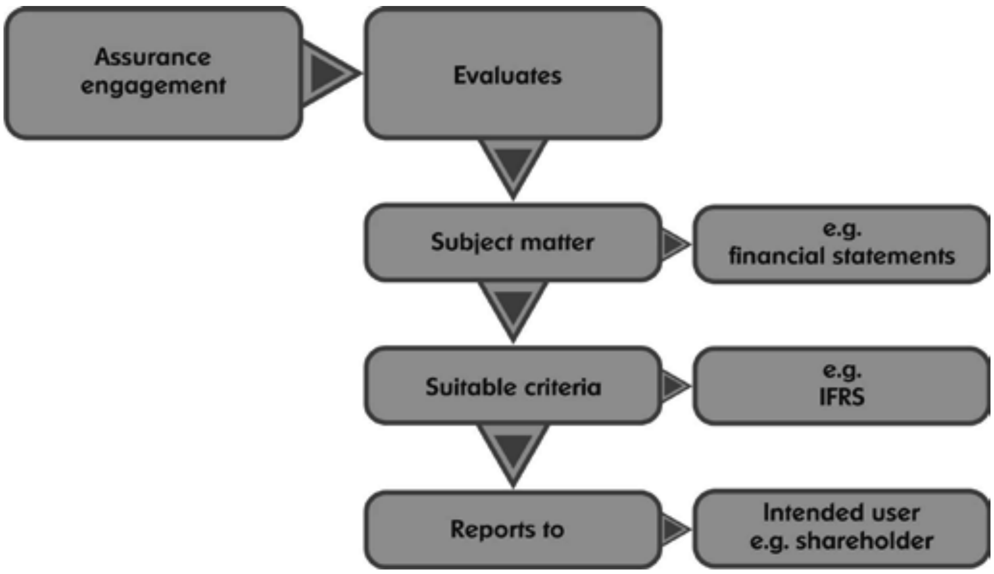
The objective of the assurance engagement is to measure or evaluate a subject matter, in compliance with the standards to express an opinion that gives a level of assurance to the intended user.

Example

The accounts of Njiro Ltd have been audited by an auditing firm, Elite Associates. The audit partner of Elite Associates, Jonathan, expresses his opinion on the financial statements of the company. The auditor's opinion gives a level of assurance to all the intended users such as shareholders of the company. This is the objective of the assurance engagement.

Example

Diagram 2: Assurance engagement



Test yourself 1

Samweli is a practicing accountant. He has been approached by Hassan, the financial controller of Jomo Engineering, which wants to invest in Mwenge Technologies. Hassan has analysed the financial position of Mwenge Technologies over the last few years. However, as the proposed investment is substantial, he wants a second opinion on the reliability of the most recent financial statements of Mwenge Technologies as a dependable basis for him to make his investment decision. Therefore, he has approached Samweli for an assurance on this matter.

Required:

Identify the key elements of the assurance engagement in this scenario if Samweli accepts the engagement.

1.2 Roles, duties and rights in an assurance engagement

1. Intended users in an assurance engagement

In the case of financial statements, external users of those statements may be domestic or spread all over the world, and may or may not have adequate accounting knowledge. **An audit gives assurance to these users that the financial statements of the company 'fairly' present the company's financial position and the results of its operations.**

User	Use of audited financial statements
Shareholders (the primary users of an organisation's financial statements)	They want as much information (from the financial statements) and detail as possible in order to determine whether their investment is safe and also growing.
Payables such as banks and other financial institutions	They need to ascertain whether the organisation has the ability to repay its debts. Therefore, they turn to the organisation's financial statements to determine the general trends of the organisation in terms of sales, profits, past scale of operations and cash flows.
Trade relations (the relations between the suppliers and customers of an organisation)	They use these statements to determine the financial condition and performance of the business in order to find out whether the organisation will be able to pay for the goods / services it orders from them.
Customers who have an on-going relationship with an organisation	They use the financial statements to determine if the organisation will continue to operate for the coming years.
Employees of an organisation.	They are interested in the financial condition and performance of an organisation because that is the source of their salaries. They use these statements to figure out their career prospects from the financial statements.
Government	Financial statements of organisations serve as a source of data for the government when it is compiling national economic statistics. It helps the government in taking different policy decisions.
Financial analysts, stock brokers, financial journalists	These statements are used as a basis from which they make predictions regarding the future financial condition and performance of the organisation. Depending upon their predictions, they then advise their clients (potential investors) on whether to invest in a particular organisation or not.
Tax authorities	These statements are used to determine tax amounts. Income shown by the income statement is used as the starting point for calculating taxable income. Revenue and purchase figures are used to determine VAT liability.

Example

Intended users may be identified in different ways, for example, by agreement between the practitioner and the responsible party or engaging party, or by law. Generally, the assurance report is addressed to all the intended users.

However, in some cases, there may be other intended users:

When the practitioner is not able to identify all intended users (as audited financial statements are read by various users) the intended users may be restricted to major stakeholders with significant and common interests (like shareholders).

When engagements are designed for specified intended users (like banks and regulators) or a specific purpose, the practitioner considers including a restriction in the assurance report that limits its use to those users or that purpose.

2. Responsible party in an assurance engagement

Shareholders make investments in the entity and expect to see growth of their money. Therefore, management (directors) being stewards, should take due care of the investments of the shareholders. They should undertake activities which will ensure that the investments of the shareholders are not only protected, but also growing.

The responsibility for the preparation of financial statements rests with the board of directors (BOD). Therefore, the **BOD is responsible for preparing** complete and accurate **financial statements** and making disclosures as set out in financial reporting standards and applicable rules and regulations such as compliance with the International Financial Reporting Standards (IFRS). Furthermore, **t**he board should present a balanced and understandable assessment of the company's results and position i.e. the financial statements must be clear and not give a biased picture of the financial health of the company.

In assurance engagements, the management may be responsible for:

The subject matter information (i.e. source data) as well as the subject matter: for example when an entity engages a practitioner to perform an assurance engagement regarding a report it has prepared about its own sustainability practices, or

The subject matter alone: for example when a government organization engages a practitioner to perform an assurance engagement regarding a report about a private company's sustainability practices that the organization has prepared and is to distribute to intended users.

3. Auditor (i.e. the practitioner of an assurance engagement) in an assurance engagement

(a) Role of the auditor

An auditor reports on the truth and fairness of the financial statements. In relation to corporate governance, it is viewed as being a part of a system of checks and balances that help ensure an organisation is being run in the best interests of all of its shareholders. This is because financial statements are used as a basis by an organisation's shareholders to evaluate its financial condition and performance (and consequently the performance of the BOD).

The practitioner is:

Responsible for determining the nature, timing and extent of procedures; and

Required to pursue any matter the practitioner becomes aware of that leads the practitioner to question whether a material modification should be made to the subject matter information (i.e. financial statements of the entity).

(b) Rights of an auditor

(i) Right of access to records

The auditor has the right to access the company's books of account, records, vouchers and other documents necessary to collect evidence, at a reasonable time, either with or without notice.

(ii) Right to information and explanations

An auditor can ask any of the officers or other persons associated with the company to provide information or explanations essential to discharge their duties effectively as an auditor.

(iii) Right to receive resolutions

The auditor also has the right to receive a copy of any written resolution proposed and any further communications related to it in the same way as a member of the company.

(iv) Right to attend and receive notice of meeting

An auditor has the right to receive all the notices of the general meetings and attend those meeting like any other member of the company.

(v) Right to speak

An auditor has the right to speak and to be heard at general meetings of the company on any of the matter which concerns him as an auditor.

(c) Duties of an auditor

(i) Adequate accounting records

The auditor while performing his duties must check whether proper and adequate accounting records have been maintained and prepared. The auditor also needs to ensure that for the branches not visited by him, adequate returns necessary for carrying out the audit have been received.

(ii) Compliance with legislation

It is the duty of an auditor to ensure that all the applicable provisions (like labour laws) have been complied with while preparing the financial statements.

(iii) Verification of records

The auditor's duty is to examine, compare and verify the accounting records and returns with the financial statements. If the accounting records do not agree with the financial statements or are incomplete, then it is the duty of the auditor to report this fact to the shareholders.

(iv) Truth and fairness

It is the primary duty of the auditor to prepare a report on the financial statements examined by him and state whether, in his opinion and to the best of his knowledge, the financial statements provide:

A true and fair state of affairs at the end of accounting period, in the case of statement of financial position (SOFP) and

A true and fair view of the amount of profit or loss during the accounting period, in the case of statement of comprehensive income (SOCI).

(v) Adequate disclosure

Another duty of an auditor is to ensure that the financial statements and all the other material disclosures are made in accordance with the applicable statute. The auditor also needs to verify whether all the payments and benefits accruing to directors from the company are properly disclosed in the accounts.

2. Identify and explain using suitable comparisons the different levels of assurance that may be obtained from assignments; State and explain the meaning of reasonable assurance; State and explain the reasons for and the benefits gained from the different types of audit and assurance assignments including those relating to financial statements, internal controls, corporate social responsibility and sustainability reports and Identify and explain the meaning of expectation gap

[Learning Outcomes b, c, d and e]

2.1 Levels of assurance engagement

Only two types of assurance engagements are permitted by the Framework. They are a reasonable assurance engagement and a limited assurance engagement.

1. Reasonable assurance engagement

Definition

The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion.

IFAC Glossary of terms

Objectives of an a reasonable assurance engagement

In a reasonable assurance engagement, the practitioner:

Gathers sufficient appropriate evidence,
Concludes that the subject matter conforms with the relevant criteria,
Ensures that the level of risk is acceptably low and
Expresses the conclusion in a positive form.

In this type of assurance engagement, the practitioner obtains sufficient appropriate evidence in order to reduce the assurance engagement risk to an acceptably low level. The practitioner doesn't aim to say that everything is fully correct, but ascertains that it is materially true and fair. **The auditor is unable to obtain absolute assurance because it is impossible to check 100% of the transactions.** Even if a 100% audit is carried out, it will not provide assurance that the financial statements are free from material misstatement, because of the **inherent limitations of the audit.** Therefore, **the auditor cannot provide absolute assurance but can provide only reasonable assurance.** A common example of a reasonable assurance engagement is an external audit.

A positive form of expression could be that "The financial statements show a true and fair view", or "The appointment of the employee was fair", or "Quality control procedures have been properly followed"

Example

The audit report of Kiluvya Company includes the following statements:

The financial statements have been prepared in accordance with the relevant accounting standards.

In our opinion, internal control is effective in all material respects, based on levels fixed by the company.

These statements show that this is a reasonable assurance engagement.

2. Limited assurance engagement

Definition

The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

IFAC Glossary of terms

Example

A retail business that produces its own financial statements but retains a practitioner for tax returns and other accounting advice is planning to open a new store. To do so, it needs to increase its existing lending facility and approaches its bank with a proposal for additional funding. The bank, which has been receiving quarterly financial statements, looks very closely at the business's current financial position. It requests that the most recent financial statements be audited. The business owner is unhappy with the cost of a full audit.

Although the bank is satisfied with the client's financial position on the basis of its financial statements, before agreeing to increase the lending facility, the bank manager needs greater assurance that the financial statements are reasonably accurate.

The practitioner proposes a limited assurance engagement that looks at the financial statements overall but at a lower cost. The result is that the bank is happy with the focussed nature of the review and the level of assurance on the financial statements, and provides the additional funding. The business owner is also happy with the cost, which is lower than the full audit alternative. Hence, the practitioner has been able to suggest a review engagement, which is a practical and a cost effective solution to the conflicting demands of the bank and the client.

Objectives of a limited assurance engagement

In a limited assurance engagement, the practitioner:

- gathers sufficient appropriate evidence,
- ensures that the subject matter conforms with the relevant criteria,
- to ensure that level of risk that is acceptable in the circumstances of the engagement, (but where the risk is higher than for a reasonable assurance engagement) and
- expresses the opinion in a negative form.

This form of assurance engagement gives a level of limited assurance that is proportional to the extent of the given circumstances. A common example of a limited assurance engagement is a review engagement which is discussed later in this Study Guide.

Absolute assurance

In most cases, users of financial information would expect a practitioner to provide 100% assurance during the audit or assurance engagement. Issuing such assurance level is not practical due to inherent limitations that are associated with assurance engagements. For this reason, International standards on assurance engagement (ISAE 3000) do not permit a practitioner from issuing a total assurance (absolute) other than the reasonable and limited assurance.

Absolute level of assurance cannot be given due to the inherent limitations associated with the work of the practitioner which includes;

- The use of selective testing.
- The inherent limitation of internal controls.
- The fact that much of the evidence available to the practitioner is persuasive rather than conclusive.
- The use of judgment in gathering and evaluating evidence and forming conclusions based on evidence.

Example

The audit report of Kiwira Company includes the following statements:

- Based on the work as described in this report, nothing has come to our attention that causes us to believe that the financial statements are not prepared in accordance to the accounting standards.
- Further, nothing has come to our notice that causes us to believe that internal control is not effective, based on the levels set by the company.

These statements show that this is a limited assurance engagement. Note that the assurance given is negative. For example, "No errors were found", or "We found no evidence of fraud".

You will understand that these statements are weaker than positive assurances such as "There are no material errors", or "No material incident of fraud has occurred".

2.2 Level of assurance provided by other review engagements

1. Review engagements

The review engagement is a means of providing limited or moderate assurance on financial statements and potentially also other information. Many clients may simply require an overall review of the financial statements that also focusses on a specific area or areas in more detail. Under these circumstances, a review engagement may be the appropriate service to provide this assurance.

A review engagement does not normally involve a study and evaluation of internal accounting controls, detailed tests of accounting records, or corroborative evidence through inspection, observation and confirmation. These are all the features of an audit. The procedures to be performed in a review engagement will vary depending on the specific requirements of the engagement.

They are generally based on:

- Gaining an understanding of the client's activities, including knowledge of the accounting practices of the industry or area in which the client operates and
- Inquiry and analytical review.

The objective of a review of financial statements 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 cause the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework (negative assurance).

2. Agreed upon procedures

Agreed upon procedures is an engagement

(i) In which an auditor is engaged to carry out procedures of an audit nature;

(ii) To which the auditor and the entity and any appropriate third parties have agreed and

(iii) to report on factual findings.

In an 'agreed upon procedures' engagement, the auditor is engaged in performing certain procedures concerning individual items of financial data e.g. accounts receivable.

Example

If Mr. Ambilike, an auditor of Ruaha Company is engaged for agreed upon procedures on accounts receivables, he will perform the following procedure:

- Obtain customers' statements or confirmation certificates from the customers.
- Compare the balances in statements with the balances in the entity's books.
- Obtain reconciliation and list outstanding invoices, credit notes and outstanding cheques etc. for large amounts.
- Enquire into old and unusual items.
- Compare the balances of major customers with the related names and amounts in the trial balance.
- Compare the total amount of account receivables in the trial balance with the total amount in the general ledger.

He will not perform any other features, as done in the normal audit.
In an 'agreed upon procedures' engagement, the auditors **will not express their opinion,** instead they will only **give the factual findings. There will also be no assurance given by the auditors.** It is up to the person who has appointed the auditor to draw conclusions from the facts given by the auditors. The access to this report will be restricted to those parties that have agreed to the procedures to be performed.

3. Compilations

A compilation of financial statements is an accounting service:

(i) in which an accountant prepares or assists in preparing financial statements;

(ii) without expressing any assurance

(iii) That the statements are accurate and complete.

In other words, it is an engagement which requires more accounting expertise than auditing expertise and is used to collect, classify and summarise financial information. It means to present data in a manageable and understandable form.

Compilation covers the preparation of the financial statements as a whole, or just a part of them. Compilation also includes collection, classification and summarisation of other financial information. **Compilation** does **not provide assurance** but it only **gives compiled information.**

The financial information compiled by the accountant should contain a reference such as **"Unaudited"**, "**Compiled without audit or review**" or "**Refer to Compilation Report**" on **each page** of the financial information or **in the front of the complete set** of financial statements.

The accountant's report in a compilation engagement should state the following:

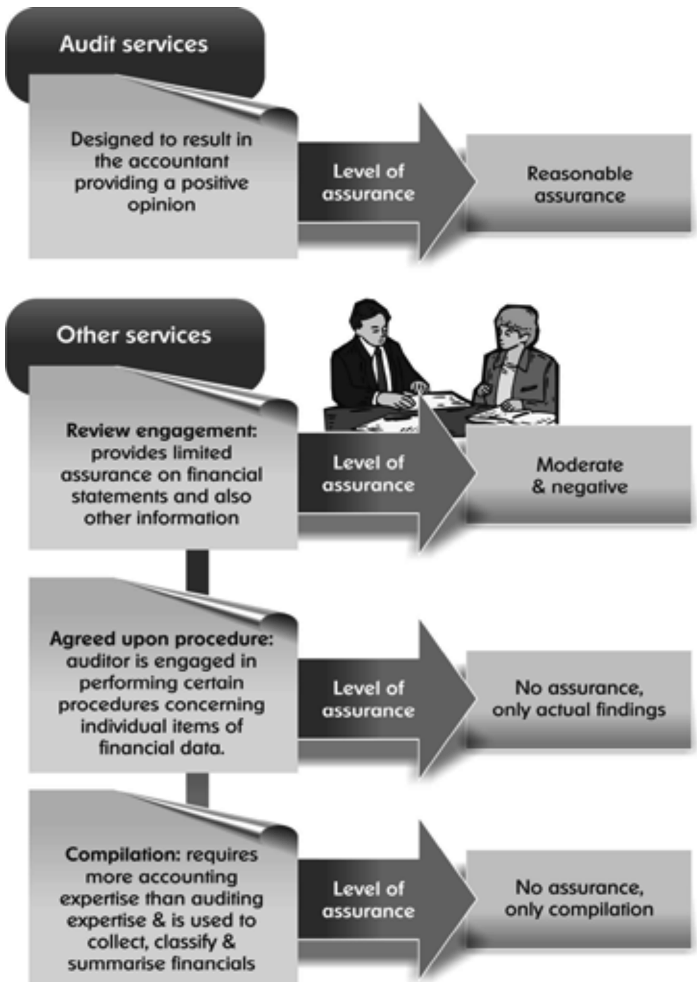
(i) A compilation is limited to a presentation of financial statements that are the representation of management.
(ii) The accountant has not been audited.
(iii) The accountant has not been reviewed.
(iv) The accountant disclaims an opinion and gives no assurance on the financial statements.

Example

Imalaseko Retails has asked its accountant, Benito, to compile financial statements that may not consider the disclosure of all generally accepted accounting principles.

Benito would compile the financial statements but would not express his opinion or give assurance. He would just present them in a manageable and understandable form and his report should clearly state that the financial statements have not been audited and reviewed.

Diagram 3: Level of assurance



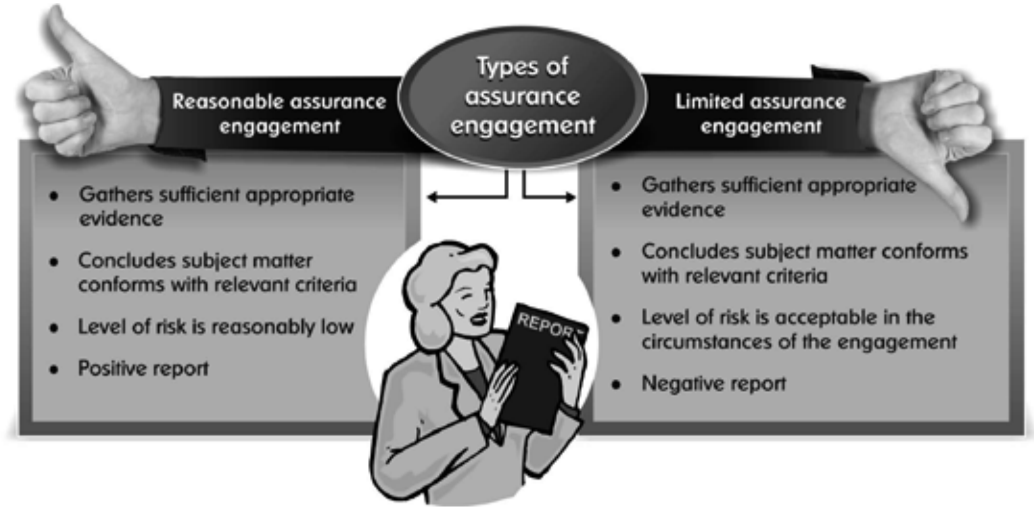
2.3 Comparisons between reasonable assurance engagement and limited assurance engagement

Under both engagements, the auditor gathers sufficient and appropriate audit evidence. However, there is a difference in the extent of evidence required under both engagements.

A lower level of evidence will be obtained for a limited assurance engagement as the assurance provided by the auditor is for a limited subject matter. e. g. in an assurance engagement where the auditor provides assurance on the entity's compliance with labour laws, the auditor will gather evidence sufficient to provide an assurance on this compliance only.

However, the extent of evidence gathered in a reasonable assurance engagement will be higher as the auditor needs to gather evidence relating to various aspects of the financial statements.

Diagram 4: Reasonable assurance engagement vs. limited assurance engagement



4 Expectation gap

Expectation gap is the gap between what public believe that auditors do and what actually auditors do or ought to do. Expectation gap occurs when the audits fail to meet the expectations of users of audited financial statements. The public is generally not aware of the auditor's actual standards of performance and the scope of his work and therefore there is always a difference between the auditor's performance and the public's expectations of the auditor's performance.

Expectation gap can arise because of the following categories:

- A standard gap - where the public believe auditing standards to be different from what the auditor actually do.
- Performance gap - where auditors operates below required standards
- A liability gap - where the public do not understand whom the auditor owes responsibility or accountability.

Factors contributing to the Audit Expectation Gap

Knowing the source of expectation gap (EG) is very important for the parties involved in the EG because it become be easier to address the problem. The source of the expectation gap can be categories into five components as explained below:

Deficient audit standards.

The audit standards do not exhaustively address all issues happening in audit. The blame for this deficiency is laid on the audit profession. For instance the audit standards do not place full responsibility over the auditor regarding detection fraud and illegal acts in the audited financial statements (ISA 240). Yet it has been widely reported that non detection of fraud and management wrong doings are one of the major expectation gap.

Substandard performance of the auditors

Expectation gap may also arise from unsatisfactory performance by an auditor i.e. low quality of the audit work performed . The blame for this deficiency is logically placed on auditor for non adherence to the required professional guidelines and standards.

Unreasonable expectations of the public

Ambitious expectation from the public may result to expectation gap. The source of this audit expectation gap is public and arise from lack of knowledge to the public about audit profession and acceptable conducts.

Minimizing expectation Gap

Audit expectation gap is a phenomenon which is likely to exist for a number of year to come. However efforts from all the concerned parties can minimize the gap. The following are just some of the measures that may reduce the expectation gap.

- Reducing non-audit services as a way of fostering more independence.
  Strict measures should be adopted by the regulator to enhance independence and quality of audit work.

- Awareness and education.
  Auditors believe that the expectation gap is largely due to the lack of public's understanding on the role of auditor in examining financial statements particularly in relation to fraud and error detection. To minimize this gap, there should awareness program and education to the public on auditor's role and guiding standards

- Reduce ambiguity in ISAs or Role of Standards.
  The international standards on auditing (ISAs) need to be refined on continual basis in order to minimize subjectivity of auditors and misapplication of auditor's judgments

2.4 Types of audit: Internal and external audit

Having discussed what an audit is, it is necessary to understand how an audit can be classified.

The function of auditing consists of two components (internal and external) and is primarily involved with providing assurances. In an external audit, an assurance is provided on the reliability and accuracy of published financial information (e.g. an organisation's SOFP). **With internal audit an assurance is given on the reliability and effectiveness of an organisation's risk management, internal control and corporate governance systems.**

1. Internal audit

Definition

Internal audit function: a function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

ISA 610(revised)

An internal audit is an audit on behalf of management to ensure that the existing internal controls are adequate and effective and each unit of the organisation follows the policies and procedures as laid down by top management. An internal audit is conducted by internal auditors, who are integral to the organisation and provide on-going assessment of all activities.

Example

The Rongai organisation is a Tanzanian company that is in the lumber trade. The organisation begins its operations by felling trees from a forest. The tree trunks are then cut into standard sizes and transported back to the organisation's warehouse.

The trunks are then categorised and stored in terms of size and quality (e.g. high, medium or low quality as well as large, medium or small sizes). The marketing team then sets about obtaining orders for various quantities of lumber from organisations across East Africa. Once an order has been secured the corresponding lumber is then dispatched to a nearby shipyard and transported to the customer. Internal controls include:

Ensuring a forward currency contract is booked each time an order is secured;

Making sure that all lumber is insured whilst on the organisation's premises and whilst in transit to the customer;

Weekly physical checks of the inventory on hand against inventory records;

Monthly checks to ensure that all relevant taxes such as VAT have been paid and are current;

Monthly checks on the number of trees being felled; and

Weekly checks to ensure that lumber is being sold at the proper market rates and terms.

Internal auditing is the function of examining and testing whether these systems have been properly designed and are functioning properly. It is important to note here that internal auditors play a very different and distinct role from management. Management is responsible for identifying potential risks in the strategy / objective setting process.

Example

An internal audit for the Rongai organisation would require the following activities to be performed:

- examining a sample of past orders to see if a corresponding forward currency contract had been booked at the time of the sale;
- Examining all insurance policies for amounts insured for and dates, to ensure that they are accurate;
- Attending some of the weekly physical inventory checks and observing how staff conduct these checks in order to ensure accurate records on inventory are being maintained;
- Examining all tax records and corresponding receipts;
- Examining a sample of production reports against inventory records for the same period and
- Examining a sample of past sales records to determine if the sales had been made at the relevant market rates and terms for that time.

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2. External audit

An external audit is performed by external auditors, who are independent of the organisation and provide an independent opinion on the organisation's financial statements.

If accounts are audited internally, the overall objective behind the audit is lost because the accounts and the financial statements prepared are not independently examined. An **external audit** is primarily concerned with the verification of accounting data in order to determine the accuracy and reliability of financial statements. In other words, it **is a review and assessment of the financial records to form an overall conclusion as to whether:**

- The financial statements show a **true and fair** view.
- The financial statements have been prepared using acceptable accounting policies, which have been consistently applied.
- The financial statements comply with all the relevant regulations and statutory requirements.
- Adequate disclosure of all material matters relevant to the proper presentation of financial information has been made.

In most developed countries, all publicly quoted companies as well as all large companies are required by law to produce annual financial statements and have them audited by external auditors. Other organisations may also choose to get their accounts audited, even if there is no legal requirement.

3. Qualities of External Auditor

Qualities of external auditor can be divided into two parts:
i) Technical qualities
ii) Personal qualities

Technical qualities
The auditor must have necessary professional qualifications i.e. technical knowledge of accounting and auditing. Also external auditor must be familiar with standards accounting and auditing practices and other regulatory regulations. An auditor in Tanzania must be registered with the NBAA as " Certified Public Accountant in Public Practice" .

Personal qualities
Independence
Independence is defined as an attitude of mind characterized by integrity and an objective approach to professional work.

Independence can also be defined as a quality which permits an individual to apply unbiased judgment and objective consideration to established facts in arriving at an opinion or decision.

IFAC Code of ethics requires firms and members of assurance teams to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules which may be arbitrary in the public interest.

Independence are of two types:

(a) Independence of Mind
The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectively and professional scepticism.

(b) Independence of Appearance

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's integrity, objectivity or professional scepticism had been compromised

2.5 Benefits gained from the different types of audit and assurance assignments including those relating to financial statements, internal controls, corporate social responsibility and sustainability reports

1. Benefits of audit relating to internal controls

Effective internal audit function:

(a) **identifies** any **weaknesses** and / or **areas for improvement** in an internal control system;
(b) provides management with a **feedback mechanism** as well as an **independent assessment** of its departments / processes: this enables the management to exercise effective controls and take corrective action where required;
(c) Provides an organisation with **an objective evaluation** of **all potential risks including detection of fraud and errors**;
(d) Provides **regular examinations** and **evaluations** of its internal control system; and
(e) Provides **regular reviews** of its **operational and financial performance**.

2. Benefits of audit relating to corporate social responsibility and sustainability

A social and environmental audit is a systematic, independent internal review to check whether the results of environmental and social work meet the targets. It also focuses on whether the methods used to achieve goals are effective. In other words, the work of a social and environmental audit is a study of documents and reports to see whether there are any deviations from targets.

A social and environmental audit can add to an organisation's annual financial audit in the following ways:
(a) It can provide clear and concise information on performance against social objectives.
(b) The outcomes can be incorporated in the organisation's strategic review and planning processes to improve overall performance and social impact.

(c) The accountability of the organisation to its stakeholders can be increased and can also be used for marketing, promotion and propagating purposes.

3. Benefits of external audit relating to financial statements:

(a) Audited financial statements are an important part of the financial information that is available to investors and an important part of effective corporate governance. An audit improves the reliability of financial statements i.e. it makes them more credible and increases shareholders' confidence in them.

(b) Audit facilitates tax calculations and makes them more reliable and acceptable to tax authorities.
(c) Audited accounts make borrowing easier, prompt and adequate.
(d) Audited accounts help or even may be a necessity for securing a government contracts and various licences.

(e) Audited accounts can be used as a source of evidence in a court of law.

(f) Auditing helps in settling disputes, obtaining credit, securing loans, admitting a partner and selling a business

Example

A Tanzanian Company, Masika Ltd has engaged a CPA, Fair, to prepare and audit the financial statements of the Company. It is the duty of Fair:

To express an opinion on the **truth and fairness** of the financial statements.
To check whether the financial statements have been prepared using appropriate accounting policies.
To see whether the financial statements comply with all the relevant regulations and statutory requirements as laid down by the Government.
To see whether adequate disclosure of all significant matters related to the proper presentation of financial information has been made.

Test Yourself 2

The audit report of Segera Limited includes the following statements:

All the government guidelines with respect to environmental issues have been complied with.
Nothing has come to our notice that makes us believe that NEMC guidelines have not been complied with.

Required:

Identify the type of assurance engagement and give an appropriate reason.

3. State and explain the meaning of an opinion and an assurance report.

[Learning Outcome d]

3.1 Opinion

The objective of an external audit engagement is to enable the auditor to express an opinion on whether all the financial statements have been prepared in all material respects, in accordance with the applicable financial reporting framework. The basic aim is to express an opinion on the **truth and fairness** of the financial statements.

The auditor's report contains a clear written expression of opinion on the financial statements. An unqualified opinion is 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.

An example of how an opinion on the financial statements is expressed by an auditor is given below. This example highlights the objective of financial statements.

Example

Independent Auditor's Report

We have audited the financial statements of Kirereni Company for the year ended October 31, 20X9. We conducted our audit in accordance with the International Standard on Auditing.

An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the supplementary information. We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the information is free from material misstatements

The financial statements of Kirereni Company have been prepared, in all material respects, in accordance with the financial reporting framework. In our opinion and based on the information available to us, the financial statements provide a true and fair view of the financial position of the company.

M. Ali
8 December 20X9

3.2 Assurance Report

An assurance report is the opinion that is given by the practitioner to the intended user and the responsible party.

ISA 700 states that the auditor's report should contain a clear expression of the auditor's opinion on the financial statements. When the audit is conducted in accordance with ISAs it leads to consistency in reporting and offers credibility to the audit reports on a global level. It also improves the understandability of the audit reports for the readers.

The assurance report is discussed in detail in Study Guide E1.

Test Yourself 3

Why does an external auditor provide an opinion on whether the financial statements are true and fair rather than true and correct?

Answers to Test Yourself

Answer to TY 1

The key elements of assurance engagement

A three-party relationship is present, involving Hassan (the intended user), Samweli (the practitioner) and the directors of Mwenge Technologies (because they produce the financial statements - the responsible party)

A suitable subject matter is the financial statements that the responsible party (Mwenge Technologies) has prepared, and which requires verification.

Suitable criteria would be the applicable financial reporting framework. The financial statements would be compared to the criteria in order for them to be assessed and an opinion provided.

Appropriate evidence has to be obtained by Sam in order to give the required level of assurance.

An assurance report in the appropriate form is the opinion that is given by the practitioner to the intended user and the responsible party.

Answer to TY 2

The first statement that all the government guidelines with respect to environmental issues have been complied with is an example of a reasonable assurance engagement. The practitioner has given a positive assurance report, after having performed intensive procedures and gathering sufficient evidences to reduce risk to an acceptably low level.

The second statement that nothing has come to the notice of the practitioner that causes him to believe that NEMC guidelines have not been complied with is an example of a limited assurance engagement. This is a negative assurance report that conveys a level of limited assurance that is proportional to the given level of circumstances and involves a moderate level of risk.

Answer to TY 3

The external auditor has to report whether the financial statements are true and fair and not true and correct.

Truth and correctness concentrates only on arithmetical accuracy and not on the application of the accounting principles and disclosures.

However, the financial statements may contain a figure such as valuation of a property that is an estimate and where it is impossible to say precisely what the correct figure is. As long as the auditor agrees that the estimate is reasonable, the auditor can state in the report that the financial statements are true and fair.

It is also practically difficult for an auditor to provide an opinion on the truth and correctness of financial statements due to limitations of audit like auditors conducting audit on transactions on sample basis rather than on 100% transactions due to the huge volume of transactions.

Quick Quiz

1. The objective of an assurance engagement is:

   A To measure or evaluate a subject matter in compliance with the standards to express an opinion that gives a level of assurance to the intended user.
   B A reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement
   C To review and monitor all the activities of the entity, financial as well as non-financial, and provide assurance and recommendations on the activities of the entity
   D To ensure the overall well-being of stakeholders

2. In a reasonable assurance engagement, the level of risk:

   A Is very high
   B Is acceptable in the circumstances of the engagement
   C Is nil
   D Is reasonably low

3. Match the following:

A	B
(a) Audit engagement	i. Agents of the shareholders
(b) Review engagement	ii. Owners of the organisation
(c) Management	iii. High assurance and positive report
(d) Shareholders	iv. Moderate assurance but negative report
(e) Agreed upon procedures	v. No assurance, only factual finding

4. Audit is an assurance assignment. State whether this is true or false and give reason.

5. The primary responsibility of preparation of financial statements is that of

   A Shareholders
   B Audit committee
   C Board of Directors
   D Auditors

Answers to Quick Quiz

1. The correct option is **A.**

   Option B relates to the objectives of a limited assurance engagement. Option C relates to the objectives of internal audit and option D describes the main objective of implementing a system of corporate governance.

2. The correct option is **D.**

3. a) (iii), b) (iv), c) (i), d) (ii), e) (v)

4. True; audit is an assurance engagement because the financial statements are checked by an independent auditor and this therefore provides assurance to the user that they can be relied upon.

5. The correct option is **C**.

   The directors of the company are responsible to prepare the financial statements.

Self-Examination Questions

Question 1

Explain the responsibilities of external auditors to directors and shareholders.

Question 2

Discuss the advantages and limitations of auditing.

Answers to Self-Examination Questions

Answer to SEQ 1

(i) External auditors are required to give assurance to shareholders in their report on the truth and fairness (or fair presentation) of financial statements.

(ii) The auditors are the agents of the shareholders, as they are appointed by them to evaluate the performance of the management.

(iii) Auditors are the agents of the shareholders. Therefore they have no duties towards the directors. However, they need to have a reasonable working relationship with them, so as to enable the smooth functioning of the audit activities and procedures. However, the directors are bound by a duty to provide the auditors with all information, explanations, and documents as and when required by the auditor during their performance of audit.

(iv) According to the auditing standards, the auditor is required to report the weaknesses of the systems discovered during the course of the audit to management.

Answer to SEQ 2

Advantages of Auditing

The fact that firms for which an audit is not compulsory also carry out an audit speaks highly of the direct advantages of auditing.

1. In the complex business world, where there has been a complete separation between ownership and management, an audit is the only effective source of crucial checks on directors or managers.

2. Although auditing does not ensure complete absence of errors and frauds, these are material misstatements should be found and corrected.

3. Auditing facilitates tax calculations and makes them more reliable and acceptable to tax authorities.

4. Audited accounts are a source of evidence in a court of law.

5. Auditing can help a company in:

   Settling disputes in the firm
   Obtaining or extending credit
   Obtaining loans
   Selling the business
   Converting it into another form of business organisation

The fact that more and more entities are introducing compulsory audits speaks of the various advantages of auditing.

Limitations of Auditing

Like any other art, auditing has limitations. Some of these are conceptual and others arise from the audit being conducted below standard.

(i) Auditors examine the prepared accounts. They may find themselves unable, despite their training and knowledge, to reveal any ingenious manipulation of accounts at the preparatory level. Hence, audited accounts do not always disclose the complete facts.

(ii) Auditing is normally conducted on a test basis.

(iii) Auditing depends heavily on judgement and opinion. Any wrong opinion, advice or estimate will restrict the audit's ability reveal problems.

(iv) Auditing, to be real, must have an independent auditor. This independence, however, can be compromised in practical life despite safeguards.

(v) A real and purposeful audit demands a sense of judgment, understanding and application in various circumstances and difficult situations. This judgment may vary from one auditor to another.

SECTION A

OBJECTIVES, PROCESS AND NEED FOR EXTERNAL AUDIT AND ASSURANCE

A2

STUDY GUIDE A2: REGULATORY REQUIREMENTS FOR OBTAINING ASSIGNMENTS

Get Through Intro

Imagine that you as a banker have a set of financial statements in front of you, brought by a customer who has requested for a loan from your bank. Neither do you have an access to the accounting records of the customer nor the time to do so. However, unless you are convinced that the financial statements are reliable, you may not like to grant loan to the customer. What do you do? You look for an independent auditor's audit report that confirms the fairness of the financial statements.

An audit is described as being an official examination of an organisation's financial statements and accounting records so as to be able to express an opinion whether the financial statements fairly represent the financial position and the result of the operations.

The audit framework ensures that the external auditors have the requisite qualification and experience and they actually exercise professional diligence while performing the audit function.

This Study Guide will discuss the appointment of auditors, the process through which auditors obtain assignments and the auditor's scope of work.

Learning Outcomes

a) State and explain the following basic components of an assurance process relating to the regulatory requirements of assignments:
   i. The approach, obtaining assignments and nomination
   ii. Accepting an engagement
   iii. Appointment, removal and resignation of auditors
   iv. Scope of work

1. State and explain the following basic components of an assurance process relating to the regulatory requirements of assignments:
i. The approach, obtaining assignments and nomination
[Learning Outcome a]

Tip

The basic steps / components of an assurance process can be split into three main areas:

Component of assurance process	Details of matters discussed	Discussed in
Regulatory requirements for obtaining assignments	The approach, obtaining assignments and nomination Accepting an engagement Appointment Scope of work	This Study Guide
Planning the engagement	Risk and risk assessment Different approaches to audit Planning	Study Guide A3
Obtaining evidence and testing	Performance Evidence and obtaining evidence Testing and other work Evaluating results Concluding and considering an appropriate report Reporting Records and working papers	Study Guide A4

1.1 The approach, obtaining assignments and nomination

Accountants and accounting firms are forbidden from directly marketing their services to potential clients. This means that they cannot directly contact a potential client (be it an individual or an organisation) and "pitch" the services they offer. In addition they cannot also engage in false advertising of any kind (e.g. claim expertise and experience they do not have) or unfairly criticise the work of other accountants.

Therefore for the scope of this Learning Outcome the assumption is made that the audit engagement process begins with an organisation approaching an accountant. At this point the organisation describes the type of audit work it would like conducted and discussions as well as negotiations begin.

Matters **that would be covered and agreed upon** in these talks would be:

1. The **objective of the audit** (e.g. a statutory audit on the organisation's financial statements);

2. The **extent of access to information the auditor would have** (e.g. would the auditor have complete and unhindered access to all information)

3. He **extent to which the auditor would be responsible for uncovering fraud** (e.g. the organisation suspects certain employees are embezzling and would like the auditor to investigate further as a separate assignment);

4. The **extent to which the auditor would be responsible for evaluating internal control systems** (e.g. if the previous auditor has commented that the internal control systems are not sufficient and the organisation would like a thorough re-evaluation);

5. The **number** (if any) **of areas of special concern** (e.g. the organisation requests the auditor to check a greater number of samples of receivables during the audit) and

6. The **remuneration** that would be paid to the auditor.

At this point the accountant (i.e. the nomine auditor) must also ascertain whether he has the necessary expertise, knowledge and resources (manpower and time) to competently and diligently complete the audit.

The fundamental principles are discussed in detail in section D of the book.

This would also include learning more about the organisation and the industry it operates in. The accountant must also be reasonably certain that taking on the assignment will not cause him to violate any of the five main fundamental principles of the Code of Ethics.

The audit fees quoted by the auditor must reflect the level of risk expected in respect of the audit and should not breach the 10% / 15% maximum rule for fees received from any single client. (i.e. if the client is a public interest company, the fees should not exceed 15% of the total fees received by the firm and for other clients, it should not exceed 10%)

In order to understand the entity, the auditor will also assess the integrity of the board of directors running the company. This is because the auditors of entities that are run by boards lacking integrity will not be able to adhere to the fundamental principles of The Code of Ethics for accountants (for example, client involvement in illegal activities such as money laundering, dishonesty or questionable financial reporting practices).

Information about clients can be obtained from the entity's bankers, solicitors, press reports, annual accounts, credit ratings, etc.

This leads to the stage of the accountant needing to communicate with the organisation's previous / current auditor. The process and protocol that must be followed here are:

The accountant needs to obtain their prospective client's permission to contact the auditor;

If the organisation refuses to give this permission (for whatever reason) then the accountant must respectfully decline the assignment;

If permission is granted the accountant should then write to the auditor informing him of the intention to become the organisation's new auditor. The accountant may use this opportunity to obtain further information about the organisation / audit assignment and get answers to any queries he may have;

The previous / current auditor has to obtain permission from the client to communicate with the new auditor.
If the client does not grant this permission, the audit should be declined.

The auditor would then either write back with a favourable report, an unfavourable report or not reply at all;

If the report is favourable the accountant may then accept the assignment;

If the report is unfavourable the accountant should then turn down the assignment and

If no reply is received then the accountant must use their judgment and discretion as to whether to accept the assignment.

The reason for this stage is that regulatory bodies consider it highly important for the prospective and the current / previous auditors to have a chance to communicate. This allows the previous / current auditor to point out and explain any grievances he and the organisation have had and any other areas of importance.

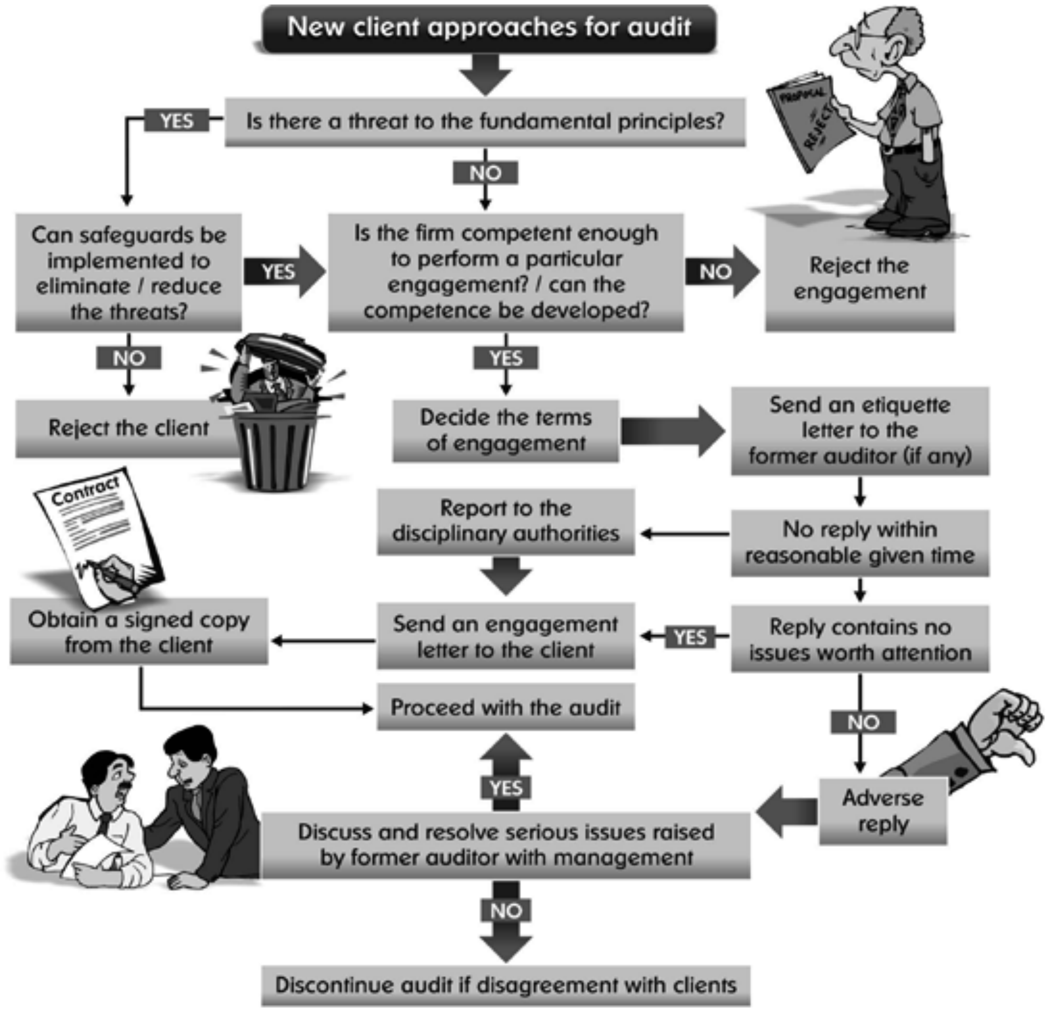
If the report is favourable the accountant is now reasonably confident that he can competently complete the assignment on the agreed upon terms and conditions. The accountant should then send out an audit engagement letter to the organisation.

The content of an audit engagement letter is basically all the topics that have been discussed and agreed upon by the accountant and the organisation. Therefore it represents an official documentation of all the terms and conditions of the audit and is signed by both parties.

Audit engagement letters are important because they outline the responsibilities and expectations of both parties and help to avoid any misunderstandings taking place during the course of the audit.

The final stage of the audit engagement process is that the audit engagement letter is sent to an organisation's board of directors for approval. In most jurisdictions the appointment of the auditor must also be voted upon by the organisation's shareholders (usually during their annual general meeting).

Diagram 1: Process through which an auditor obtains an audit engagement



The steps given in the above diagram will guide the nominee auditor on whether to accept the nomination.

Example

Situations which indicate a high engagement risk are as follows:

- Significant weaknesses in client's internal control systems
- Client involvement in money laundering activities
- Non-availability of qualified accountants with client
- Dishonest management
- Probable lack of finance with client.

Tip

The ethical aspects of obtaining 'other assignments' is quite similar to the above, except that the auditor / accountant will not be required to send out an 'etiquette letter' to the former auditor. Furthermore, the legal considerations those are applicable to 'assurance engagements' would be quite different from other engagements. For example, in money laundering, an accountant should understand not only his new clients but also those clients to whom he provides services on an on-going basis. This means that an accountant should review customer due diligence and other client information periodically.

Test Yourself 1

Along with considering the nature and scope of the assignment what other considerations must an accountant bear in mind before accepting an audit engagement?

2. State and explain the following basic components of an assurance process relating to the regulatory requirements of assignments:
ii. Accepting an engagement

[Learning Outcome a]

2.1 Accepting an engagement

Preconditions in relation to the acceptance of new audit engagements

According to ISA 210, auditors need to carry out the following steps before accepting a new audit or continuing on an existing audit engagement.

Step 1

Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable.

For determining this, the auditor needs to consider the following factors:

(i) The nature of the entity, (for example, whether it is a business enterprise, a public sector entity or a not for profit organization)

(ii) The nature and purpose of the financial statements; and

(iii) Whether law or regulations prescribes the applicable reporting framework.

For example the financial statements of an entity which is listed on the Dar es Salaam Stock Exchange (DSE) should be prepared in accordance with IFRSs, whereas the financial statements of an entity which is listed on the New York Stock Exchange (NYSE) should be prepared in accordance with US GAAPs.

Step 2

Obtain an acknowledgement from the management relating to its responsibility on the following matters

(i) Preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;

(ii) 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; and

(iii) To provide the auditor with:

Access to all relevant information (including records, documentation) relating to the preparation of the financial statements,

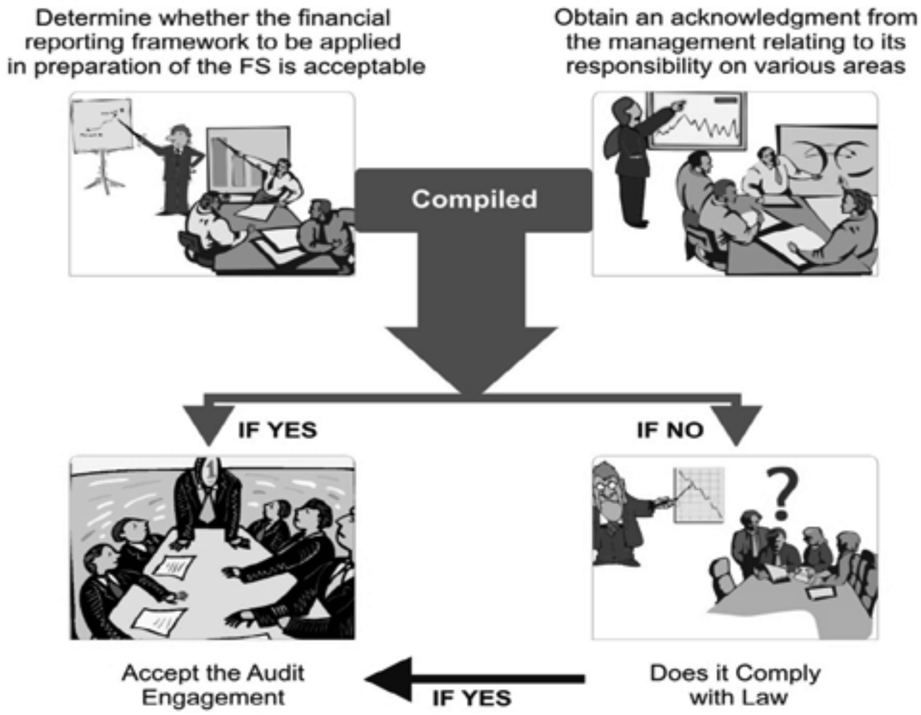
Any additional information that the auditor may request from management and

Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Conclusion

If the preconditions for an audit are not present, the auditor shall discuss the matter with management. If any of the preconditions mentioned above are not met, the auditor shall not accept the proposed audit engagement, unless required by law to do so.

Diagram 2: The preconditions in relation to the acceptance of new audit engagements



3. State and explain the following basic components of an assurance process relating to the regulatory requirements of assignments.
iii. Appointment, removal and resignation of auditors

[Learning Outcome a]

3.1 Appointment

1. Who can be appointed as auditor?

(a) Only a **member of a recognised supervisory body is** eligible to be appointed as an auditor. The person to be appointed as the auditor is required to hold a professional accountancy qualification.

Example

In Tanzania, auditors should be members of the NBAA and should have qualification of CPA (T) (Certified Practicing Accountant) from the NBAA.

In the UK, the accountancy qualifications are awarded by the following supervisory bodies which recognise professional qualifications for auditing purposes.

The Institute of Chartered Accountants in England and Wales,
The Institute of Chartered Accountants of Scotland,
The Institute of Chartered Accountants in Ireland,
The Chartered Association of Certified Accountants, and
The Association of Authorised Public Accountants

These 5 principal accounting bodies together form the CCAB – Consultative Committee of Accountancy Bodies:

Association of Chartered Certified Accountants (ACCA)
Chartered Institute of Management Accountants (CIMA)
Institute of Chartered Accountants in England and Wales (ACA)
Institute of Chartered Accountants of Scotland (CA)
Chartered Institute of Public Finance and Accountancy (CPFA)

(b) **An external auditor is an independent person i.e. not related** to the entity in any capacity other than as an auditor. Therefore, a person cannot be appointed as an auditor if he is:

(i) An officer or employee of the company

Example

Florence, a CPA (T), is employed with CBC Ltd as the chief accounts officer. As an employee of the company she cannot be appointed as the auditor of the company.

(ii) An officer or employee of an associated company, parent company or subsidiary company

Example

Florence, an CPA (T), is employed with CBC Ltd as the chief accounts officer. CBC Ltd is a subsidiary company of CTC Ltd. Florence cannot be appointed as the auditor of CTC Ltd. This is because she is an employee of an associated company i.e. CBC Ltd.

(iii) A partner or an employee of an officer or employee of the company, or

(iv) A partnership of which such a person is a partner.

(c) A person is qualified to be an auditor **only if he possesses a current audit-practising certificate issued** by a recognised supervisory body.

(d) In addition to the above, a qualified auditor **should possess integrity, objectivity, professionalism, good communication skills, good information technology skills** and thorough knowledge of accounting and auditing issues.

Tip

Appointment of auditors should not be restricted to The Companies Act requirements. Different laws forming different entities have specific clauses / provisions for appointment of auditors. For example in Tanzania, dealers of securities are appointed in accordance with the provisions laid down in The Capital Markets and Securities Act.

2. Who appoints an auditor?

Only a member of a recognised supervisory body is eligible to be appointed as an auditor. The person to be appointed as the auditor is required to hold a professional accountancy qualification.

Generally, an auditor is **appointed by the shareholders in the Annual General Meeting** and holds his post until the conclusion of the next AGM in which the auditor for the next year is appointed. Sometimes an auditor is appointed by the directors or the audit committee.

For **entities in which a government own at least 50% (i.e. public body), their accounts are audited by Controller and Auditor General (CAG)**. This is as per provision from the Constitution of United Republic of Tanzania of 1977 and the public audit act of 2008. However, the CAG is mandated to subcontract and appoint any other independent audit firm to carry the audit of a public body. The public sector has been covered in section F

3.2 Removal of an auditor

Generally an **auditor is removed / resigns when there is a serious disagreement between the auditor and management,** such as a disagreement on the accounting policies.

In order to protect the interests of the auditor as well as the shareholders, in many countries, **the law requires the consent of a majority of shareholders for the removal of the auditor so as to protect the interests of the auditor.** It also provides an opportunity for the auditor to make a representation before all the shareholders.

The auditor has to give a statement to all the shareholders in the Annual General Meeting about the reason for

the disagreement. This is to ensure that the auditor has not been removed simply to protect the management's interests.
The facts should be communicated to the shareholders. The letter communicating the circumstances is usually called a **statement of circumstances**.

Example

Emmanuel was appointed as the auditor of Arusha Company Limited for 20X7. During the audit, he noticed that management had committed fraud. The management of Arusha Company Limited decided to remove Able from his post.

In this situation, Emmanuel could make a statement of circumstances to the shareholders stating the facts of the removal and revealing the fraud. If this opportunity was not given to Emmanuel, management could have removed him to ensure that the fraud committed by them would not come to the notice of the shareholders.

3.3 Resignation of an auditor

We know that generally an auditor resigns when **there is a serious disagreement between the auditor and management,** such as a disagreement on the accounting policies.

Example

Lunogelo has been newly appointed as the auditor for Mafinga Plc. The company is introducing a new product this year and for this, it has decided to raise funds from the bank. The directors of Mafinga Plc inform Lunogelo, that to obtain a loan it is necessary that the audit report should be unmodified.

During the course of the audit, Lunogelo finds that in order to show more profit, depreciation on the assets has not been provided. Therefore she cannot give an unmodified report. Management does not agree with Lunogelo. Lunogelo decides that she will not continue with the assignment and resigns.

The auditor should communicate his resignation to the entity. The **communication should be made in writing along with a statement of circumstances**. If there is nothing in particular that the shareholders should know about, then this should be made clear in the statement of circumstances Company act 2002

According to Company Act 2002, Section 177 require that the **appointment of the auditor, his removal or his resignation should be communicated to the regulatory authorities.**

Example

In the above example, when Lunogelo resigns, she needs to make a statement about why she resigned. In this she should explain the circumstances that led to her resignation i.e. she was being pressurised into giving an unmodified audit report.

Test Yourself 2

In order to remove the auditor, the following is required:

A Consent of all shareholders
B Statement of circumstances
C Consent of all board members
D All of the above

---

4. State and explain the basic components of an assurance process relating to the regulatory requirements of assignments.
iv. Scope of work

[Learning Outcome a]

4.1 Scope of work

An **audit engagement occurs when an organisation has enlisted the services of an accountant to conduct an audit**. The accountant and the organisation have worked out the terms and scope of the audit and documented these in an engagement letter which is then signed by both parties.

Effectively, the engagement letter acts as a contract between auditor and client. Furthermore it also ensures that no misunderstanding arises between the client and the auditor.

1. Contents of an audit engagement letter

It contains:

(a) **Confirmation that the auditor has accepted the appointment**. The engagement letter creates a contract between the auditor and the client.

(b) **A summary of the responsibilities of client's management** (e.g. directors in the case of a company) and auditors;

(c) **Details** on:

(i) The **objective of the audit**

(ii) The **responsibilities of the directors** e.g. maintenance of accounting records, the preparation of the financial statements and the selection of accounting policies that are used to prepare them.

(iii) The **responsibilities of auditors** and the **scope of the audit** e.g. duty to conduct audit in accordance with various applicable auditing standards, to review accounting policies and practices of the client and to form an opinion on the client's financial statements

(iv) The **form of report that will be issued after the audit**

(v) Any **other services** that would be provided by the auditor

(vi) The **method through which the audit fees would be calculated and billing arrangements made**

(vii) The various **applicable legislations**

The following information can also be included in an audit engagement letter:

- The form in which any other communication may take place between the client and the auditor.
- The auditor's expectation that the management will provide the auditor with written representations.
- The fact that even after conducting an audit in accordance with ISAs, the auditor may not detect some material misstatements due to the inherent limitations of the audit and the internal controls used by the client.
- The arrangements to be made for planning and performing the audit e.g. composition of audit team.
- Involvement of other auditors, experts, internal auditors and other staff.
- Any arrangement that must be made with the previous auditor.
- Any obligation that requires the auditor to provide audit working papers to other parties.
- A request to the management to acknowledge the receipt of the engagement letter and to accept the terms of the audit.
- Any restriction on the liability of the auditor.
- A reference to any further agreement between the auditor and the client.
- Practical arrangements, such as audit timing and reporting dates.

2. Proforma of an Audit Engagement Letter

The following letter is an example of an audit engagement letter for an audit of general purpose financial statements. This audit engagement letter deals with the audit of financial statements for a single reporting period. This audit engagement needs to be adjusted according to individual requirements and circumstances.

Example

To the appropriate representative of management or those charged with governance of ABC Company:

The objective and scope of audit

You have requested that we audit the financial statements of ABC Company, which comprise the SOFP as at __________, and the SOCI, SOCIE and SOFP for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of expressing an opinion on the financial statements.

The responsibilities of the auditor!

We will conduct our audit in accordance with International Standards on Auditing (ISAs). 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 judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.

In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the

Auditor disowns responsibility of efficiency of the internal controls used by

purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

Our audit will be conducted on the basis that (management and, where appropriate, those charged with governance) acknowledge and understand that they have responsibility:

(a) For the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards;

(b) 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; and

(c) To provide us with:

(i) Access to all information of which [management] is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
(ii) Additional information that we may request from [management] for the purpose of the audit; and
(iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence.

As part of our audit process, we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

XYZ & Co
Acknowledged on behalf of ABC Company by
(Signed)
....
Name and Title
Date

Test Yourself 3

Nestory has directly telephoned the CFO of an organisation and asked to be their auditor. During the course of the conversation Nestory has also stated that their current auditor is too expensive and that he would do a better job at a cheaper price. Does this constitute an ethical breach of conduct?

Answers to Test Yourself

Answer to TY 1

An accountant must also carefully consider whether he will be able to work on and complete the audit without compromising on any of the five main ethical principles.

Answer to TY 2

The correct option is **B.**

Consent of all the shareholder or board member is not required. Only a majority of shareholders can remove the auditor. However, in order to protect the interest of the shareholders and the auditor, the auditor has a right to give a statement of circumstances, stating the reasons for removal.

Answer to TY 3

Yes, Nestory has committed an ethical breach of conduct. He has broken the following codes of conduct:

(a) An auditor must not directly contact prospective clients: an auditor is forbidden from directly contacting potential clients and pitching his services. Nestory telephoned the CFO and offered his services to the organisation.

(b) Acceptance of audit assignment without conducting due diligence: according to the code of conduct Nestory should have formally discussed the audit assignment with the prospective client. The discussion would have allowed Nestory to ascertain whether he has the required expertise, knowledge and resources to conduct the audit.

(c) Unfair criticism of a fellow auditor: Nestory may not have sufficient data to comment on the services provided by another auditor to the organisation. Hence, his criticism of the organisation's accountant is unfair.

Quick Quiz

1. Explain any two provisions relating to appointment of an individual as an auditor.

2. Which of the following statements is / are correct?

   A An officer or employee of the parent company can be appointed as an auditor
   B The auditor is appointed by the shareholders for a period of 5 years
   C An officer or the employee of the company cannot be appointed as an auditor
   D None of the above

3. Fill in the blanks:

   (a) The engagement letter creates a _________________ between the auditor and the client.

   (b) For entities in which a share is owned by the state, the auditor is appointed by __________________________.

   (c) If any of the preconditions mentioned above are not met, the auditor shall not accept the proposed audit engagement, unless____________________.

Answers to Quick Quiz

1. The following are the provisions regarding the appointment of an individual as an auditor:

   (a) Only a member of a recognised supervisory body is eligible to be appointed as an auditor. The person is required to hold a professional accountancy qualification.
   (b) An external auditor should be an independent person i.e. not related to the entity in any capacity other than as an auditor.
   (c) A person is qualified for being appointed as an auditor only if he possess a current audit-practising certificate issued by a recognised supervisory body.

2. The correct option is **C.**

   Option A is incorrect as a person cannot be appointed as an auditor if he is an officer or employee of an associated company, parent company or subsidiary company.

   Option B is incorrect as an auditor is appointed by the shareholders in the Annual General Meeting and holds his post until the conclusion of the next AGM in which the auditor for the next year is appointed.

3.
   (a) Contract
   (b) The Secretary of State or Ministry of Finance
   (c) Required by law to do so

Self-Examination Questions

Question 1

Alex is the managing director of Ilala Company. His sister, Martha, is a qualified chartered accountant from a recognised supervisory body holding audit-practising certificate. She is not directly related to Ilala Co in any manner other than being Alex's sister. Alex wants to appoint her as an external auditor of Ilala Co, as he thinks that she would be the best person to report on the financial position of Ilala Co bearing in mind she is his sister.

Required:

State whether Martha can be appointed as an external auditor of Ilala Co.

Question 2

You are a fairly recent CPA and for the past two years have been operating your own practice. Business has been good and you now have a portfolio of 10 clients comprising of various small and medium sized enterprises.

You have just been approached by a large corporate, Masaki Inc, with an offer to be their statutory auditor. The organisation owns and operates a chain of educational and training facilities spread across the globe.

In addition, they have also said they would require you to take on various MIS consultancy assignments over the course of the year.

The remuneration offered to you by the statutory audit itself is very attractive. In addition the income from the subsequent consultancy work would mean you would be able to triple your income.

However given your limited resources, taking on this assignment would mean that you would have to let all your other clients go and concentrate all your time and effort on Masaki Inc.

Required:

Explain why you should or should not take on this assignment paying particular attention to the fundamental principles of professional ethics and the conceptual framework.

Question 3

Fredrick is a partner with a large-sized firm of Chartered Certified Accountants. He has just been approached by Mwenge Technologies, a large manufacturing firm to be their statutory auditor. Fredrick is very interested in taking the assignment and has set up a meeting with the organisation's Chief Financial Officer and Finance Director to progress matters.

Required:

Discuss and describe the process that Fredrick must now follow to earn an audit engagement from Mwenge Technologies

Question 4

(a) The rights, duties and responsibilities of an auditor are sometimes confused with those of management by stakeholders. Some of them are of the view that the auditors are the same as the management of the company. This is based on the fact that the auditors and management of a company are both concerned with financial reporting. Although there is common ground regarding the actual work done, the functions of the auditors and management are essentially different. Consequently, their respective rights, duties and responsibilities will also differ.

Required:

Outline and explain any three:

(i) Rights of auditors.
(ii) Duties of the auditor.

(b) Assume that you have been properly appointed as an auditor of MAKARI Enterprises Ltd. As part of your first interim audit of the company you attended a wages payout. The exercise brought to light the fact that some of the wages were drawn for non-existent employees. Further enquiry revealed more that some of the wages were in fact for the personal domestic staff of the five directors of the company and that this had been a practice for some years. The practices were never authorized by any policy documents of MAKARI Enterprises Ltd.

You indicated that the matters should be reported to the shareholders. It seems that the directors were unhappy about your reaction of reporting the matter to the shareholders. You have been accordingly informed that your services are no longer required. You have received a special notice of general meeting of the company to be held for the purpose of dismissing you as one auditor of MAKARI Enterprises Ltd in due course.

Required:

(i) State the procedures applied to protect the removal of an auditor from the office.

(ii) From the scenario above, State whether the auditor may be removed in the manner proposed. Give reasons.

Answers to Self-Examination Questions

Answer to SEQ 1

(a) The following are qualifications for the appointment of an auditor:

(i) The auditor should be a member of a recognised supervisory body.

(ii) The auditor should be an independent person. That means he should not be an officer or employee of the company or an associate, subsidiary or parent company. He should also not be a partner or employee of the officer or employee of the company.

(iii) The auditor should possess a current audit-practising certificate.

Considering the above, Martha is qualified to be appointed as an external auditor of Ilala Company. However, apart from these requirements, an auditor should also maintain integrity, objectivity etc. while performing an audit. As Martha is Alex's sister and Alex being the managing director of the company,

Martha may not maintain objectivity in her job i.e. she may get influenced by Alex's opinion. She may try to hide mistakes which are neither in public interest, nor in the interest of the organisation. Therefore, although she is qualified and can be appointed, she should not be appointed as an external auditor of Ilala Co, as there could be a conflict of interest and in order to maintain a degree of independence.

Answer to SEQ 2

Taking on the assignment will provide you with the opportunity to triple your income without having to make any additional investments. However before accepting any assignment you must look at not only this opportunity but also whether anything in the nature and scope of the assignment will cause you to violate any of the five main ethical principles.

These principles are:

(i) Integrity;
(ii) Objectivity;
(iii) Professional Competence and Due Care;
(iv) Confidentiality and
(v) Professional Behaviour

The one principle that is in danger of being violated by taking this assignment is the objectivity principle. The objectivity principle states that accountants must not accept any assignments where the potential exists for there to be a conflict of interest.

In this particular scenario given that 100% of your revenue will be derived from only one client there is a significant potential for a conflict of interest to exist. This is because you in effect will have more of an employee - employer relationship with Masaki Inc rather than an auditor-client one. This in turn may jeopardise your independence (and subsequently objectivity) as the danger exists that you may be influenced into delivering a more favourable picture of the organisation's financial performance and condition.

The IFAC code of ethics states that the maximum percentage of total turnover that auditors can receive from one client is 10% for a listed or Public Interest Company and 15% for a privately held organisation.

Lastly, it is increasingly considered best practice around the world for accountants to not accept any other types of assignments from clients whose financial statements they are auditing. Therefore despite however lucrative taking the assignment from Masaki Inc may be, it should be respectfully turned down.

Answer to SEQ 3

Fredrick should begin the process by first researching Mwenge Technologies and the type of industry that it operates in to determine if he has the necessary expertise the necessary resources (e.g. time, staff) to competently conduct an audit for the organisation.

If Fredrick is reasonably certain that he can competently perform the audit then the meeting must be used as a platform to find out the scope of the audit of Mwenge Tech. would like to have performed. As this is a statutory audit, the scope is likely to be largely set out in the relevant statues. Topics of conversation that Fredrick should cover and agree upon with the Chief Financial Officer and Finance director include:

(i) The objective of the audit;
(ii) The extent of access to information he would have;
(iii) The extent to which he would be responsible for uncovering frauds;
(iv) The extent to which he would be responsible for evaluating internal control systems;
(v) The number (if any) of areas of special concern and
(vi) The remuneration that would be paid.

Fredrick must then (with Mwenge's explicit permission) contact their current / previous auditor. Fredrick must inform the auditor of his intention to become Mwenge Tech's new auditor and use the opportunity to gain any further information he would like on the organisation / assignment. After hearing back from the auditor Fredrick will be in position to evaluate whether he can and should take the auditing assignment.

If the auditor provides a favourable report then Fredrick can accept the assignment. If the report is unfavourable Fredrick should decline the assignment. If Fredrick receives no reply at all then he must use his judgment and discretion as to whether to accept or decline the assignment.

Assuming the report is favourable, Fredrick is now reasonably certain that he can competently conduct the audit on the agreed upon terms and conditions. Lastly, Fredrick must then draft an audit engagement letter to Mwenge Tech officially documenting the agreed upon terms and conditions. Once this letter has been signed by both parties work on the audit can begin.

Answer to SEQ 4

(a) Rights and Duties of an Auditor

(i) Rights of Auditors

- Rights of access to records – the auditor has the right to access the company's books of account, records, vouchers and other documents necessary to collect evidence.
- Right of information and explanations – auditor can ask any of the officers or other persons associated with the company to provide information or explanations essential to discharge their duties effectively as an auditor.
- Right to receive resolutions – auditor has the right to receive a copy of any written resolution proposed and any further related to it in the same way as a member of the company.
- Right to attend and speak – auditor has a right to speak and to be herd at general meetings of the company on any matter which concerns him as an auditor.

(ii) Duties of Auditor

- Ascertain adequate of accounting records – auditor must check whether proper and adequate accounting records have been maintained and prepared, adequate returns have been received from the branch not visited by them.
- Check compliance with legislation – it is the duty of the auditor to ensure that the applicable provisions of the laws have been complied with while preparing the financial statements.
- Verification of records – it is the auditors' duty to examine, compare and verify the accounting records and returns with the financial statements. If the accounting records do not agree with the financial statements or are incomplete, then it is the duty of the auditor to report this fact to the shareholders.
- To provide an opinion on truth and fairness – it is the duty of the auditor to make sure that he prepare the audit report stating whether in his/her opinion, the financial statements give a true and fair view of state of affairs and of its income statements for the period ended, comply with the reporting framework and other relevant statutory provisions.
- Adequate disclosure – auditor should make sure that the financial statements and all other material disclosures are made in accordance with the applicable laws and other reporting

framework. For example, the auditor needs to verify whether all the payments and benefits accruing to directors from the company are properly disclosure in the accounts.

(b) (i) Procedures to protect the removal of an auditor.

- The appointment and removal is placed on the shoulders of shareholders – it is the shareholders who can appoint, remunerate and remove the auditor from the office.
- Directors are not empowered to remove the auditors – directors can only recommend to the shareholders if they think the auditor is to be removed from the office.
- Right to make representation – auditors have the right to make representation to the shareholders as to why they should not be removed from the office. This gives them the chance to defend their position before the shareholders.
- Depositing the statement of circumstances – when resigning the auditors are required to deposit the Statement of Circumstances to the shareholders, explaining clearly the reasons for their resignation. This afford them the chance to express themselves to the shareholders as to whether there are pressures from the directors/management.
- Requirement for professional clearance – during the professional clearance the auditor may get a chance to express themselves whether there are any professional reasons for not accepting the assignment by the outgoing auditor.

(ii) The auditor should not remove as there is no professional reasons for terminating his/her services.

Reasons:

(a) The auditor applied all professional ethics in performing his/her duty.

(b) As known auditor's proposal was to help safeguarding the company's assets to maximize shareholder's wealth as the auditor performed.

(c) The auditor also performed in considering public interest since these transactions has impacts on tax.

SECTION A

OBJECTIVES, PROCESS AND NEED FOR EXTERNAL AUDIT AND ASSURANCE

A3

STUDY GUIDE A3: PLANNING THE ENGAGEMENT

Get Through Intro

An audit involves systematically analysing and evaluating the risks facing an organisation, so an auditor must have a well-thought-out and methodical plan in place before commencing his work. Furthermore, the inherent limitations of audit make it necessary that the auditors assess the risk of material misstatements in the financial statements before giving their opinion.

For example, an entity in the fashion industry faces the challenge of changing tastes of its customers. This would mean that the inventory the entity holds contains certain slow moving or non-moving items.

Such items need to be appropriately valued. Here, the auditor could face the risk of:
- not being able to identify the items which are slow moving; and
- not being able to determine the net selling price of such items.

Therefore, a study of the components of audit risks and an understanding of the risk of material misstatements play a very important role in planning the audit.

This Study Guide will provide you with an insight into how audits are planned and performed, paying particular attention to the various aspects of planning an audit like the various risks faced by a business, the risk assessment procedures carried out by an auditor, an analysis of the entity's financials in order to understand its implications on the audit of the financial statements and the development of audit strategy and audit plan which is the document that guides the auditor during the audit.

Learning Outcomes

a) State and explain the following basic components of an assurance process relating to planning the engagement:
   i. Risk and risk assessment
   ii. Different approaches to audit
   iii. Obtaining an understanding of the entity
   iv. Audit strategy and audit plan
   v. Analytical procedures
   vi. Audit documentation

1. State and explain the following basic component of an assurance process relating to the regulatory requirements of assignments:
i. Risk and risk assessment

[Learning Outcome a]

1.1 Different types of risks

1. Business risk

Definition

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

Business risks are those risks which arise from the nature of the entity's business and could prevent the entity from achieving its goals. Business risk may arise from change or complexity. A failure to recognise the need for change may also give rise to business risk.

Example

Peter is the auditor of Magomeni Ltd. Magomeni Ltd manufactures printing machines. The company is exposed to business risks from the development of new products in the market. If the company is not geared up to manufacture printing machines of the latest techniques, it may lose out market share and in the process not achieve its ultimate goal of increasing shareholder wealth (by increasing its turnover and thereby its market share).

These risks are sometimes categorised into the following:

- Financial risks i.e. risks related to the way an entity is financed i.e. a combination of long-term debt and equity, or shareholders' funds used to finance non-current assets, acquisition, development or project investment.

- Operational risks i.e. risks related to the entity's operations These risks result from inadequate or failed processes, people or systems or from external events, e.g. the information systems that process data everyday may get corrupted and this may disrupt the day-to-day accounting process

- Compliance risks i.e. risks arising because of non-compliance with the applicable laws and regulations. These risks include risks related to reporting i.e. possible misstatement in the financial statements, and related to the breach of any law or regulation.

In order to become successful, an entity should identify and mitigate these risks.

Test Yourself 1

Pamba Plc sells designer wear in Tanzania. Its designer wear is very popular in Tanzania and the business is doing well. In a recent board meeting, the board decided to trade in leather accessories and jewellery.

Required:

Identify the business risks involved in decisions taken in Pamba plc's board meeting.

2. Audit risks

Definition

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

Alternatively put, it can be described as being the risk that an auditor will incorrectly certify that an organisation's financial statements are true and fair. When this occurs, the best interests of the client, the accounting profession and society at large have been compromised as inaccurate and / or fraudulent financial statements have been published.

The main reason for an incorrect audit opinion is that the auditors receive and rely upon fraudulent or inaccurate information to base their findings and conclusions on. Consequently the main reason why an auditor ends up using such information is because of the three different types of risks all organisations (and subsequently their audits face). These **risks are inherent risks, control risks and detection risks**.

Definition

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

ISA 200

Inherent risks are the risks that organisations face because of the business they are in and the nature of their industry. The term inherent is used here because these types of risks will always be present for the organisation and are an inevitable part of its business environment.

Organisations cannot eliminate these types of risks. However they can take steps and precautions to mitigate them. One of the most common methods is to implement a system of internal controls. However, this rarely mitigates all inherent risks. This leads to the second type of risk facing organisations.

Definition

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

ISA 200

Control risk is the risk that an organisation's internal control systems do not adequately protect the organisation either because they have not been adequately designed and / or implemented.

Definition

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

ISA 200

The third type of risk, detection risk covers the risk that an auditor's checking and sampling procedures will not uncover any existing irregularities or misrepresentations. The existence and combination of these risks all potentially lead to the possibility that any auditor may unwittingly end up using inaccurate or fraudulent information whilst conducting their audit. If detection risk is too high, auditors then carry out more audit procedures to mitigate the risk.

For a material error to finally appear in the audited and published financial statements, three things have to happen:

- The error occurs in the first place (inherent risk)
- The error is not detected and corrected by the internal control system (control risk)
- The auditor does not identify the error as part of the audit procedures (detection risk)

Example

Kariakoo Boutique's is a very large and high end retail shop selling suits, tuxedos, ties, shoes and other accessories for formal wear. The types of inherent, control and detection risks facing the organisation and its auditor are:

1. Inherent

Like almost all other organisations that operate in the retail industry, Kariakoo Boutique's is faced with the problem of pilferage. Items can and have either been shoplifted by customers or misappropriated by employees. The risk to the auditor here is that inventory records (one of Kariakoo Boutique's main assets) will not be accurate.

2. Control

To mitigate this main risk, Kariakoo Boutique's implements the following internal controls. All items on display have a security tag attached to them which can only be removed at the sales counter. If a customer tries to leave with the security tag still attached, an alarm will ring at the exit door (which is manned by a security guard). In addition, to help prevent misappropriation by employees, inventory levels are physically verified on a weekly basis. However the control risk still exists here that despite these measures items will still be stolen (and hence again leading to inaccurate inventory records). For instance an employee may work in conjunction with a "shoplifter" by removing the security tag even though the customer has not paid.

3. Detection

Being aware of the existence of these risks, Kariakoo Boutique's auditor first checks the effectiveness of the security system in place. He does this by observing the employees at work for some time satisfying himself that they are diligently removing the security tags only after payment has been made and that security is stopping any customers trying to leave when the alarm sounds.

The auditor also attends a few of the weekly inventory counts to satisfy himself that the goods on hand are accurately counted and recorded. In addition the auditor also does a routine sample check of a few sales transactions where he checks to see if the sale is accurately recorded in the inventory, sales and cash records. However in spite of these procedures the auditor may still not uncover incidents where items have been either stolen or misappropriated.

Diagram 1: Audit Risk

Tip

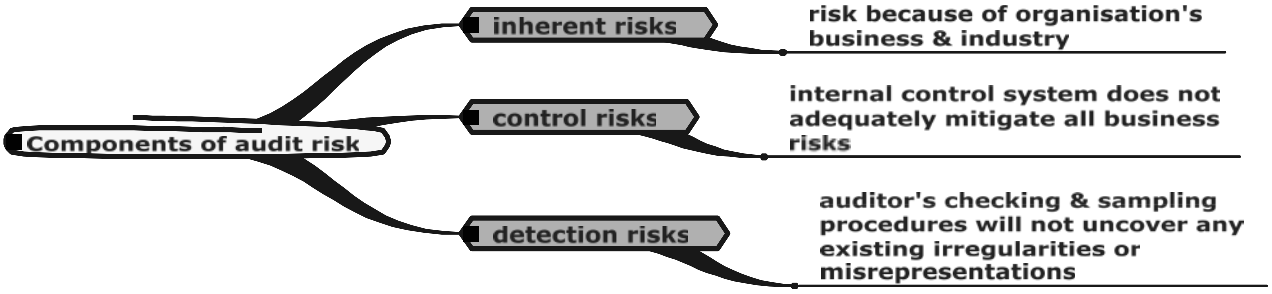
Inherent risk and control risk are within the entity and cannot be controlled by the auditor. Therefore, i**n circumstances where there is high inherent and / or control risk, the auditor must plan and perform a much more rigorous and thorough audit in order to compensate and therefore reduce the level of the overall audit risk.**

If inherent risk and control risk are both low, then detection risk can be high whilst still achieving low audit risk. Less audit work will be required to reduce the audit risk to an acceptable level.

Exam Focus

The meaning of audit risk along with its purpose is very important for students. The exam can have scenario based questions on this topic, so you need to know audit risk in the practical context. Although knowledge based questions may be asked, the number of marks for such questions is very low. You therefore need to apply your understanding of audit risk to the scenario and come up with appropriate risk assessment procedures.

SUMMARY



Test Yourself 2

Flora is the new auditor of Bunju Mobile Company, an organisation that sells mobile phones. Bunju sells a large number and variety of phones through its chain of nationwide showrooms and agencies. It has expanded rapidly. The chief executive officer is from a sales background and has little understanding or appreciation of the importance of internal control.

At present, Bunju also accepts sales orders by mail as well as over the phone. In addition the organisation is also considering going “on-line” and taking orders over the internet. An accounting MIS has recently been implemented, though the staff have not yet been fully trained on its use.

One of the issues that Bunju would like to have investigated is why; despite the sales levels increasing (20% in the last year alone) the organisation’s profitability is not showing a corresponding increase.

Required:

(a) Explain audit risk and its components
(b) Identify and describe the matters that give rise to the audit risk of Bunju Mobile Company.

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3. Financial statement risks

Financial statement risks refer to the probability that the financial statements made available to the public, shareholders and the regulatory authority is not accurate i.e. materially misstated. Risk of material misstatement is also referred to as financial statement risk.

The material misstatements are mainly of two kinds:

(a) Error or omission from the disclosure requirement
(b) Errors in the amounts recorded in the financial statements

Example

Examples of financial statement risks:

- Non-detection of fraud existing on the date of financial statements
- Provision for warranties not made or made less provision
- Inability to identify the uncertainties over going concern status of the entity

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1.2 Risk assessment

Definition

Risk assessment procedures—The audit procedures performed to obtain an understanding of the entity and its environment, including the entity’s internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

IFAC Glossary of Terms

ISA 315 recommends discussion among the engagement team members on matters relating to how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.

ISA 315 **requires a discussion among the engagement team members on matters relating to how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.**

Risk assessment procedures are carried out in order to obtain information of the entity and its environment, which are susceptible to fraud. These procedures include:

1. **Inquire from management** and **others within the entity** (employees, operating staff, chief ethics officer, persons dealing with allegations of fraud, etc.) regarding:

(a) **Management's assessment of risks of material misstatement due to fraud.**

This will require an understanding of the methods followed by the management, for instance:

(i) **Identifying the areas where a material misstatement due to fraud could arise,** like embezzlement of cash received from sale of scrap, recording of personal expenses of officials as corporate expenses.

(ii) **Assessing the impact of the risks (identified above) on the business, and the probability of their occurrence**. For example, if the value of scrap is insignificant then the likelihood of material misstatement due to fraud is also low.

(b) **Whether proper risk management procedures are in existence in the company and whether they are managing the risks that the business faces.**

(c) **Management's communication to those charged with governance** regarding the process for identifying and responding to the risk of fraud, i.e. the minutes of the board meeting or audit committee meeting where the matters were discussed.

(d) **Management's communication to employees about business practices and ethical behaviour** i.e. through the entity's code of ethics or ethical policies.

(e) **Knowledge of any actual / suspected fraud within the entity**: the auditor will enquire about the management's knowledge of material errors and fraud which have occurred within the entity and suspected fraud which exists within the entity which is being investigated by the management.

2. **For entities with an internal audit function**, the auditors must make enquiries with the internal audit department about the internal auditors' knowledge / suspicion of the existence of fraud affecting the entity.

   This will require an enquiry into:

(a) **The methodology followed by internal auditors to detect fraud** i.e. physical verification of inventory, non-current assets, etc.

(b) **The management's response to** the **observations** made by the **internal auditors** (as stated above).

3. The auditor must **enquire from those charged with governance** about:

(a) **how they monitor the management's process for identifying and monitoring risks of fraud**, i.e. through the audit committee meeting reports, review of the internal audit reports, report of management's assessment of risks of material misstatement due to fraud etc.

(b) **A failure by management to attend to the material weaknesses in the internal controls** which were identified in the audit during the previous year

(c) **The overall audit procedures** which the auditor proposes to undertake

(d) **Their knowledge** of any **actual / suspected fraud** within the entity

4. Auditors **must evaluate any unusual and unexplained relationships that have been identified while performing analytical procedures.**

Example

Mujuni is the auditor of Kagera Plc. Mujuni made an analysis of the financial statements of Kagera by studying significant ratios and changes to amounts. One of the figures that he studied was subsistence expenses which have doubled over the past year (sales increased only modestly)

Hence, Mujuni has reason to believe that there is some unusual variation in the subsistence figure. Mujuni will consider the results of such analytical procedures while drawing up his audit plan and plan to spend more time to subsistence expenses, the authorisation of expense claims and so on.

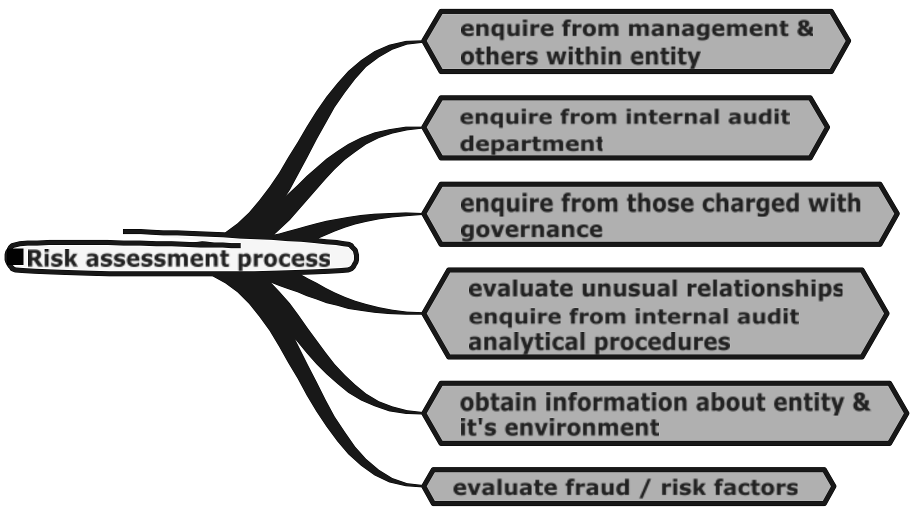
5. **Other information obtained about the entity and its environment which will help to identify the risk of material misstatement due to fraud**. For example **information** gained from **past experiences of dealing with the client** in other engagements e.g. preparing project finance reports or interim audits of financial statements.

6. **Evaluation of fraud / risk factors**

Although the existence of fraud risk factors does not automatically mean that fraud has occurred, the likelihood of it taking place is definitely higher. For example:

(a) The **domination of management** by a single person can result in fraudulent financial reporting.
(b) Granting **significant bonuses** to meet unrealistic targets. This can prompt mis-reporting of results.
(c) **A control environment which does not deter fraud**. For example, if the company has no system of taking serious action against staff who are involved in fraud and internal control is not taken seriously by management.
(d) **An entity's size, complexity and ownership have a bearing on the relevance of the fraud risk factor**. For example, in a large entity, an effective internal audit function will act as an obstacle to management overriding the controls.

SUMMARY



2. State and explain the following basic components of an assurance process relating to the regulatory requirements of assignments:
ii. Different approaches to audit

[Learning Outcome a]

2.1 Different Approaches to audit

Previously, auditors used to audit almost 100% of an entity's transactions. However, when the volume of transactions increased, auditors started relying on the internal control system and the concept of 100% checking became outdated. With the increase in an entity's risks, auditors found that by concentrating on the risky areas, most of the material misstatement will be identified. This is how the risk-based auditing emerged.

1. Risk-based auditing

In risk-based auditing, **auditors focus on the audit risks associated with the entity** which pose the greatest risk of material misstatement in the financial statements. The rationale behind the approach is that by identifying and concentrating on the areas that pose the highest audit risk of providing misrepresented or inaccurate information, the majority of the material misstatements will be found through the audit.

Diagram 2: Risk-based auditing

Example

Florence has recently been appointed as the auditor of a gift shop, Happy Boutique. He has decided to conduct the audit using the risk-based approach and therefore goes through the following process:

(a) Identifying business risks

Happy Boutique's main activity is selling gifts and cards. These goods are typically paid for in cash. One of the main risks facing Happy Boutique (and Florence's audit) is that goods could be shoplifted by customers or misappropriated by employees. Another risk facing Happy Boutique is that cashiers may embezzle money from their tills.

(b) Determining probability

Florence studies the industry and finds that a gift shop typically loses approximately 10% of its goods due to theft in a financial year.

(c) Determining exposure

By going through previous financial statements and records, Florence discovers that Happy Boutique spends an average of TZS5 million on purchasing goods. Therefore this risk could potentially cost the organisation TZS500,000.

(d) Reviewing controls

Florence studies the internal control system and finds that Happy Boutique has implemented the following measures:

Attached security tags to all gifts which can be removed only after payment is made
Appointed security guards at all exits
Installed security cameras
Instructed all cashiers to "balance" their tills at the ends of their shifts
Carried out physical inventory counts and verification on a weekly basis

Continued on the next page

From her evaluation, Florence concludes the following:

- The requirement for cashiers to balance their tills is a satisfactory control against embezzlement.
- The weekly physical inventory verification is not a satisfactory control against misappropriation of goods by employees.
- The security system (guards plus video cameras) is not a satisfactory control against customer theft, as the guards change frequently and the video cameras do not show all parts of the store.
- The use of security tags, although it is a good measure for preventing theft by customers, cannot prevent misappropriation by employees if they collude.

(e) Deciding the audit strategy

Therefore, as Florence knows that the internal controls of the company are strong, she decides that the majority of her audit will be concentrated upon the risk posed to the organisation by customer and employee theft. Florence plans to determine the extent to which goods have gone missing by reconciling opening and closing inventory balances against purchases and sales made (the opening inventory balance plus purchases minus the closing inventory balance must equal sales made for the period).

This type of checking is intended to take up 30 per cent of her audit work. Florence would then spend 10 per cent of the audit attending the weekly physical inventory verifications and another 10 per cent of audit time checking a sample of cash tills (to verify that they balance) at the end of shifts.

A risk-based approach is suitable in the following cases:

- When the nature of business is such that the audit risk is very high e.g. a cash based business (as the possibility of misappropriation is higher).
- If the business environment is complex e.g. international business with a centralised information system.
- When the entity's internal control system is effective and can be relied upon for areas other than those for which the risk is assessed as high.

Test Yourself 3

Which of the following options relates to a risk-based approach to audit?

A Audit resources are aimed at testing large volumes of transactions
B Auditors assess that the internal controls of the entity are effective
C Auditors assess that the business environment is complex
D None of the above

Requirements of ISAs

International auditing standards require that the auditor should assess the entity's risk assessment process, assess the audit risks and consider these risks while planning his audit. This means that the standards support the risk-based auditing.

2. Top-down approach

This is a **business risk-based auditing** in which an auditor identifies the business risks and relates them to the financial statements. This is called the top down approach since it starts from the business level (higher level) and works down to the financial statements (detailed level).

It helps an auditor to prevent the possibilities risk of material misstatement by focusing on the controls over the accounts, the disclosures and the assertions. It saves the auditor's time as he does not have to spend time in understanding the processes and controls of an organisation which do not have any material effect on the organisation's financial statements.

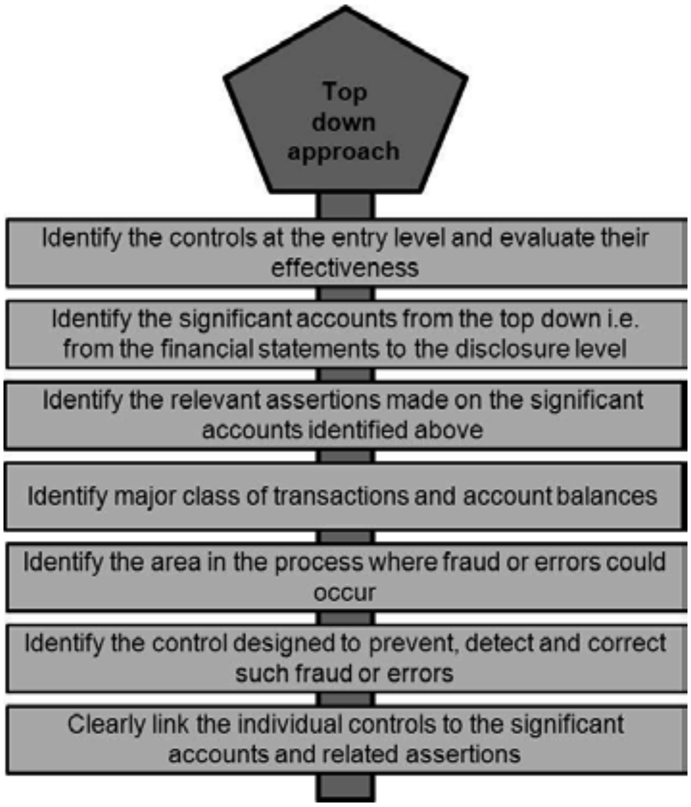
This approach works as follows

An auditor is required to obtain an understanding of the organisation's internal control over its financial reporting. This can be done by performing an audit procedure. He is required to start the audit procedure by testing the controls in sequence, starting with the controls at the entity-level and continuing down to the significant accounts, processes and lastly the individual control over the transactions, process, etc.

The top down approach is both effective and efficient. It is effective because it helps to identify the significant accounts at the financial statement level (i.e. the top level) and then it works down towards the individual control level (i.e. the bottom level). Therefore the auditor is assured of identifying controls that address relevant assertions for significant accounts. It is efficient because it reduces the time and effort taken by the auditor to understand the process or control. Analytical procedure is used to understand which areas in the financial statements are material and the auditor will concentrate on these.

The auditor performs the following procedure in the top down approach:

Diagram 3: Top down approach



On the basis of the results of the tests of controls and analytical procedures so performed, the extent of substantive procedures is determined. Generally, less extensive substantive procedures are performed. The top down approach can be used when:

- the auditor has a thorough understanding of the client and its business the control environment is sound
- the client expects value addition from the audit up-to-date, adequate and reliable information about the business is available

Example

Njombe Co is a furniture manufacturing company. Its clients include big malls. Richard has been appointed as an auditor of Njombe Co. He has noticed that Njombe has received many complaints during the year about the quality of its products. This information indicates that there are the following risks to the business: dissatisfied customers may refuse to pay such customers may be attracted to competitors. He then identifies the financial risks arising from these business risks. The financial risks are as follows:

Non-payment of money will have an impact on the accounts receivables, a working capital problem may arise and the loss of dissatisfied customers may create a threat to the going concern status of Njombe.

Taking this into account, he decides to perform the risk-based auditing for Njombe. After identifying the risks, he plans to perform the following:

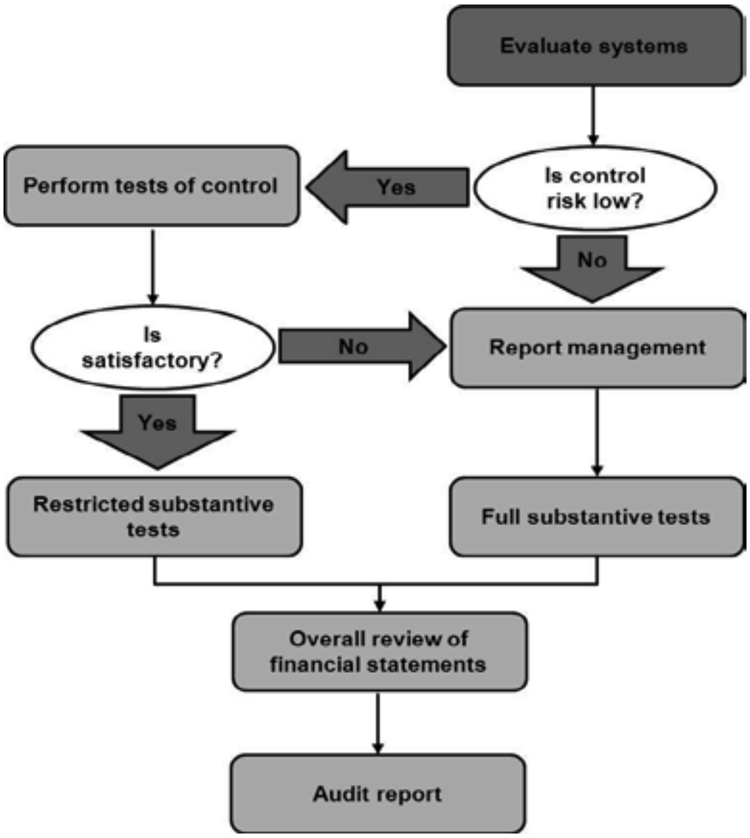
- Whether regular customers have made any defaults in payment
- Whether there has been any decrease in the volume of sales i.e. whether regular customers have been attracted to competitors
- Whether there has been any improvement in the quality of the products (he can check this by analysing the recent complaints)

3. Systems audit

Instead of performing 100% audit, nowadays an auditor determines the efficiency and effectiveness of the internal control system of the entity and decides the audit strategy. System-based auditing is an audit approach. It employs a scientific and systematic method to identify the core problems.

It applies the traditional practice of examining the operations. In other words, it thoroughly studies and analyses the data, identifies the key audit points and then begins the audit procedure. The basis of this approach is that instead of checking in detail, the auditor should obtain an overall view of the effectiveness of the system. The auditor will identify the weaknesses in the system and give recommendations to remove such weaknesses.

Diagram 4: Systems audit



Example

Kitulo is an organisation that manufactures garden equipment. It sells garden equipment only over the phone and the Internet. Kitulo has appointed Rweyemamu as its new statutory auditor. Rweyemamu has decided to use the system-based approach for the audit. He begins his work by obtaining an understanding of Kitulo's method of operations. Kitulo always keeps 2 months inventory in stock at its warehouse.

The stock is insured against all risks such as fire and theft and is physically counted on a weekly basis. Sales orders are taken by employees either over the phone or via the Internet. Employees note down all the customer's details (i.e. name, address, etc) and their credit card details.

The credit card is then "run through" and, if accepted, the employee then begins the shipping process. Employees are required to prepare three invoices for each sales order. One invoice is sent to the warehouse where the manager will then ship out the order. The second copy is filed in the office and the third is sent directly to the customer. Rweyemamu evaluates these procedures and believes them to be adequate.

He then begins the observation stage by spending one week at the warehouse and then one week at Kitulo's sales and administration office. Rweyemamu observes how inventory is physically counted as well as how orders are dispatched and the relevant paperwork filed. At the office, Rweyemamu also watches how sales orders are taken and processed. He speaks to management and employees to gain a greater understanding. Rweyemamu notes that the organisation's biggest operational weakness is that employees sometimes do not wait for the credit card to run through before processing a sales order.

Continued on the next page

This means that Kitulo has begun processing a sales order before it has received payment for it. Based upon all of these factors Rweyemamu carried out the following audit: He checked a sample of the organisation's records to determine the number of instances where an order was shipped without receiving a credit card payment.

He found that such transactions occurred frequently and therefore decided to write a letter to management warning them of the fact. He also attended a number of physical inventory counts. He verified a sample of week-end inventory balances against sales made.

A system-based approach focuses on the tests of controls and substantive procedures are used only when tests of controls cannot provide sufficient appropriate audit evidence. This approach is suitable for large entities.

4. Balance sheet approach

In this approach, the auditor primarily concentrates on the account balances (this is why it is called the balance sheet approach) and uses substantive procedures extensively. The argument is that if an auditor audits the balance sheet one year, and then the following year, he will have confirmed the balance sheet values.

The income statement is simply the difference between the 2 balance sheets and therefore is automatically assumed to be correct. The auditor should also check that the closing balances of the previous year have been properly carried forward to the current year. Circumstances in which this approach can be used

This approach is suitable for small entities. This is because, in small entities, internal controls may not be effective and even if they are effective, they may not be documented properly. As a result, it will be difficult for the auditor to gather sufficient appropriate audit evidence.

This is also useful for entities have not adopted computerised systems. This approach is suitable for organisations in which the operating system and the internal control are weak. The limitations of this approach are that it does not focus on the income statement at all. The risk of misstatement is not detected unless all the transactions and the balances are tested.

The following is the procedure that an auditor will be required to perform:

- Understand the entity's environment including the internal controls to identify the risk of material misstatement in the financial statements.
- Perform a rigorous assessment at the financial statements level and the relevant assertion level only for balance sheet items.
- Assess each material class of transactions and determine the difference between the expected value and the recorded amount for balance sheet items.
- Assess the account balances of each account such as accounts receivable, accounts payable, inventory, non-current assets, loans and share capital.
- Check the disclosures such as compliance with the required laws and regulations.
- Perform analytical review on the Income statement to ensure that it looks reasonable

Example

Mwatenga owns a small sweet shop. He has appointed Mkomole to audit its financial statements. Mkomole decides to conduct the audit by adopting a balance sheet approach. Mkomole finds that Mwatenga employs one person in his shop. Matters related to finance are dealt with by Mwatenga himself.

In addition, he has appointed one part-time accountant to record the transactions. Mkomole will first obtain an understanding of the business. He will then assess which of the balance sheet categories is material and which are likely to potentially have misstatement. This could include the premises, inventory, trade payables, cash and any loans. He will identify the risks both at the financial statement level as well as the assertion level for these categories. For example, at the financial statement level there is a risk that error that may be made by the accountant when preparing the figures for the balance sheet. At the assertion level he may assess the risk of inventory pilferage as high.

Mkomole will concentrate on auditing the balance sheet items through substantive testing (as this is a small shop). For example, he will prepare a trade payables circularisation and look for payments made after the year end to confirm the valuation, existence and completeness of trade payables. Once assured of these figures, Mkomole a may perform analytical procedures to identify any significant differences in the rest of the balance sheet and the income statement. He will also check whether all the closing balances of the previous year are properly carried forward to the current year.

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5. Transaction cycle approach

A transaction cycle is referred to the sequence of procedures for processing a particular type of transaction such as revenue, purchases and cash. In this approach, the auditor selects a sample of transactions and tests them thoroughly to ensure that all the transactions are processed correctly through the cycle.

This approach is similar to the systems approach; the only difference is that in the systems approach, the auditor tests controls and in this approach, he tests cycles of transactions e.g. purchases cycle; sales cycle.

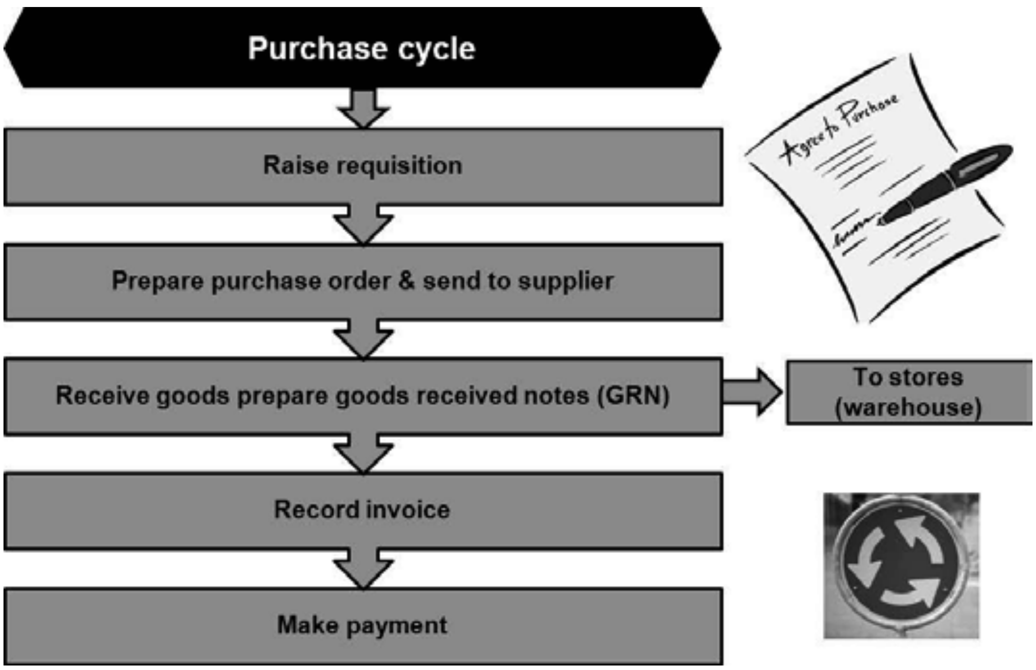
The auditor tests transactions from their occurrence to the amount entered in the income statement.

Transaction cycles include the following:

(a) Revenue
(b) Purchases
(c) Banks and cash
(d) Inventory
(e) Revenue and capital expenditure
(f) Payrolls

In order to use the transaction cycle approach, an auditor should have thorough knowledge of the entity. This approach is used when the auditor assesses that the internal controls are not effective.

Diagram 5: Purchase cycle

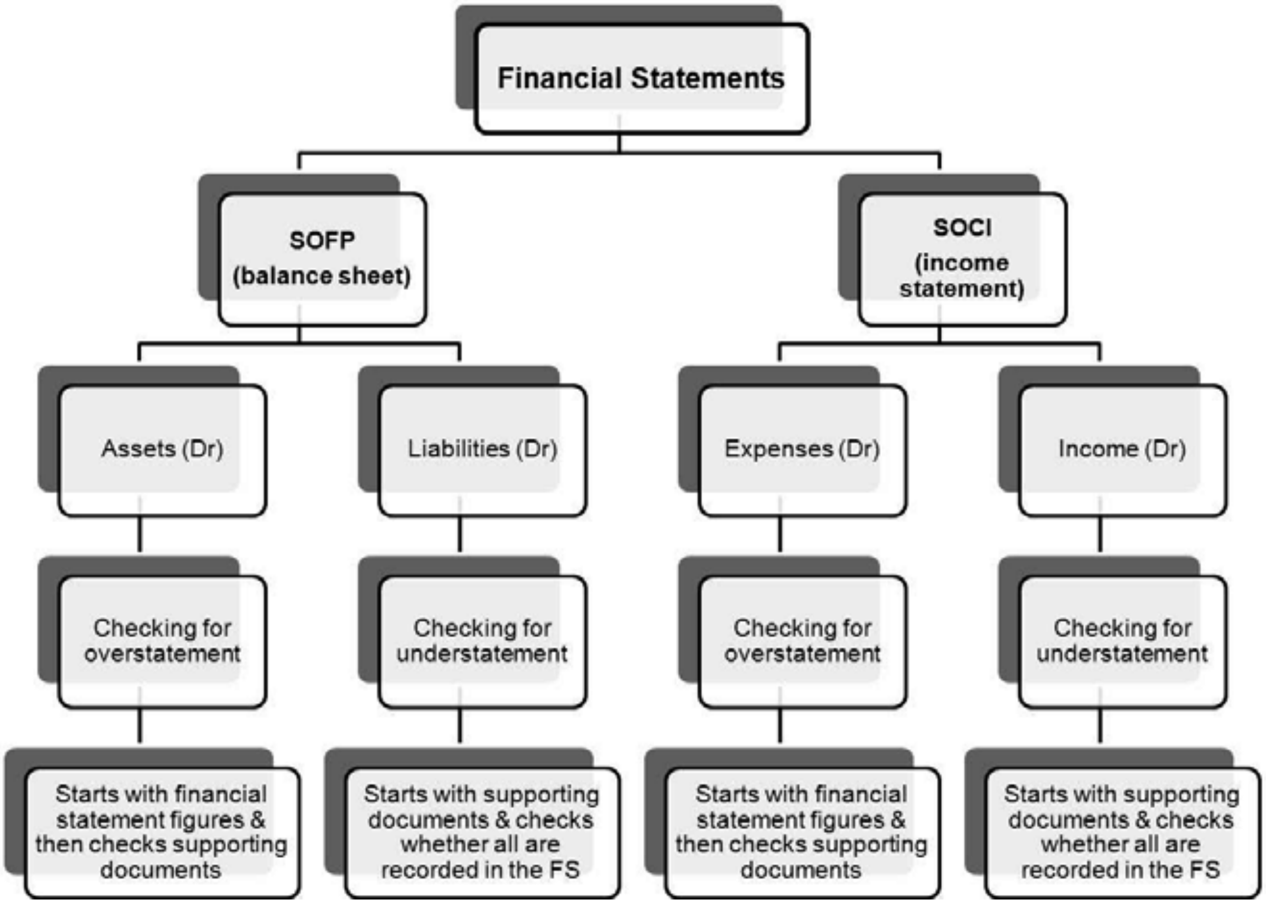


6. Directional testing

It is an approach in which an organisation has an objective of minimise its taxes and maximise the chances for obtaining funding. Here auditor identifies the direction of the test to find the errors and omissions (if any) in the financial statement of an organisation.

Bearing these factors in mind, auditors need to examine the SOFP (balance sheet) and SOPL (income statement) of an organisation to determine whether: assets have been overstated liabilities have been understated income has understated and expenses have been overstated

Diagram 6: Financial statements



This means the auditor should check for the overstatement of debit balances (i.e. assets and income) and understatement of credit balances (i.e. liabilities and expenses). By doing this, he indirectly checks the opposite side i.e. understatement of credit balances and overstatement of debit balances.

Example

By testing trade receivables of over statement, the auditor is indirectly testing sales for overstatement at the same time, as the credit side of the trade receivable will be in sales. This is sometimes also known as corollary testing (as in your body you have arteries and veins next to each other the arteries pump blood away from the heart and the veins take blood towards the heart),

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Therefore an auditor is required to begin the audit by looking at the balance sheet of an organisation. He needs to check if the organisation's assets have been overstated.

Example

Moshi Ltd has appointed Mr. Malya to perform an audit. Mr. Malya has noticed that Moshi Ltd has valued its land and buildings at TZS300 million. To ensure that the assets are not overstated, he first drills down into the ledger accounts to see if this TZS300 million is for 1 piece of land and building or several.

He finds that it is made up of 4 buildings and 6 pieces of land. Mr. Malya needs to obtain documents to confirm the total value of TZS300 million from all these properties and land. He may need to conduct an independent appraisal of some or all of the land and buildings. To do this, he may appoint an expert to value the land and buildings.

An auditor also needs to check if the organisation's liabilities have been understated. He is required to examine the documents to see if they match the amounts listed in the balance sheet and check for unrecorded liabilities.

Example

Continuing the previous example of Moshi Ltd

Moshi Ltd has listed its accruals figure as TZS330,000 for the year ended 31 December 20X7. To ensure this figure is accurate and not understated, Mr. Malya must look at payments made after the year end by Moshi Ltd. If any payments are made, they will probably relate to balances that could have been outstanding at the year end.

Mr. Malya scrutinises the cash book and sees that a payment of TZS75,000 has been made to Mawenzi advertisers in February 20X8. Mr. Malya asks for the invoice, which was received in January 20X8, but relates to advertising carried out in December 20X7. Mr. Malya checks if this was included in the accruals figure of TZS330,000 but finds it was not. Hence the accruals figure given by Arian is understated by TZS75,000.

An auditor is also required to determine whether the income has been understated. To do this he should take the source document as a base and verify it against the figures recorded in the income statements.

Example

Continuing the previous example of Moshi Ltd

Moshi Ltd has shown its sales figure as TZS9 millions. Mr. Malya must then check that all sales orders were converted into sales invoices and that this total is fairly stated. For every order there should be an invoice.

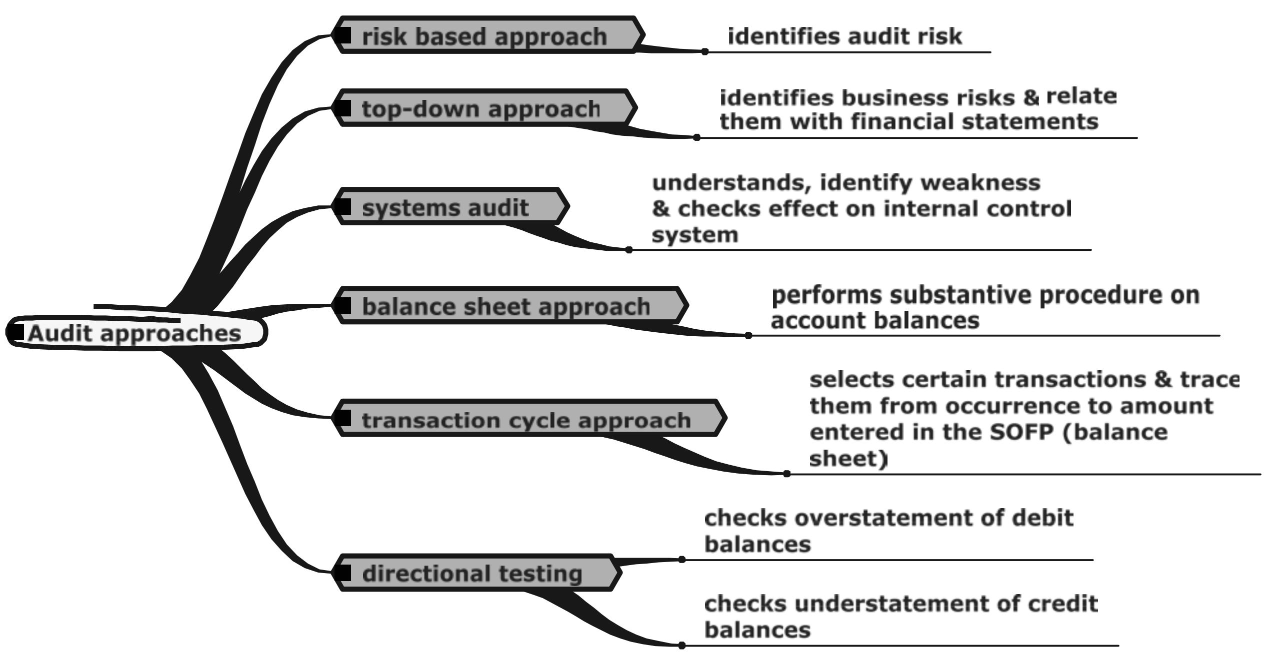
An auditor should not only check the income but also the expenses of an organisation. He should check that each expense is supported by adequate documents.

Example

Continuing the previous example of Moshi Ltd

Arian Ltd has stated its direct expenses as TZS50,000. To check that the expenditure has not been overstated, Mr. Malya will examine each listed expense and the relevant supporting documents such as a bill raised by advertising agencies.

SUMMARY



3. State and explain the following basic components of an assurance process relating to the regulatory requirements of assignments.
iii. Obtaining an understanding of the entity
[Learning Outcome a]

3.1 Obtaining an understanding of the entity

1. Need for understanding the entity

Understanding an entity is a basic requirement for planning and performing an audit. It is essential that an auditor gathers an understanding of the entity and sufficient knowledge of the business of the entity in order to plan and implement an audit assignment. This will **enable them to identify and assess the risks of material misstatements in the financial statements** and to **decide their audit strategy**. The audit strategy contains the materiality levels that need to be set as well as the nature, timing and extent of audit procedures, which in turn would help them in forming their opinion about the truth and fairness of the financial statements.

2. Sources of information to obtain an understanding of the entity

Understanding the entity and its environment involves knowing the following:

Factors to be considered	Explanation
Industry conditions	An auditor should obtain basic knowledge of the industry in which the entity is working. This includes knowledge of: i. Competition in the market ii. Cyclical or seasonal activity iii. Technological and other developments in the industry and their impact on the entity iv. Regulatory environment and external factors such as an understanding of the laws and regulations those are applicable to the entity.
Nature of the entity	The nature of the entity refers to the entity's operations, its ownership and governance and the types of investments it is planning to make. Furthermore the auditor should also obtain an understanding of the investment and financing activities.
Entity's selection and application of accounting policies including the reasons for changes thereto	An understanding of the entity's selection and application of accounting policies includes: The methods the entity uses to account for significant and unusual transactions: This involves enquiries of employees involved in initiating, processing or recording complex or unusual transactions Appropriateness of changes in the entity's accounting policies When and how the entity will adapt to the financial reporting standards and laws and regulations that are new to the entity
Objectives and strategies and significant business risks of the entity	Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives. They may also arise from a change, although a failure to recognise the need for change may also lead to risk.
Measurement and review of the entity's financial performance	An understanding of the measurement and review of the entity's financial performance includes analysis of the performance of the entity. This audit procedure is important as performance measures create pressures on the entity to either improve business performance genuinely or misstate the financial statements. Therefore by understanding the pressures it is possible to achieve performance targets. Furthermore auditors will also be able to determine the areas in the financial statements where there is an increased risk of material misstatement.
Internal control	Discussed in detail in Section C

3. Obtaining an understanding of the entity and its environment based on risk assessment procedures

Obtaining an understanding of the entity and its environment, including its internal control is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. According to ISA 315, an auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

(a) Inquiry of management and others within the entity

The auditor may make enquiries of management, of appropriate individuals within the internal audit function (if the function exists), and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.

(b) Those charged with governance

Definition

The person(s) or organisation(s) (for example, a corporate trustee) with the responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

ISA 260

Inquiry of those charged with governance enables an auditor to know the environment in which the financial statements are prepared.

(c) Internal audit personnel

Inquiry of the personnel from the internal audit department (like the chief internal audit executive or other personnel within the function) can provide important information to the auditor. An internal audit primarily evaluates the adequacy and effectiveness of the internal control system. Inquiry of the internal audit department will also enable the auditor to determine the attitude of management towards the internal control system.

(d) Employees

Inquiry of the employees will help the auditor to determine the problems of the employees while actually implementing the policies of management. This will also enable the auditor to identify the potential risks. Inquiry of the employees will assist the auditor to understand the operations of the entity, for example, how the transactions are initiated, approved, recorded, reported etc. This will help the auditor to identify the risk associated with the initiation, approval, recording and reporting of transactions and accordingly decide the nature, timing and extent of the audit procedures.

(e) Legal counsellors

Inquiry regarding legal matters should be made from the legal counsellor. Inquiry of the legal counsellor will enable the auditor to determine whether or not all the applicable laws and regulations have been complied with and also whether there are any on-going legal problems.

(f) Marketing or sales personnel

This will enable the auditor to know the objectives of the entity, its marketing strategy and the risks associated with the sale of the entity's products.

(g) Analytical procedures

Analytical procedures will **help the auditor to identify any unusual items**. For this, the auditor will have to decide his expectations in advance and then **compare the recorded amounts or calculated ratios from recorded amounts with the expected ones**. The auditor will then consider these results for risk assessment.

This is discussed in detail, in Learning Outcome 5.

Example

Ronald is the auditor of Mzumbe Ltd. Ronald made an analysis of the financial statements of Mzumbe Ltd by studying significant ratios. One of the ratios that he studied was the gross profit margin. The gross profit ratio of Mzumbe Ltd for the current year, 20X1, is 20% and the gross profit percentage for the previous year, 20X0s, was 24.5%. This is quite a large variation in the gross profit percentage.

Hence, Ronald has reason to believe that there is some unusual variation in the figures. Ronald will consider the results of such analytical procedures in planning his audit plan and allot more time to studying purchases, inventory and sales.

(h) Observation and inspection

Observation is regarded as the best method of obtaining an understanding of the entity and its environment because, through observation, **an auditor personally observes a procedure when it is actually performed**. However, sometimes it may happen that personnel may work cautiously when they know that they are being observed by the auditor.

Example

Observation includes:

- Observation of entity activities and operations
- Visit to the entity's premises and plant facilities

(i) Inspection is **examining records and documents** (whether internal or external) or examination of tangible assets.

Example

Inspection includes:

- Inspection of documents (such as business plans and strategies), records, and internal control manuals
- Reading reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings)

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4. Additional methods of obtaining knowledge of business

The auditor can obtain knowledge of the industry and the entity from a number of sources. These sources can be listed as below:

- Previous experience of the auditor with the entity and its industry
- Visits to the entity premises and plant facilities
- Last year's audit team
- Last year's audit file and the permanent audit file
- Auditor's firm industry expert
- Industry surveys
- Financial press
- Internet
- Publications related to the industry
- Legislation and regulations which significantly affect the entity
- Discussions within the entity (client, client's staff)
- Documents produced by entity
- The client's website
- Observation of events and processes at the client's premises

Test Yourself 4

What is meant by knowledge of a business? What should the auditor consider in order to make effective use of knowledge about the business?

3.2 Need for planning an audit

Planning assists an auditor in conducting the work in an effective manner. It has the following aims:

1. Identifying the important areas that require more attention

In planning an audit, auditors obtain knowledge of the entity and its environment including the internal control system. They also identify the significant transactions and areas that need more attention. In planning an audit, auditors decide what work to delegate, to whom and to what extent. They also decide the number of days that should be allocated to a particular area.

Example

Monica was appointed as the auditor of the manufacturing company, CBC Ltd. As CBC Ltd was a new client, she held an initial interview with CBC Ltd in which she tried to obtain as much background information as possible. She wanted to know the nature of the entity's business, the nature of the entity's products or services, the nature of the entity's records and the significant trends within and outside the entity.

Monica also examined the previous year's financial statements and found that trade payables had increased by 40% and therefore, special attention was required in this area. This helped Monica to find the areas that required attention and she planned her audit accordingly.

---

2. Identifying potential risks having effect on audit as well as financial statements

The auditors also identify the potential risks associated with the financial statements. They analyse them and prepare their audit plan accordingly.

Example

Unguja Ltd had an unsettled dispute in which the customer of the company was claiming compensation of TZS100,000 for the late delivery of cement pipes. Robert, the auditor of Unguja Ltd, identified the risk, analysed it and prepared the audit plan accordingly. He also made a note to make a provision for the unclaimed compensation.

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3. Planning work to enable it to be conducted an effective audit in an efficient and timely manner

The time required for each section of the audit should be estimated and the appropriate grade of staff determined. The company's year-end accounting timetable and the deadlines for the completion of the audit should be reviewed with the company's chief financial officer to ensure that all deadlines have been met. A detailed audit timetable should then be prepared, giving the dates on which schedules are due from the client and the dates when various sections of the audit are to be completed.

Example

After accepting the appointment letter as an auditor of Pemba Co, Roger prepared a detailed audit timetable, giving the dates when various sections of the audit would be completed. As Pemba Co deals in complex transactions, a senior team will be chosen with no new inexperienced audit staff.

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4. Allocating work to assistants in such a manner that they would be best utilised

The allocation of individuals to particular audits should take account of the experience of each staff member and the degree of skill required for the particular assignment concerned. It is preferable that the audit team contains members of staff who have visited the client previously, not only to maintain good relationships but also because they will have gained detailed knowledge of the client and the industry in which the client operates.

Example

Jerry, the auditor of Kilosa Ltd, appointed Peter, an experienced staff member, to supervise the work performed by the junior audit staff and also to review and report on the work done by them.

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5. Identify the need for experts and co-ordination of work of others

To ensure that an audit is carried out effectively and efficiently, the work is controlled and recorded at each stage of its progress. The most important elements of control are the direction and supervision of the audit staff and the review of the work they have done. In certain specialist industries, it is desirable that some members of the audit team have previous audit experience in that industry. Furthermore, it can be ascertained whether the use of experts such as valuers, solicitors and architects would be needed for the audit.

Example

The audit team prepared by Assenga for the audit of Kondoa Co included John, who had been involved in the audit of the company for the last two years. John was chosen as he had knowledge of the industry and was able to plan his audit programme properly. It was also identified that an actuary's report would need to be provided in respect of the company's pension liabilities.

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6. Determining the nature, timing and extent of the audit procedures

The auditor also determines the nature, timing and extent of the audit procedures that they should perform to carry out the audit work in an effective and timely manner. Once the procedure, the timing and extent are decided, it will be easy for an auditor to perform the audit according to the plan.

Example

Anne is the auditor of Nyegezi Ltd, a manufacturing concern with a number of factories. Anne planned a programme of site visits on a rotational basis. She also determined the time when the audit would be completed and extent of the substantive audit procedures. This helped Anne to identify the problematic areas so they could be addressed in time and accordingly design the audit procedures.

Test Yourself 5

List the advantages of audit planning.

Test Yourself 6

What are the factors to be considered by the auditor in planning their audit?

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4. State and explain the following basic component of an assurance process relating to the regulatory requirements of assignments.
iv. Audit strategy and audit plan

[Learning Outcome a]

According to ISA 300, Planning an audit of financial statements, planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. The benefits of planning the audit have been explained in the earlier Learning Outcome (para 3.2).

4.1 Audit strategy

An audit strategy sets the scope, timing and direction of the audit and guides the development of the more detailed audit plan. Once the overall strategy has been planned, detailed consideration can be given to each individual audit objective and how it can be best met.

Example

Henry was the auditor of Chewa & Co. Henry decided the planning materiality at 5% of profits i.e. the estimate of the size of misstatement that would be regarded as 'material' in relation to the accounts under review. The strategy adopted by Henry was that if any error exceeded 5% of profits, it would be considered material.

Materiality is discussed in detail in Study Guide A5

Audit strategy includes the following information:

1. Understanding the entity's environment

It contains details of the industry such as its location, activities and strategies.

2. Characteristics of the engagement that define its scope

Determination of the scope includes the consideration of **the financial reporting framework**, **statutory obligations on the auditor** and also the **scope** defined in the engagement letter. It also includes the consideration of the **need to use an expert** and **determination of the extent to which the auditor can rely on the work of the experts and the internal auditor**.

Example

Nelson has been appointed the auditor of Jomo Ltd. She intends to liaise with the internal audit department to help her understand the whole internal control system before preparing the audit plan.

3. Ascertaining the reporting objectives, timing of the audit and communications required

The engagement team considers the **type and timing of the audit report**. The auditor needs to set the **deadlines for interim as well as final reporting**. The strategy also includes expected communication with third parties such as reports of experts whose work is considered in the financial statements. Furthermore, the schedule of meetings with management during the various stages of audit will be considered in the audit strategy. The timing of carrying out the audit work must be considered as the audit strategy is developed, since these are often closely inter-related. The normal timetable for an audit includes:

An interim visit, usually at least three-quarters of the way through the accounting year
Attendance at stocktaking
Year- end circulations
The final audit shortly after the accounting year-end

This pattern will often be modified to suit the needs of the particular business.

Example

Jeremy has many small clients. Interim visits may be uneconomical for small clients, while two interim visits may be appropriate if the client's accounting system is radically amended during the year, as would be the case when a system is computerised for the first time.

4. Understanding the accounting and internal control systems

This includes details of accounting policies of the client and assessments of internal control systems during the previous year and whether the auditor can rely on them.

(a) Deciding the direction of the audit

The engagement team considers the important factors that will affect the nature, timing and extent of the audit procedures.

Such factors include:

(i) **Preliminary risk assessment** i.e. areas with high risk of material misstatement on account of errors and fraud.
(ii) **Identification of the entity, specific, industry, financial reporting or other developments** etc.
(iii) consideration of the **accounting policies adopted by the client and changes in those policies**.
(iv) Setting of **materiality levels.**
(v) Identification of areas of weaknesses during **previous audits.**

Example

Richard has been appointed as an auditor of Jeti Ltd. It is important for him to determine in advance the precise time when each audit procedure must be started and completed. This will enable him to divide the work among the various audit staff, thereby avoiding the possibility of wastage due to audit staff not being available. It is possible that the underlying records are not available as a result of their use by the employees of the client organisation or by other members of the audit team.

(vi) **Consideration of the team-members required** i.e. while deciding the audit strategy, of the composition of the engagement team should be considered using evidence obtained during the preliminary engagement activities. Preliminary engagement activities include evaluation of the compliance with ethical requirements, understanding of the terms of the engagements and the procedures regarding the continuance of the client relationship and the specific audit engagement.

Example

Mark has been appointed as the auditor of Kibaha Co. As it is the first audit, more elaborate preliminary arrangements will have to be made than in the case of a repeat audit. He will have to obtain a no objection certificate from the previous auditor and understand the terms of engagement before starting the work. He will also have to obtain knowledge of the economy and the industry within which Kibaha Co operates before accepting the audit.

He may also find later that special visits by audit teams will be necessary to all or some of the locations where the client organisation carries out its business activities. In addition, particular locations may have material quantities of inventory, in which case arrangements will have to be made to attend stocktaking at such locations.

In audits of small entities, the entire audit may be conducted by a very small audit team. Many audits of small entities involve the audit engagement partner working with one engagement team member. With a smaller team, co-ordination and communication between team members are easier. Establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise. It varies according to the size of the entity and the complexity of the audit.

Example

The audit for a small concern, Kibaha Ltd, was carried out by a team with only two members, Danny and Fred. A brief summary was prepared based on the review of the working papers and highlighting issues identified in the audit just completed. Co-ordination and communication between team members was easier with a smaller team and establishing the overall audit strategy for the audit was not a time-consuming exercise.

It is also important that the **audit strategy suggested should be appropriate**.

Example

Ben is the auditor of a software company. Suggesting an inventory count for a software company whose work in progress consists of the unamortised costs of developing its products is not an appropriate audit strategy. It would be appropriate to conduct extensive testing in the area of amortisation of various projects in hand.

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5. The nature, timing and extent of resources necessary to perform the engagement

This involves finalising the engagement budget, selecting the engagement team and assigning work to the various team members.

For example, the strategy will take into account the amount of resources necessary for specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas.

4.2 Audit plan

An audit plan **converts the audit strategy into a more detailed plan and includes the nature, timing and extent of audit procedures to be performed** by engagement team members in order to obtain sufficient appropriate audit evidence to **reduce audit risk to a low level**. Audit planning is a detailed recording of each procedure and process required to perform an audit. Once the overall strategy has been determined, the auditor should prepare a detailed plan of the areas determined in the audit strategy. Once the audit strategy has been decided, the next stage is to decide how it is going to be carried out; an audit plan is necessary. The audit plan contains the nature, timing and extent of the procedures to be performed.

1. Contents of audit plan

Following are some matters which are included in the audit plan:

(a) **A description of the nature, timing and extent of planned risk assessment procedures which will enable the assessment of the risks of material misstatement due to fraud:** For example auditor will enquire about the management's knowledge of material errors and fraud which have occurred within the entity and suspected fraud which exists within the entity which is being investigated by the management,

(b) **Understanding and assessing of the strength of the control environment of the entity:** This will require an assessment of the control risk and the inherent risks which the entity. As discussed in Study Guide B2, this assessment is very important as neither of the risks can be controlled by the auditor. Therefore, in order to reduce the level of the overall audit risk the auditor needs to plan and perform a much more rigorous and thorough audit when an entity faces a high inherent and / or control risk.

(c) **A description of the nature, timing and extent of planned further procedures at the assertion level:** This applies to each material class of transactions, account balance, and disclosure.

Example

Following is an extract of the audit plan (for 20X3) prepared by Mikindani & Co, the auditors of Mtwara plant Enterprises which manufactures mining equipment:

Inventory
Nature: Physical verification
Timing: 30 June 20X3 and 31 December 20X3
Extent: 100% verification

Receivables
Nature: Direct confirmation
Timing: 30^{th} June 20X3 and 31 December 20X3
Extent: For all account receivables which exceed TZS200,000 as on 31 December 20X3 and all receivables having credit balances

---

(d) **Formation of audit team and allocation of work and duties to the assistants**

Example

The audit senior carries out the audit in the areas which are exposed to significant risks (like review of the internal control questionnaire) whereas the junior auditor carries out audit of routine matters (like test of details in purchases).

The audit plan will set out the names of the team members and the nature of audit work which will be carried out by each of the members.

(e) **Types of audit evidence desired in order to comply with ISAs**

Example

Physical count of non-current assets
Physical count of inventory
Observation of disbursement of wages to employees
A bank's certificate confirming balances at a given date
Circularisation of receivables, where requests are sent to customers to confirm balances

---

(f) Explanation on decision relating to testing the operating effectiveness of controls and nature, timing and extent of planned substantive procedures

The explanation is important as it will decide whether the auditor will be able to rely on the internal controls. Study Guide B4, discusses how the auditor can reduce the level of substantive procedures when the controls are operating properly. Therefore this decision is very important and hence needs to be documented.

Example

Example of an Audit plan

Name of the client	Ngorongoro Machines Ltd.
Address of the client	P o Box 222, Arusha
Nature of the work (audit work)	Statutory Audit
Date of engagement letter	05/01/20X9
Period covered by audit	01/01/20X9 to 31/12/20X9
Details of the client	Buys tools and equipment to make machines for manufacturing sugar from various suppliers and then resells them. No. of warehouses 4 No. of branches 4
Expected date of the report	31/03/20Y0
Man hours required to complete the audit work	256 hours
Engagement team of the previous year	Mr. Mgaya - manager Mr. Meshak Miss. Joyce Mr. Harvey Mr. David Miss. Florence
Engagement team of the current year	Mr. Mgaya - manager Mr. Bernard Miss. Prisca Mr. Augustino Mr. Ivan Mr. David Miss. Florence
Evaluation of internal control system	Need to evaluate the whole internal control system.
Any change in the accounting or internal control system since last year	Yes, accounting system has been changed from manual to fully computerised as a result of which the internal control system has also changed.
Any change in the accounting policy since last year	No change in the accounting policies of the entity.
Nature of audit	Tests of controls will be performed as far as possible.
Areas of special attention	Trade receivables have increased by about 50%. Therefore special attention is required.
Inventory verification	The inventory is required to be verified physically by the engagement team. Mr. David and Miss. Prisca will be responsible for physical verification of the inventory on 31/12/20X9.
Physical verification of cash and investments	The cash and the investments at the head office should also be verified physically by Mr. Ivan.
Audit of fixed assets	Physical verification by Mr. Augustino.
Associated party transactions	Ledger scrutiny by Miss Florence
Materiality level	Materiality level appears to be accurate.

Exam Focus

In the exam, you may be asked to 'list and explain the purpose of the main sections of an audit strategy document'.

This can be a case study question where marks will be allotted for using aspects from the scenario to the answer.

Test Yourself 7

"Audit Planning should be a continuous process throughout the audit". Do you agree?

5. State and explain the following basic component of an assurance process relating to the regulatory requirements of assignments.
v. Analytical procedures

[Learning Outcome a]

5.1 Analytical procedures

Definition

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

ISA 520

Analytical procedures are audit **procedures which seek to provide evidence as to the completeness, accuracy and validity of the information contained in the accounting records or in the financial statements**.

These assertions can be tested only if the data that is tested is reliable!

The procedure consists of the systematic study and comparison of relationships and trends among elements of financial information and the investigation of significant fluctuations and variances from the expected relationships and trends.

Inconsistent relationships and trends should be investigated.

Example

Deogratias is the auditor of Selous Ltd. Deogratias made an analysis of the financial statements of Selous Ltd by studying significant ratios. One of the ratios that he studied was the gross profit margin. The gross profit ratio of Selous Ltd for the current year, 20X9, was 25% and the gross profit percentage for the previous year, 20X8, was 24.5%.

There was not much variation in the gross profit percentage in the two years.

Hence, Deogratias has no reason to believe that assets and liabilities, transactions or events have been omitted that should be included or that there is understatement or overstatement of amounts in the financial statements.

Hence, **assuming that there is other evidence to back this up**, the information contained in the financial statements is reasonably complete and accurate and no further investigation is needed.

5.2 Steps involved in analytical procedures

Analytical procedures are substantive procedure. Substantive procedures are those activities performed by the auditor that gather evidence as to the completeness, accuracy and validity and accuracy of account balances.

Unlike vouching, physical verification and external confirmation, analytical procedures do not provide direct evidence about the amount of transaction or balance. Rather, they give an idea of what the amount should be or is reasonably expected to be.

Analytical procedures involve the following steps:

1. Expectation

This step involves developing an expectation of what the financial information figures should be. This can be agreed through comparisons of financial information or considerations of relationships (ratio analysis).

2. Identification

This step involves identification of significant variations between the actual data with the expected data.

3. Investigation of unusual variances

Once the variation has been computed, and if significant variations are found, the auditor would consult the management in order to establish explanations for the variations revealed.

The auditor needs to exercise professional scepticism while auditing, so although the ratios are close to the expected, evidence needs to be corroborated!

4. Performance of alternate procedures

If the auditor or management do not find the variation reasonable, then they investigate further, for example, by inspecting inventory or sales invoices.

Example

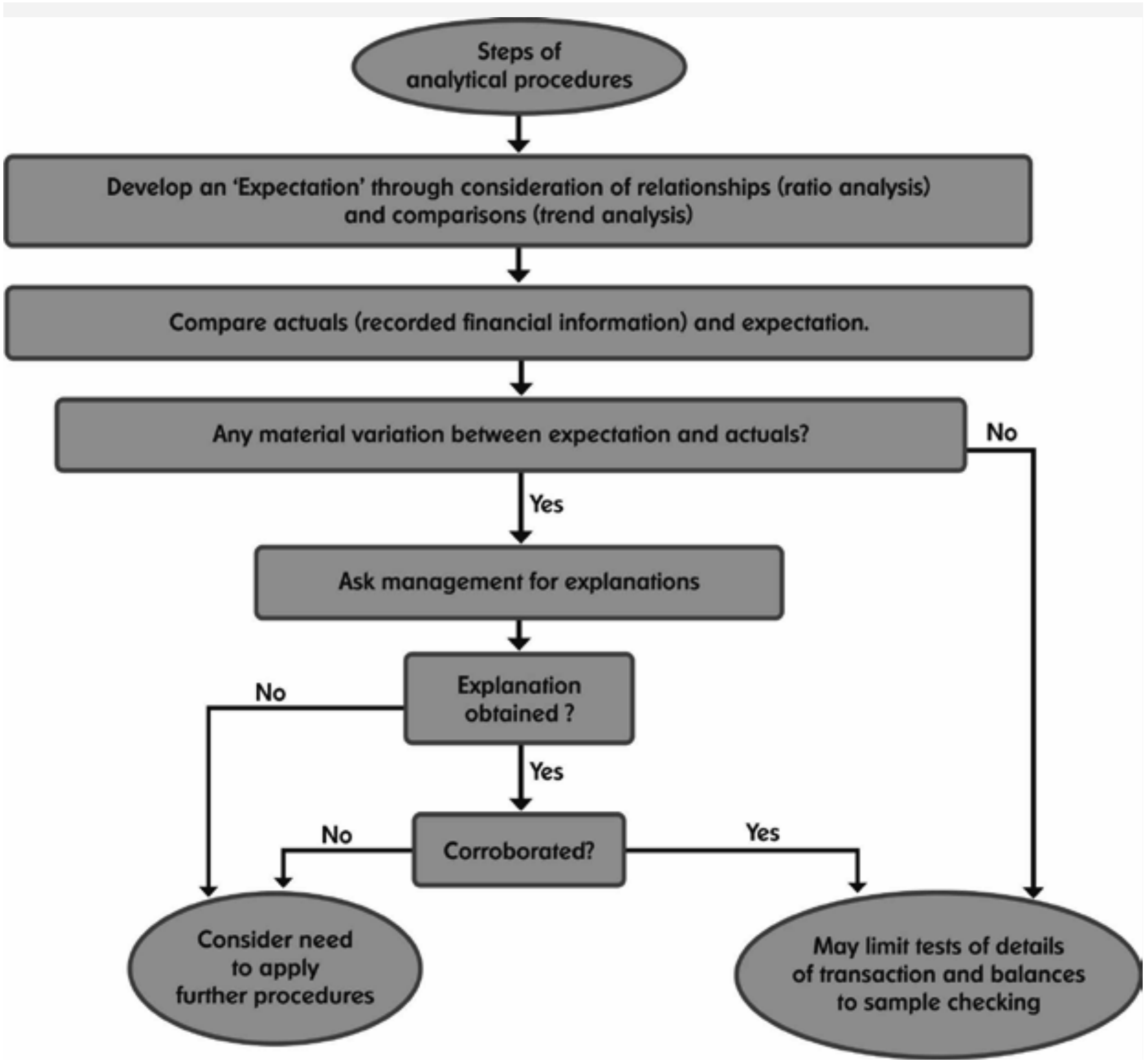
The budget of Katavi Ltd for the year 20X9 had set the net profit margin (before tax) at 15%. As part of analytical procedures, the auditors decided to compare it with the actual net profit margin (before tax). The auditors decided that variations which exceed 3% of the expected results would be considered as significant.

The actual net profit (before tax) of Tone Ltd for the year 20X9 was 10%. Therefore the auditors felt that the difference of 5% was abnormal.

Thus, the auditors decided to investigate further and apply additional tests to find the reason for the difference. For this, they decided to carry out a detailed analysis of sales, purchases, individual expenses and miscellaneous income to find the reason for the difference.

The diagram given below summarises the steps involved in analytical procedures

Diagram 7: Steps involved in analytical procedures



5.3 Nature of analytical procedures

Although various methods ranging from simple comparisons to complex analyses using advanced statistical techniques may be employed in performing analytical review procedures, **key accounting ratios** are the most commonly used tools for this purpose. Analytical procedures consist of analysing relationships between not only financial figures but also non-financial information to identify relationships and trends.

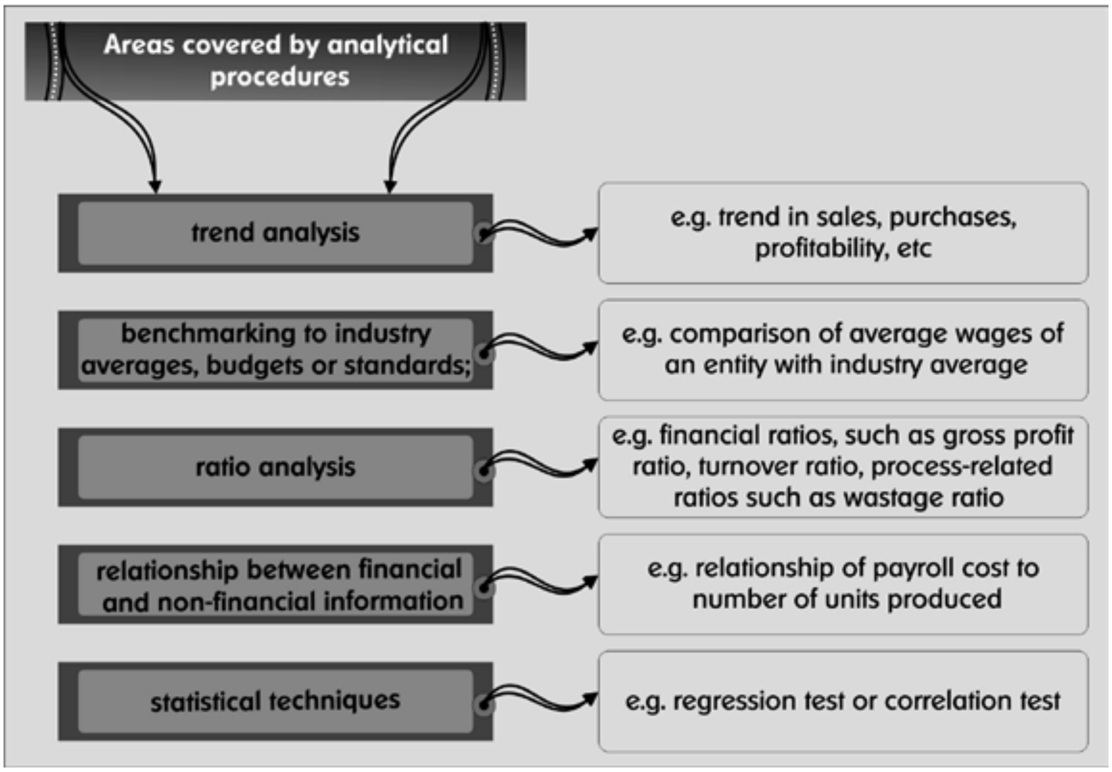
Example

The partner of CLK associates compared the figures of wages with the number of workers to identify relationships and trends. Here, the figure of wages was a financial figure, whereas the number of workers was a non-financial figure. So, analytical procedures are the analysis of financial and non-financial information to identify relationships and trends.

Many of the analyses consist of measuring ratios, and comparing the ratios obtained from the current year's financial results with:

- Expected ratios
- Ratios from previous financial periods
- Expected results (for example budgets)
- Industry average results
- Results of other comparable parts of the business

Diagram 8: Areas covered by analytical procedures



Test Yourself 8

What is the basis for application of analytical procedures?

5.4 Financial ratio

Financial ratios focus attention on the interrelationships between various items of financial information. They not only look at relationships inside the industry / firm, but also allow comparison of one industry / firm with another.

This method of comparison doesn't depend on the size of either industry / firm. An industry / firm of one size can be directly compared to a second industry / firm (or a collection of industries / firms) which may be larger or smaller or even in a different business.

Financial statement ratio analysis provides a broader basis for comparison than that provided by raw numbers.

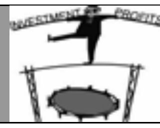
However, ratios on their own, without year-to-year or other industry / firm comparative ratios are of little use in

Judging the health or future of the industry / firm being analysed.

The following table contains a few key ratios that are generally used by the auditor:

	Key accounting Ratios	Formula	Interpretation	Favourable situation	
				High	**Low**
A	**Profitability ratios**				
1	Gross profit margin	$\frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$	Reflects gross margin (i.e. profitability before taking overheads into account) made 		
2	Operating profit margin	$\frac{\text{Operating profit margin}}{\text{Sales revenue}} \times 100$	Reflects operating margin made on sales		
3	Net profit margin	$\frac{\text{Net profit (PBT)}}{\text{Sales revenue}} \times 100$	Reflects net margin (i.e. profitability after taking		
4	Return on capital employed	$\frac{\text{Operating profit}}{\text{Capital employed}} \times 100$	Reflects relationship between profits earned and size of company (measures overall performance		
5	Return on assets	$\frac{\text{Operating profit}}{\text{Total assets}} \times 100$	Reflects relationship between profits earned and total assets		
B	**Liquidity ratios**				
1	Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	Measures ability to pay current liabilities from the current assets		
2	Quick ratio	$\frac{\text{Quick assets}}{\text{Current liabilities}}$	Indicates the ability to pay all current liabilities if they		
C	**Working capital efficiency ratios** 				
1	Asset turnover	$\frac{\text{Sales revenue}}{\text{Total assets}}$ (times p.a.)	Shows how much revenue generated by a Tsh1		
2	Inventory turnover	$\frac{\text{Cost of sales}}{\text{Inventory}}$ (times p.a.)	Indicates how many times the inventory is being		
3	Receivable days	$\frac{\text{Receivable}}{\text{Credit sales}} \times 365$ days	Reflects the number of days it takes for a customer to pay		
4	Payable days	$\frac{\text{Payables}}{\text{Credit purchases}} \times 365$ days	Reflects the number of days it takes for a company to settle its		
5	Working capital cycle	Inventory turnover days + Receivable days - Payable days	Approximate number of days it takes to purchase the inventory, sell the		

Continued on the next page

D	**Investor performance ratios** 				
1	Earnings per share (EPS)	Profits available for distribution to ordinary shareholders/Weighted average number of ordinary shares outstanding	Amount which an entity has earned per share for the given period.		
2	Price / Earnings ratio	$\frac{\text{Current market price per share}}{\text{Earnings Per Share}}$	Helps to assess the relative risk of an investment		
3	Profit retention ratio	$\frac{\text{Profit after dividend}}{\text{Profit before dividend}} \times 100$	Measures the proportion of retained profits to the profits earned by the entity		
4	Dividend yield	$\frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$	Measures the return on capital investment as a percentage of market prices		
5	Dividend cover	$\frac{\text{Profit after tax}}{\text{Dividend}}$	Measures the ability of the company to maintain its existing levels of dividends		
E	**Financial risk ratios** 				
1	Capital gearing ratio	$\frac{\text{Total long-term debt}}{\text{Shareholders' funds}} \times 100$	It expresses the relationship between a company's borrowings and its own funds i.e. reliance on external finance	-	
2	Debt ratio	$\frac{\text{Total liabilities}}{\text{Total assets}}$	Indicates the percentage of assets financed with debt		
3	Interest cover	$\frac{\text{Profit before interest and tax}}{\text{Interest expenses}}$	Indicates the ability to pay interest charges		
4	Cash flow ratios				
(i)	Ratio of long-term borrowings to cash generated from operations	$\frac{\text{Long-term borrowings}}{\text{Cash generated from operations}}$	Measures the ability of the company to meet its long-term obligations from its operating activities		
(ii)	Ratio of net cash from operating activities to capital expenditure	Net cash flow from $\frac{\text{Operating activity}}{\text{Capital expenditure}} \times 100$	Helps decide the extent to which the operating activities of a company can Finance its capital expenditure		

Example

The following information is available from the financial statements of Lovely Ltd:

	20X8 TZS'000	20X9 TZS'000
Credit sales	110,000	200,000
Receivables	13,000	28,000
Credit purchases	130,000	210,000
Payables	10,000	25,000
Profit before interest and tax	370,000	475,000
Interest	75,000	84,000

Interpretation of some ratios along with its implications on audit based on above data, is as follows:

Ratios	20X8	20X9	Implications on audit
Average Collection Period is	43 days (13,000/110,000 x 365)	51days (28,000/200,000 x 365)	The average collection period has increased from 43 days to 51 days. This indicates that customers are taking longer to pay, Perhaps they can't pay or perhaps Lovely Ltd has increased its credit terms. The auditor will investigate this information to find out the cause of the increase. There might be implications for the valuation of receivables.
Average payment period is	28 days (10,000/130,000 x 365)	43 days (25,000/210,000 x 365)	This shows an increase in number of days it takes for the company to settle its bill. The auditor needs to find out whether the company is able to settle its invoices on time and if there are any going concern issues.
Interest cover	4.93 (370,000/75,000)	5.65 (475,000/84,000)	The increase in the interest cover shows that the entity is in a better position to pay the fixed charge of interest. The payables and the unsecured loan holders will feel more secure with a higher interest cover. The auditor needs to ensure that the profit has been calculated correctly and no expenses have been missed out. Only then will the auditor be assured that the increase in interest cover is genuine.

Tip

Remember that single ratios are meaningless. The exam questions can relate to computation and interpretation of ratios. Computing ratios is quite simple. However, the real challenge lies in interpretation of the ratios. Interpretation must include the following matters:

1. What is the **cause** of the change? For example, in a liquidity ratio it could be on account of an abnormal increase in inventory and cash reserves. It could also simply be caused by an accident of timing, such as when a large invoice was received or paid.

2. Is the change **genuine**? This means that if the increase in cash took place, it needs to be ascertained whether the increase is on account of a genuine reason (such as sale of some non-current asset) or accidental (on account of an error).

3. Is there any **test** which can be performed to arrive at a conclusion on the matter? The auditor would have to verify the documents relating to the sale of non-current assets and also scrutinise the cash flows to confirm the explanations received. (Remember, auditors need to do something to confirm the genuineness of their observations)

4. What is the **effect** of the change? For example, an increase in current ratio would indicate an improvement in the liquidity position. However, the threshold limit of the industry must also be checked to ensure that the increase is not unreasonable.

5. Is this change **consistent** with other information? This point is again a continuation of the earlier point i.e. to ensure that the change is genuine and consistent with other ratios such as inventory turnover, quick ratio etc.

Test Yourself 9

Explain the audit implications which arise due to the following changes found at the planning stage of the audit:

(a) An increase in the quick ratio
(b) A decrease in the current ratio
(c) An increase in the gearing ratio
(d) A decrease in the average payment period
(e) A decrease in the interest cover

Auditor's responses to assessed risks (ISA 330)

Once the auditor has assessed the risk of material misstatement, the auditor will use such assessment as a basis for further audit procedures. *'ISA 330: Auditor's responses to assessed risks'* provide guidance on determining overall responses and designing further audit procedures to respond to the assessed risks of material misstatement at the financial statement and assertion levels in a financial statement audit.

An auditor is expected to prepared audit responses for all significant risks.

Significant risk is defined as any risk that requires auditor's attention during the audit engagement. This significant risks can a risk of fraud, or risk of revenue recognition etc. The focus of the auditor should be risks identified as significant.

ISA 330 stipulates that the responses of an auditor can be:

- Overall/General responses or
- Specific responses (Audit procedures responsive to risks of material misstatement at the assertion level)

ISA 330 provide that in order to reduce audit risk to an acceptably low level, the auditor should determine overall responses to assessed risks at the financial statement level, and should design and perform further audit procedures to respond to assessed risks at the assertion level'.

Overall Responses

Overall responses are those responses which are designed by auditor and cut across risks of material misstatements identified. These responses do not focus or address a particular/specific risk identified by auditors as per ISA 315.

Overall or general responses when the risk of material misstatement is high may include:

- Assigning more experienced staff or those with special skills or using experts,
- Emphasizing to the audit team the need to maintain professional scepticism in gathering and evaluating audit evidence,
- Providing close supervision and monitoring by audit directors and partners or
- Incorporating elements of unpredictability in the selection of audit procedures to be performed.

Additionally, the auditor may make general changes to the nature, timing, or extent of audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

The assessment of the risks of material misstatement at the financial statement level is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at period end.
If there are weaknesses in the control environment, the auditor should:

- Conduct more audit procedures as of the period end rather than at an interim date,
- Seek more extensive audit evidence from substantive procedures,
- Modify the nature of audit procedures to obtain more persuasive audit evidence, or
- Increase the number of locations to be included in the audit scope.

Specific Responses

Specific responses are those responses or set of audit procedures which is directed toward addressing specified significant risks. This includes respective audit Procedures Responsive to Risks of Material Misstatement at the Assertion Level

ISA 330 requires an auditor to design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the risk assessment. In designing further audit procedures, the auditor should consider such matters as the following:

- The significance of the risk.
- The likelihood that a material misstatement will occur.
- The characteristics of the class of transactions, account balance, or disclosure involved.
- The nature of the specific controls used by the entity and in particular whether they are manual or automated.
- Whether the auditor expects to obtain audit evidence to determine if the entity's controls are effective in preventing, or detecting and correcting material misstatements.

The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. In some cases, the auditor may determine that only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion.

In other cases, the auditor may determine that performing only substantive procedures is appropriate for specific assertions and, therefore, the auditor will have to exclude the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing the operating effectiveness of controls would be inefficient. However, in such cases the auditor needs to be satisfied that performing only substantive procedures for the relevant assertion would be effective in reducing the risk of material misstatement to an acceptably low level.

In most cases, the auditor may determine that a combined approach using both tests of the operating effectiveness of controls and substantive procedures is an effective approach. Irrespective of the approach selected the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure. This requirement by ISA 330 reflects the fact that the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations to internal control including management override.

In the case of very small entities, there may not be many control activities that could be identified by the auditor. For this reason, the auditor's further audit procedures are likely to be primarily substantive procedures.

Considering the Nature, Timing, and Extent of Audit Procedures

Nature

The nature of further audit procedures refers to their purpose (tests of controls or substantive procedures) and their type, that is, inspection, observation, inquiry, confirmation, recalculation, re-performance, or analytical procedures.

Certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.

The auditor's selection of audit procedures should be based on the assessment of risk. The higher the auditor's assessment of risk, the more reliable and relevant is the audit evidence sought by the auditor from substantive procedures. This may affect both the types of audit procedures to be performed and their combination.
For example, the auditor may confirm the completeness of the terms of a contract with a third party, in addition to inspecting the document.

In determining the audit procedures to be performed, the auditor should consider the reasons for the assessment of the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure. This includes considering both the particular characteristics of each class of transactions, account balance, or disclosure (i.e., the inherent risks) and whether the auditor's risk assessment takes account of the entity's controls (i.e., the control risk). For example, if the auditor should consider that there is a lower risk that a material misstatement may occur because of the particular characteristics of a class of transactions without consideration of the related controls, the auditor may determine that substantive analytical procedures alone may provide sufficient appropriate audit evidence.

Timing

Timing refers to when audit procedures are performed or the period or date to which the audit evidence applies. The auditor may perform tests of controls or substantive procedures at an interim date or at period end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters.

If the auditor performs tests of controls or substantive procedures prior to period end, the auditor should consider the additional evidence required for the remaining period.

In considering when to perform audit procedures, the auditor also should consider such matters as the following:

- The control environment.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may wish to examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.

Certain audit procedures can be performed only at or after period end, for example, agreeing the financial statements to the accounting records and examining adjustments made during the course of preparing the financial statements.

Extent

Extent includes the quantity of a specific audit procedure to be performed, for example, a sample size or the number of observations of a control activity. The extent of an audit procedure is determined by the judgment of the auditor after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. In particular, the auditor ordinarily increases the extent of audit procedures as the risk of material misstatement increases. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk; therefore, the nature of the audit procedure is the most important consideration.

The use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

Valid conclusions may ordinarily be drawn using sampling approaches. However, if the quantity of selections made from a population is too small, the sampling approach selected is not appropriate to achieve the specific audit objective, or if exceptions are not appropriately followed up, there will be an unacceptable risk that the auditor's conclusion based on a sample may be different from the conclusion reached if the entire population was subjected to the same audit procedure.

Tests of controls

The auditor is required to perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.

Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures, the auditor determines that the relevant controls exist and that the entity is using them. When performing tests of the operating effectiveness of controls, the auditor should obtain audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. If substantially different controls ere used at different times during the period under audit, the auditor should consider each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

Nature of Tests of Controls

The auditor should select audit procedures to obtain assurance about the operating effectiveness of controls. As the planned level of assurance increases, the auditor should seek more reliable audit evidence. In circumstances when the auditor adopts an approach consisting primarily of tests of controls, in particular related to those risks where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures, the auditor ordinarily performs tests of controls to obtain a higher level of assurance about their operating effectiveness.

The auditor should perform other audit procedures in combination with inquiry to test the operating effectiveness of controls. Although different from obtaining an understanding of the design and implementation of controls, tests of the operating effectiveness of controls ordinarily include the same types of audit procedures used to evaluate the design and implementation of controls, and may also include re-performance of the application of the control by the auditor. Since inquiry alone is not sufficient, the auditor should use a combination of audit procedures to obtain sufficient appropriate audit evidence regarding the operating effectiveness of controls. Those controls subject to testing by performing inquiry combined with inspection or re-performance ordinarily provide more assurance than those controls for which the audit evidence consists solely of inquiry and observation. For example, an auditor may inquire about and observe the entity's procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor ordinarily supplements the observation with inquiries of entity personnel, and may also inspect documentation about the operation of such controls at other times during the audit period in order to obtain sufficient appropriate audit evidence.

In designing tests of controls, the auditor should consider the need to obtain audit evidence supporting the effective operation of controls directly related to the assertions as well as other indirect controls on which these controls depend.

The absence of misstatements detected by a substantive procedure does not provide audit evidence that controls related to the assertion being tested are effective. However, misstatements that the auditor detects by performing substantive procedures are considered by the auditor when assessing the operating effectiveness of related controls. A material misstatement detected by the auditor's procedures that was not identified by the entity ordinarily is indicative of the existence of a material weakness in internal control, which is communicated to management and those charged with governance.

Timing of Tests of Controls

The timing of tests of controls depends on the auditor's objective and determines the period of reliance on those controls. If the auditor tests controls at a particular time, the auditor only obtains audit evidence that the controls operated effectively at that time However, if the auditor tests controls throughout a period, the auditor obtains audit evidence of the effectiveness of the operation of the controls during that period.

Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor requires audit evidence of the effectiveness of a control over a period, audit evidence pertaining only to a point in time may be insufficient and the auditor supplements those tests with other tests of controls that are capable of providing audit evidence that the control operated effectively at relevant times during the period under audit. Such other tests may consist of tests of the entity's monitoring of controls.

ISA 330 requires that when the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor should determine what additional audit evidence should be obtained for the remaining period. In making that determination, the auditor should consider:

i] The significance of the assessed risks of material misstatement at the assertion level,

ii] The specific controls that were tested during the interim period,

iii] The degree to which audit evidence about the operating effectiveness of those controls was obtained,

iv] The length of the remaining period, the extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls, and

v] The control environment.

The standard allows an auditor to use audit evidence about the operating effectiveness of controls obtained in the prior audits, only that the auditor should obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit. The auditor should obtain audit evidence about whether such changes have occurred by performing inquiry in combination with observation or inspection to confirm the understanding of those specific controls.

If the auditor plans to rely on controls that have changed since they were last tested, the auditor should test the operating effectiveness of such controls in the current audit. Changes may affect the relevance of the audit evidence obtained in prior periods such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of prior period audit evidence; however, a change that causes data to be accumulated or calculated differently does affect it.

If the auditor plans to rely on controls that have not changed since they were last tested, the auditor should test the operating effectiveness of such controls at least once in every third audit.

Extent of Tests of Controls

The auditor should design tests of controls to obtain sufficient appropriate audit evidence that the controls operated effectively throughout the period of reliance. Matters the auditor may consider in determining the extent of the auditor's tests of controls include the following:

i] The frequency of the performance of the control by the entity during the period.

ii] The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.

iii] The relevance and reliability of the audit evidence to be obtained in supporting that the control prevents, or detects and corrects, material misstatements at the assertion level.

iv] The extent to which audit evidence is obtained from tests of other controls related to the assertion.

v] The extent to which the auditor plans to rely on the operating effectiveness of the control in the assessment of risk (and thereby reduce substantive procedures based on the reliance of such control).

vi] The expected deviation from the control.

The more the auditor relies on the operating effectiveness of controls in the assessment of risk, the greater is the extent of the auditor's tests of controls. In addition, as the rate of expected deviation from a control increases, the auditor increases the extent of testing of the control. However, the auditor should consider whether the rate of expected deviation indicates that the control will not be sufficient to reduce the risk of material misstatement at the assertion level to that assessed by the auditor. If the rate of expected deviation is expected to be too high, the auditor may determine that tests of controls for a particular assertion may not be effective.

Because of the inherent consistency of IT processing, the auditor may not need to increase the extent of testing of an automated control. An automated control should function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor should consider performing tests to determine that the control continues to function effectively.

Substantive procedures

Substantive procedures are performed in order to detect material misstatements at the assertion level, and include tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures. The auditor should plan and perform substantive procedures to be responsive to the related assessment of the risk of material misstatement.

The auditor's substantive procedures should include the following audit procedures related to the financial statement closing process:

i] Agreeing or reconciling the financial statements with the underlying accounting records; and

ii] Examining material journal entries and other adjustments made during the course of preparing the financial statements.

When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor may find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

Nature of Substantive Procedures

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Tests of details are ordinarily more appropriate to obtain audit evidence regarding certain assertions about account balances, including existence and valuation. In some situations, the auditor may determine that performing only substantive analytical procedures may be sufficient to reduce the risk of material misstatement to an acceptably low level. For example, the auditor may determine that performing only substantive analytical procedures is responsive to the assessed risk of material misstatement for a class of transactions where the auditor's assessment of risk is supported by obtaining audit evidence from performance of tests of the operating effectiveness of controls. In other situations, the auditor may determine that only tests of details are appropriate, or that a combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

The auditor should design tests of details responsive to the assessed risk with the objective of obtaining sufficient appropriate audit evidence to achieve the planned level of assurance at the assertion level. In designing substantive procedures related to the existence or occurrence assertion, the auditor selects from items contained in a financial statement amount and obtains the relevant audit evidence. On the other hand, in designing audit procedures related to the completeness assertion, the auditor should select from audit evidence indicating that an item should be included in the relevant financial statement amount and investigate whether that item is so included. For example, the auditor might inspect subsequent cash disbursements to determine whether any purchases had been omitted from accounts payable.

In designing substantive analytical procedures, the auditor considers such matters as the following:

i] The suitability of using substantive analytical procedures given the assertions.

ii] The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed.

iii] Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance.

iv] The amount of any difference in recorded amounts from expected values that is acceptable.

Timing of Substantive Procedures

In some circumstances, substantive procedures may be performed at an interim date. This increases the risk that misstatements that may exist at the period end are not detected by the auditor. This risk increases as the remaining period is lengthened. In considering whether to perform substantive procedures at an interim date, the auditor considers such factors as the following:

i] The control environment and other relevant controls.

ii] The availability of information at a later date that is necessary for the auditor's procedures.

iii] The objective of the substantive procedure.

iv] The assessed risk of material misstatement.

v] The nature of the class of transactions or account balance and related assertions.

vi] The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that exist at period end are not detected.

When substantive procedures are performed at an interim date, the auditor should perform further substantive procedures or substantive procedures combined with tests of controls to cover the remaining period that provide a reasonable basis for extending the audit conclusions from the interim date to the period end.

Extent of the Performance of Substantive Procedures

The golden rule here is clear, that the greater the risk of material misstatement, the greater the extent of substantive procedures. Because the risk of material misstatement takes account of internal control, the extent of substantive procedures may be increased as a result of unsatisfactory results from tests of the operating effectiveness of controls. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size, which is affected by the risk of material misstatement. However, the auditor also should also consider other matters, including whether it is more effective to use other selective means of testing, such as selecting large or unusual items from a population as opposed to performing representative sampling or stratifying the population into homogeneous subpopulations for sampling.

In designing substantive analytical procedures, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by materiality and the consistency with the desired level of assurance. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balance, class of transactions, or disclosure could aggregate to an unacceptable amount. In designing substantive analytical procedures, the auditor should increase the desired level of assurance as the risk of material misstatement increases.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

Based on the audit procedures performed and the audit evidence obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate.

An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures. Information may come to the auditor’s attention that differs significantly from the information on which the risk assessment was based. For example, the extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor’s judgment about the risk assessments and may indicate a material weakness in internal control.

The auditor should further conclude whether sufficient appropriate audit evidence has been obtained to reduce to an acceptably low level the risk of material misstatement in the financial statements. In developing an opinion, the auditor considers all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.

The sufficiency and appropriateness of audit evidence to support the auditor’s conclusions throughout the audit are a matter of professional judgment. The auditor’s judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as the following:

i] Significance of the potential misstatement in the assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.

ii] Effectiveness of management’s responses and controls to address the risks.

iii] Experience gained during previous audits with respect to similar potential misstatements.

iv] Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.

v] Source and reliability of the available information.

vi] Persuasiveness of the audit evidence.

vii] Understanding of the entity and its environment, including its internal control.

It is noteworthy that if the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor should attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should express a qualified opinion or a disclaimer of opinion.

Audit documentation

Documentation is very important for different kinds of assignments. For financial statements audit work conducted according to ISAs, documentation is a requirement that is guided by ISA 230. The purpose of ISA 230 is to establish standards and provide guidance on audit documentation.

The ISA requires an auditor to prepare, on a timely basis, audit documentation that provides:

i] A sufficient and appropriate record of the basis for the auditor’s report; and

ii] Evidence that the audit was performed in accordance with ISAs and applicable legal and regulatory requirements.

Audit documentation, according to ISA 230, means the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Other terms such as “working papers” or “workpapers” are also sometimes used to mean the same with audit documentation.

Objective of sufficient and appropriate audit documentation:

The primary objective of audit documentation is to enhance the quality of the audit facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized.

More specifically, audit documentation serves a number of purposes, including:

i] Assisting the audit team to plan and perform the audit;

ii] Assisting members of the audit team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities.

iii] Enabling the audit team to be accountable for its work;

iv] Retaining a record of matters of continuing significance to future audits;

v] Enabling an experienced auditor to conduct quality control reviews, and AUDITING

vi] Enabling an experienced auditor to conduct external inspections in accordance with applicable legal, regulatory or other requirements.

Timing of Documentation

The ISA does not give 'hard and Fast' rules on the timing of audit documentation, but rather gives an indicative statement that supports the documenting as soon as practicable. It provides that 'documentation prepared at the time the work is performed is likely to be more accurate than documentation prepared subsequently'.

Nature of Audit Documentation

Audit documentation may be recorded on paper or on electronic or other media. It includes, for example, audit programs, analyses, issues memoranda, summaries of significant matters, letters of confirmation and representation, checklists, and correspondence (including e-mail) concerning significant matters. Abstracts or copies of the entity's records, for example, significant and specific contracts and agreements, may be included as part of audit documentation if considered appropriate.

Audit documentation, however, is not a substitute for the entity's accounting records. The audit documentation for a specific audit engagement is assembled in an audit file.

Naturally, in the conduct of an audit, the auditor may supersede some of the working papers. The auditor should exclude from audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

Form, Content and Extent of Audit Documentation

The auditor should prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand:

i] The nature, timing, and extent of the audit procedures performed to comply with ISAs and applicable legal and regulatory requirements;

ii] The results of the audit procedures and the audit evidence obtained; and

iii] Significant matters arising during the audit and the conclusions reached thereon.

The form, content and extent of audit documentation depend on factors such as:

i] The nature of the audit procedures to be performed;

ii] The identified risks of material misstatement;

iii] The extent of judgment required in performing the work and evaluating the results;

iv] The significance of the audit evidence obtained;

v] The nature and extent of exceptions identified;

vi] The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained; and

vii] The audit methodology and tools used.

It should be noted, however, that it is neither necessary nor practicable to document every matter the auditor considers during the audit.

Documentation of the Identifying Characteristics of Specific Items or Matters Being Tested

ISA 230 requires an auditor, in documenting the nature, timing and extent of audit procedures performed, to record the identifying characteristics of the specific items or matters being tested. This serves a number of purposes, for example, it enables the audit team to be accountable for its work, and facilitates the investigation of exceptions or inconsistencies.

Identifying characteristics will vary with the nature of the audit procedure and the item or matter being tested. For example:

i] For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers.

ii] For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register).

iii] For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point and the sampling interval (for example, a systematic sample of shipping reports selected from the shipping log for the period from April 1 to September 30, starting with report number 12345 and selecting every 125th report).

iv] For a procedure requiring inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of the entity personnel.

v] For an observation procedure, the auditor may record the process or subject matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

Documentation of Significant Matters

The auditor should document discussions of significant matters with management and others on a timely basis. The audit documentation should include records of the significant matters discussed, and when and with whom the discussions took place. It is not limited to records prepared by the auditor but may include other appropriate records such as agreed minutes of meetings prepared by the entity's personnel. Others with whom the auditor may discuss significant matters include those charged with governance, other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

Judging the significance of a matter requires an objective analysis of the facts and circumstances. Significant matters include, amongst others:

i] Results of audit procedures indicating; that the financial information could be materially misstated, or a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.

ii] Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.

iii] Findings that could result in a modification to the auditor's report.

Documentation of Departures from Basic Principles or Essential Procedures

The basic principles and essential procedures in ISAs are designed to assist the auditor in meeting the overall objective of the audit. Accordingly, other than in exceptional circumstances, the auditor should comply with each basic principle and essential procedure that is relevant in the circumstances of the audit.

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

The documentation requirement does not apply to basic principles and essential procedures that are not relevant in the circumstances, i.e., where the circumstances envisaged in the specified basic principle or essential procedure do not apply. For example, in a continuing engagement, nothing in ISA 510, "Initial Engagements—Opening Balances," is relevant. Similarly, if an ISA includes conditional requirements, they are not relevant if the specified conditions do not exist (for example, the requirement to modify the auditor's report where there is a limitation of scope).

Identification of Preparer and Reviewer

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

i] Who performed the audit work and the date such work was completed; and

ii] Who reviewed the audit work performed and the date and extent of such review.

The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The audit documentation, however, evidences who reviewed specified elements of the audit work performed and when.

Assembly of the Final Audit File

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

ISQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files. As ISQC 1 indicates, 60 days after the date of the auditor's report is ordinarily an appropriate time limit within which to complete the assembly of the final audit file.

The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if they are administrative in nature. Examples of such changes include:

i] Deleting or discarding superseded documentation.

ii] Sorting, collating and cross-referencing working papers.

iii] Signing off on completion checklists relating to the file assembly process.

iv] Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the audit team before the date of the auditor's report.

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

The retention period is the minimum period for which the audit documentations should be kept. ISQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. As ISQC 1 indicates, the retention period for audit engagements ordinarily is no shorter than five years from the date of the auditor's report, or, if later, the date of the group auditor's report.

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

i] When and by whom they were made, and (where applicable) reviewed;

ii] The specific reasons for making them; and

iii] Their effect, if any, on the auditor's conclusions.

Changes to Audit Documentation in Exceptional Circumstances after the Date of the Auditor's Report

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

i] The circumstances encountered;

ii] The new or additional audit procedures performed, audit evidence obtained, and conclusions reached; and

iii] When and by whom the resulting changes to audit documentation were made, and (where applicable) reviewed.

Such exceptional circumstances include the discovery of facts regarding the audited financial information that existed at the date of the auditor's report that might have affected the auditor's report had the auditor then been aware of them

Answers to Test Yourself

Answer to TY 1

The business risks involved in the decisions taken during Muheza's board meeting include the following:

Trading in leather accessories and jewellery

Although, Muheza is a brand name in designer wear, it has no experience in leather accessories and jewellery, so it may not get a good response from customers.

Products which Muheza deals in are subject to frequent change. They change according to fashion trends and therefore there is a risk that inventory may become quickly outdated.

Trend has chosen to trade in leather, which in itself is a risk. Generally, the leather used in accessories is snake skin, deer skin, etc. There is always a risk that the use of certain kinds of leather may be banned on account of allegations from animal rights activists.

Answer to TY 2

(a) Audit risk

The risk that an auditor expresses an inappropriate audit opinion when the financial statements are materially misstated i.e. the auditor gives an unmodified opinion when the financial statements are materially misstated.

There are three main components to audit risk, inherent risk, control risk and detection risk.

(i) Inherent risk

This is the risk associated with the nature of business and the industry the organisation operates in. This type of risk will always exist. It cannot be eliminated but by taking certain measures it can be mitigated against. One common method is to implement an internal control system.

(ii) Control risk

However an internal control system is unlikely to mitigate all inherent risks. This is known as control risk i.e. the risk that an organisation's internal control system does not adequately protect the organisation against all inherent risks.

(iii) Detection risk

This is the risk that the audit procedures will not uncover all irregularities or the misstatements.

(b) Situations that can give rise to audit risk for Bunju

(i) Many branches

Generally, an organisaation with many branches scattered throughout the country us more prone to audit risk. It is more difficult to supervise staff, inventory and sales. Interbranch transfers add complications to accounting.

(ii) Small, high-value, desirable inventory

Mobile phones are very susceptible to theft. The disappointing profitability might be caused by this, at least in part.

(iii) Ineffective MIS

Although Bunju has implemented a management MIS they have not fully trained their staff on it. Therefore the risk exists that how well designed the system may be it may be ineffectively used causing inaccurate information / reports to be generated.

(iv) Internet

Bunju has implemented an electronic sales delivery channel. However its employees may have not been adequately trained (just as with the MIS) on the proper procedures and safety controls to follow with this type of selling.

(v) Rapid expansion

This can often mean that staffs are over-worked and that they have had little training. Supervision is likely to be patchy.

(vi) Control environment

The CEO is not interested in internal control and this lax approach is likely to affect the design of the internal control system and the operation of any controls that are present.

(vii)First year audit

Given that this is the first year, Janet is conducting the audit, her unfamiliarity with the organisation, procedures etc. adds to the overall general risk of the audit.

Answer to TY 3

The correct option is **D.**

This is because a risk-based approach to audit requires the auditor to direct all resources towards those areas of financial statements that may contain misstatements.

Answer to TY 4

Knowledge of the business is a frame of reference within which the auditor exercises professional judgment. The auditor's knowledge of the business for an audit engagement would include:

1. A general knowledge of the economy within which the client operates
2. A general knowledge of the industry in which the client operates
3. A more particular knowledge of how the entity operates

The auditor should consider the following points in order to make effective use of knowledge of the business:

(a) How it affects the financial statements taken as a whole.
(b) Whether the assertions in the financial statements are consistent with the auditor's knowledge of the business.

Answer to TY 5

Adequate appropriate planning helps in following ways:

1. It ensures appropriate attention to the important areas of the audit.
2. It prompts identification of potential problems.
3. It helps in speedy completion of work.
4. It helps in proper utilisation of members of the audit team.
5. It helps to co-ordinate the work done by other auditors and experts

Answer to TY 6

In planning their audit, the auditor will consider factors such as:

- The complexity of the audit
- The environment in which the client operates
- Their previous experience with the client
- Knowledge of the client's business

Answer to TY 7

It is true that audit planning is a continuous process throughout audit. The overall plan and the audit programme may have to be revised due to:

- Changes in conditions (clients start a new line of business in addition to existing business).
- Unexpected results of audit procedures such as fraud detected during the audit.

Answer to TY 8

The application of analytical procedures is based on the expectation that:

(i) Relationships among data exist
(ii) Such relationships will continue in the absence of known conditions to the contrary
(iii) The presence or continuance of these relationships provides audit evidence as to the accuracy
(iv) Completeness and validity of the data produced by the accounting system
(v) Changes raise the suspicion that errors or fraud might have occurred.

Answer to TY 9

The changes stated may be due to simple accounting errors or due to misappropriation of inventory or cash.

(a) Increase in quick ratio: This ratio helps to decide whether the quick assets of a company can generate sufficient cash to pay off the current liabilities as and when they fall due. A high level of liquidity indicates that the company will find it easier to pay its liabilities as they fall due. The auditor will try to investigate the reasons for this. For example, it could be due to a recent sale of non-current assets or a capital advance received from a customer for an order not yet executed.

(b) Increase in the current ratio: This ratio shows the relationship between the current assets and the current liabilities of an enterprise. It is calculated by dividing current assets by current liabilities and indicates whether or not the enterprise has sufficient current assets to meet its short-term obligations. An increase in current ratio may indicate that the **enterprise is in a position to meet its short-term liabilities.** The auditor will try to investigate whether the values of inventories and receivables have been manipulated in order to arrive at the ideal figure.

(c) Increase in the gearing ratio: This ratio measures the company's risk and stability because it expresses the relationship between a company's borrowings and its own funds. An increase in gearing could mean that the **company is at risk of going concern problems.** The auditor will therefore investigate management's assessment of the going concern status of the company.

(d) Decrease in the average payment period: The average payment period means the number of days an entity takes to settle its bills. A decrease in this ratio indicates that the entity is settling its payables invoices faster, perhaps to gain settlement discounts or simply because its liquidity has improved and it can pay its bills on time. The auditor will test the discount received account to confirm that early settlements are supported with receipt of discounts from vendors.

(e) Decrease in the interest cover: Interest cover shows the capability of the entity to pay off the interest on borrowings. This indicates how many times a company could pay the interest. A decrease in the interest cover means the entity is suffering more risk because it will be more difficult to pay the interest due out of the profits available. The auditor needs to scrutinize the cash flow forecast to confirm that the liquidity of the company will not be adversely affected in future due to the interest commitment.

Quick Quiz

1. List eight possible sources of knowledge of a business.

2. Why should the auditors have an understanding and knowledge of the business?

3. Obtaining knowledge relating to competition in the market, cyclical or seasonal activity, regulatory environment and external factors will provide an understanding of:

   A Industry conditions
   B Objectives and strategies and significant business risks for the entity
   C Nature of the entity
   D Measurement and review of the entity's financial performance

4. Which of the following options is not a valid source for obtaining knowledge of the industry and the entity?

   A Previous experience of the auditor with the entity and its industry
   B Visits to the entity's premises and plant facilities
   C Industry surveys
   D The website of the client's competitor

5. Inquiry of management and others within the entity excludes:

   A Those charged with governance
   B Regulators
   C Internal audit personnel
   D Employees

Answers to quick quiz

1. The auditor can obtain knowledge of the industry and the entity from a number of sources. Possible sources are listed below:

   Previous experience of the auditor with the entity and its industry
   Visits to the entity premises and plant facilities
   Last year's audit team
   Last year's audit file and the permanent audit file
   Auditor's firm industry expert
   Industry surveys
   Financial press
   Internet
   Publications related to the industry
   Legislation and regulations which significantly affect the entity
   Discussions within the entity (client, client's staff)
   Documents produced by entity
   The client's website
   Observation of events and processes at the client's premises

2. The auditor members of audit staff should have knowledge of the business for the following reasons:

   To enable them to identify and understand the events, transactions or practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report.
   To assess the inherent and control risks.
   To determine the nature, timing and extent of audit procedures.
   To evaluate audit evidence.
   To make judgments about many matters throughout the course of the audit.

3. The correct option is **A.**

   Knowledge relating to competition in the market, cyclical or seasonal activity, regulatory environment and external factors will provide an understanding of industry conditions.

   The other options are incorrect as they do not relate to industry conditions.

4. The correct option is **D**

   The client's website rather than the website of the client's competitor is a valid source for obtaining knowledge of the industry and the entity. The other options are incorrect as they are valid sources for obtaining knowledge of the industry and the entity.

5. The correct option is **B.**

   Regulators are from outside the entity. The other options refer to personnel from within the entity. Therefore they are incorrect.

Self-Examination Questions

Question 1

Andrew owns and operates his own accounting practice. He specialises in statutory audits and has a number of large corporate clients. His largest client is Upanga Plc (for whom he has been the auditor for the last 5 years) an organisation that manufacturers and sells LCD televisions. Upanga has managed to increase their turnover from TZS50 million to TZS75 million and has just started to diversify into cosmetics. Andrew has also recently taken on a new client, Kurasini Bank. Kurasin Bank offers banking through conventional and electronic channels and is undergoing rapid growth. The bank currently has four branches, two of which are fully computerised.

Andrew plans to conduct the two audits simultaneously and begins the planning process. He believes that as he has been Upanga's audit manager for the last five years, he is completely familiar with their accounting procedures, policies and internal controls of Upanga. He had found the internal controls adequate and effective during the earlier years. Therefore he decides that he will not at thoroughly check the internal control system. He also decides that he can use the same audit plan he prepared for the previous year.

For Upanga Bank, Paul decides that because the head office and two branches are fully computerised they will require a minimal amount of testing. For the remaining two branches Paul plans to extensively check the internal control systems that are in place

Required:

Evaluate how effective you believe Andrew's audit plan to be? Also, state which factors could give rise to audit risk for both entities.

Question 2

Malaika Resorts is a chain of hotels. Ivan is the auditor of Malaika for the year, 20X9. The hotels provide various facilities such as lodging, travel facilities, restaurant, conference facilities, party venues, swimming, badminton, golf etc. The financial information of Malaika for the year 20X9 is as follows:

	20X9 (Projected)	**20X9 (Actual)**
	TZS million	**TZS million**
Revenue	45,928	40,825
Cost of sales	(37,998)	(31,874)
Gross profit	**7,930**	**8,951**
Administration and distribution costs	(4,994)	(4,758)
Interest	(2,000)	(1,800)
Tax	(500)	(700)
Net profit	**436**	**1693**
Non-current assets (at net book value)	3,600	4,500
Current assets		
Inventory	200	1278
Receivables	7,245	7,017
Cash and bank	500	1,590
Total assets	**11,545**	**14,385**
Capital and reserves		
Share capital	1,000	1,000
Accumulated profits	5,300	5,764
Total shareholders' funds	**6,300**	**6,764**
Non-current liabilities	**2,245**	**5,023**
Current liabilities	**3,000**	**2,598**
Total equity and liabilities	**11,545**	**14,385**

Other information

1. Revenue includes credit sales of TZS25,928 million in 20X9 (projected) and TZS20,515 million in 20X9 (actual).
2. Cost of sales includes credit purchases of TZS15,865 million in 20X9 (projected) and TZS16,900 million in 20X9 (actual).
3. Dividend of TZS1,400 million has been paid for the year 20X9. The dividend expected to be paid was TZS1,200 million.

Required:

(a) Calculate the key financial ratios used in planning:

(i) Gross profit ratio
(ii) Current ratio
(iii) Quick ratio
(iv) Inventory turnover
(v) Average collection period
(vi) Dividend cover ratio
(vii) Interest cover ratio

(b) Interpret the key financial ratios and their impact on designing the nature, timing and extent of audit procedures.

Answers to Self-Examination Questions

Answer to SEQ 1

There are two main components to audit planning: professional scepticism and audit risk. The principle of professional scepticism states that an auditor should not accept every piece of information or explanation put to him at face value and should have a questioning mind.

In the case of Upanga Plc, Andrew is not adopting an attitude of professional scepticism as he is blindly relying on the organisation's internal control systems that were in place previously. He is repeating the same mistake with Kurasini Bank by again relying on the bank's MIS (for its computerised branches). He should conduct sufficient testing on the internal control systems for both entities.

In addition, his decision to use the same audit plan for Upanga Plc again shows a lack of professional scepticism. An auditor should not assume that financial statements will automatically be free from any material misstatements because they have been true and fair in the past.

Audit risks

Before devising an audit plan, Andrew should take into consideration the audit risk present. This risk should be freshly assessed each year to accordingly decide the nature, timing and extent of the audit. The audit risks associated with Upanga Plc and Kurasini Bank are as follows:

Pearl Plc

Adequacy of the internal control system

Adequacy of the internal control system should be questioned and examined given the increase in turnover.

Diversification

Pearl has just started to diversify into a completely new product line. This adds to the risks facing the organisation given their lack of experience and expertise in the area.

Fast growth

Turnover of Upanga Plc has increased significantly. Andrew should check whether the pressure to meet the orders has resulted in staff compromising on following internal controls. He should also investigate how this expansion is being financed.

Dollar and Pound Bank

Computerised system

Andrew should extensively check the effectiveness of the internal control system of all branches. In case of the two computerised branches, risks still exist as employees may not be adequately trained in using the MIS. Computers do not guarantee that no errors will be made.

Control environment

In addition, given that the bank is now computerised and on-line, it faces risk of intrusion from viruses and hackers. Appropriate controls to mitigate these risks need to be put into place and evaluated by the auditor.

First year audit

This is the first year Andrew is conducting the audit so his unfamiliarity with the organisation, procedures etc. adds to the overall general risk of the audit.

Answer to SEQ 2

(a) The key ratios used in analytical procedures are as follows:

(i) Gross profit ratio

$$\text{Gross profit ratio} = \frac{\text{Gross Profit}}{\text{Sales Revenue}} \times 100$$

20X9(Projected) TZS million	$= \frac{7,930}{45,928} \times 100 = 17.27\%$
20X9(Actual) TZS million	$= \frac{8,951}{40,825} \times 100 = 21.93\%$

(ii) Current ratio

$$\text{Current Ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

20X9(Projected) TZS million	$= \frac{7,945}{3,000} = 2.648$
20X9(Actual) TZS million	$= \frac{9,885}{2,598} = 3.805$

(iii) Quick ratio

$$\text{Quick ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$

20X9(Projected)TZS million	$= \frac{7,745}{3,000} = 2.581$
20X9 (Actual) TZS million	$= \frac{8,607}{2,598} = 3.313$

(iv) Inventory turnover ratio

$$\text{Inventory turnover ratio} = \frac{\text{Cost of sales}}{\text{Inventory}} \quad \text{(Times p.a.)}$$

20X9 (Projected) TZS million	$= \frac{37,998}{200} = 189.99\text{times}$
20X9 (Actual) TZS million	$= \frac{31,874}{1,278} = 24.941\text{times}$

The inventory turnover ratio can also be used to find the number of days inventory has been held in the warehouse.

(v) Average collection period

$$\text{Average Collection Period} = \frac{\text{Receivables}}{\text{Credit sales}} \times 365 \text{ days}$$

20X9(Projected) TZS million	$= \frac{7,245}{25,928} \times 365 \text{ days} = 102 \text{ days}$
20X9(Actual) TZS million	$= \frac{7,017}{20,515} \times 365 \text{ days} = 125 \text{ days}$

(vi) Dividend cover ratio

$$\text{Dividend cover ratio} = \frac{\text{Profit before interest and tax}}{\text{Dividend}}$$

20X9(Projected) TZS million	$= \frac{2,936}{1,200} = 2.447$
20X9(Actual) TZS million	$= \frac{4,193}{1,400} = 2.995$

(vii)Interest cover ratio

$$\text{Interest cover ratio} = \frac{\text{Profit before interest and tax}}{\text{Interest expenses}}$$

20X9(Projected) TZS million	$= \frac{2{,}936}{2{,}000} = 1.468$
20X9(Actual) TZS million	$= \frac{4{,}193}{1{,}800} = 2.329$

(b) Ivan can interpret the key financial ratios as follows:

(i) There is an increase in the gross profit ratio. This could be due to the reduction in cost of raw materials or decrease in bought-in-goods or an increase in selling prices.

(ii) The current ratio is more than expected, which may be due to increased inventory and cash.

(iii) The high quick ratio indicates that the company has more cash and bank balance than it had projected. This might indicate that the company has not made investments and has kept high liquidity.

(iv) There is a huge decrease in the inventory turnover ratio, which indicates that there is could well be serious overstocking of goods. Since inventory figures are prone to such manipulations like inclusion of obsolete items, misstatement of values or quantities and improper cut-off procedures, Ivan will have to perform additional audit procedures such as physical verification of inventory.

(v) There is an increase in the average collection period, which might indicate that the entity has problems in collecting its debts. Ivan will discuss with the audit committee the various methods they have adopted for recovery of debts. He will enquire whether there are any litigation cases against the entity. If management agrees that some debts cannot be recovered, then these debts can be reflected as bad debts.

(vi) The dividend cover ratio has increased, which indicates that the entity is retaining a greater proportion of profits.

(vii) The higher interest cover ratio indicates that the company is better able to pay the interest on its borrowings.

SECTION A

OBJECTIVES, PROCESS AND NEED FOR EXTERNAL AUDIT AND ASSURANCE

A4

STUDY GUIDE A4: OBTAINING EVIDENCE AND TESTING

Get Through Intro

After completion of the planning process, the actual execution of the audit begins. At this stage, the audit team uses the audit plan as a guidance document to conduct the audit. Various audit procedures are carried out to obtain audit evidence. For example, the audit team would carry out tests of control in the area of purchases, if mentioned in the audit plan.

Every audit involves performing tests of control in order to assess the efficiency of internal controls. If controls are efficient, it indicates that the extent of misstatements would not be extensive. However, as internal controls have limitations (like management overriding controls) auditors would still have to perform substantive procedures.

The audit senior / engagement partner would assess the audit evidence gathered by the team and draw a conclusion on the audit opinion. Based on this, the audit report would be prepared.

This Study Guide gives a brief overview of the above steps to enable you to understand the components of the audit process.

Learning Outcomes

a) State and explain the following basic or components of an assurance process relating to performance and reporting:
   i. Performance
   ii. Evidence and obtaining evidence
   iii. Testing and other work
   iv. Evaluating results
   v. Concluding, considering an appropriate report and reporting
   vi. Records and working papers

b) State and explain why it is important to maintain and keep working papers and other documentation.

1. State and explain the following basic components of an assurance process relating to performance and reporting:
i. Performance
ii. Evidence and obtaining evidence
[Learning Outcome a]

1. Meaning

Audit evidence means all the information used by the auditor in order to arrive at the conclusions on which they form their opinion. It includes the information contained in the accounting records underlying the financial statements as well as other information.

Tip

Performance of audit (after the planning of audit) means gathering audit evidence.

Audit evidence may be obtained from:

- **Audit procedures performed during the course of the** audit and
- **Other sources** such as previous audits, a firm's quality control procedures for client acceptance and continuance.

Example

The audit evidence that the auditors would obtain in order to form their opinion (about the truth and fairness of the accounts payable) will include a review of the following information:

1. The suppliers' statements or confirmation certificates.
2. Reconciliations and the list of outstanding invoices.
3. Debit notes and outstanding checks.

Audit evidence verifies the correctness of the assertions contained in the financial statements.

2. Audit assertions

The audit assertions are explained in detail in Study Guide C2. However, they are summarised as follows:

Assertions	Meaning
Occurrence	The transactions and events and other matters that have been recorded actually took place and relate to the entity.
Completeness	All assets, liabilities, equity interests (capital and reserves) and other disclosures have been included in the financial statement.
Accuracy	Amounts and other data relating to transactions and events have been recorded appropriately.
Valuation and allocation	All the items in the SOFP have been included in the financial statements at appropriate amounts, according to company policy and the relevant financial reporting framework. Any allocations or valuation adjustments required have been made appropriately.
Cut-off	Transactions and events have been recorded in the correct accounting period.
Classification	Financial statements are appropriately presented and clearly described in accordance with company policy and the relevant financial reporting framework
Existence	Assets, liabilities and equity interests (capital and reserves) do really exist at the SOFP date.
Rights	The entity has a right to an asset. It is free to use or dispose of the asset as it sees fit. The entity is obliged to pay the liability that is shown in the SOFP.
Understandability	Disclosures are clearly expressed so as to make them understandable to the users.

Audit evidence can be obtained by conducting various audit procedures.

3. Obtaining evidence

Audit procedures are the procedures followed or methods used by the auditor during the course of audit. In short obtaining audit evidence involves performing audit procedures.

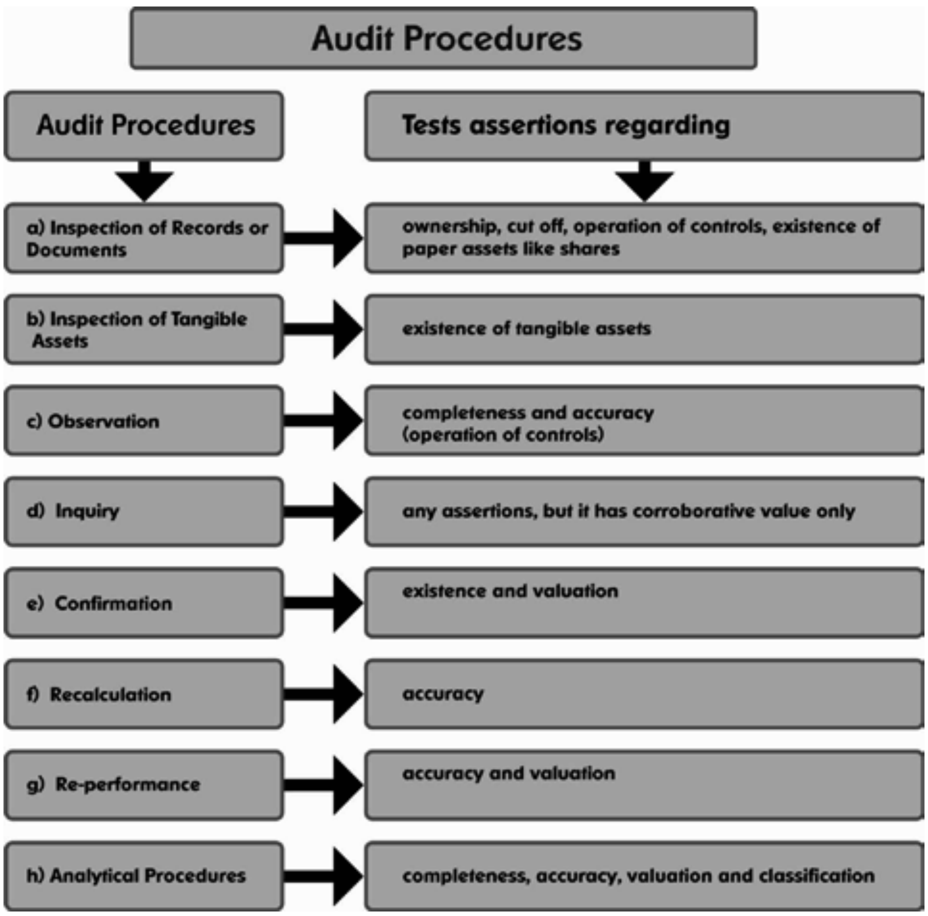
Example

If the auditors are engaged in checking the accounts payables, they will perform the following procedures:

1. Obtain suppliers' statements or confirmation certificates from the suppliers.
2. Compare the balances in the statements with the balances in the entity's books.
3. Obtain reconciliation and list outstanding invoices, debit notes and outstanding cheques etc. for large amounts.
4. Enquire into old and unusual items.
5. Compare the balances of major suppliers with the related names and amounts in the trial balance.
6. Compare the total amount of account payables in the trial balance with the total amount in the general ledger.

The following diagram summarises the various kinds of audit procedures performed in order to obtain audit evidence:

Diagram 1: Audit procedures



Audit evidence is necessary to support the auditor's opinion and report. Section C of the syllabus discusses audit evidence in detail.

4. Importance of evidential material in the audit process

(a) Principal support for the auditor's report

The objective of an audit is to enable the auditor to express an opinion on whether all the financial statements have been prepared in accordance with the applicable financial reporting framework that is designed to achieve true and fair presentation of the financial position of the concern. Therefore **audit evidence serves to provide the principal support for the auditor's opinion in the audit report.**

(b) Facilitates effective planning

Audit planning assists an auditor in conducting the work in an effective manner. Proper planning of the audit work is a necessary pre-requisite for the effective and efficient conduct of an audit. Planning should be a continuous process, carried out throughout the engagement period and plans should be revised to suit changing circumstances. **Audit evidence confirms that the audit planning decisions were followed in the conduct of the audit.**

Example

Jessy is the auditor of Green House Ltd, a manufacturing concern. Jessy planned a programme of site visit for the audit team. He also determined the time when the audit would be completed and extent of the substantive audit procedures. This helped Jessy to identify the problematic areas so they could be addressed in time and accordingly design the audit procedures. After the team's visit the audit partner verified the audit evidence which was in the form of working papers and included the transactions on which the substantive procedures were made.

(c) Facilitates supervision and review of the audit work

Audit is normally performed by various team members who are assigned various tasks in the audit process. The members of the team perform the audit and the senior auditor reviews their work. The senior auditor needs to review how and to what extent the audit team has taken its assignment and followed accounting principles and auditing standards**. A review of the audit evidence enables the senior auditor to determine whether there are any omissions, deviations from normal procedures and unusual problems**. The auditor can therefore assess the performance of his staff so as to have an idea of the reliability of his own report.

(d) Provide defence against negligence charges

An auditor may be charged with negligence in a Court of Law for not being able to detect a material fraud**. Audit evidence, which is documented in the form of working papers, will enable him to defend himself by proving that he had taken reasonable care and skill while carrying out his audit and drafting his report**.

(e) Serves as a data bank

Audit evidence, which is in the form of various lists, statements and schedules supplies a lot of information on different aspects of the concern. This **information is useful for current as well as future audits**.

(f) Facilitates improvement to internal control systems

Audit evidence relating to internal control systems will include areas and processes where the controls are either insufficient or unavailable. A review of this audit evidence will **enable the auditor to recommend improvements to the systems so that they become more efficient**.

These are discussed in detail in Section B.

Test Yourself 1

Which of the following options does not relate to the role of / purpose of evidential material in the audit process?

A Providing principal support for auditor's report
B Facilitating supervision and review of the audit work
C Facilitating improvement to internal control systems
D Retaining audit evidence for a period of five years from the date of the auditor's report.

2. State and explain the following basic components of an assurance process relating to performance and reporting:
iii. Testing and other work
[Learning Outcome a]

Audit evidence is gathered by performing tests of control and substantive procedures.

2.1 Tests of control

1. Meaning

Tests of control are tests conducted by auditors to gather audit evidence to test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Tests of control are discussed in detail in section B of the book.

Examples of tests of control to **prevent, detect** and **correct** material misstatement at the assertion level are as follows:

Test of control to **detect** material misstatements in the amount of bad debts	Documentary evidence of authorisation of the bad debt write-off Correspondence with accounts receivables and any press reports which give additional evidence.
Test of control to **prevent** material misstatements	Segregation of duties between the salesman who receives the sales order, sales executive who raises the invoice, cashier who collects the cheques and accounts executive who handles the accounts receivable ledger. This type of segregation of duties will prevent material misstatement in the revenue account.
Test of control to **correct** material misstatements	Preparation of a bank reconciliation statement will enable to correct any material misstatement in the financial statement with respect to bank transactions.

Auditors normally **gather evidence** regarding the **completeness, validity and accuracy of account balances and classes of transactions.**

2. Timing of Tests of Controls

(a) **If the auditor tests controls at a particular time, the auditor only obtains audit evidence that the controls operated effectively at that time**. For example, the auditors observed the method of ensuring security in the premises of the factory by observation. This is audit evidence at the time of observation.

(b) **If the auditor tests controls throughout a period, the auditor obtains audit evidence of the effectiveness of the operation of the controls during that period**. For example, the auditor inspected the register maintained by the administration department containing cases of reported theft by employees. This is testing of controls for the entire period of review.

(c) **When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor should determine further audit evidence required for the remaining period.**

For example, the auditors checked the various activities in the procurement of raw materials with documents for the period 1 January 20X6 to 30 September 20X6 during the interim audit. Later when the auditors came for the final audit, they conducted a similar review (of the various activities in the procurement of raw materials with documents) for the period 1 October 20X6 to 31 December 20X6.

(d) Tests of controls **performed** in the **previous years** may be **relevant** to the **current year**, if they have **not changed**. However, **operating effectiveness of transactions and operations which are not significant for the operations of the entity, may be retested at least once every third year**.

(e) **Controls related to significant risks should be tested every year.**

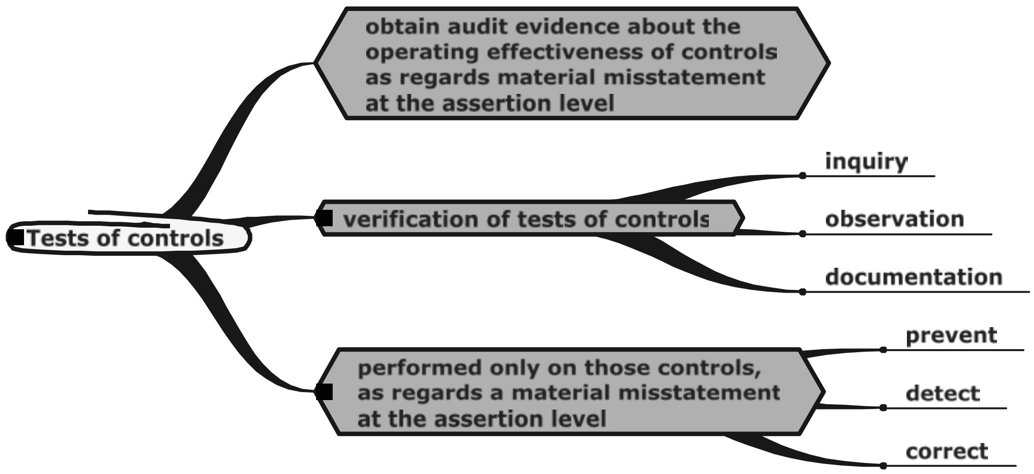
Example

Kyela Ltd has an internal control system which is laid out and followed by the organisation, in the area of stores operations. The auditors of the entity have carried out a detailed study of the system in 20X8.

However inventory is a major component of the financial statements of the entity, therefore the auditors carried out a similar study of the internal control systems in 20X9.

The study gave an assurance to the auditors about the truth and fairness of the information relating to inventory in the financial statements.

SUMMARY



Test Yourself 2

Linda has been auditing Korogwe Co, a manufacturer of plastic furniture. She has noticed that last year the company purchased four machines.

Required:

List five tests of control that she should employ regarding the purchase of the machinery.

3. Important points

(a) Internal control systems are set by the management of the company.

(b) Auditors test the internal controls by performing tests of control to **prevent, detect** and **correct** material misstatement at the assertion level in the financial statements. **Auditors** normally **gather evidence** regarding the **completeness, validity and accuracy of account balances and classes of transactions.**

(c) **If the controls are effective,** the auditors can **reduce the amount of evidence that they would otherwise gather (i.e. substantive audit procedures)** as to completeness, validity and accuracy of account balances and classes of transactions**.** Tests of control are verified by a combination of **inquiry, observation and inspection** of the documentation and recalculation / **reperformance**.

(d) When the auditor determines that the risk of misstatement at the assertion level is significant, the auditor must specifically perform extensive substantive procedures that are responsive to that risk.

(e) On account of the limitations of the internal control systems, even though the tests of control indicate an effective internal control system, the auditor would need to perform limited substantive audit procedures.

2.2 Substantive procedures

1. Meaning

Definition

Substantive procedures: Audit procedures **designed to detect material misstatements** at the assertion level. Substantive procedures comprise:

Tests of details (of classes of transactions, account balances; and disclosures) and

Substantive analytical procedures.

Glossary of terms, Published by the International Auditing and Assurance Standards Board

Substantive tests are procedures that provide evidence supporting the fairness of management's financial statement assertions. They are aimed at detecting material misstatements at the assertion level. Usually one would expect that tests of details, for example tests of details of transactions, account balances and disclosures would help in detecting material misstatements.

However, sometimes analytical procedures are used to supplement the tests of details.

2. Substantive analytical procedures

When analytical procedures are used as substantive procedures, they are known as **substantive analytical procedures.**

Example

The auditors of Serengeti Corp carried out the following substantive tests:

As on 31 December 20Y0, the auditors conducted a physical verification of the valuation of the inventory. This provided evidence that the inventory which was shown in the financial statements was actually available and ensured "existence of the inventory valued".

The auditors obtained confirmation of balances from the customers, examined aged analyses and also made enquiries to management regarding the collectability of accounts receivable. This ensured "valuation of account balances".

Reading loan documents provides substantive evidence about the terms of loan agreements. This ensured "classification".

All the above gave an assurance to the auditors about the true and fair view of the financial statements.

3. Method of performing substantive procedures

(a) The **auditor** shall **design and perform substantive procedures** for:

(i) Each material class of transactions (this is explained in the earlier section**)**
(ii) Account balances (example: accounts receivable, accounts payable, inventory, non-current assets, loans, share capital)
(iii) Disclosure (example: disclosure relating to compliances of accounting policies of the company)

The auditor is required to carry out substantive procedures on each of the above categories irrespective of the assessed risks of material misstatement.

(b) Substantive procedures comprise the following

(i) Analytical procedures
(ii) Tests of details (of classes of transactions, account balances, and disclosures)

(i) Analytical procedures

Analytical procedures mean the analysis of significant ratios and trends and comparison of data with relevant data in the previous year. It also involves the investigation of resulting fluctuations and inconsistent relationships. This has been explained in detail under Study Guide A3. **Analytical procedures** are normally considered to be **less effective than tests of detail** and are used as a supplementary technique.

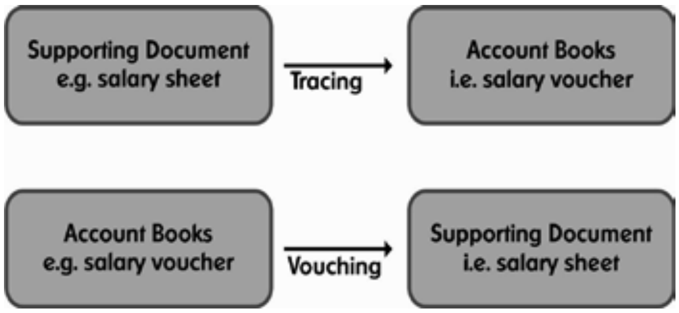
(ii) Test of detail

Test of detail is carried out for **transactions** and **balances.**

Details of transaction

These are tests to obtain evidence of individual debits and credits that make up an account to reach a conclusion about the account. The tests can be made through tracing and vouching of transactions.

Diagram 2: Vouching and tracing



The tests enable to ensure monetary accuracy of debits and credits.

Detail of balances

These are tests to obtain evidence about the accuracy of the closing balances on the reporting date e.g. accounts receivable balance, accounts payable balance etc.

(c) Substantive procedures should be specifically responsive to identified significant risks

When the auditor determines that the risk of misstatement at the assertion level (while carrying out tests of control) is significant, the auditor must specifically perform substantive procedures that are responsive to that risk.

Example

An entity has weak computer general controls including control over the approval of system changes. This is a potential risk of unauthorised changes to the computer programs. Therefore the auditor will perform tests to analyse all the changes in the computer programs made during the year, the nature of changes made and the risk of misstatement due to the changes made to the programs. This will enable them to obtain assurance relating to the true and fair view of the financial information.

(d) Timing of substantive procedures

At the time of annual closing of accounts:

Substantive procedures related to the financial statement year end process

The substantive procedures related to the financial statements in the year end process need to include the following:

(i) Reconciliation of the financial statements with the accounting records

Example

The auditors of Jasmine Ltd checked the following reconciliation in the process of accounts closing:

Vendor’s individual ledger with the vendor control ledger.
Customer’s individual ledger with the receivables control ledger.
Bank reconciliation statements.
Inventory ledger with the final inventory statement.
Fixed asset register with the final fixed assets in the financial statements.

The above relate to the substantive procedures in the year end process. This will give assurance to auditors about the true and fair view of the financial information.

(ii) Examination of material journal entries and other adjustments prepared in the course of finalisation

Example

The auditors of Jasmine Ltd checked the following journal entries and adjustment entries prepared in the course of finalisation:

JV for depreciation of non-current assets
JV for turnover discounts payable to dealers
JV for provision for doubtful debts
JV for bad debts
JV for provision for non-moving and slow moving inventories

This will give assurance to auditors about the true and fair view of the financial information.

When the **risk of misstatement at the assertion level** is **significant**, the auditor must perform substantive procedure**s a few months before the year end.**

Then, at **the year end** the auditor will perform the substantive procedures **for the balance of the period where the tests were not carried out.**

Example

During the audit for the year 20X6, the auditors of Java Ltd performed tests to analyse all the "changes made to the computer programs" twice during the year:

Period	Audited during
1 January 20X6 to 31 October 20X6	November 20X6
1 November 20X6 to 31 December 20X6	January 20X7

Substantive audit procedures are discussed in detail in section C of the book.

2.3 Substantive procedures versus tests of control

1. Substantive procedure is **an audit procedure** which is **designed to detect material misstatements** at the **assertion level. Tests of controls** are **tests performed** to obtain **audit evidence** about the **operating effectiveness of controls** in **preventing**, or **detecting** and **correcting, material misstatements at the assertion level** i.e. they provide audit evidence that internal control procedures are being applied properly or that the controls are operating as they should.

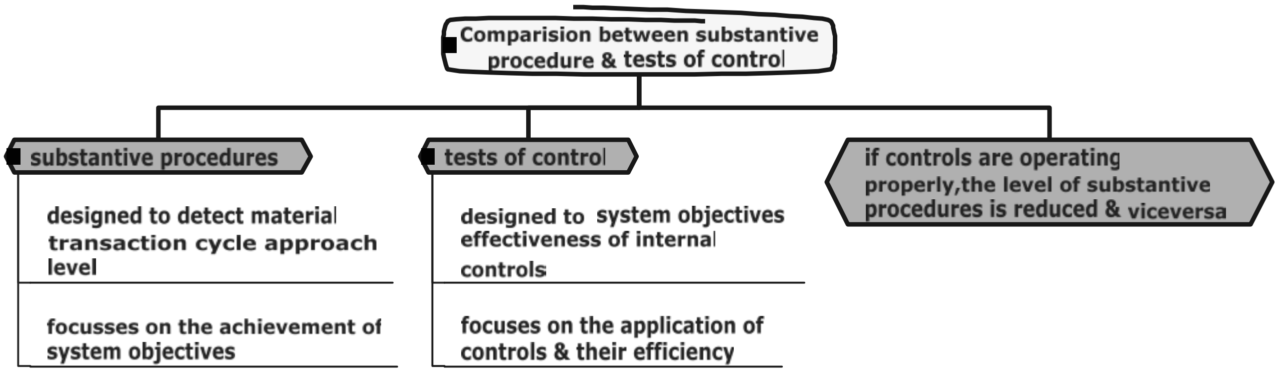
2. **Substantive procedures** are **carried out** to **establish directly whether** or not system **objectives are being achieved. Tests of control focus** on **how controls were applied**, the **consistency** with which they were applied, and **by whom** or **by what means** they were applied.

3. The relationship between tests of control and substantive procedures is that **if controls are operating properly, auditors may reduce the level of substantive procedures** necessary to provide an opinion on adequacy of output. **However,** to prove the reliability of the controls assessment, **some substantive procedures will always be necessary.**

Tests of controls **performed** in **previous years** may be **relevant** to the **current year**, if they have **not changed**.

However, **operating effectiveness may be retested at least once every third year**. Generally c**ontrols** related to **significant risks** should be **tested every year.**

SUMMARY



Test Yourself 3

Identify whether the following are tests of control or substantive procedures (analytical procedures) or substantive procedure (test of transactions) or substantive procedures (test of balances):

(a) Comparison of this year's expenses with last year's expenses.
(b) Observation by auditor that cash is deposited daily by a specific clerk.
(c) Inquiry by auditor about who deposits cash and how often.
(d) Examination of invoices to support additions to fixed assets account during year.
(e) Examination of sales invoices to see if initials of credit manager are present to indicate a credit approval.
(f) Vouching from sales invoices to credit files to see if customer has a credit file and has been approved for credit.
(g) Confirmation of year-end balances in accounts receivable.
(h) Observation of the existence of a building.

---

3. State and explain the following basic components of an assurance process relating to performance and reporting
iv. Evaluating results
v. Concluding, considering an appropriate report and reporting
[Learning Outcome a]

3.1 Evaluating results

After completing the audit work in accordance with the audit plan, a senior level auditor (e.g. an engagement partner who is ultimately responsible for a particular audit) should conduct an overall review of the financial statements.

At this stage of the audit, the auditor arrives at an audit opinion after re-examining:
- The audit evidence gathered during the course of audit; and
- The final edition of the financial statements.

The objective of a review of financial statements is to form an opinion on the financial statements, based on review of the audit evidence which is obtained.

The evaluation process is explained in detail in Study Guide C4.

3.2 Concluding, considering an appropriate report and reporting

A **conclusion** means a clear written expression of opinion on the financial statements. The objective of an audit is to enable the auditor to express an opinion on whether all the financial statements have been prepared in accordance with the applicable financial reporting framework that is designed to achieve true and fair presentation of the financial position of the concern.

As discussed in Study Guide A1, only reasonable assurance engagement and limited assurance engagement are the two types of assurance engagements permitted by the Framework. There can be a positive assurance, a negative assurance or no assurance.

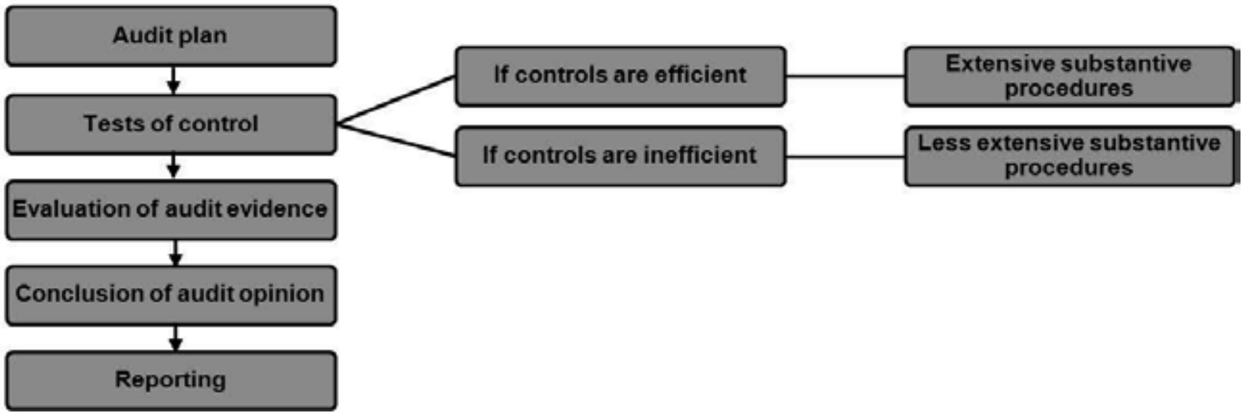
In an assurance engagement, the auditor's report can be divided into two broad categories - either an unmodified opinion or a modified opinion.

Modifications in an auditor's opinion can be mainly due to:

The financial statements containing a material misstatement
The auditor being unable to obtain sufficient appropriate audit evidence

Study Guide E1 discusses the circumstances under which each of the opinions is formed by auditors.

Diagram 3: Audit process



4. State and explain the following basic components of an assurance process relating to performance and reporting.
vi. Records and working papers
State and explain why it is important to maintain and keep working papers and other documentation.
[Learning Outcomes a and b]

1. Meaning of audit documentation (Records and working papers)

Definition

Audit documentation' means the record of audit procedures performed, relevant audit evidence obtained and the conclusions the auditor reached.

ISA 315

Documentation means the records maintained by the audit team during the course of audit. It includes all important documents, data-analysis, calculation papers, schedules, notes, certificates extracts and completed audit programmes. **Terms such as working paper or working papers are often used for documentation**. In other words, working papers are also records of the auditor's collection of evidence and examination.

2. Need for and importance of audit documentation

Audit documentation should contain sufficient information to enable an experienced auditor, who has had no previous connection with the audit, to ascertain from the audit documentation the evidence that supports the auditors' conclusions.

A summary of why audit documentation is necessary is as follows:

(a) Facilitates adequate planning

Documentation helps to ensure that:

Planning is completed in an organised manner,
Planning decisions are followed during the conduct of audit;
An appropriate reference point is available for review both during and upon completion of the audit.

In short, working papers make the auditor aware of the work performed. This helps the auditor in designing and deciding the nature, timing and extent of the audit procedures. It also saves time and repetition of work, as well as training the audit staff. Audit projects are often repeated, extended to cover additional areas or used as a basis for planning other assignments.

(b) Facilitates supervision and review of the audit work

Working papers provide an efficient means for the audit team to communicate the results of their work to their senior auditors. Working papers **enable the team members to be accountable for their work**. Working papers are the means by which the auditor supervises and maintains control of the audit work already done and yet to be done. An audit is performed by the audit team, as it is not possible for the senior auditor to perform all the procedures.

The supervision and review of working papers further **facilitates the conduct of quality control review and inspections within the firm.**

(c) Provide the basis of audit report

Working papers represent evidence of the work done. The auditor may not be able to remember everything that has been noticed or observed during the audit up to the time of completion or issuance of report. Working papers facilitate the preparation of the report since everything noticed during the audit, queries raised and responses received are recorded here. An auditor refers to the audit findings recorded in the working papers while preparing the audit report and expressing an opinion on the financial statements of the entity.

(d) Allows discussion of audit findings with management

The auditor is able to discuss the audit plan before commencing the audit, and also the findings of the audit before issuing the audit report. Working papers are an effective means by which the auditor is able to discuss major audit findings with management or audit committee of the client.

(e) Provide defence against negligence charges

An auditor may be charged with negligence in a Court of Law for not detecting a material fraud or error. The suit may come up a long time after the audit is completed. The working papers will enable them to defend themselves by proving that they had taken reasonable care while carrying out their audit and drafting their report.

(f) Serves as guide for succeeding auditors

Given the typical limitations on staff continuity, good working papers contribute to the quality of subsequent or complementary audits by providing a good starting point for succeeding auditors to:

- Reduce time spent in understanding the nature of the business operations,
- Identify areas of audit risks,
- Determine the scope of audit required and;
- Determine, with a greater degree of accuracy, the time and staff required.

(g) Serves as a data bank

Working papers help in accumulation of information for the final report. The various lists, statements and schedules supply a lot of information on different aspects of the concern. This information is useful both for current and future audits.

Example

Shah & Co has engaged its audit team for the audit of Chato Ltd. During the course of the audit, the audit staff find and document some bad debts. In the next year, while conducting the audit, they can refer to these working papers and try to see whether these bad debts have been recovered or not. This shows that the working papers serve as a data bank for current as well as future years.

Test Yourself 4

Who owns the working papers: the auditor or the client? Discuss.

3. Features and nature of audit documentation

There is no precise form of working papers and perhaps, there cannot be one because the form of the working papers depends upon the particular circumstances of each audit. However, general characteristics such as the following may exist:

(a) Informative: working papers are prepared to provide finalised opinions. They must be informative and avoid irrelevant and unnecessary details which could create confusion.

(b) Accuracy: the information conveyed in the working papers must be accurate. Inaccurate information will lead to further complexities.

(c) Clarity: the working papers should be very clear in thought and expression. Unclear information is no information. Every audit working paper has relatively more of a deferred long-term value than an immediate value.

(d) Legibility: all the working papers should be legible. Complete, accurate and clear information will be useless if it cannot be read.

(e) Design: the working paper should have a design and layout which leads to better understanding. This may be achieved by using pre-printed audit stationery or automatically-generated standard working paper formats. A standard format will ensure uniformity and help in better understanding of the working papers.

(f) Proper index: the working papers should be indexed with a proper narration for all volumes in an audit summary file and an index for each of the working paper files.

(g) Confidentiality: above all, the information contained in the working papers is confidential information and should not be disclosed to the client's staff during the course of the audit. As far as outsiders are concerned, it should not be disclosed either during the currency of the audit or afterwards or even when a new auditor has been appointed. Disclosure could be made either with the express consent of the client or by the operation of law in force.

4. Types of audit files

The files in which all the working papers are put are termed audit files. Every audit generally requires two types of files:

(a) Permanent file papers

The permanent file contains matters of continuing importance affecting the company or the audit. This generally has future or long term use. A permanent audit file generally contains the following papers:

Type of file papers	Details
(i) Documents and other legal papers	Certified copies of the Memorandum of Association, Articles of Association or other deeds Extracts of various material agreements Extracts of minutes from the minutes books Engagement letter New client questionnaire
(ii) About the company and its personnel	Organisational set-up-holding / subsidiary; Managerial set-up with list of directors; executives and other officers Accounts section and the books maintained
(iii) Functioning of the organisation	Organisational set-up-holding / subsidiary; Managerial set-up with list of directors; executives and other officers Accounts section and the books maintained Internal control documentation Its evaluation by the auditor Lists of books and registers
(iv) Final Processing	Copy of approved income statement and SOFP Tax returns and tax proceedings Copy of auditor's report to shareholders / appointing authorities

(b) Current file papers

The current file which is broadly concerned with the accounts being audited. This generally serves an immediate purpose. It generally contains the following papers:

(i) Relating to current year's audit

Details of the assistants who performed the audit and the date the work was completed
Details of who reviewed the audit work performed
Internal control questionnaire and management's reply thereto
Audit programmes in force
Working papers of assistants and the reviewed remarks
Last year's accounts and auditor's report
Working trial balance
Adjusting entries affecting income statement and SOFP
Audit notes
Lists / statements / schedules, certificates and confirmations
Queries and the replies thereto, other correspondence to and from the client
Draft final accounts for the year
Draft auditor's report for the year
Management letter
Communication with experts

(ii) Relating to each audit area

Risk assessment
Sampling plans
Audit programmes
Analytical review
Details of substantive tests and tests of control
Major observations and conclusions drawn

Audit documentation is generated at the time of gathering audit evidence. However, modifications are sometimes needed to the working papers, may be on account of errors in the original working papers, discovered at a future date. At such times, care needs to be taken to ensure that the document includes the circumstances which led to the change, the reasons for the change, the time and the persons involved in the change. Audit files may be recorded on paper or through electronic or other media.

Example

Crispy Snacks Ltd is a partnership company. Its accounting is computerised. It is a reputable company and its range of snacks is well-known and popular. The sales are increasing day by day and it has a worldwide market. Ashley also won the audit engagement of Crispy Snacks Ltd. Since it is his the first audit of Crispy Snacks Ltd he needs to set up both a permanent and current audit file. The audit team will obtain various documents from the entity for these files

In the permanent file:

Partnership Deed
Memorandum of Association
Articles of Association
Organisation chart, rules and policies
List of directors
Engagement letter.
Internal control documentation

In the current file:

Copies of letters concerning audit matters communicated to client
Correspondence related to acceptance of annual appointment
Audit plan and the audit programme
Analysis of transactions and balances,
Draft of financial statements and auditor's report

The following are a few samples of working papers for accounts payable and accounts receivable

Date	31/01/20X9
Prepared by	M. George
Index	C-5
Aim	To obtain external confirmation of receivables

KIWI LTD — Name of client

ACCOUNTS PAYABLE - CONFIRMATION STATISTICS — Subject

31/12/20X8 — Year-end date

Remember to put
- the date
- reference of working papers
- name of the preparer
- objective of work

	Accounts			TZS		
	Number		**%**	**Amount**		**%**
Confirmation Requests						
Positives	80		5.33	930,000		37.20
Negatives	112		7.47	759,000		30.36
Confirmation not received	8		0.53	145,890		5.84
Total selected for testing	200		13.33	1,834,890		73.40
Total accounts payable at 31/12/20X8	**1,500**		**100.00**	**2,499,900**	*	**100.00**
RESULTS Replies received through 25/01/20X8						
Positives-no exception	60	C	4	472,500		
Negatives-no exception	80	C	5.33	385,000		
Total confirmed without exception	140		9.33	857,500		
Differences reported and resolved, no adjustment						
Positives	18		1.20	351,750		
Negatives	26		1.73	260,125		
Total	**44**		**2.93**	**611,875**		
Differences found to be potential adjustments						
Positives	2	CX	0.13	105,750		
Negatives	6	CX	0.40	113,875		
Total	8		0.53	219,625		
Confirmation not received	8	R	0.53	145,890		

Work done

Results / analysis / any other observations

Conclusions

Tickmark Legend

	Agreed to accounts payable ledger
*	Agreed to general ledger and lead schedule
C	Confirmed without exception (without a discrepancy)
CX	Confirmed with exception (with a discrepancy)
R	Second reminders sent

Must be clear and self-explanatory

Tip

Test checking should cover a major portion of the total balance.

Test Yourself 5

What do you understand by standardisation of working papers? What are the benefits of standardisation?

Test Yourself 6

Can the auditor obtain and utilise working papers prepared by the client?

5. Retention of the working papers

The auditor should complete the assembly of the final audit file on a timely basis after the date of the auditor's report. According to the International Standards on Auditing (ISA), 60 days after the date of the auditor's report is ordinarily an appropriate time limit within which the assembly of the final audit file should be complete.

The retention period is the period for which the document should be preserved and kept by the auditors. The retention period for audit engagements ordinarily is no shorter than five years from the date of the auditor's report. However, the ISA requires firms to establish policies and procedures for the retention of the engagement documentation. The auditor should not delete or discard audit documentation before the end of its retention period.

Answers to Test Yourself

Answer to TY 1

The correct option is **D.**

It relates to the retention period of audit evidence.

Answer to TY 2

Linda should employ the following tests of control for verifying the purchase of the new machinery:

(i) On a sample basis verify the ownership documents for non-current assets purchased during the year and confirm that the entity owns them.

(ii) Check if the useful life of the machinery is estimated rationally. For this the report of an expert can be used after the auditor has evaluated the work of the expert.

(iii) Verify that the depreciation charged is appropriate i.e. in accordance with the life of the machinery.

(iv) On a sample basis verify the purchase voucher and confirm that the purchases are approved by an authorised official of the company (in addition to board approvals).

(v) Verify the physical presence of the asset.

Answer to TY 3

(a) Substantive procedure-analytical procedure
(b) Test of control
(c) Test of control
(d) Substantive procedure-test of details (transactions)
(e) Test of control
(f) Test of control
(g) Substantive procedure-test of details (balances)
(h) Substantive procedure-test of details (balances)

Answer to TY 4

The auditors claim ownership and control on the grounds that the working papers are prepared by them, during the course of the audit. They have to keep these as evidence of their work and for that reason must be in possession of the papers for a reasonable time. It is argued by the auditors that the working papers belong to them because they act as independent contractors and not as agents of the client. Hence, they have a right to retain the working papers as if it was their property, even after being paid their audit fee in full.

Answer to TY 5

Standardisation of working papers involves use of standardised papers such as checklists, standard audit programs, specimen letters, consistently laid out schedules etc. The benefits of standardisation of working papers are:

- It improves the efficiency in preparation and review of working papers.
- It facilitates delegation of work.
- It provides a means to control the quality of audit work delegated to assistants.

Answer to TY 6

The auditor may obtain and utilise schedules, analysis and other working papers prepared by the client to improve the audit efficiency. However, the auditor should satisfy themselves that these working papers have been properly prepared, so that the financial statements prepared by them show a true and fair picture of the financial position of the company. For example, an auditor can use a copy of a client's bank reconciliation, but should independently verify, by reperformance, that it has been correctly prepared

Quick Quiz

1. Inspection of tangible fixed assets provides conclusive evidence of its ownership". True or false?

2. The auditor of Dodoma Ltd matched the amount of purchases recorded in the purchase ledger with the amount mentioned in the purchase invoice.

   What type of audit procedure is this?

   A Analytical review procedure
   B Substantive procedure - test of detail
   C Test of control
   D Substantive procedure - test of balances

3. Name the four characteristics that a working paper should have

   (a) ____________________
   (b) ____________________
   (c) ____________________
   (d) ____________________

4. Although the audit working papers are the property of the auditor, sometimes they prove to be useful for the entity. However, the audit working papers cannot be regarded as a substitute for the accounting records of the entity. State whether true or false.

5. Define documentation.

Answers to Quick Quiz

1. False. Inspection provides evidence for the existence of an asset, not its ownership.

2. The correct option is **B**.

   Option A is incorrect as analytical review procedures involve computation of significant ratios and trends. Option C is incorrect as a test of control is the test performed to obtain audit evidence about the efficiency of the internal controls. While performing tests of control, matching the amounts is just one of the audit procedures to test the controls. Option D is incorrect as they relate to year-end balances. The purchase of inventory is not a year-end balance but rather a transaction.

3.
   (a) Informative
   (b) Clarity
   (c) Proper index
   (d) Legibility

4. True

5. **Documentation** means the material (working papers) prepared by and for, or obtained and retained by the auditor in connection with the performance of the audit. Working paper may be in the form of data stored on paper, firm, electronic media or other media.

Self-Examination Questions

Question 1

Thomas has acquired the audit of Gombe Pvt. Ltd, a company manufacturing jelly products and chocolates. The products of Gombe Ltd are very popular all over the country and have great demand. Thomas organises an audit team consisting of three fresh trainees and two experienced members. He assigns them the work and asks the three fresh trainees to record all the findings and obtain supporting documents wherever required. He therefore calls a meeting of the audit team members and discusses the audit documentation which they should have. The three fresh trainees are still not able to document their findings properly.

Required:

Explain the features of good working papers to the fresh trainees.

Question 2

What is the rationale for maintaining both a permanent file and a current file for recurring audits?

Question 3

The following Accounts Receivable – Confirmation Statistics working paper (indexed C-80) was prepared by an audit assistant, Ben, during the audit of Mason Ltd. A senior auditor, Bartholomew, is reviewing the working papers.

Index	C-80

MASON LTD
Accounts receivable - CONFIRMATION STATISTICS

	Accounts			TZS		
	Number		**%**	**Amount**		**%**
Confirmation Requests						
Positives	50		5.00	143,500		7.99
Negatives	70		7.00	170,450		6.50
Confirmation not received	5		0.50	31,450		1.75
Total selected for testing	125		12.50	345,400		19.24
Total accounts receivable at 31/12/20X6	**1,000**		**100.00**	**1,795,000**	*	**100.00**
RESULTS						
Replies received through 25/01/20X6						
Positives-no exception	37	C	3.7	106,190		5.92
Negatives-no exception	49	C	4.90	119,315		6.65
Total confirmed without exception	88		8.80	231,245		12.88
Differences reported and resolved, no adjustment						
Positives	9		0.90	25,830		1.44
Negatives	17		1.70	41,395		2.31
Total	26		2.60	67,225		3.75
Differences found to be potential adjustments						
Positives	2	CX	0.20	5,740		0.32
Negatives	4	CX	0.40	9,740		0.54
Total	6		0.60	15,480		0.86
Confirmation not received	5	R	0.50			

Tick mark Legend

	Agreed to accounts payable ledger
*	Agreed to general ledger and lead schedule
C	Confirmed without exception (without a discrepancy)
CX	confirmed with exception (with a discrepancy)

Required:

Describe the discrepancies in the working paper that the senior auditor should discover.

Answers to Self-Examination Questions

Answer to SEQ 1

The general characteristics are as follows:

1. **Informative:** working papers are prepared to provide finalised opinions. They must convey information and avoid irrelevant and unnecessary details.

2. **Accuracy:** the information conveyed in the working papers must be accurate. Inaccurate information will lead to further complexities.

3. **Clarity: t**he working papers should be very clear in thought and expression. Unclear information is no information. Every audit working paper has relatively more of a deferred long-term value than an immediate value.

4. **Legibility:** all the working papers should be legible. Complete, accurate and clear information will be useless if it cannot be read.

5. **Design: t**he working paper should have a design and layout which helps to create better understanding. This may be achieved by using pre-printed audit stationery or automatically generated standard working paper formats which will ensure uniformity.

6. **Proper index: t**he working papers should be indexed with a proper narration for all volumes in an audit summary file and an index for each of the working paper files.

7. **Confidentiality:** the information contained in the working papers is confidential information and should not be disclosed to the client's staff during the course of audit. As far as outsiders are concerned, it should not be disclosed either during the currency of the audit or afterwards or even when a new auditor has been appointed. Disclosure could be made either with the express consent of the client or by the operation of law in force.

Answer to SEQ 2

It is very important to maintain a permanent and current file separately for recurring audits. Certain documents such as the Memorandum of Association or Articles of Association or Partnership Deed / Trust deed have continuing relevance not only for the current year's audit but for future years also. It may happen that assistants may take a document out of a previous year's file and put it in the current year's file.

If the audit firm has been auditing the client for, say, 15 years, then to locate a document of continuing importance, they have to search the files for the last 15 years. In order to avoid this, documents of continuing importance beyond a particular year's audit are filed in a permanent file. Documents which are of relevance only to a particular period's audit will be filed in that period's current file.

Answer to SEQ 3

The working paper prepared by Ben contains the following discrepancies:

1. The working paper has not been initialled and dated by Ben.

2. The working paper does not mention the date for which the accounts receivable have been made.

3. The dollar percentage for confirmation requests- negative is incorrectly calculated at 6.5% instead of 9.5%.

4. The symbol R has not been explained.

5. The two positive confirmations (50-37-9-2 = 2) that were sent but were unanswered have not been accounted for.

6. There is no documentation of alternative procedures, possible scope limitation, or other working paper reference for the six accounts selected for confirmation but for which confirmation has not been received.

7. The percentage selected for testing in dollars should not normally be as low as 19.24%.

SECTION A

OBJECTIVES, PROCESS AND NEED FOR EXTERNAL AUDIT AND ASSURANCE

A5

STUDY GUIDE A5: PROFESSIONAL SCEPTICISM, MATERIALITY AND FRAUD

Get Through Intro

The audit function comprises examining and forming an opinion on the truth and fairness of an organisation's financial statements. Therefore, it is only logical that an auditor should possess a sceptical mind and attitude when performing their work.

The **concept of materiality** is very **important** throughout the **audit exercise,** especially during the process of risk assessment, planning, deciding the sample size to be checked, the actual checking and reporting.

Information is material if its **omission or misstatement** has the **ability to influence the economic decisions of the users** taken on the **basis of the financial statements**. Materiality changes from year to year and from entity to entity.

This Study Guide explains the meaning of public interest and the importance of maintaining professional scepticism throughout the audit process. Furthermore, it explains the basic concepts of materiality, and how to calculate the materiality levels from financial information.

The knowledge of professional scepticism and materiality will be essential to you when you audit the accounts of any entity, as any error in these areas might increase audit risk. Moreover, knowledge of these topics will help you to answer exam questions on the topic.

Learning Outcomes

a) State and explain the meaning of public interest and the need for professional scepticism in carrying out assurance engagements.
b) State and explain the meaning of materiality·
c) Describe audit risk and audit risk model.
d) Explain the consequence of fraud and misstatements on the audit strategy and audit work.
e) Explain auditor's responsibilities for prevention and detection of fraud and error.

1. State and explain the meaning of public interest and the need for professional scepticism in carrying out assurance engagements.
[Learning Outcome a]

1.1 Public interest

1. Meaning of public Interest

Public interest refers to the general good of ordinary people as well as the shareholders of a particular company.

2. IFAC states its mission as 'the worldwide development and enhancement of an accountancy profession with harmonised standards, able to provide services of consistently high quality in the public interest'.

In their ethical code IFAC state 'a professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer. In acting in the public interest a professional accountant should observe and comply with the ethical requirements of this Code.'

Professional interest requires integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

The ethical requirements of the code are explained in detail in Study Guide D1

Fundamentally public interest is 'contextual'; it is in the context of the work that accountants perform. In essence this means that accountants are not required professionally to deliver the best 'welfare' of the public but are required to consider whether a 'public' interest exists in relation to their work and whether it should override the interests of their client or employer.

A firm of accountants may for example act as auditor for a tobacco company without any professional ethical dilemma despite what might be 'personal moral dilemmas'. Indeed a professional accountant may pursue maximisation of profit for himself or his clients with a clear 'professional conscience' despite any 'personal social or economic reservations' that he might have.

Example

The directors of ABC Plc refuse to disclose material payments made to customers that represent illegal bribes. The auditors argue contravenes accounting standards, fails to give a true and fair view and conceals information that should in any event be disclosed to authorities in the public interest. The auditors have threatened to resign and disclose or to qualify their opinion and disclose.

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3. There are **differing opinions** on **the number of members of the public who should benefit from an action for the action to be said to be in the public interest** i.e. whether, to qualify as an action in the public interest, an action must benefit all members of the society or may benefit only a few members of the society, It has to be accepted that since members of society often have conflicting or different interests that this can rarely be fulfilled.

Example

Songea Bank plc has been using a high risk business model lending to high risk customers and obtaining finance in the inter-bank market. The financial statements of the bank gave a true and fair view and disclosures relating to the business and corporate governance complied with relevant codes.

The company provided reliable plans supporting the going concern assumption. The auditors are aware of the risks the bank is taking and have discussed its position with the board and with regulators.

The finance director a qualified accountant was aware of the risks to investors but believed that the business model was in the interests of customers and shareholders since it provided loans at low cost, good returns on deposits and potential growth and dividends for shareholders.

Subsequently due to volatile market changes the inter-bank market has dried up and the bank is unable to obtain funds to sustain business operations. The central bank has provided funds at a penal rate and the government has guaranteed the loans. Information was made public after some delay by the board.

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The share price has fallen such that investors have made massive losses but public deposits and loans have been protected. The auditors have not considered resignation and have no professional reason to disclose any matters in the public interest.

The audit partner is aware that the financial statements for the current year will need to make disclosure of going concern risks in order to give a true and fair view. He believes that since matters escalated over a short period of time after the issuance of financial statements and during a period where he had no legal obligation to report that he had no responsibility to identify or report such matters.

Further he was confident that those who deposited money or those with loans were not materially at risk even though there was business risk for investors.

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4. The benefits received by acting in the public interest are different for different persons. However, a **decision** which serves the interests of the maximum number of people is said to be in the public interest.

Example

Continuing the above example of Songea Bank plc

If the auditors had concerns regarding the going concern assumption as it affected the financial statements or the consequent risks for deposits and loans to the public last year then they may have qualified their opinion in the event of failure to disclose the problems and may also have considered 'forcing' the directors to seek advice and support from regulatory bodies, with the threat that they would go directly to them if the directors did not act, and the central bank to avert losses in public confidence notwithstanding that this may cause losses to investors.

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5. Public interest versus private or individual interest

Whenever an accountant faces the dilemma of whether to act in the interests of an individual or in the public interest, **professionalism would involve acting in the public interest**.

Example

The auditors of RNB Bank Plc have identified a significant fraud that involves a director of the bank. The matter is not however material to the financial statements and does not require disclosure under law or International Financial Reporting Standards. The directors have asked that the matter remain confidential in the interests of the company since if it were public knowledge then it would damage the reputation of the bank.

The auditor will need to consider whether the public interest overrides the interest of his client. However it is possible that, in some cases, acting in the public interest may damage certain private interests such as a minority interest. Under such a situation, protection of a minority interest will become a part of the public interest.

1.2 Professional scepticism

1. Meaning

Definition

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

ISA 200

Given that the audit function comprises examining and passing an opinion on the truth and fairness of an organisation's financial statements then it is only logical that an auditor should possess a sceptical mind and attitude when performing their work. For instance, ISA 240 states 'When obtaining reasonable assurance, the auditor is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls and recognising the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud'.

There are two important points to note here:

First is that the **auditor should always bear in mind that even though the management / employees of a particular organisation have never omitted or misrepresented any facts or figures in the past, it does not automatically mean that they will continue to do so in the future**.

Second, auditors should not suspect every employee and question every fact and figure put before them.

What is required then is for an auditor to find a balance between these two extremes: auditors should maintain an open but cautious mind.

An auditor cannot and should not verify every procedure, report, and financial statement etc. of an organisation. However, they must ensure that during the course of the audit they perform sufficient number of checks to gain reasonable assurance that all information and reporting is true and fair.

Work on an audit typically begins with the auditors planning their audit strategy. The main issue that needs to be decided upon here is the risk of material misstatement that exists. The higher the risk of material misstatement the more involved and rigorous the audit will need to be.

Example

Paul is the new auditor of a manufacturing organisation, Max and has just begun the planning process. Paul has been made aware that there were substantial misrepresentations in the past year to the extent that inventory values had to be written down after the audited statements were published. Thus Paul knows that his audit will have to incorporate a very thorough and rigorous checking of inventory.

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2. An attitude of professional scepticism should especially prevail under the following situations:

(a) When audit evidence contradicts other audit evidence obtained: For example if the auditor notices that the list of related party transactions provided by the management is not exhaustive as there are more transactions which came to light while carrying out the audit, it would be an instance of contradictory evidence. At such times, the auditor will take more care while conducting the audit on this area.

(b) When information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.

Example

An auditor asks for the organisation's closing year end closing bank balance. After receiving this information the auditor should cross verify the figure with an official confirmation from the organisation's banker and fully investigate any differences.

(c) Conditions may indicate possible fraud

Example

An auditor notices that purchases of raw materials for March were at TZS6 million when the normal figure averages TZS3 million. Fearing misappropriation or fraud, the auditor investigates further and discovers that the organisation had received a very large one-off order from a new customer earlier that month.

(d) Circumstances that suggest the need for audit procedures in addition to those required by the ISAs:

In the case of **asset valuation**, as a general rule, the larger the value of the asset the more important it is that the auditor obtain an independent verification of the asset's value.

Example

A building valued at TZS500 million should be more carefully verified than a piece of equipment valued at TZS1,000.

In the case **of ownership of assets**, the auditors should **independently verify the title deeds or other relevant legal documentation** regarding assets claimed to be owned by the entity. This will ensure that the business has a free and clear title.

Example

If a company owned a building, the auditor would need to examine the original title deed and registration documents relating to the building to ensure that the building is legally owned by the organisation, and has not been pledged as security to a third party.

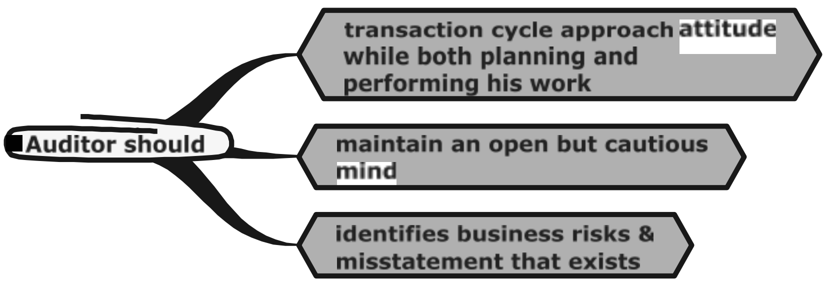
When receiving information **directly from the management / employees of the organisation**, auditors should not blindly accept and then rely upon information and data that is provided to them. They should conduct checks on random and very important items of information.

Example

An auditor asks for the organisation's closing year end bank balance. After receiving this information they should cross verify the figure with an official confirmation from the organisation's banker.

To conclude an **auditor needs to adopt an attitude of professional scepticism whilst both planning and performing an audit.** For the end objective of an audit is for the auditor to certify that the financial statements of an organisation are true and fair after they have taken every reasonable precaution.

SUMMARY



Test Yourself 1

ISA 240 states that the auditor should maintain an attitude of professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance.

Required:

State and explain where professional scepticism should be exercised.

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2. State and explain the meaning of materiality.
[Learning Outcome b]

2.1 Materiality

The concept of materiality is a fundamental consideration in all auditing situations. The dictionary defines the term materiality as 'important or essential'. **Materiality** refers to the **level of misstatement (including omissions) that could individually or in aggregate affect the economic decisions of the users of the financial statements.**

Whatever is important or essential in a given auditing situation would automatically be material. The onus is on the auditor to decide what material is and what is non-material. It is difficult to lay guidelines which would define the materiality of an item in all circumstances.

Materiality is not an absolute term and must only be seen in the relative context. This means that the same item may be material to one concern and non-material to another, or the same item could be material in a particular year and not material in another. The above general consideration may help an auditor to form an opinion as to whether a transaction, an error or a method is material or not.

Additionally materiality can be both quantitative and qualitative. So TZS10,000 might not be material with respect to understated electricity costs, but might be with respect to understated directors' emoluments.

Example

To most people buying a box of matches or bar of chocolate is not a lot of money. Both cost under Tsh10. However, buying a car is an expensive proposition. A car could cost TZS12 million. So we would say the cost of a matchbox is not material to us, but a car is.

Therefore for an entity whose turnover is TZS5 million and profit is TZS65,000, a TZS500 error is unlikely to be material. However, for an entity whose turnover is TZS0.25 million and profit is TZS500, a TZS500 error will be material.

The concept of materiality is very important throughout the audit exercise. Materiality helps the auditors:

- During the process of risk assessment and planning,
- To decide the sampling techniques and the sample size to be checked,
- During the actual checking and reporting, in order to determine the level of errors at which the audit report may be qualified.
- Evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements

2.2 Determinants of materiality

Materiality is considered at both the overall financial information level, and in relation to individual account balances and classes of transactions. Determining materiality for the financial statements as a whole is a matter of professional judgement. Materiality is determined on the basis of **quantitative and qualitative factors**.

1. Qualitative factors

The list of factors that determine materiality is not exhaustive. Some of the factors that need to be considered when making a judgement on materiality are:

(a) Relative significance

This is to determine the materiality of the item by viewing its significance in relation to the class to which it belongs.

Example

An amount of TZS250,000 received as dividend might not be material when compared to a company's total profits (TZS10 million, say) from all sources. However, if the total amount of income from investments is TZS200,000, then a misstatement of only TZS50,000 might be material if it causes users of the accounts to make incorrect assumptions about investment income.

(b) Comparison with the corresponding previous year's figures: patterns of income and expenses

Comparison with previous year's figures under similar headings is yet another criterion for determining materiality.

Example

A company has made a series of losses and is now showing a small profit for the first time in many years. In fact, the results should show a small loss. Even if the error is very small, and not material in itself, it might give false hope to users of the accounts.

(c) Transactions of abnormal and non-recurring nature

If a transaction is of an abnormal or of non-recurring nature, it is considered to be material, even if the amount involved may not be large e.g. related party transactions, acquisition of new business, research and development expenses etc.

Example

Musoma Engineering trades in different products. It plans to discontinue one of its operations. As a result, it disposes of the scrap related to the product for a small sum of TZS20,000. This figure may appear small; nevertheless it is material as the transaction is related to an operation that is discontinued.

(d) Statutory requirement

Omission of any amount that has to be disclosed because of statutory requirements is material in nature. Hence, qualitative materiality refers to a transaction which is not material because of its size, but because of the nature of the item e.g. statutory requirement.

Example

If there is a statutory requirement for disclosure of amounts paid as a sitting fee to directors, the amount paid must be disclosed precisely and separately. So, even an excess payment of TZS10,000 may be significant.

(e) Regular checks

Few items should be regularly checked for misstatements even though their monetary value might be insignificant. This is because these items are material to the users. Certain errors such as critical point errors need to be examined as they have the capability to change a loss into a profit.

(f) Recurring errors

Certain errors are recurring errors and occur frequently. While determining materiality levels, it is important to include these items even though they are of small amounts as they signify a weakness in the accounting system. For example, if the internal audit report of the previous year indicates that there were errors in the calculation of wages during the earlier year because it was handled by a trainee, then the auditor, during the current year, will have to check the calculation of wages for amounts which exceed the set materiality level.

2. Quantitative factors

Calculated materiality amounts derived using quantitative approaches may be increased or decreased based on the auditors' professional judgement about the possible effect of qualitative factors.

Example

Qualitative factors that help in determining materiality level may be:

- Possible effect on misstatement on profitability trends
- Magnifying effect of misstatement on the share price for the company
- Accuracy and reliability of accounting system
- Possibility of imminent acquisition / merger / sale
- Possible effect of a misstatement on segment reporting
- Possibility of imminent public stock offering

2.3 Calculation of materiality levels

Determining materiality involves professional judgement and the partner in charge of the audit makes the final decision. However, some guidance needs to be given to audit team members when they are planning and performing the audit. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

The following factors affect the identification of an appropriate benchmark:

The **elements of the financial statements** (e.g. assets, liabilities, equity, revenue, expenses).

Whether there are **items on which users of the entity's financial statements tend to focus** (e.g. users may tend to focus on profit, revenue or net assets).

The **nature of the entity, the industry and economic environment in which the entity operates.**

The **entity's ownership structure and the way it is financed** (e.g. if an entity is financed solely by debt rather than equity, users may put more emphasis on the assets and liabilities of the entity, rather than on the entity's earnings); and

The relative volatility of the benchmark.

The following benchmarks are often used, and acceptable in you exam, in the calculation of materiality on the financial statements as a whole:

Details	%
Revenue	½ to 1
Profit before taxation	5 to 10
Total assets	1 to 2

Example

The following is an extract from the draft financial information of Esteem Co for the year ended 31 March 20Y0:

	TZS million
Revenue	350
Profit before taxation	4.1
Total assets	225

Preliminary materiality can be calculated as follows:

Revenue		Profit before taxation		Total assets	
20Y0	TZS'm	20Y0	TZS'm	20Y0	TZS'm
1/2%	1.75	5%	0.21	1%	2.25
1%	3.5	10%	0.41	2%	4.50

Materiality must not be too low or too high. If it is set on the basis of profit it would be too low for revenue and may result in over auditing. On the other hand, if it is set at 2% of the total assets it would be too high and as a result the auditor may fail to check material items. It should be set between TZS2.25m and TZS3.5m.

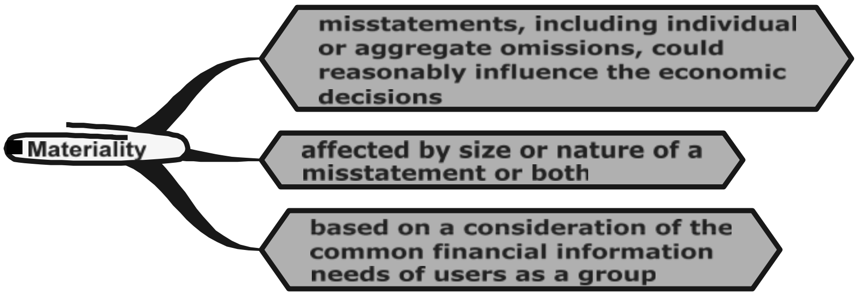
The auditor must try to ensure that no figure in the financial statements contains a material misstatement and therefore has a balancing act between too much auditing (expensive) and too little (dangerous). There can be conflicting indications as to materiality because companies differ. Calculating depreciation slightly incorrectly, at 15% rather than 20%, in a manufacturing company (many non-current assets) might make little difference to net asset values but a huge difference to profit. In a service industry (few non-current assets), the same depreciation error will have much less effect on profit.

In addition, the same company with the same revenues and statement of financial position could make no profit, small profit or large profits. Therefore the auditor has to be careful not to drastically increase the amount of testing carried out simply because profit falls, dragging down the materiality based on profits. However, quantitative effects also have to be taken into account.

In the above example, if materiality is set on the basis of profit it would be too low for revenue and may result in over auditing. On the other hand, if it is set at 2% of the total assets it would be too high and as a result the auditor may fail to check material items. It should be set between TZS2.25m and TZS3.5m.

When answering questions, you should remember that if the matter in the question is an income statement item the materiality for the income statement should be considered. If the matter in the question is a statement of financial position (SOFP) item, the materiality for the SOFP should be considered. Sometimes the matter in the question relates to both, income statement and a SOFP (e.g. inventory); in this case, materiality for both should be considered.

SUMMARY



2.4 Performance materiality

Definition

Performance materiality: the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

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

ISA 320

Performance materiality should be taken into account by the auditor at the planning stage.

Tip

Performance materiality for the financial statements as a whole will be lower than:

The materiality of the financial statements as a whole.
The materiality levels of a particular class of transactions, account balances or disclosures.

2.5 Altering or revising materiality levels

According to ISA 320, sometimes the auditor becomes aware of some piece of information (like knowledge of significant amounts of material costs not reported) which could have caused the auditor to set a different amount as materiality during the planning stage.

Therefore the level of materiality (determined at the time of preparing the audit strategy) may change during the course of audit.

When the level of materiality (for the financial statements as a whole) is revised to a lower amount, the auditor needs to determine whether:

(i) The performance materiality would have to be revised and
(ii) The nature, timing and extent of audit procedures will also need to be revised.

Example

At the planning stage, considering the previous year's results and experience, the auditor (who has started an audit before the preparation of financial statements) has set materiality at TZS1 million and performance materiality at TZS0.9 million.

However, when the financial statements are prepared, they find that turnover has reduced significantly. Assets have reduced significantly too and therefore the materiality level should be lowered. Accordingly they have decided to set materiality at TZS0.80 million. The auditor also determined that the performance materiality would also have to be revised downwards to TZS0.60 million.

The reduction in the material measures means that the auditor would have to perform more extensive audit procedures on revenue.

2.6 Materiality and audit risk

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Therefore, in order to reduce audit risk to an acceptably low level, the auditor obtains sufficient appropriate audit evidence.

Example

The internal audit reports of KJ Plastics, indicate that the internal controls in the area of sales are weak. Peter, an auditor of Peer Ltd, decides that that he should reduce the materiality level for sales transactions from TZS5 million (which had been planned earlier) to TZS2 million.

Therefore, Peter has identified the risk of material misstatement, in relation to sales as transactions which have values higher than TZS2 million. This means that more sales transaction will be examined, so reducing the audit risk.

Test Yourself 2

(a) How does materiality affect the audit work performed by auditors;
(b) Give an example of qualitative materiality.

Test Yourself 3

You have been appointed as the auditor of Gallata Co, which is a logistics company with over 1,000 employees. This long-established company provides bulk and heavy haulage transport services to time-sensitive delivery schedules. The following are the extracts of the financial statements relating to Gallata Co.

Extracts of SOCI for the year to 30 June	**20X8 Draft TZS '000 million**	**20X7Actual Tsh '000 million**
Revenue	161.5	144.4
Materials expense	88.0	74.7
Staff costs	40.6	35.6
Depreciation and amortisation	8.5	9.5
Other expenses	19.6	23.2
Finance costs	2.9	2.2
Total expenses	159.6	145.2
Profit / (loss) before taxation	**1.9**	**(0.8)**
Extracts of SOFP as at 30 June		
Intangible assets	7.2	6.2
Tangible assets		
Property	55.1	57.8
Vehicles and transport equipment	16.4	16·0
Other equipment	7.4	9.3
Inventories	0.6	0.5
Trade receivables	13.7	13.4
Cash and cash equivalents	3.4	2.8
Provisions		
Restructuring	9.7	10.8
Tax provision	3.0	3·3
Liabilities		
Finance lease liabilities	5.4	4.4
Trade payables	13.8	13.1
Other liabilities	8.5	7.9

Required:

Calculate the preliminary materiality.

3. Describe audit risk and audit risk model.
[Learning Outcome c]

This is discussed in detail in Study Guide A3, Learning Outcome 1.

4. Explain the consequence of fraud and misstatements on the audit strategy and audit work.
[Learning Outcome d]

4.1 Meaning

Definition

Fraud is an **intentional act** by **one or more individuals among management**, those **charged with governance, employees, or third parties**, involving the **use of deception to obtain an unjust or illegal advantage**. Two types of intentional misstatement are relevant to the auditor: misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

Fraudulent financial reporting involves intentional misstatement, including omissions of amounts or disclosures in the financial statements, to deceive financial statement used.

Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more capable of disguising or concealing misappropriations in ways that are difficult to detect.

IFAC Glossary of terms

1. Fraud

The term fraud refers to the intentional misrepresentation of financial information by one or more individuals among management, employees or third parties. Fraud may involve manipulation of records or documents, misappropriation of assets, suppression or omission of the effects of transactions from records or documents, recording of transactions without substance or misapplication of accounting policies.

2. Misstatement

Definition

Misstatement is difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. A misstatement of financial statements can arise from fraud or error.

IFAC Glossary of terms

A misstatement may result from the following:

- Inaccurate collection and processing of data in the financial statements
- Omission of an amount or non-disclosure of any fact
- Incorrect accounting estimates- by overlooking or misinterpreting facts
- Management's accounting estimates considered unreasonable by the auditor
- Management's adoption and application of accounting policies considered inappropriate by auditor

3. Fraudulent financial reporting

This means manipulation, i.e.

(i) **Alteration of an accounting record** or supporting document. For example, the quantity received in a purchase transaction is altered after it is authorised by the purchase manager.

(ii) **Intentional omission of events or transactions** from the financial statements. For example, not recording a credit note for sales return, so that the financial records indicate higher revenue.

(iii) **Intentional misapplication of an accounting principle** regarding amounts, classification, disclosure, etc. For example, not disclosing the directors' remuneration in the annual report of the company, intentionally, so that the remuneration paid to the directors is kept confidential.

4. Misappropriation of assets

Misappropriation of assets can occur in many ways, including:

(i) Theft of assets e.g. inventory, cash or non-current assets of the entity.

(ii) Embezzling receipts e.g. cash received from sale of scrap is recorded at a lower amount than the actual cash received. The difference in cash is kept by the cashier.

(iii) Making a payment for goods and services not received. For example, making payments to fictitious employees.

(iv) Using the entity's assets for personal use e.g. employee's family members using the company car.

4.2 Auditing with professional scepticism

As mentioned earlier, auditors are watchdogs and not bloodhounds. They are not supposed to presume the presence of any misstatement or fraud in the financial statements, but during the course of audit if they come across any misstatement they should consider whether the overall audit strategy and audit plan need to be revised. Remember, the auditor should however be auditing with an air of professional scepticism.

Example

In the case of an indication of fraud involving removal of inventory from the company's warehouse without the inventory being accounted for, the auditors should enlarge the coverage of their substantive tests regarding dispatches of inventory and the correlation of such dispatches with invoices raised. This would be further supplemented by surprise physical verification and inventory reconciliations.

4.3 Risk assessment process

ISA 315 **requires a discussion among the engagement team members on matters relating to how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.**

Risk assessment procedures are carried out in order to obtain information of the entity and its environment, which are susceptible to fraud. These procedures include:

Inquire from management and **others within the entity** (employees, operating staff, chief ethics officer, persons dealing with allegations of fraud, etc.) regarding:

(a) Management's assessment of risks of material misstatement due to fraud.

This will require an understanding of the methods followed by the management, for instance:

Identifying the areas where a material misstatement due to fraud could arise, like embezzlement of cash received from sale of scrap, recording of personal expenses of officials as corporate expenses.

Assessing the impact of the risks (identified above) on the business, and the probability of their occurrence. For example, if the value of scrap is insignificant then the likelihood of material misstatement due to fraud is also low.

(b) Whether proper risk management procedures are in existence in the company and whether they are managing the risks that the business faces.

(c) Management's communication to those charged with governance regarding the process for identifying and responding to the risk of fraud, i.e. the minutes of the board meeting or audit committee meeting where the matters were discussed.

(d) Management's communication to employees about business practices and ethical behaviour i.e. through the entity's code of ethics or ethical policies.

(e) Knowledge of any actual / suspected fraud within the entity: the auditor will enquire about the management's knowledge of material errors and fraud which have occurred within the entity and suspected fraud which exists within the entity which is being investigated by the management.

1. **For entities with an internal audit function**, the auditors must make enquiries with the internal audit department about the internal auditors' knowledge / suspicion of the existence of fraud affecting the entity.

2. The auditor must **enquire from those charged with governance** about:

(a) **How they monitor the management's process for identifying and monitoring risks of fraud**, i.e. through the audit committee meeting reports, review of the internal audit reports, report of management's assessment of risks of material misstatement due to fraud etc.

(b) **A failure by management to attend to the material weaknesses in the internal controls** which were identified in the audit during the previous year

(c) **The overall audit procedures** which the auditor proposes to undertake

(d) **Their knowledge** of any **actual / suspected fraud** within the entity

3. Auditors **must evaluate any unusual and unexplained relationships that have been identified while performing analytical procedures.**

Example

Donald is the auditor of Purple Plc. Donald made an analysis of the financial statements of Purple by studying significant ratios and changes to amounts. One of the figures that he studied was subsistence expenses which have doubled over the past year (sales increased only modestly)

Hence, Donald has reason to believe that there is some unusual variation in the subsistence figure. Donald will consider the results of such analytical procedures while drawing up his audit plan and plan to spend more time to subsistence expenses, the authorisation of expense claims and so on.

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4. **Other information obtained about the entity and its environment which will help to identify the risk of material misstatement due to fraud**. For example **information** gained from **past experiences of dealing with the client** in other engagements e.g. preparing project finance reports or interim audits of financial statements.

5. **Evaluation of fraud / risk factors**

Although the existence of fraud risk factors does not automatically mean that fraud has occurred, the likelihood of it taking place is definitely higher. For example:

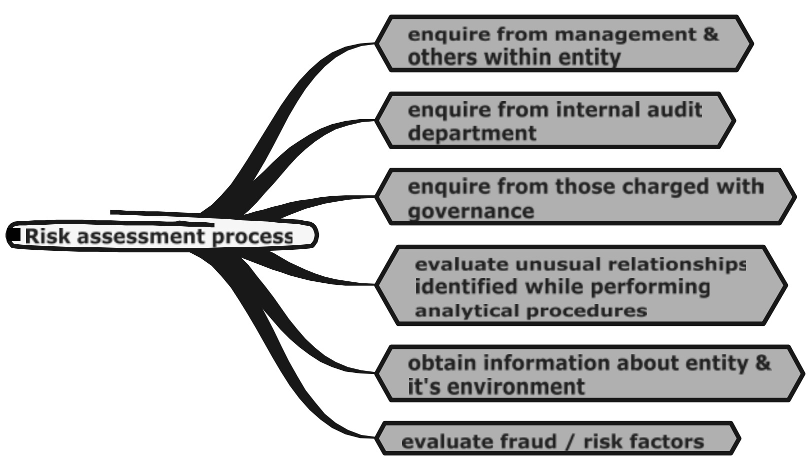
The **domination of management** by a single person can result in fraudulent financial reporting.

Granting **significant bonuses** to meet unrealistic targets. This can prompt mis-reporting of results.

A control environment which does not deter fraud. For example, if the company has no system of taking serious action against staff who are involved in fraud and internal control is not taken seriously by management.

An entity's size, complexity and ownership have a bearing on the relevance of the fraud risk factor. For example, in a large entity, an effective internal audit function will act as an obstacle to management overriding the controls.

SUMMARY



4.4 Communication relating to fraud

Fraud and error are to be reported:

1. **to the appropriate level of management**: according to ISA 240, auditors are required to report fraud to the level of authority which is at least one level higher than the level of the employees who are involved in the fraud.

2. **to the appropriate level of management for further investigation: i**f the misstatement is not material, the auditor has no duty to investigate the matter further; however, they should communicate the matter to the appropriate level of authority.

3. **on a timely basis**: when the auditor determines that fraud exists the matter needs to be reported promptly.

4. **To those charged with governance**

(a) when the auditor identifies fraud / suspected fraud involving management, employees (who have a significant role in internal control) or others.

(b) when the auditor becomes aware of fraud in which employees (other than management) are involved, and which does not result in a material misstatement,

(c) so that the auditors can understand the action proposed by the entity to prevent the fraud in the future and also get to know whether the entity has taken any legal advice on the matter.

5. **in situations when the auditors have doubts about the integrity of the management or those charged with governance**. In such cases, they are required to seek legal advice.

6. the communication may be either oral or written.

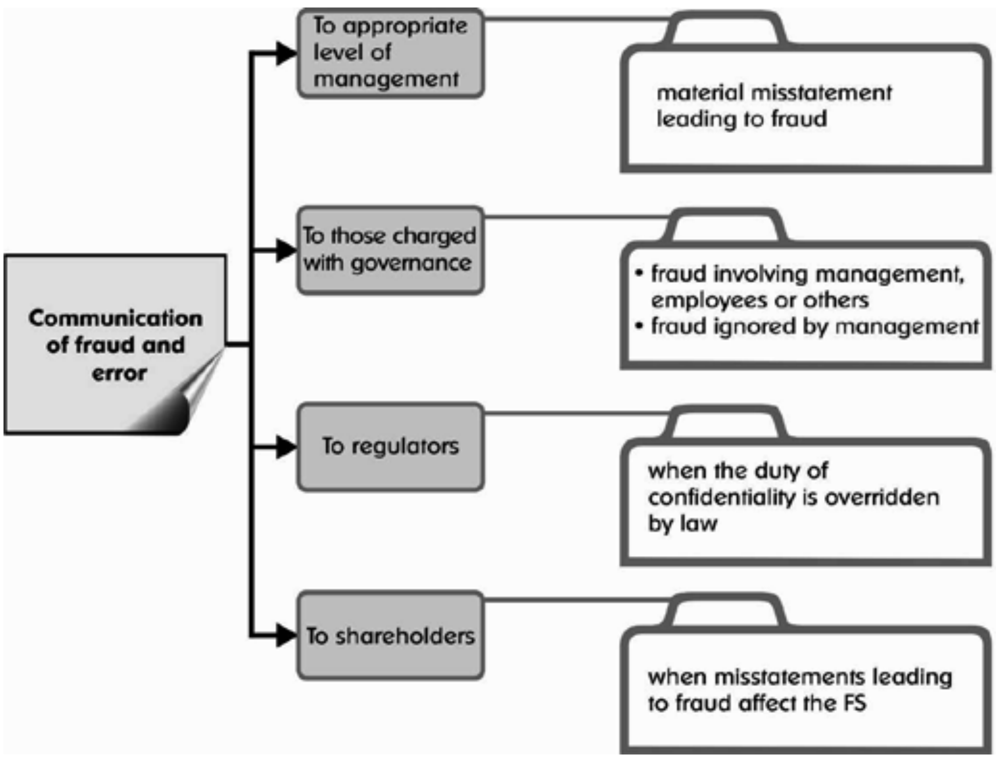
7. **Communication with regulators**

Revealing client information to parties other than the client will lead to a breach of the fundamental principles of confidentiality which auditors are required to adhere to. However the duty of confidentiality may be overridden by law.

8. **Communication with shareholders**

Auditors are appointed by the shareholders and are required to report whether the financial statements are true and fair. Hence the auditors will have to communicate with the shareholders about any fraud that affects the true and fair nature of the financial statements.

Diagram 1: Communication relating to frauds



4.5 Effect of fraud or error on audit strategy

Unless circumstances clearly indicate otherwise, the auditor should not assume that an instance of fraud or error is an isolated occurrence. **If the fraud or misstatement could have been prevented or revealed by the system of internal control, the auditor should reconsider their prior evaluation of the system and, if necessary, adjust the nature, timing and extent of the substantive procedures**. For this the auditor needs to consider whether the overall audit strategy as well as audit plan needs to be revised.

Example

Cathy is the auditor of Wami Ltd and has designed her audit procedures in such a way that she has not included any detailed substantive testing. This is because, when she reviewed the system and carried out sample testing, she found the internal controls to be effective. During the course of the testing, she found some material misstatements in the sales day book, and so she changed her idea and performed a detailed audit procedure to determine the effectiveness of the internal controls system of Wami. The misstatement in the sales day book due to ineffective internal controls indicates the possibility of misstatement in other areas of operation.

The auditor **should communicate the misstatements identified by them during the course of audit and their impact on the audit strategy to the audit committee / top management.**

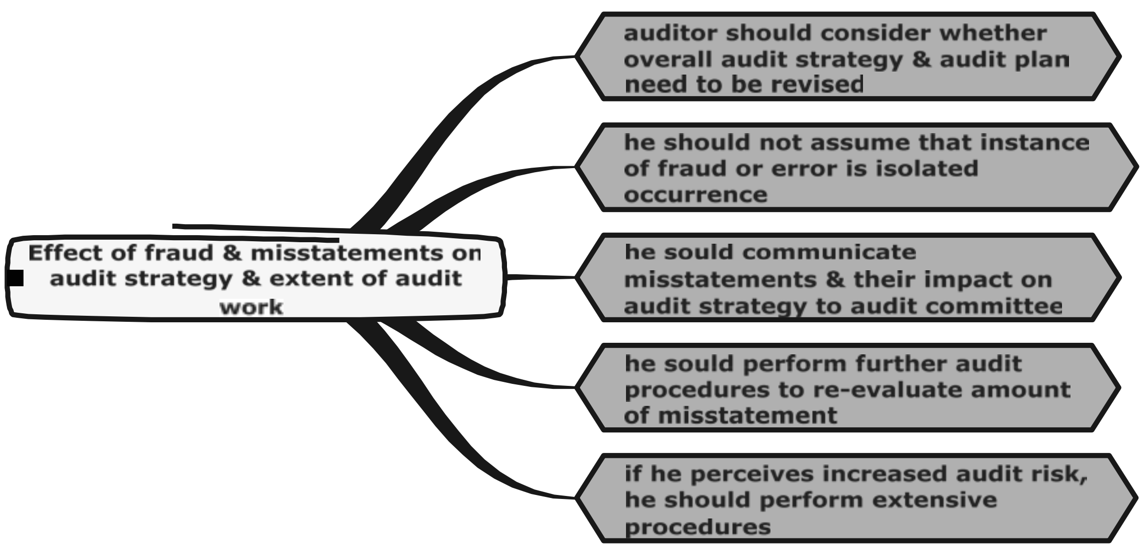
The audit committee should ask management to examine a class of transactions, account balances or disclosures to identify and rectify misstatements therein. After the examination and rectification by management, the auditor should **perform further audit procedures to re-evaluate the amount of misstatement.**

If misstatement or fraud is identified by the auditor, the audit risk will increase so the extent of audit evidence to be gathered must also increase in response. In this situation, the auditor will have **to perform extensive procedures to gather sufficient and appropriate audit evidence either to confirm the misstatement or to dispel it**.

Example

In the course of verification of records of the inventory management system, some receipts of material are found not to have been recorded in the stores ledger and in the bin cards. The auditors have reason to believe that more similar incidents might have taken place during the period under audit. Accordingly, they need to plan for extensive audit procedures on inventory recording.

SUMMARY



Performing modified or additional procedures will normally enable the auditor to confirm or dispel a suspicion of misstatement or fraud. Where the suspicion is confirmed, they should satisfy themselves that the effect of misstatement or fraud is properly reflected in the financial information or the error is corrected.

However, the auditor may be unable to obtain audit evidence either to confirm or dispel a suspicion of fraud. In this circumstance, the auditor should consider the possible impact on the financial information. The auditor will also need to consider the relevant laws and regulations and may wish to obtain legal advice before rendering any report on the financial information or before withdrawing from the engagement.

While considering the need to revise the audit strategy and the audit plan, the auditor should consider the materiality of the misstatements. In addition, the identification of a number of immaterial misstatements within an account balance or class of transactions may require the auditor to reassess the risk of material misstatement for that account balance or class of transactions.

Example

In Robin Plc, the auditor had considered a materiality level of TZS 2,000,000 for overhead expenses and planned his audit strategy accordingly. However, in the course of the audit, he finds that there are several errors each of which has a value of less than TZS 200,000 and the total impact of such errors is to the tune of TZS 10,000,000.

Accordingly, he needs to reassess the risk of material misstatement and revise his audit plan.

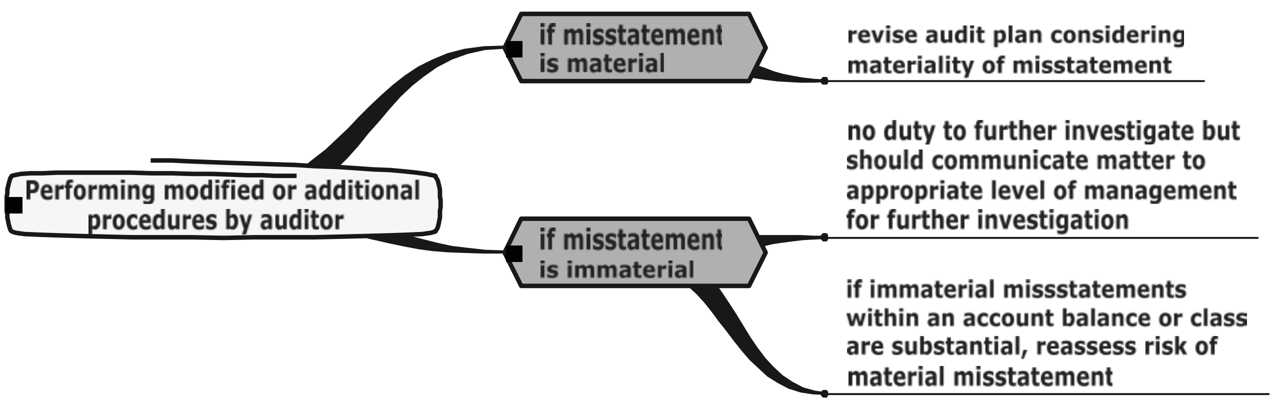
If non-compliance with the laws and regulations has no *direct* effect on the financial statements, the auditor should consult an expert to determine the effect of such non-compliance. If, in the opinion of the expert, non-compliance could have an impact on the financial statements or the going concern status of the entity, the auditor should report the matter to the audit committee / top management and should modify the report to that effect.

Example

A chemical factory operating profitably in Tanzania must comply with the strict regulations of Tanzania's Pollution Control Act. Such pollution control measures do not have any direct effect on the financial statements. However, the external auditor consulted legal experts on the issue and found out that if the company cannot comply with the pollution control regulations, it may be asked by the authority to close the factory. Considering that the issue might adversely affect the going concern status of the entity, the external auditor should modify their report to that effect.

If the misstatement is immaterial, the auditor has no duty to further investigate the matter, but they should communicate the matter to the appropriate level of management for further investigation. If management ignores the matter and does not investigate, the auditor should communicate it to the audit committee / top management.

SUMMARY



4.6 Written representations

According to ISA 240, auditors need to obtain a written representation from management and, where appropriate, those charged with governance confirming that they have disclosed to the auditor:

- Their responsibility for internal control designed, implemented and maintained to prevent and detect fraud,
- The results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and;
- Their knowledge of actual, suspected or alleged fraud affecting the entity.

Test Yourself 4

Ginger Ltd is a manufacturing unit manufacturing cookies which it supplies over the country. It has regional offices which supply the cookies to retail or wholesale shopkeepers. It has appointed Jim to audit its accounts. Jim reviews the internal controls system by verifying the tests of controls and designs suitable audit procedures. He finds the sales system seems to be effective, so he plans to carry out only 10% substantive checking. However while he is performing his tests, he discovers many errors and problems which indicate that there is a need to carry out extensive checking as the sales manager is not following and maintaining the internal control system. Jim decides to modify his audit procedures and plans to carry out extensive checking.

Required:

Explain whether Jim should only modify the audit plan for sales, as it indicates the need for extensive auditing or whether he should change his approach to the overall audit. Explain any other steps he should take.

5. Explain auditor's responsibilities for prevention and detection of fraud and error. [Learning Outcome e]

5.1 Meaning of error

Definition

Error is an unintentional misstatement in financial statements, including the omission of an amount or a disclosure.

IFAC Glossary of terms

The term **fraud** refers to the **intentional misrepresentation of financial information** by one or more individuals among management, employees or third parties.

The term **error** on the other hand refers **to unintentional mistakes** in financial information, e.g. mathematical or clerical mistakes, oversight or misinterpretation of facts, or unintentional misapplication of accounting policies.

5.2 Responsibility of management

According to **ISA 240**, **the primary responsibility for the prevention and detection of the fraud rests with both those charged with governance of the entity and with management.** This responsibility varies from entity to entity.

Prevention of fraud typically involves designing internal controls by the management of an organisation such that **internal controls are in place for each process and it ensures that** the work done by one person is checked by another person. For example, a cash voucher would be verified and authorised by the accountant, the payment would be made by the cashier, but the cash voucher would be recorded by the accounts clerk.

Internal controls provide reasonable assurance regarding the **efficiency and effectiveness of operation** i.e. the internal controls over the operations, the **reliability of financial reporting (**the financial controls) and **compliance with applicable laws and regulations (**the compliance controls). **Thus, internal controls assist management to prevent fraud.** The implementation and continued operation of an adequate internal control system reduces the possibility of fraud or error. However, it should be recognised that **any system of internal control may be ineffective against certain types of fraud.**

The **risk of not detecting a material misstatement resulting from fraud is greater than the risk of not detecting a material misstatement resulting from erro**r. This is **because fraud usually involves acts designed to conceal it**.

5.3 Responsibility of the external auditor

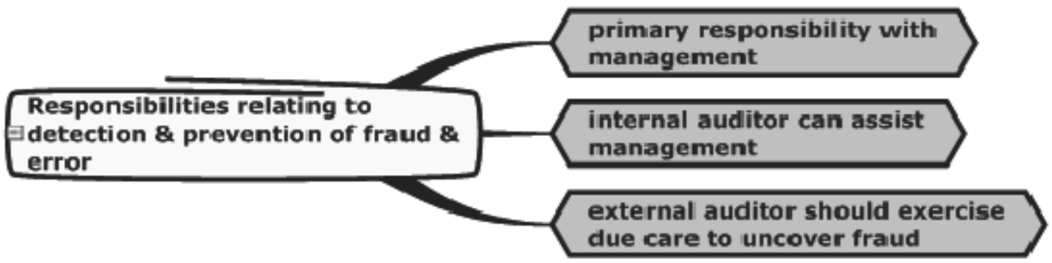
According to ISA 200, the overall objective of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are true and fair and are prepared, in all material respects, in accordance with an applicable financial reporting framework.

It is not the primary responsibility of the external auditor to prevent or detect fraud or error in the financial statements. However, in the course of conducting the audit, if they come across a situation where they have reason to believe that fraud or error might exist to a material extent, they should modify their audit programme or perform additional procedures to confirm or dispel their suspicion of fraud or error.

However, at the same time, this does not mean that it is not the duty of the auditor to detect fraud if situations give indications of fraud. The **auditor should exercise due care and diligence to uncover the fraud**.

If circumstances indicate the possibility of fraud, the auditor should perform a detailed examination and should confirm or dispel their suspicion.

SUMMARY



Test Yourself 5

Ruaha Plc, a TANAPA company, has a system of receivables accounting. The internal auditor plans an extensive audit of receivables accounting since it is one of the most vulnerable areas of accounting in the company.

Required:

Discuss, in brief, the responsibilities of management with respect to the prevention and detection of fraud and error.

Answers to Test Yourself

Answer to TY 1

Professional scepticism is an attitude that includes a questioning mind and a critical assessment of evidence. It does not mean that the auditor should not rely on management but rather that they should not rely blindly on management. This still holds true even if management has been always honest in the past.

The auditor needs to be sceptical throughout the entire audit and not just for any one specific procedure. General principles governing an audit of financial statements require that the auditor should plan and perform an audit with an attitude of professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.

Before starting an audit, the auditors need to formulate a plan. They must decide upon the nature, timing and extent of the audit procedures to be performed. Their audit plan will be based upon their assessment of the effectiveness of the internal control system and the risk of material misstatement.

After the planning stage, professional scepticism should continue to be exercised throughout the entire audit. It is especially important in the following cases:

- When audit evidence contradicts other audit evidence obtained
- When information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence
- When conditions may indicate possible fraud
- Circumstances that suggest the need for audit procedures, in addition to those required by the ISAs
- When receiving information directly from the management / employees of the organisation

Answer to TY 2

(a) Audit work

Materiality is crucial for the auditor, as they use it for assessment of risk and planning their audit procedures, for evaluating the results and also at the time of reporting.

Materiality is considered at both the overall financial statement level and in relation to individual account balances and classes of transactions. The quantitative aspects of materiality are calculated as a percentage of turnover, profit before taxes, or net assets.

(b) Qualitative materiality

Materiality is considered in the context of quantitative and qualitative factors. Qualitative materiality is one which is not material because of its size but because of the nature of the item e.g. statutory requirement.

An item is said to material in qualitative respect if its disclosure is required by the standards. The disclosure of accounting policies is also a qualitative aspect of materiality in order for the financial statements to give a true view. The financial statements will not be a true and fair presentation if the disclosure of accounting policies has not been made, even though the figures are correct.

Answer to TY 3

Revenue			Profit before taxation			Total assets		
Materiality percentage	20X8	20X7	Materiality percentage	20X8	20X7	Materiality percentage	20X8	20X7
	(TZS '000 m)	(TZS '000 m)		(TZS '000 m)	(TZS '000 m)		(TZS '000 m)	(TZS '000 m)
1/2%	0.8	0.7	5%	0.1	N/A	1%	1.0	1.1
1%	1.6	1.4	10%	0.2	N/A	2%	2.1	2.1

Interpretation

The preliminary range of materiality can be set between TZS1000m - TZS1,600m.

Gallata has low profits before taxation. Therefore, the materiality that has been set for profits will result in a large sampling size and will lead to unnecessary excessive auditing of the financial statements. Therefore, preliminary materiality based on profits appears to be an incorrect practice.

The revenue statement indicates that the amounts in excess of TZS1,600 m are material to the SOCI, whereas amounts less than TZS 800 m are not material to the SOCI. Therefore, preliminary materiality must be set between these two values.

TZS1,600 m represents 1.5% of the total assets. No doubt, if this was a regular audit, the preliminary materiality could be set at a higher amount. However, this is the first audit. Therefore, as a caution, preliminary materiality must be set at a level lower than this value.

There has been a marginal decrease in the total assets of the entity, whereas the revenue has increased by 11.8%. This indicates that the draft figures in the SOFP are more stable, hence materiality based on the SOFP appears to be a better proposition.

The 20X8 financial statements are in draft form so there is a risk of errors. Therefore, preliminary materiality levels should be set at lower levels.

Answer to TY 4

Jim had taken into consideration the chances of misstatements or fraud when he was assessing the risk to the entity, understanding the entity, preparing audit strategies and designing the audit procedures. So Jim was not supposed presume presence of the fraud or errors in the financial statements but, in the course of the audit, he identified some misstatements which also showed the involvement of the managerial staff. He should therefore consider modifying the overall audit strategy as it shows that the attitude of the management towards the internal control process is poor.

The discovery of misstatements and the involvement of management indicate that there may be misstatements in other areas, therefore Jim should modify his whole audit strategy.

Jim should perform further audit procedures to evaluate the quantity of misstatements and determine whether other areas of the business are similarly affected.

Before modifying the audit plan, Jim should consider the materiality of the misstatements. Jim should judge the increase in risk due to the misstatements and perform extensive procedures, if required. Therefore, as the level of identification of fraud or misstatement raises the level of audit risk also rises and so does the need to gather audit evidence

Jim must communicate all the misstatements which he discovered and their impact on his planning to those who are charged with governance, the audit committee or top management.

Answer to TY 5

T**he primary responsibility** for the detection and prevention **of fraud and error** still lies with **management**.

Since the auditor seeks to obtain persuasive rather than conclusive evidence and relies on selective verification (e.g. test checks), there is a possibility that some material misstatement resulting from fraud or error may not be detected by them. The risk of not detecting a material misstatement resulting from fraud is greater than the risk of not detecting a material misstatement resulting from error. This is because fraud usually involves acts designed to conceal it.

The implementation and continued operation of an adequate internal control system reduces the possibility of fraud or error. However, it should be recognised that any system of internal control may be ineffective against certain types of fraud.

Therefore management takes help of internal auditors to assist management in the prevention and detection of fraud in the following ways:

by assessing the risks and control strategies of an entity

by providing suggestions for improvement of risk management and control strategies

by designing an effective internal audit programme and by implementing it.

Quick Quiz

1. Complete the sentence.

   (a) Professional scepticism is an __________ that includes a _________ and a ___________ of evidence.
   (b) Audit risk is the risk that the __________________ expresses an inappropriate audit opinion, when the _______________ are materially misstated.

2. ISA 240 states the auditor should maintain an attitude of professional scepticism throughout the audit. True or False.

3. Define ‘materiality’.

4. Which of the following options does not contain the qualitative factors that help to determine materiality?

   A Possible effect of a misstatement on segment reporting
   B Possibility of imminent public stock offering
   C 1% of total assets
   D Possibility of imminent merger

.

5. Which of the following options is false?

   A. Professional scepticism is used to describe an attitude that includes a questioning mind and a critical assessment of evidence.
   B. Professional scepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
   C. The auditor should always bear in mind that when the management / employees of a particular organisation have never omitted or misrepresented any facts or figures in the past, it automatically means that they will continue to do so in the future.
   D. An auditor needs to adopt an attitude of professional scepticism whilst both planning and performing an audit.

Answers to Quick Quiz

1.
   (a) Attitude, questioning mind, critical assessment
   (b) Auditor, financial statements

2. **True.** An auditor should maintain an attitude of professional scepticism throughout the audit as there could be material misstatement due to fraud, not withstanding the past experience of auditor with the entity (in regards to management's honesty and integrity).

3. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on both quantitative and qualitative considerations.

4. The correct option is **C.**

   '1% of total assets' is the benchmark used to compute materiality, so it is a quantitative factor used to determine materiality.

   The other options are qualitative factors used to determine materiality, so the options are incorrect.

5. The correct option is **C.**

   Professional scepticism requires that the auditor should always bear in mind that even though the management / employees of a particular organisation have never omitted or misrepresented any facts or figures in the past, it does not automatically mean that they will continue to do so in the future.

   The other options are incorrect as they contain true statements relating to professional scepticism.

Self-Examination Question

Question 1

Define materiality and determine how the level of materiality is assessed.

Question 2

It is not the primary responsibility of the external auditors to prevent or detect fraud or error in the financial statements. However, if, during the audit, they come across a situation where they have reason to believe that there is fraud or error they must try to either confirm or dispel it.

Required:

What steps should an auditor take in discharging his duties towards detecting fraud and error?

Question 3

A small publishing company paid royalties to authors at an agreed percentage of sales revenue for each title.

Re-computation by the auditors of royalties payable indicated a substantial underpayment on a regular basis. The chief financial officer claimed that any underpayment was an error. She added that authors had the right to appoint a representative to check payments. Since they failed to do so the company had no further liability.

Required:

Comment on the implications for the audit and discuss further actions the auditors should take.

Question 4

(a) Swahili Holidays & Safaris is an independent travel agency. It takes commission on holidays sold to customers through its chain of high street shops. Staff are partly paid on a commission basis.

Well-established tour operators run the holidays that Swahili Holidays & Safaris sells. The networked reservations system through which holidays are booked and the computerized accounting system are both well-established systems used by many independent travel agencies.

Payments by customers, including deposits, are accepted in cash and by debit and credit cards.
Swahili Holidays & Safaris is legally required to pay an amount of money (based on its total sales for the year) into a central fund maintained to compensate customers if the agency should cease operations.

Required:
Describe the nature of the risks arising from fraud and errors to which Swahili Holidays & Safaris is subjected to.

Answer to Self-Examination Question

Answer to SEQ 1

'Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.'

In assessing the level of materiality, there are a number of areas that should be considered. Firstly, the auditor must consider both the amount (quantity) and the nature (quality) of any misstatements, or a combination of both. The quantity of the misstatement refers to the relative size of it and the quality refers to an amount that might be low in value but due to its prominence could influence the user's decision - for example, directors' transactions.

In assessing materiality, the auditor must consider that a number of errors each with a low value may, when aggregated, amount to a material misstatement.

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

In calculating materiality, the auditor should also consider setting the performance materiality level. This is the amount set by the auditor, which is less than the materiality set, and is used for particular transactions, account balances and disclosures.

According to ISA 320, materiality is often calculated using benchmarks such as 5% of profit before tax or 1% of gross revenue.

These values are useful as a starting point for assessing materiality.

Answer to SEQ 2

The following steps should be taken by the auditor, in discharging his duties towards detecting fraud and error:

Risk assessment process

In this process an auditor gathers information to identify the risks of material misstatement due to fraud.

ISA 240 prescribes certain procedures auditors need to perform.

Auditors are required to perform the risk assessment procedures by **enquiring from management** and **others within the entity** (employees, operating staff, chief ethics officer, persons dealing with allegations of fraud, etc.) regarding:

(i) Management's assessment of risks of material misstatement due to fraud

(ii) Whether proper risk management procedures are in existence in the company and whether they are effectively managing the risks that the business faces

(iii) Management's communication to employees about business practices and ethical behaviour

(iv) Knowledge of any actual / suspected fraud within the entity

The auditor should consider the potential effect of the suspected fraud or error on financial information. If it has a significant effect on the financial information of the entity, the auditor should modify the plan and try to confirm the fraud or to dispel it.

If it is not possible for the auditor to confirm or dispel the fraud, the auditor should obtain legal advice.

If the auditor confirms the significance of the fraud, the auditor should disclose it in the financial statements.

The auditor's responsibility is to properly plan, perform and evaluate their audit work so as to have a reasonable expectation of detecting material misstatements in the financial statements.

The auditor's duty is to report fraud to senior management as soon as possible.

If they have no confidence that senior management will deal adequately with the matter or where they have reason to believe that senior management is involved in fraud, they should report the fraud to the authority to which, in their opinion, it is appropriate to report.

Answer to SEQ 3

Fraud is an **intentional act** by **one or more individuals among management**, those **charged with governance, employees, or third parties**, involving the **use of deception to obtain an unjust or illegal advantage**. According to the royalty contract, the company is liable to make payments to the authors, but these amounts have been consistently understated and underpaid.

It is not clear if this was error or fraud. Either way, there was substantial underpayment of royalties. Because of the duty of confidentiality, the auditors cannot inform the injured party i.e. the authors.

The auditors must seek legal advice on whether the action of the company's underpayment of royalties was a criminal act. For example, the auditors must obtain legal views regarding whether there is a conspiracy to defraud the authors or false accounting, to obtain a pecuniary advantage. The auditors might then have a legal duty to inform the authorities.

The auditors must expect the directors to pay the amounts due to the authors in full. The auditor must consider resigning if the directors refuse to do so.

If the amount is material and the company has not made adequate provisions for it in the financial statements there will be a material misstatement in the financial statements. Hence, the auditor must issue a qualified auditor's report

Management's attitude implies a poor control environment and this increases audit risk. If management has been careless or potentially fraudulent the auditors will have to consider if other areas could be affected and will need to increase the amount of audit work they carry out.

If management seems to have a careless of fraudulent attitude towards accounting matters and internal control, the auditors should consider resigning to protect their position.

In discharging their duties towards detecting fraud and error, an auditor should maintain / perform the following:

Professional scepticism

According to ISA 240, the auditor should maintain an attitude of professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist.

An auditor should, while planning the audit, consider the risk of material misstatement of the financial statements caused by fraud or error. If they feel that any fraud or error might have occurred during the year they should modify their plan.

Furthermore, while conducting their audit, they should neither consider the management dishonest nor rely excessively on the management. The auditor should gather sufficient appropriate audit evidence for each of their suspicions.

Discussion among the engagement team

According to ISA 240, the members of the engagement team should **discuss the** possibility that the financial statements will contain fraudulent financial reporting or intentional misappropriation of assets.

This enables the auditor to consider an appropriate response to the susceptibility and to modify the audit programme to conduct further audit procedures.

Answer to SEQ 4

Nature of risks arising from fraud and error: Swahili Holidays & Safari.

- Swahili Holidays & Safaris is subject to all of the risks of error arising from the use of computer systems. If programmed controls do not operate properly, for example, the information produced may be incomplete or incorrect. Inadequate controls also rise to the risk of fraud by those who understand the system and are above to manipulate it in order to hide the misappropriation of assets such as receipts from customers.

- All networked systems are also subject to the risk of error because of the possibility of the loss or corruption of data in transit. They are also subject to the risk of fraud where the transmission of data is not securely encrypted.

- All entities that employ staff who handle company assets (such as make mistakes (error) or that they may misappropriate those assets (fraud) and then seek to hide the error or fraud by falsifying the records.

- Swahili Holidays & Safaris is subject to problems arising from the risk of fraud perpetrated by customers using stolen credit or debit cards or even cash. Whilst credit card companies may be liable for such frauds, attempts to use stolen cards ca cause considerable inconvenience.

- There is a risk of fraud perpetrated by senior management who might seek to lower the amount of money payable to the central fund (and the company's tax liability) by falsifying the company's sales figures, particularly if a large proportion of holidays are paid in cash.

- There is a risk that staff may seek to maximize the commission they are paid by entering false transactions into the computer system that are then reversed after the commission has been paid.

SECTION B

THE NATURE AND USE OF INTERNAL CONTROLS

B1

STUDY GUIDE B1: INTERNAL FINANCIAL CONTROLS AND INTERNAL CONTROLS

Get Through Intro

In today's global world, there has been an enormous growth in the size and complexities of business. Proper management of modern business undertakings is not possible unless there is an adequate internal control.

Internal controls are the means by which the operations, assets and performance of an entity are directed, controlled and safeguarded so that the risk of errors and fraud is minimised and the performance of the entity is kept within practicable performance ranges.

Before carrying out a detailed verification of the transactions of an entity, an auditor carries out a review of the organisation's internal financial control and internal control system. As a result of this review, the auditor can determine the degree of reliance he can place on the various systems and procedures. This, in turn, determines the nature, extent and timing of audit tests to be applied. In the areas where the auditor finds that the internal financial control and internal controls are effective, the auditor may resort to selective checks. Wherever the internal controls are weak, he may conduct a detailed examination of the transactions of the organisation.

For example, Mbezi Ltd manufactures bicycles. While testing the system for procuring materials, the auditors noticed that all purchases were supported by purchase orders, goods received notes and vendors' invoices. Furthermore, all the purchases were also recorded properly in the inventory ledgers. Management felt that every transaction was well-documented so their control systems were very effective.

During the receipt of the next five consignments, the auditors took a physical count of the materials received. It was observed that the actual quantity received matched the purchase order. However the vendor's delivery notes and the goods received notes prepared by the storekeeper, showed quantities in excess of 1% of the purchase order quantities.

Furthermore, the auditors noticed that the person who raised the purchase order was responsible for receipt of materials and also for recording the entry of receipt and issues in the stores ledger. In other words, there was no segregation of duties because one person was in charge of the whole ordering and receipts process. This was a loophole in the internal control system because that person was not subject to another person's scrutiny and checks. This was brought to management's attention. Management gave responsibility to separate people for raising purchase orders, accepting materials and maintaining the stores ledger.

This ensured that there was less risk of fraud or error occurring. In addition, the auditors could place more reliance on the client's system and procedures and thereby the nature, extent and timing of audit tests to be applied.

Learning Outcomes

a) State and explain the nature of internal financial controls and internal controls.
b) State and explain the different types of internal control with emphasis on internal financial controls.
c) State and explain the meaning of effective internal financial controls and internal controls.
d) Identify and explain the business, reporting and compliance objectives supported by internal controls.

1. State and explain the nature of internal financial controls and internal controls.
State and explain the different types of internal control with emphasis on internal financial controls.

[Learning Outcomes a and b]

1.1 Meaning and nature of internal controls

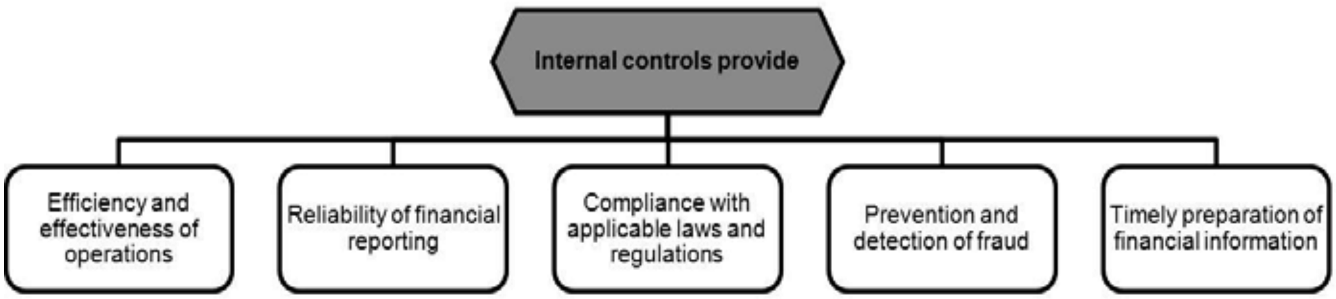
Internal control is the process designed to mitigate risks to the business and ensure that the business operates efficiently and effectively.

Definition

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

IFAC Glossary of terms

Diagram 1: Internal controls



Internal control is a process which is effected by an entity's board of directors, management and other personnel. It provides reasonable assurance regarding the achievement of the objectives in the following categories:

1. Efficiency and effectiveness of operations

The efficiency and effectiveness of operations are vital to any business in delivering value to customers and margin to shareholders so that strategic objectives can be achieved through excellence in key business processes. Businesses need to be able to anticipate and meet customer demands and deliver contribution on sales in the short and long run. Quality management, quality control, process control and responsiveness to issues enable businesses to meet customer value propositions and achieve returns.

The efficiency and effectiveness of operation can be ensured by:

- Adhering to all management policies
- Safeguarding assets and records: Internal control systems must ensure that assets (tangible as well as intangible) are optimally utilised and protected from misuse, fraud, misappropriation or theft.

Example

Venus Ltd has the following policies

(a) With respect to staff attendance (adhering to all management policies)

Control	Impact on financial statements
All employees are required to swipe their identity cards while entering and leaving the office premises.	The financial statements relating to employee salary will be correct if the salary sheet is made based on the attendance policies mentioned alongside.
All employees going on outdoor duty are required to enter an outdoor slip duly authorised by their seniors.	

Continued on the next page

(b) With respect to safeguarding of inventory

Control	Impact on financial statements
Inventory is stored only in the inventory stores.	The control activities will ensure that the inventory is properly safeguarded. So the value of the inventory which appears in the financial statements will be reliable and accurate.
The stores are kept under lock and key.	
No outsiders are permitted to enter the stores.	
Only the persons who are working in the stores are allowed access to the stores.	
Every quarter, the management carries out a physical verification of the inventory.	
The inventory is also insured against natural disasters, theft and riots.	

2. Reliability of financial reporting

Information systems must be reliable to ensure that information supports the compilation of financial statements that give a true and fair view and internal management reports can be used with confidence. The reliability of financial reporting can be achieved if controls are in place to support the validity, accuracy and completeness of accounting records. This is essential if the financial statements are true and fair. Reliability of financial reporting is possible if controls are in place to ensure the **accuracy** and **completeness** of accounting records.

Example

Venus Ltd follows the following method of accounting for inventory:

Control	Impact on financial statements
Materials received in stores are supported by purchase orders.	The controls mentioned alongside will ensure that the financial statements with respect to purchases and inventory are reliable, since the information of receipt of purchases is accurate and complete.
Materials received are supported by goods received notes.	
Materials received are tested by the quality control department.	
Only tested material is issued for production.	
Purchase vouchers are prepared after comparing the goods received notes and purchase orders.	

3. Compliance with applicable laws and regulations

The internal controls support compliance with applicable laws and regulations. Sometimes, controls designed to detect non-compliance with laws and regulations may have a direct and positive impact on the financial statements.

Example

CRK bank has employed Samweli & Co as consultants. They are entrusted with the task of checking that the entity has complied with all applicable laws and regulations.

Control	Impact on financial statements
All the laws and regulations (banking laws, labour laws etc.) which are applicable to Indo bank.	The controls will ensure that the company adheres to all laws and regulations. This will ensure that the financial statements prepared by the entity have taken into account all the liabilities which are applicable to the entity in this account. Hence the financial statements will be more reliable and there is no risk of any statutory non-compliance.
Ensure that the bank is kept informed of all new laws or regulations which are applicable to Venus Ltd.	

4. Internal controls also ensure the following:

(a) Prevention and detection of fraud

Fraud is an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. That is why detection of fraud is not easy. Undetected fraud would affect the truth and fairness of financial statements.

Internal controls include segregation of duties and a system of checks and balances for each activity. For example, in a manufacturing entity, the purchase manager will be responsible for raising the purchase order, whereas another official will be responsible to physically receive the materials and store it in the warehouse. This official will receive only those materials which are supported by valid purchase orders. This will thereby reduce the risk of fraud of fictitious purchases. That is why internal controls play an important role in preventing and detecting fraud.

(b) Timely preparation of financial information

Internal controls include the system of internal audit and external audit, which ensure that the elements of the financial statements recorded are not just true and fair, but also prepared on a timely basis i.e. statutory reporting (of year end accounts, for example) and also management accounts, if appropriate, for the facilitation of effective management decision-making.

Therefore internal controls assure management of the accuracy of the financial statements, that the operations of the entity are conducted efficiently and that the entity has complied with all the laws and regulations which are applicable to the entity.

Test Yourself 1

Airforce Services manufactures and markets air conditioners. The company has a network of dealers which sell its products to customers. The company offers credit limits to its dealers. The following is the credit policy for the dealers:

First year of operation	Nil credit
After the first year	
For A class dealers	40% of the sales which are unpaid
For B class dealers	25% of the sales which are unpaid
For C class dealers	15% of the sales which are unpaid

Dealers are classified as A, B or C class, based on the turnover in the previous year of operation. The company's internal control system ensures that the credit limits never exceed the sanctioned limits. However, the company faces the risk of non-recovery of receivables from about 40% of the dealers.

Required:

In order to improve the design of the internal controls relating to receivables explain the factors which need to be considered before setting credit limits for its customers.

The scope of internal controls includes not just accounting controls but also operational controls such as quality controls, budgetary controls (i.e. testing whether expenses, assets etc. are according to budget) quantitative controls (e.g. actual output / production from machine matches the expected production), internal checks (i.e. ensuring that the work of one person is verified by another official) and so on.

1.2 Risk management

Internal control is a part of enterprise risk management; enterprise risk management is broader. In particular, enterprise risk management includes, additionally, financial and non-financial internal reporting systems, a broader view of objectives to encompass strategic objectives, and a portfolio approach to risk as well as specific All entities face uncertainty, and the challenge for management is to determine how much uncertainty the entity is prepared to accept as it strives to increase stakeholder value. Enterprises operate in environments where factors such as globalisation, changes in technology, regulation, restructuring, market changes and competitions create uncertainty. Uncertainty emanates from an inability to precisely determine the likelihood that potential positive or negative events will occur and what the outcomes will be after those events.

The concept of risk also underpins this section and includes in particular the negative aspect of risks such as natural disasters, terrorist activity, malfunctions of technology, human error, human malicious damage, fraud and mistakes of all types. Risks are therefore both external and internal. They are not always driven from the environment; there is also a threat from within. There is an essential set of links between corporate governance, strategic planning, etc.

Example

Mbeyawood is a Tanzania company that is in the lumber trade. The company begins its operations by felling trees from a forest. The tree trunks are then cut into standard sizes and transported back to the organisation's warehouse.

The trunks are categorised in terms of size and quality (e.g. high, medium or low quality as well as large, medium or small sizes), and stored. The marketing team obtains orders for various quantities of lumber from organisations across Africa. Once an order has been secured, the corresponding lumber is then dispatched to a nearby shipyard and transported to the customer.

The internal controls and risk management of Mbeyawood include:

- Ensuring a forward contract is entered into each time an order is secured
- Ensuring that all lumber is insured while on the organisation's premises and while in transit to the customer
- Weekly physical checks of the inventory on hand against inventory records
- Monthly checks to ensure that all relevant taxes such as VAT have been paid and are current
- Monthly checks on the number of trees being felled
- Weekly checks to ensure that lumber is being sold at the prevalent market rates and terms

These controls help:

- To protect the organisation against any exchange rate fluctuations (and therefore risk)
- To protect the assets of the organisation
- To ensure that the organisation complies with all relevant laws and regulations
- To monitor the efficiency and effectiveness of operations

Diagram 2: Internal control and risk management

Therefore risk management includes strategic controls along with the internal controls mentioned above.

Corporate governance is relevant in here to the extent that **senior management needs to articulate risk management from the top of the organisation to the bottom and ensure that risk management is embedded in all processes.** Risk management and internal controls should be incorporated into the design of all business processes as a matter of course.

1.3 The various types of controls which the company can adopt can be classified as follows:

1. Voluntary and mandatory controls
2. Financial and non-financial controls
3. Manual and computerised controls
4. Administrative and accounting controls
5. Discretionary and non-discretionary controls
6. General and application controls
7. Preventive, detective and corrective controls

1. Voluntary and mandatory controls

Voluntary controls are controls which are not enforceable by law. In other words, the company lays down the controls so that the business can run smoothly.

Example

Royale Bikes is a newly set-up small company which manufactures bikes. The company implements a policy with respect to authorisation of transactions and processes such as raising purchase orders, accepting materials from vendors, approving the quality of materials and signing cheques.

Mandatory controls are controls which are enforceable by law. For instance, Royale (discussed above) ensures that the company's manufacturing process meets the standards laid down by the pollution control authorities. This will ensure that the company will not have to face penalties due to statutory non-compliance.

2. Financial and non-financial controls

Financial controls are controls which lead to safeguarding of the assets of the company and maintaining and providing proper and reliable financial information. For instance, Royale (discussed above) maintains records of financial information such as purchases, sales, expenses incurred and purchases of non-current assets. The information must be reliable and lead to reliable financial statements. Therefore all sales orders have a unique sequential reference, to ensure all of the orders are recorded and missing orders can be identified.

Non-financial controls deal with areas which are not directly reported in the financial statements. For instance, Royale (discussed above) has the following controls: organisation structure, strategic policies, policies and procedures for various activities of the company such as the company's HR policy. Having an organisation structure will help management ensure that all tasks that need to be carried out are assigned to appropriate persons in the organisation chart. This in turn will help Royale to achieve its objectives.

3. Manual and computerised controls

Manual controls are controls which are monitored manually. For instance, an entity may have a manual system of monitoring sales orders i.e. the orders are received by telephone, mail or fax. These will have to be recorded in a register and monitored manually. This will ensure that all orders are fully executed.

Computerised controls are controls which are programmed to prevent, detect and correct errors. For instance, Royale (discussed above) has "in built" controls in the software e.g. the software can be used by authorised persons only. This will help to prevent errors. The software has a provision through which transactions cannot be cancelled. Transactions can only be cancelled by recording journal entries. Hence, the software has a provision through which audit trails can be established. This can help to detect errors.

Manual Vs Automated Elements of Internal Control Relevant to the Auditor's Risk Assessment

Most entities make use of IT systems for financial reporting and operational purposes. However, even when IT is extensively used, there will be manual elements to the systems. The balance between manual and automated elements varies. In certain cases, particularly smaller, less complex entities, the systems may be primarily manual. In other cases, the extent of automation may vary with some systems substantially automated with few related manual elements and others, even within the same entity, predominantly manual. As a result, an entity's system of internal control is likely to contain manual and automated elements, the characteristics of which are relevant to the auditor's risk assessment and further audit procedures based thereon.

Controls in a manual system may include such procedures as approvals and reviews of activities, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace such paper documents as purchase orders, invoices, shipping documents, and related accounting records. Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls.

Benefits and risks of automated controls

Generally, IT provides potential benefits of effectiveness and efficiency for an entity's internal control because it enables an entity to:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- Enhance the timeliness, availability, and accuracy of information;
- Facilitate the additional analysis of information;
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- Reduce the risk that controls will be circumvented; and
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

Risk associated with automated control

IT also poses specific risks to an entity's internal control, including the following:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorized changes to data in master files.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

Areas where manual controls are preferable

Manual aspects of systems may be more suitable where judgment and discretion are required such as for the following circumstances:

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls.

However, due to the fact that manual controls are performed by people, they may be less reliable than automated controls because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Specifically, manual systems may be less suitable for the following:

- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented or detected by control parameters that are automated.
- Control activities where the specific ways to perform the control can be adequately designed and automated.

4. Administrative and accounting controls

Administrative controls are controls established to accomplish the objectives of the company. The administrative controls for Royale (discussed above) would include preparing an appropriate organisation structure which should specify the various reporting levels of the company. Responsibilities are clearly set out e.g. the responsibilities of the purchase department are entrusted to the purchase manager (i.e. an appropriate level of authority).

Accounting controls are controls which lead to accurate and reliable financial statements. The accounting controls of Royale (discussed above) include ensuring that all transactions are supported with appropriate documentation and recorded properly. This will require the company to have policies and procedures for the various activities of the company. So for example, as soon as an invoice is received from a supplier, it is recorded in the payables ledger.

5. Discretionary and non-discretionary controls

Discretionary controls are controls which are based on judgement i.e. based on discretion. The discretionary controls of Royale (discussed above) include not making purchases from vendors who have a bad reputation in the market and raising sales invoices only at the time of dispatch of goods. This would ensure that the company does not face the risk of purchasing poor quality products.

Non-discretionary controls are controls which are automatically generated by the computer system. These controls cannot be evaded. The non-discretionary controls of Royale (discussed above) include access to software by authorised persons and recording the date of a transaction only in the format (MM/DD/YY) set by the software. These controls will ensure that transactions are properly authorised and recorded according to the requirements of the software.

6. General and application controls

IT controls are grouped under two categories: application controls and general IT controls.

General controls are controls over the environment in which the computer functions. They enable the continued proper operation of information systems by ensuring the effective functioning of application controls. Some of the general controls for Royale (discussed above) are as follows:

Systems need to be used for authorised purposes only.

Royale has a system of password access to the system. This ensures that the data is not misused or corrupted.

Authorised programs need to be used.

Royale (discussed above) has a system whereby the programs (e.g. SAP) which are run are authorised by the IT department and ratified by the board of directors. This would require maintaining a library of programs which is accessed only with the approval of the librarian. Such a control will ensure that data are processed correctly.

Application controls relate to the **processing of individual applications. Applications are the computer programs and processes, including manual processes that will enable Royale to conduct its essential activities.**

Application controls help to ensure that transactions are authorised, complete and accurately recorded. Royale implements application controls with respect to transactions relating to buying products, paying vendors, accounting for travelling expenses and forecasting and monitoring budgets, i.e. payments are made only if they are supported by vouchers duly authorised by the accounts manager and accompanied with valid goods received notes authorised by the quality department and purchase orders.

7. Preventive, detective and corrective controls

Preventive controls are controls to prevent errors from occurring. The preventive controls for Royale (discussed above) include, preparation of goods received notes only if purchase orders are available and authorisation of purchase orders, salary sheets, overtime sheets, etc. by appropriate personnel. These controls ensure that the purchase transactions recorded are physically received, unnecessary purchases are not made by the company and the salaries and overtime paid, are correctly calculated and made to real people who have worked the hours stated.

Detection controls are controls which enable detection of errors. The detection controls for Royale (discussed above) include bank reconciliation statements and surprise cash counts.

Corrective controls are controls to correct errors. The corrective controls for Royale (discussed above) include virus protection for all programs and back-ups of all system programs.

1.4 Internal financial controls

Internal financial controls are the risk management tools which are built into the procedures and practices of the company in order to ensure that the entity's assets are safeguarded, its funds are effectively and efficiently used and proper and reliable financial information is provided and maintained.

Financial controls relate to controls in various areas, some of which are as follows:

1. **Cost budgeting:** In the example of Royale discussed above, the company has a system of preparing annual budgets after reviewing each business center and getting the budgets sanctioned by the board.

   The annual budget setting process includes a detailed review of each business unit and the approval of the budget by the board. Costs and performance are monitored on a monthly basis against budgets. Monthly Operational Review meetings are held with senior management to discuss financial issues.

2. **Treasury:** the Treasury department of Royale is responsible for placing deposits, arranging borrowings and making payments. The operations of the Treasury department are reviewed by the directors or senior management. The terms of reference for the Treasury department are approved by the board.

3. **Insurance risk:** Royale holds insurance cover for all employer liability and public liability claims, which is issued by the insurance company. The insurance cover restricts the company's exposure to a fixed amount per claim (as mentioned in the insurance policy). All claims are subject to expert assessment and challenge and, where applicable, independent medical and legal opinion.

4. **Capital expenditure:** all major capital projects at Royale require the approval of the board. The investment committee chaired by the finance director approves smaller capital projects. Senior executives are invited where appropriate. The investment committee reviews projects with a cost in excess of a pre-decided amount (mentioned in the internal control policy manual).

5. **Internal audit in areas of internal financial controls:** the internal audit function of an entity (which reports to the audit committee) reviews the design and operation of internal financial controls on an ongoing basis, i.e. the systems established to identify, assess, manage and monitor financial risks. For example, for companies which have a high percentage of export sales, the internal auditors will review whether the company has implemented the procedure of taking forward exchange contracts on all exports, so that the risk of loss due to fluctuations in foreign currency is avoided.

6. **External audit in areas of internal financial control:** entities undertake external audit on an annual basis, which covers internal financial controls. This is turn improves the reliability of the financial reporting system.

From the above discussion, it is clear that internal financial controls lead to:

1. Sound financial procedures and information through development of procedures, establishment of controls and monitoring of accounting activities: for example, internal audit explained above. This in turn will ensure achievement and maintenance of profitability.

2. Efficient operations: for example cost budget explained above.

3. Integrity of financial and accounting information: for example, external audit explained above.

4. Ensuring that financial systems are in line with the generally accepted financial control standards i.e. with the financial reporting framework: for example, a pharmaceutical company which undertakes research and development work will have financial controls in the area of research and development, which will involve monitoring of the activities in this area in order to ensure that the development cost which is reported adheres to the financial reporting framework.

5. Integrating financial management to support the organisation in decision-making, accountability and transparency.

Example

While conducting the audit of an organisation, the auditors will carry out an assessment of the internal controls in all areas / activities e.g. procurement, sales, cash operations, banking operations, production, quality control, planning and so on. The auditor will test the internal controls in all the areas and then form an opinion regarding the truth and fairness of the financial statements.

6. Protection of organisation's resources from loss or fraud.

2. State and explain the meaning of effective internal financial controls and internal controls. [Learning Outcome c]

2.1 Meaning of effective internal controls and internal financial controls

An **internal control system** is said to be effective if it enables an organisation to achieve its objectives, which include:

Effective and efficient operations (including risk management);
Accurate and timely financial reporting and
Compliance with all relevant laws and regulations

Management appoints auditors to confirm that the internal control system is operating effectively on a continual basis. Auditors are responsible for assessing whether the system has been properly designed and whether it is working effectively.

If auditors find any weaknesses or operational lapses in an internal control system, they are required to report these (with their recommendations for improvement) to either the audit committee or the board of directors.

Management is ultimately responsible for approving and implementing any changes to the internal control system. The division of responsibilities helps to maintain the system of checks and balances that lies at the core of good corporate governance.

Example

While performing an internal audit of accounts receivables, the internal auditor needs to ensure that the accounts receivables on a particular date reconcile with the accounts receivables at the beginning of the year, taking into consideration the total amount of billing made and the amount collected with respect to the receivable accounts under consideration.

If the balances reconcile, it gives him some assurance about the effectiveness of the internal control of the receivables. In order to be more confident about the effectiveness of the internal control system, an internal auditor may carry out an ageing analysis of the receivable accounts with large outstanding amounts.

An **effective system of internal controls (and internal financial control)** ensures:

1. Avoidance of fraud, errors, wastes and inefficiency

Internal controls involve **control over losses** that may arise due wastage, fraud, carelessness of staff, and unforeseeable events such as fire, earthquakes, riots etc.

Example

Silverline Engineering manufactures engineering items. Each quarter, the production department generates “input-output” reports for its moulding machine. The company’s internal control system requires that production reports are generated for all its machines. This report is prepared to ensure that the actual input-output ratio of each machine matches the capacity of the machine.

For example, assume that the moulding machine has a prescribed input output ratio of 10:9. During the period 1 April 20X9 to 30 June 20X9, the output from the machine was 320,000 and the input was 400,000.

Therefore the actual ratio was 10:8. This is unfavourable for the entity. This report will inform management that the company has suffered losses due to the inefficiency of its moulding machine. Management will take up this matter with the manufacturers of the machine or the maintenance department so that future losses can be prevented.

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2. **Maximum accuracy of all records, data and statements** which bring in **accuracy of policy decisions.**

Example

Continuing the previous example of Silverline

Silverline has the following policy for making wage payments:

All employees swipe identity cards while entering and leaving the factory premises. This is further verified by the security guard who is present. Each month, a report is taken from the system and employees' attendance is recorded in the wage sheet. The wage sheet is prepared by an official of the personnel section.

The company has a personnel policy wherein all the rules for attendance, payment of wages and so on are mentioned. The computer system also generates an exception report. This report shows whether any change has been made to the master information relating to basic salary and various allowances of all employees each month.

The wage sheet is verified by the accounts department along with the exception report and the authorisations for the changes to the master file. This system will ensure that the records and statements relating to wages are accurate and also in accordance with management policies. This will, in turn, give management and the auditors, confidence in the information relating to wages in the financial statements.

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3. **Enabling auditors to determine the degree of reliance** they can place on the various systems. This will enable the auditors to assess the correctness, truth and fairness of the financial statements.

Example

While conducting the audit of an organisation, the auditors will carry out an assessment of the internal controls in all areas / activities e.g. procurement, sales, cash operations, banking operations, production, quality control, planning and so on. The auditor will test the internal controls in all the areas and then form an opinion regarding the truth and fairness of the financial statements. In the example given above, the auditors conducted an assessment of the internal audit systems with respect to wages paid.

Their assessment showed that the system did not have any irregularities. Therefore the auditors can be reasonably assured that they can rely on the controls relating to wage payments and that this in turn provides reasonable assurance that the financial statement figures relating to wages are true and fair and contain no material misstatement.

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4. **Informing management about weaknesses detected in internal controls so that corrective action** can be taken.

Example

Continuing the example of Silverline Engineering,

The internal auditor prepares a report each quarter. The irregularities in the area of the input output ratio of the moulding machines are reported by the auditors. This will enable management to take corrective action to prevent irregularities in the future.

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5. **Enabling planning of the audit**

A study of the internal control activities enables the auditors to **plan the audit** and to **determine the nature, timing and extent of tests to be performed.**

(a) The auditors will be more concerned with the controls which affect the financial statements of the entity. For example, an auditor will be less concerned with the maintenance of records showing the details of the customers who have contacted salesmen as this is a control which will not affect the financial statements of the entity. The auditor would, however, be more concerned with the controls in the areas of expenses, income, assets and liabilities, as these controls directly affect the financial statements.

(b) Businesses are often large and complex. Therefore it is not possible for the auditors to check all the transactions in detail, and so auditors depend on internal controls in the various activities of the entity. The study of the internal control systems will enable external auditors to determine the extent of testing to be carried out so as to ensure that there is no risk of material misstatement.

Example

While testing the internal control in the area of procurement, the auditors of Stars Ltd noticed a number of faults such as non-authorisation of purchase orders and the deployment of purchase department staff in the receipt section on some days. This forced the auditors to increase the sample size so as to form a proper opinion on the financial statements of the entity.

While testing the internal controls in the area of sales, the auditors observed that the receivables ledger was not properly maintained i.e. it was incomplete and also not properly recorded. The auditors asked the company to record all the transactions properly. In addition, they decided to obtain direct confirmation of balance from the customers.

The above testing will enable the auditors to ensure that the financial statements are reliable and accurate.

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6. Understanding the components of internal control

While planning the audit, the auditor must understand the various components of the internal control so as to:

- Identify the types of potential misstatements.
- Consider the factors that affect the risk of misstatement.
- Design effective substantive tests.

Example

Continuing the previous example of Stars Ltd

The auditors of an entity are required to state whether the financial statements present a true and fair view of the financial status of the entity. In the process, the auditors will find out all possible areas which could affect the accuracy of the financial statements.

In the previous example of Stars Ltd, the auditors understood the entire internal control system for purchases and identified that in the area of purchases there is a potential risk of misstatement since all the purchases were authorised and proper segregation of duties was not carried out.

Therefore the auditors decided to increase the sample size to ensure that the financial statements reflected a correct picture of the financial status of the entity.

Example

Examples of efficient internal control are:

1. **Safety and security of all assets:** equipment, inventories, cash and other property are secured physically, counted periodically, and compared with item descriptions shown on control records.

2. **Internal checks:** one person checks another person's work

3. **Internal control manuals:** entities prepare manuals which contain descriptions of how the various processes function, who does what and when, and the systems of internal control

4. **Segregation of duties:** duties are divided, or segregated, among different people to reduce the risk of error or inappropriate actions.

5. **System of authorisation:** the level of authority for all important transactions and processes is identified and each transaction is authorised before moving to the next stage of the process

6. **Performance review:** management undertakes comparison of different sets of data (comparing actual with the budgets, forecasts and prior period items) to determine whether the financial statements indicate some irregularities.

The primary role of the internal auditors tends to be to measure and assess the effectiveness of internal controls, whereas the main role of the external auditors includes the assessment of the adequacy of the accounting system and the control environment as a basis for the preparation of the financial statements, in addition to providing assurance on the financial statements. Therefore external auditors focus more on testing internal financial controls rather than operational internal controls.

2.2 Effective internal financial controls

Effective internal financial controls enable entities to limit costs in accordance with budgets, through the use of cost budgets and variance analysis. It also enables entities to decide the amount of budget which should be allocated to different areas of the company or project. Effective internal financial controls also enable entities to set up good financial and accounting systems through introducing procedures which ensure that management has correct, accurate and relevant financial data to ensure sound decision-making. A sound and effective system of internal financial control can therefore improve the integrity of the financial statements.

From the above, it is clear that efficient internal controls improve the controls in all areas of the entity's operations, including financial controls.

2.3 Benefits of effective internal controls and financial controls

Effective internal control system (including risk management) brings about multiple benefits to an organisation.

These include:

1. Allowing an organisation to **proactively identify** and therefore **respond to business risks** quicker (e.g. an organisation expecting a significant portion of its sales to come from exports decides to take steps to protect itself from exchange rate risks).

2. Allowing an organisation to **safeguard** both its **tangible assets** such as plant and machinery and its **intangible assets** such as patents and trademarks (e.g. an organisation implements a policy of having all its valuable assets insured).

3. Forcing an organisation to **maintain proper records** to ensure that financial reporting is timely and accurate (e.g. an organisation implements a policy that the accounting department will produce SOFP and SOCI on a monthly basis).

4. Helping an organisation to **comply with all relevant laws and regulations** (e.g. an organisation implements monthly checks to ensure all taxes are paid)

5. Improving the integrity of the financial statements.

Test Yourself 2

Your firm has recently been appointed as auditor to Boma Ltd, a private company that runs a chain of small supermarkets selling fresh, frozen food, canned and dry food. Boma Ltd has very few controls over inventory because the company trusts local managers to make good decisions regarding the purchase, sale and control of inventory, all of which is done locally.

Required:

What reasons would you give to management as to why inventory should be safeguarded and what recommendations will you make to management to safeguard Boma Ltd's inventory?

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3. Identify and explain the business, reporting and compliance objectives supported by internal controls.

[Learning Outcome d]

3.1 Objectives of business supported by internal controls

1. Business objectives

Business organisations are formed to satisfy the following objectives relating to carrying on business activities:

(a) Economic objectives: Business organisations are basically formed to meet the economic objective of making profits. This relates to the money earning capacity of a business, profit making, creating and maintaining customers, innovations and developments. Profits can be earned not just by selling the entities' products at a profit, but also by carrying out the various activities and processes economically, efficiently and effectively i.e. by saving time and also achieving economies of scale.

(i) Economy: implies the principle of prudence i.e. the least possible cost should be incurred to fulfill any need.
(ii) Efficiency: implies the maximisation of the output-input ratio i.e. output per unit of input should be maximised.
(iii) Effectiveness: focuses on the achievement of the desired objectives through the utilisation of available funds. It considers what the proper role of an organisation should be.

Effective internal controls aim to:

- Control costs
- Avoid wastages
- Prevent and detect fraud and errors
- Include controls on financial budget, allocation of costs to different areas and various expenses
- Minimise the company's business risk
- Ensure the continuing effective functioning of the company
- Confirm that the company complies with relevant laws and regulations
- Create a market by attracting customers (e.g. by providing genuine products and services to its customers, acting ethically with customers etc. so that customers will continue to support the entity)
- Include internal controls in the area of research and development by supporting improvement in technology which will then improve the final product, and ensure that expenses incurred in this activity, which are Normally substantial, are kept under control.

(b) Social objectives: these objectives relate to the responsibilities of a business entity towards the society and include:

- Providing employment to the society
- Providing quality goods / services at affordable prices
- Ensuring fair returns to investors
- Participating in society development
- implementing various environmental policies in order to manage the environmental and social issues relating to different areas (e.g. pollution can be reduced by offering incentives internally as well as externally, waste is minimised by offering waste disposal services to customers, environmentally safe substitutes are used in products).

An effective internal control in this area ensures that the social objectives are met efficiently:

Example

1. Duties are segregated among staff such that all **goods** which are manufactured are tested by an official from the quality department to confirm that they **meet the quality requirements** pre-established by the entity. Thus, an efficient internal control system enables the entity to provide superior quality goods to its end customers.

2. Efficient internal controls ensure **avoidance of anti-social practices** like fraud, money laundering etc. by introducing internal checks in all activities so that fraud is not just prevented, but also detected at an early stage.

3. Efficient internal controls include choosing employees for jobs based on the job requirements relating to qualifications, experience and skills and also providing on-the-job training. This meets the social objective of providing employment and also **choosing the best persons for each job**, which in turn will ensure efficient operations.

3.2 Reporting objectives supported by internal controls

1. **Internal controls are incorporated into the design of all business processes as a matter of course. The controls are designed to mitigate business risks. Shareholders,** as owners, **require assurance** that the internal controls system **ensures safeguarding** of their **investments.** Therefore Corporate Governance compliances suggest that the board of directors to **conduct a review of the effectiveness** of the **internal controls** and **risk management** and **report their findings to the shareholders.**

2. **Need** for **adequate information flows** to **management** for the **purposes** of the **management of internal control and risk**

(a) Information on internal control and risk enables the board to monitor the performance of a company on critical matters like legal compliance, performance against targets and effectiveness of existing controls.

(b) One of the functions of the board is to take strategic decisions relating to allocation of the most efficient and effective resources. This decision is based on the information relating to business impact of operational controls and risks. Therefore non-availability / incorrect information on internal control and risk would mean wastage due to improper allocation of resources.

(c) Furthermore, accurate information on efficiency and effectiveness of internal control systems will enable the board to provide this information to the external stakeholders such as the shareholders. Information on the internal control systems, levels of compliance with systems, improvement measures required to be taken etc. need to be accurately communicated to the board.

Therefore, a sound system of internal controls must also include monitoring of the controls on a regular basis. Furthermore, as part of the **monitoring process, the board and management** should receive **reports which provide information on the progress made towards achieving the business objectives and managing the risk**.

These reports may be in the form of MIS reports, internal audit reports etc. and should enable management to identify and manage risks. The **reports** must **be received from different sources** so as to facilitate the review of the internal control systems.

3. Responsibilities of the board towards internal control systems

Sound corporate governance practices suggest that the board of directors report on controls. It suggests that:

(a) The **board is responsible for the company's internal control systems.**

(b) The board should **explain that the internal control system:**

(i) Is **designed to manage** rather than eliminate the **risk of failure** to **achieve business objectives**
(ii) Can only **provide reasonable** and **not absolute assurance** against **material misstatement** or loss

(c) The board is required **to summarise the process of reviewing the effectiveness of the internal control systems**.

(d) If the annual report specifies any significant problems, the **board** is required to **disclose the process applied to deal with the internal controls relating to the significant problems**.

(e) The board should **disclose** that, during the review period, the **company had an ongoing process in place to identify, evaluate and manage the significant risks faced by the company.**

(f) The board should **disclose** that the **ongoing process was reviewed** on a regular basis and was found to **comply with the provisions of the corporate governance code**.

(g) The board should ensure that its disclosures provide meaningful, high-level information and do **not give a misleading impression**.

4. Annual review of the effectiveness of the internal control systems should be conducted by the board. The same needs to be reported to the shareholders.

(a) The review process includes the following points:

(i) The **board** should **satisfy itself that the company has a system of internal controls, which ensures effective monitoring on a continuous basis**. For example, the board will regularly review the audit reports of internal auditors.

(ii) In addition, the **board** is required to **carry out an annual assessment of the internal controls**.

(b) The board's annual assessment should consider the following factors:

(i) The changes in the nature and extent of significant risks, and the company's capacity to respond to the changes. The changes to be considered are those which have taken place since the last period of assessment.

For example, if a company has started a new line of business; the company will face the risk of the non-recovery of dues leading to the failure of the new line of business. The board will review whether the company has proper mechanisms to ensure that the risk of non-recovery of dues is managed, e.g. by "sale to customers on cash basis".

(ii) The scope, quality of the management's method of monitoring risks, the system of internal control, the work of its internal audit function (if available) and other providers of assurance.

Example

Crispy Chips manufactures potato chips. The areas of risk are as follows:

Poor quality products
Non-recovery of receivables
High cost of inputs
Damage to the machinery

Management would review whether there exists a system whereby the risks in the areas mentioned above are identified and managed e.g. in the case of "poor quality products", whether a system of monitoring the levels of rejections due to poor quality exists and whether corrective action is taken.

Management would review whether internal control systems in the areas of high risk are effective and also the work of the internal audit.

(iii) The level and frequency of reporting by the management on the internal controls and risk management. For example, the frequency of internal audits reports.

(iv) The frequency of occurrence of significant failures or weaknesses that have been identified at any time during the review period and their impact on the financial statements of the entity.

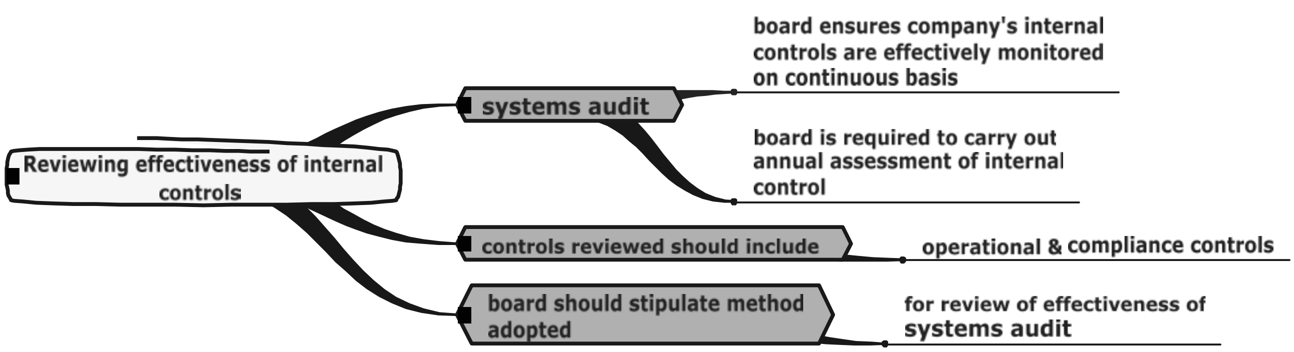
(v) The effectiveness of the company's public reporting processes. For example, whether the financial results published every quarter are authentic.

(c) The **controls which are to be reviewed** should include **operational controls and compliance controls**.

(d) The **board** should **spell out the method adopted to review the effectiveness of the internal controls**.

The method includes the scope of internal audit, the frequency of reports received from management and the method of assessment of the effectiveness of the controls. Hence, to support its assessment regarding internal controls, the board must be provided with documentary evidence.

SUMMARY



5. The reporting objectives of an entity

These include ensuring open communication between management and the board on matters relating to risk and control. This will be possible if there is proper documentation of the board's statement on internal controls in the company's annual report and accounts. To do so, the scope and frequency of the reports it receives and reviews need to be decided by the board.

6. Management and the board must receive **information** which has the following **characteristics**:

(a) The information is related to progress against business objectives and the related risks.

Example

Childcare Medical is a provider of medical services. Its business objective is to provide the highest quality services. The administration manager handles all complaints relating to the quality of services, which are recorded in a register. When a complaint is recorded, the administration manager is contacted and preventive measures are undertaken to ensure that the problem does not recur.

The manager prepares a summary of the complaints received and the actions taken to prevent their recurrence and this information is communicated to the trustees in their monthly meeting. Therefore management is given information which relates to the business objectives of the company.

(b) The **information is of high quality as it is needed for decision-making and management review purposes**.

Example

Continuing the above example of Childcare Medical

Childcare Medical has another business objective which is to provide prompt services to its patients. In this connection, the manager has received several complaints that the company could not attend to patients on time due to a shortage of ambulances. The manager informed the BOD / trustees of this fact so that they could decide whether or not to purchase more ambulances.

The information may be obtained from inside the company and from outside the company. This internal and external information could include performance reports, indicators of change and qualitative information such as information on customer satisfaction, employee attitudes etc. In short, information can be gathered from numerous sources and incorporated into management reports.

Example

Examples of information which can be gathered are as follows:

1. Periodic information (monthly, weekly, daily production reports)
2. Comparisons between actual and budgeted results, with comments on variances
3. Minutes of departmental team meetings
4. Information from external sources (for example, literature on other businesses' performances)

(c) The information is timely.

Example

Copiers Ltd manufactures a variety of photocopier machines. Two years ago, the company launched a new machine which was an innovation. The company became a market leader for this brand of photocopier machine. During the year 20X7, the company budgeted to sell 3,500 machines. The company has two imported machines which are used to make the copiers.

In June 20X7, one of the machines suddenly broke down. The company was informed that they would have to purchase a new machine. The vendor informed the company that the machine would be available only after three months. Due to this delay the company was not able to meet its commitments towards its customers and faced heavy liquidated damages. The manager located a vendor who had a similar machine and could carry out the operations of the machine. However, the costs of outsourcing would be double the cost of the machine.

The information about the break-down, liquidated damages and outsourcing was informed to the senior managers immediately, so that the company could take a decision to either pay the liquidated damages or to outsource the operations of the machine. Therefore the information was timely.

(d) The company can set up its own policy on the timeliness of reports.

Example

(i) **Significant** information must **be made available to management immediately** so that an appropriate decision can be taken by management.

Such information could relate to:

- Areas where there is a significant risk due to failure of the control systems such as heavy pilferage from the stores due to inadequate security of the inventory; or
- Areas where major changes have occurred such as the entry of a new competitor

(ii) **Information which does not indicate any significant changes to the risk faced** such as internal audit reports which do not contain any failures in the control systems, or the minutes of the risk committee meeting wherein no significant observations were discussed, **can be reported to management on a quarterly basis,** after the audit committee or risk committee meetings have been held.

(e) The information is relevant and complete. For example, a shipping company would require information relating to issues with ports, maritime safety issues, emergent risks, accidents etc.

Example

Continuing the above example of Copiers Ltd

The information given to management must be relevant since it is needed by management to take decisions relating to the achievement of the business objectives of the company. If, on the other hand, the company faces a minor problem due to which a machine did not operate for three hours on one day, such information may not be relevant.

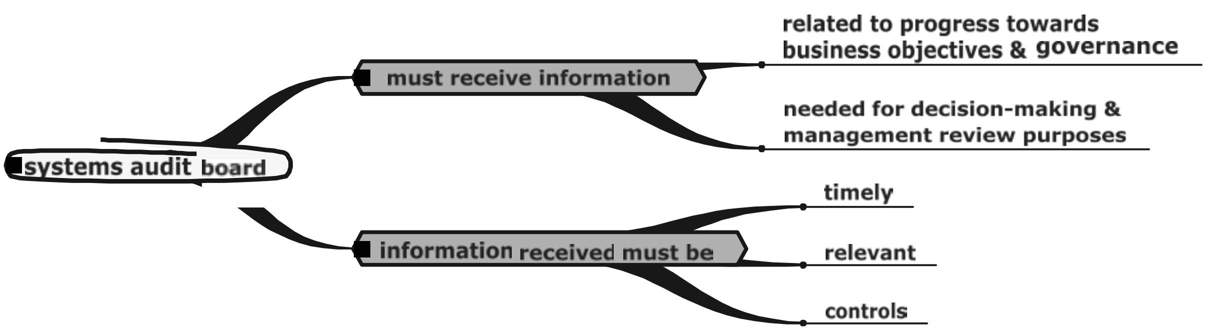
(f) The information is reliable (i.e. trustworthy, truthful and clear)

Example

Continuing the above example of Copiers Ltd

The information about the machine breakdown, liquidated damages and the outsourcing which is submitted to management must be reliable i.e. the information must be supported by all the relevant documents such as the machine breakdown report, the vendor's quotation and the statement of liquidated damages.

SUMMARY



(g) Other points

(i) Management control and effectiveness will suffer if information is irrelevant, delayed or excessive.

(ii) Information which is significant, e.g. reports on the internal controls submitted to the senior management, must be formal i.e. in writing. This will ensure that relevant information relating to risks and weaknesses in the internal controls is brought to the attention of management and the operations manager who is responsible for ensuring controls in that area of business.

(iii) The information provided must be a mixture of both objective and subjective information. For example, a budget will contain forecasting information, which is subjective and also data containing financial information, which is objective.

(iv) Information must have qualitative and quantitative details. For example, a budget variance report containing the variances of sales quantity and sales value.

(v) As an aid to data communication and making numbers 'work', the following seven presentation tips need to be followed wherever practical:

Drastic rounding by eliminating obscurities
Columns instead of rows which will make the data easier to read
Ordering by size which will make the data easier to understand
Row / column averages as a focus which will give benchmarks
Verbal summaries which will highlight the important facts
'Big' numbers at the top which will be easier to read
graphs for better effect

SUMMARY

Responsibilities of the board towards internal financial controls

Reviewing the internal financial controls of the company

The audit committee should review the company's internal financial controls i.e. the systems established to identify, assess, manage and monitor financial risks.

For example, for companies which have a high percentage of export sales, the audit committee will review whether the company has implemented the procedure of taking forward exchange contracts on all exports, so that the risk of loss due to fluctuations in foreign currency is avoided.

3.3 Objectives of compliance supported by internal controls

Some of the indications of efficient internal controls include compliance with laws and regulations (labour laws, statutory safety requirements set by government agencies, etc.) and conduct of entities' operations in accordance with entity's policies (like authorisation of operations, transactions, complying with quality requirements relating to manufactured goods etc.).

Entities appoint internal auditors to conduct compliance audits at periodic intervals to confirm that the entity has complied with laws, and operations are in accordance with the entity's policies. Internal auditors are appointed by audit committees.

Therefore, internal audit reports are provided to the audit committee. If non-compliances are reported, it implies that the entity has not complied with laws or not adhered to the entity's policies.

This matter will be reported by the audit committee to the management and corrective action will be carried out by the operations team. Thus, it will help to bring about an improvement in the effectiveness and efficiency of the entity's operations.

Test Yourself 3

The following are the MIS reports made available to the board members of Mars Ltd each month:

Financial statements including the company's statement of financial position and income statement
Production (quantity) report
Sales report (quantity) report
Purchase (quantity) report
Report of deviation in internal controls - from each of the departments
Reports of internal auditors discussed in the audit committee

The management feels that information systems must produce reports containing operational, financial and compliance-related information that make it possible to run and control the business.

Required:

In your opinion, is the information provided to the board sufficient? Is there any other information which needs to be provided to the board?

Answers to Test Yourself

Answer to TY 1

In the process of setting up the credit policies for its dealers, the company will have to decide:

1. Whether the dealer is creditworthy and a reliable payer;
2. The credit limit and the discount which can be extended to the dealer;
3. The settlement period; and
4. Fundamentally, how the company rates the dealer in terms of contribution to be gained from sales

The following factors need to be considered before setting the credit limits:

(a) Decisions relating to all the above points can be decided only by the team of credit manager.

(b) Decisions to be taken will be based on the attitude of the company towards doing business with the dealers. If the company is conservative, it will set very tight credit limits and vice versa. If the company is in need of sales it may take a greater risk. This does not require a change to the system; merely a change to parameters.

(c) The company will have to review the environment and the customer sales and payment experience and, on the basis of this review, decide the standards or settings, i.e. dealers who have recorded good sales in very tough competitive locations can be given better limits and dealers who have a good record of paying dues may also be extended good limits.

Answer to TY 2

Reasons for safeguarding inventory

(a) In the given case, the inventory is of perishable nature. Hence, if it is not well-managed it may result in:

A breach of health and safety regulations which may result in fines or even closure of the supermarkets.
Wastage of inventory leading to excess cost for the entity.

(b) Again sales, purchase and custody of inventory is in the hands of local managers, and as there are few controls they or their staff might misappropriate inventory.

(c) Supermarket inventory is very easily stolen either by staff or customers even where it is well controlled, so there are high risks when it is not controlled.

Safeguards for inventory

(a) An integrated system should be introduced across all supermarkets that link sales, purchases and inventory records. This would enable the company to have:

An overall view of the inventory which is held at any particular time.
A central order system which would reduce the scope for theft. It would also take control away from local managers.

(b) Regular and continuous inventory counting should be carried out at each supermarket together with prompt update of inventory records for discrepancies found and investigation of the reasons for the discrepancies.

(c) Spot checks of inventory should be carried out by head office personnel.

(d) Gross profit percentages for the different types of food will be well known and stable. This will allow a reconciliation of sales and cost of sales.

(e) Closed circuit TV should be installed in the shops and their store rooms.

Answer to TY 3

It is not sufficient that the information provided to the board contains operational, financial and compliance-related information. The other elements of the information are:

(a) The information must be timely. The information must include a budget variance report which points out variances between budgeted income and expenses and actual income and expenses. This will enable the company to understand the risks and take timely corrective / preventive action.

(b) The information must provide some early warning of the potential problems which the company could face.

The MIS report must include:

Information on employee turnover: This will enable the directors to take timely action. For example, if the company faces a high turnover in the production department, this information must be shared with the board immediately so that the board can take action to make new recruitments so that production will not be hampered.

Information on customer satisfaction: This will ensure that the directors are informed in advance of impending problems related to customer satisfaction and can therefore take suitable corrective action.

Information about employee attitude: This will ensure that the directors receive information relating to employee unrest in advance. So they can make contingency plans to deal with the situation.

Quick Quiz

1. Internal control provides a reasonable assurance regarding the achievement of the objectives in the following categories:

   (i) Efficiency and effectiveness of operation
   (ii) Reliability of financial reporting
   (iii) Compliance with applicable laws and regulations
   (iv) Financial statements being free from fraudulent financial reporting

   A (i), (ii) and (iii)
   B (ii),(iii) and (iv)
   C (i), (iii) and (iv)
   D None of the above

2. Efficiency and effectiveness of operations can be achieved by:

   A Complying with all laws and regulations
   B Ensuring that the financial statements are reliable
   C Preventing and detecting fraud
   D Adhering to all management policies and safeguarding assets and records

3. The board's annual assessment of internal controls excludes an evaluation of:

   A The changes in the nature and extent of trivial risks which the company is exposed to, and the company's capacity to respond to the changes
   B The level and frequency of reporting by the management on the internal controls and risk management
   C The frequency of occurrence of insignificant failures or weaknesses that have been identified at any time during the review period and their impact on the financial statements of the entity
   D The effectiveness of the company's public reporting processes

4. Which of the following are not the features of a report on internal controls?

   A The report should be brief, specific, to the point and based on facts and figures
   B An in-depth, cost-benefit analysis should be presented along with each significant recommendation
   C The report should be able to address the objective of the assignment
   D The report should only report on the weaknesses in the internal control systems

Answers to Quick Quiz

1. The correct option is **A**.

Internal control is a process which is effected by an entity's board of directors, management and other personnel.

It provides a reasonable assurance regarding the achievement of the objectives in the following categories:
- Efficiency and effectiveness of operation
- Reliability of financial reporting
- Compliance with applicable laws and regulations

Option (iv) is incorrect as fraudulent financial reporting is an intentional act which is carried out by overriding the controls.

2. The correct option is **D.**

Quality management, quality control, process control and responsiveness to issues will enable businesses to meet customer value propositions and achieve returns. Therefore the efficiency and effectiveness of operation can be ensured by adhering to all management policies and safeguarding assets and records.

The other options are incorrect as complying with all laws and regulations, ensuring that the financial statements are reliable and preventing and detecting fraud will not affect the efficiency and effectiveness of operations.

3. The correct option is **A.**

The board's annual assessment of internal controls includes an evaluation of the changes in the nature and extent of **significant** risks, and the company's capacity to respond to the changes.

The other options are the factors evaluated by the board while conducting an annual assessment of the internal controls. Therefore the options are incorrect.

4. The correct option is **D.**

Positive points should also be highlighted in the report. The auditee should not feel that his achievements are not being appreciated.

The other options are the features of a report on internal controls. Therefore they are incorrect options.

Self-Examination Questions

Question 1

Boko Pumps is a newly set-up small company which manufactures pumps. The company has software which records all inventory, purchases, sales and accounting transactions. Sales orders are received through mail, fax or telephone. The sales orders received are not monitored through the computer software. The software can be used by authorised persons only. The dates of transactions are only recorded in the format (MM/DD/YY) set by the software. The software has a provision through which transactions cannot be cancelled. Transactions can be cancelled only by recording journal entries.

Required:

With the help of examples, explain the types of control procedures which the company must adopt so as to ensure good internal controls.

Question 2

Sober Collections is a garment manufacturing company situated in Tanzania.

The company has procured new ERP software. The board has not reviewed the risks associated with the utilisation of the new software. The company has an internal audit department which is headed by the CIA. The CIA decides the charter based on his assessment of the risks faced by the company.

There is no specific frequency for the preparation of internal audit reports i.e. sometimes reports are prepared quarterly and sometimes half yearly. During 20X6, the company's quarterly results when compared with the audited financial statements showed a fall of 20% in the net profits.

The following are the policies and practices of the company with respect to the evaluation of the effectiveness of internal controls:

1. The board satisfies itself that the company has a system of internal controls, which ensures effective monitoring on a continuous basis.

2. In addition, the board is required to carry out an annual assessment of the internal controls.

During the board's annual assessment, it considers the following factors:

(a) The scope and quality of management's method of monitoring risks, the system of internal control and the work of its internal audit function (if available) and other providers of assurance
(b) The frequency of occurrence of significant failures or weaknesses that have been identified at any time during the review period and their impact on the financial statements of the entity

3. The controls which are to be reviewed include compliance controls.

Required:

Evaluate the methods adopted by the board relating to the effectiveness of the internal control systems of the company.

Answers to Self-Examination Questions

Answer to SEQ 1

Tip

Your answer should include the benefits of the controls recommended.

The various types of controls which the company can adopt can be classified as follows:

1. Voluntary and mandatory controls
2. Financial and non-financial controls
3. Manual and computerised controls
4. Administrative and accounting controls
5. Discretionary and non-discretionary controls
6. General and application controls
7. Preventive, detective and corrective controls

1. Voluntary and mandatory controls

(a) Voluntary controls are controls which are not enforceable by law. In other words, the company lays down the controls so that the business can run smoothly.

Boko should implement a policy with respect to authorisation of transactions and processes such as raising purchase orders, accepting materials from vendors, approving the quality of materials and signing cheques.

The controls in these areas may include the following:

(i) Boko should set limits on who can make purchase orders and up to what amount. The CEO may have a limit of TZS10 million whereas the accountant may only have a limit of TZS2 million.

(ii) The store keeper must be authorised to accept material from vendors. In his absence, the clerk in the department can be authorised to accept the materials.

(iii) The quality engineers and quality manager must be authorised to approve the quality of the raw materials, semi-finished and finished goods of the factory.

(b) Mandatory controls are controls which are enforceable by law. S V should ensure that the company's manufacturing process meets the standards laid down by the pollution control authorities. This will ensure that the company will not have to face penalties due to statutory non-compliance.

2. Financial and non-financial controls

(a) Financial controls are controls which lead to safeguarding of the assets of the company and maintaining and providing proper and reliable financial information. Boko should maintain records of financial information such as purchases, sales, expenses incurred and purchases of non-current assets. The information must be reliable and lead to reliable financial statements. So for example, all sales orders must have a unique sequential reference, to ensure all of the orders are recorded and missing orders can be identified.

(b) Non-financial controls deal with areas which are not directly reported in the financial statements. S Boko should set the following controls in this connection: organisation structure, strategic policies, policies and procedures for various activities of the company such as the company's HR policy. These controls will help the company to achieve its objectives. For example, having an organisation structure will help management ensure that all tasks that need to be carried out are assigned to someone in the organisation chart.

3. Manual and computerised controls

(a) Manual controls are controls which are monitored manually. Boko is a newly set up company which has a manual system of monitoring sales orders i.e. the orders are received by telephone, mail or fax. These will have to be recorded in a register and monitored manually. This will ensure that all orders are fully executed.

(b) Computerised controls are controls which are programmed to prevent, detect and correct errors. Boko has "in built" controls in the software e.g. the software can be used by authorised persons only. This will help to prevent errors. The software has a provision through which transactions cannot be cancelled. Transactions can only be cancelled by recording journal entries. Hence, the software has a provision through which audit trails can be established. This can help to detect errors.

4. Administrative and accounting controls

(a) Administrative controls are controls established to accomplish the objectives of the company. The administrative controls for Boko would include preparing an appropriate organisation structure which should specify the various reporting levels of the company. Responsibilities must be clearly set out e.g. the responsibilities of the purchase department must be entrusted to an appropriate level of authority.

(b) Accounting controls are controls which lead to accurate and reliable financial statements. The accounting controls of Boko should include ensuring that all transactions are supported with appropriate documentation and recorded properly. This will require the company to have policies and procedures for the various activities of the company. So for example, as soon as an invoice is received from a supplier, it is recorded in the payables ledger.

5. Discretionary and non-discretionary controls

(a) Discretionary controls are controls which are based on judgement i.e. based on discretion. The discretionary controls of Boko should include not making purchases from vendors who have a bad reputation in the market and raising sales invoices only at the time of dispatch of goods. This would ensure that the company does not face the risk of purchasing poor quality products.

(b) Non-discretionary controls are controls which are automatically generated by the computer system. These controls cannot be evaded. The non-discretionary controls of Boko include access to software by authorised persons and recording the date of a transaction only in the format (MM/DD/YY) set by the software. These controls will ensure that transactions are properly authorised and recorded according to the requirements of the software.

6. General and application controls

IT controls are grouped under two categories: application controls and general IT controls.

(a) General controls are controls over the environment in which the computer functions. They enable the continued proper operation of information systems by ensuring the effective functioning of application controls. Some of the general controls for Boko should be:

(i) Systems need to be used for authorised purposes only: Boko needs to have a system of password access to the system. This will ensure that the data is not misused or corrupted.

(ii) **Authorised programs need to be used:** Boko must have a system whereby the programs (e.g. SAP) which are run are authorised by the IT department and ratified by the board of directors. This would require maintaining a library of programs which is accessed only with the approval of the librarian. Such a control will ensure that data are processed correctly.

(b) **Application controls** relate to the **processing of individual applications. Applications are the computer programs and processes, including manual processes that will enable Boko to conduct its essential activities.**

Application controls help to ensure that transactions are authorised, complete and accurately recorded. Boko should implement application controls with respect to transactions relating to buying products, paying vendors, accounting for travelling expenses and forecasting and monitoring budgets.

For example Boko can adopt a system of giving access to the purchase module to the purchase manager to raise purchase orders up to an amount of TZS10 million and for amounts more than TZS10 million to the CEO.

The system must ensure that:

(i) Materials are accepted only if they are supported by valid purchase orders.

(ii) Payments are made only if they are supported by vouchers duly authorised by the accounts manager and accompanied with valid goods received notes authorised by the quality department and purchase orders.

(iii) Boko can adopt the system of recording travel expenses as follows:

The company must set limits on the amount of expenses which an employee can claim e.g. TZS100,000 per day
Vouchers should be authorised by the purchase manager.
Vouchers should be supported by a travel expense report (giving details of days of travel and nature of expenses) and bills to support the expense, etc.

7. Preventive, detective and corrective controls

(a) **Preventive controls are controls to prevent errors from occurring.** The preventive controls for Boko should include preparation of goods received notes only if purchase orders are available and authorisation of purchase orders, salary sheets, overtime sheets, etc. by appropriate personnel.

These controls will ensure that the purchase transactions recorded are physically received, unnecessary purchases are not made by the company and the salaries and overtime paid have been correctly calculated and made to real people who have worked the hours stated.

(b) **Detection controls are controls which enable detection of errors.** The detection controls for Boko should include bank reconciliation statements and surprise cash counts. For example:

(i) A monthly bank reconciliation will ensure that Boko will be able to detect any transactions relating to the bank which have either not been recorded or are wrongly recorded. The company can then take the required corrective action.

(ii) Surprise cash verification by persons from outside the accounts department such as the sales executive, purchase manager or administration manager will enable the company to confirm the genuineness of the availability of cash.

(c) **Corrective controls are controls to correct errors.** The corrective controls for Boko should include virus protection for all programs and back-ups of all system programs.

Answer to SEQ 2

1. The annual assessment of internal controls does not include:

(a) The changes in the nature and extent of significant risks, and the company's capacity to respond to the changes. The changes to be considered are since the last period of assessment. This is because the company has newly set up ERP software; however the board has not considered the significant risks faced by the company due to failure of the software.

(b) The level and frequency of reporting by management on the internal controls and risk management. This is because **there is no specific frequency for preparation of internal audit reports i.e. sometimes reports are prepared quarterly and sometimes half yearly.**

(c) The effectiveness of the company's public reporting processes. **This is because, during 20X6, the company's quarterly results when compared with the audited financial statements showed a fall of 20% in the net profits.**

2. The charter for the internal auditors has not been prepared. The CIA decides the charter based on his assessment of the risks faced by the company. Therefore the areas where controls are weak can be ignored by the CIA, either purposely or erroneously.

3. **The internal auditor normally verifies internal financial controls and compliance controls only. However,** the **controls which are to be reviewed** should include **operational controls.**

4. The **board** should **state the method adopted to review the effectiveness of the internal controls**. The method must include the scope of internal audit, the frequency of reports received from management and the method of assessment of the effectiveness of the controls. Hence, to support its assessment regarding internal controls, the board must be provided with documentary evidence.

SECTION B

THE NATURE AND USE OF INTERNAL CONTROLS

B2

STUDY GUIDE B2: COMPONENTS OF INTERNAL CONTROL

Get Through Intro

Internal control is a process through which an organisation provides reasonable assurance regarding the achievement of its objectives. The aim of internal controls is also prevention and early detection of fraud and error.

Even if an entity has very good internal controls, the controls may have certain deficiencies which can lead to errors or misstatements in the financial statements. Therefore the auditor should always be alert. The auditor should make tests of control to assess the internal controls of the entity. In the process of tests of control, the auditor is required to understand all the deficiencies of the controls.

Based on the results of the tests of control, the auditor will assess the risk of misstatement in the financial statements. If the risk of misstatement is high, the auditor will have to alter the audit plan and audit strategy to carry out more extensive controls. This will provide him with reasonable assurance of the truth and fairness of the financial statements.

Consider Eyetex Co, an eye hospital. The auditors of the company verified the internal controls for expenses. The internal control system requires that all expenses are certified by the chief maintenance manager for the nature of the expense, i.e. capital or revenue. During 20Y0, the hospital incurred very high maintenance expenses. The tests of control indicated irregularities in the control system i.e. the revenue expenses included the purchase of equipment which added to the efficiency of the hospital.

These expenses which were to be capitalised, were expensed out so as to project a low income and thereby reduce the tax burden of the company. Furthermore, these bills were also certified as revenue expenses by the chief maintenance manager. Therefore, even though the company had a good internal control system in place, the system was deficient. This allowed the company to carry out fraudulent practices.

Because of the fraud, the auditors assessed a very high level of risk of misstatement in the financial statements. So the auditors modified the audit plan with respect to maintenance expenses. They decided to verify all expenses under this accounting heading which exceeded TZS5 million, so that they could have reasonable assurance of the truth and fairness of the financial statements.

Learning Outcomes

a) State and explain the main components of internal control including, the control environment, risk assessment, control activities, information and communication and monitoring activities.
b) Identify, state and explain the limitations of internal controls.

1. State and explain the main components of internal control including, the control environment, risk assessment, control activities, information and communication and monitoring activities.

[Learning Outcome a]

Definition

Internal control consists of the following components:

- The control environment
- The entity's risk assessment process
- The information system, including the related business processes, relevant to financial reporting and communication
- Control activities relevant to the audit
- Monitoring of controls

IFAC Glossary of terms

1.1 Components of internal control

1. Control environment

Definition

Control environment: includes the governance and management functions and the attitudes, awareness and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity.

IFAC Glossary of terms

The **control environment includes** elements such as **management's integrity and ethical values, operating philosophy, commitment to organisational competence** and so on. Each of these elements is explained in the paragraphs below.

The auditor should obtain an understanding of the control environment. For obtaining this understanding, the auditor should evaluate whether:

(a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behaviour; and

(b) The strengths of the elements in the control environment collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. For example if an entity has well designed internal control systems but if the management of the entity is not serious on implementing matters recommended by the internal auditors, it implies that the auditors' evaluation of the control environment must take this into account. Auditors are required to analyse the control environment so that it will give them assurance that the entity is ethical and therefore the financial statements are likely to be true and fair.

2. Tests of the control environment will consist of a combination of procedures mentioned below:

- a review of relevant documentation of the design, inquiries of management and employees
- direct observation

Each of the above procedures is explained below.

(a) Inspection of relevant documentation of the design, inquiries of management and employees

Example

The auditors of Goldline Engineering verified the copy of the personnel manual which spelt out the following:

- Staff rules
- Levels of authority and responsibility
- The nature of the various jobs
- The nature of training for each job
- The periodicity of training to be given

Their review gave the auditors reasonable assurance that the entity is ethical and therefore the information given in the financial statements is likely to be true and fair.

(b) Observation

Example

Continuing the previous example of Goldline Ltd

The auditors of Goldline Engineering observed that the payment to suppliers was always made within the credit period received by the entity. What is more, the entity also ensured that all cheques issued were always honoured by the bank. The above policies were not documented. However, by observation, the auditors could gauge the ethical practice of the entity. This will give the auditors assurance that the entity follows ethical practices and therefore the financial statements are true and fair.

Audit evidence on the control environment may not be available in documentary form, especially in the case of small entities. In such a situation, the observation and discussion of management's attitude, awareness and actions would be of importance in assessing the control environment.

The auditor may also consider the management's response to the internal auditor's findings and recommendations relating to:

Identified deficiencies in internal control relevant to the audit,
Whether and how such responses have been implemented, and
Whether they have been subsequently evaluated by the internal audit function.

3. The control environment includes the following:

(a) Communication and enforcement of integrity and ethical values

Maintaining good communication within the organisation and with outsiders, enforcing ethical practices and integrity within the entity will assure the auditors of the control environment. The methods by which the auditor can receive assurance are explained below.

Diagram 1: Testing of communication

A company may point to its code of conduct as documenting its ethical values. However, the mere existence of the documentation is not sufficient to support a conclusion about its operating effectiveness. Management and auditors must also evaluate the effectiveness of the code's implementation.

(b) Commitment to competence

Competence is the **knowledge** and **skill** necessary **to carry out tasks** or **individual jobs.**

Management's commitment to competence will enable the auditors to ascertain that the entity has employed staff who are competent and knowledgeable. Therefore the operations of the entity will be carried out efficiently. This will provide assurance of the truth and fairness of the financial statements of the entity.

The auditor will have to ascertain how management determines:

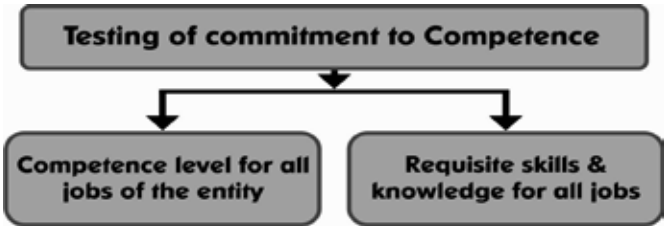
The competence levels for each job of the entity
The requisite skills and knowledge for all jobs of the entity

Example

The auditors of Skyline Ltd wanted to test the control environment with respect to commitment to competence. They checked whether the organisation had a system of defining:

All the jobs in the organisation, and
The knowledge and skills required for each job.

Diagram 2: Testing of commitment to competence



(c) Participation by those charged with governance

The auditors will test whether the attributes of personnel charged with governance include:

(i) Independence from management
(ii) Their experience and stature
(iii) The extent of their involvement and scrutiny of activities
(iv) The information they receive
(v) The degree to which difficult questions are raised and pursued with management
(vi) Their interaction with internal and external auditors

The above tests will indicate whether the persons charged with governance are independent of the entity and thereby the financial statements of the entity are likely to be true and fair.

Example

Continuing the previous example of Goldline Ltd

The auditors of Goldline Ltd collected the above information regarding the members charged with governance. It realised that the members charged with governance did not include a non-executive director. Therefore the members were not independent from management.

This raised doubts about the effectiveness of the control environment.

(d) Management's philosophy and operating style

(i) Management's philosophy and operating style includes the following characteristics:

Management's approach to taking and managing business risks

To test management's approach to taking business risks, it is necessary to understand the nature of business risks accepted, e.g. whether management often enters into particularly high-risk ventures, or is extremely conservative in accepting risks.

If management takes risks, it is possible they may take risky decisions in the financial statements too, or not disclose everything properly.

Management's attitudes and actions toward financial reporting

To test management's attitudes and actions towards financial statements, it is necessary to understand the entity's selection of accounting policies (i.e. conservative versus liberal). For example, an entity's accounting policy of recording assets at historical cost is a conservative policy.

However, an accounting policy of recording fixed assets using the revaluation model would be an example of a liberal accounting policy. If the accounting policies are conservative, the auditor can gauge that the management policies are not towards taking risks.

Therefore the financial statements will be prepared without taking risks so the financial statements will be reliable.

(ii) Management's attitude towards information processing, accounting functions and personnel.

Example

Continuing the previous example of Skyline Ltd

The auditors of Skyline Ltd wanted to test the control environment with respect to management philosophy and operating style.

They tested the following in this connection:

- Whether senior management maintains contact with and consistently emphasises appropriate behaviour to operating personnel.
- Whether the turnover in management or supervisory personnel is monitored and the reasons for significant turnover are evaluated.
- Whether management analyses the risks and potential benefits of venture

The auditors found positive responses on all counts and the auditors thereby received assurance that the information in that the control environment was favourable.

After understanding management's philosophy and operating style, the auditors will learn about management's approach towards risk, the accounting function and personnel.

If the auditor receives positive responses on the above counts, this will enable him to have assurance of the genuineness of the financial statements.

(e) Organisational structure

The organisational structure provides the framework within which an entity's activities for achieving its objectives are planned, executed, controlled and reviewed. The organisational structure of each environment will differ depending upon the size of the entity, the nature of the activities and so on.

Example

Continuing the previous example of Skyline Ltd

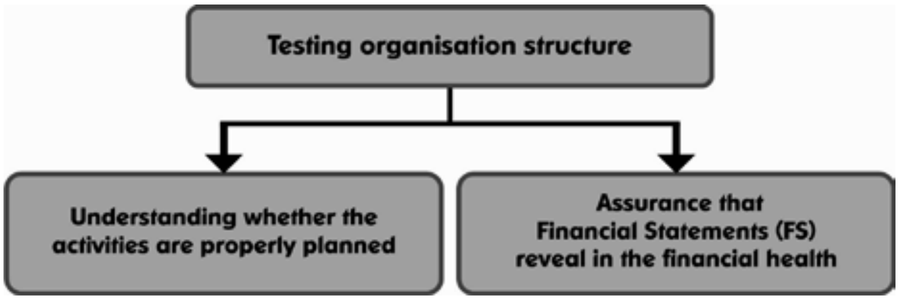
The auditors of Skyline Ltd wanted to test the control environment with respect to organisational structure. They tested the following:

- The entity's organisational structure
- The entity's flow of information
- Whether the entity's organisational structure had the ability to provide the necessary information flow to manage its activities
- The adequacy of the definition of key manager's responsibilities
- The adequacy of knowledge and experience of key managers in light of responsibilities

The auditors noticed that the entity had a well-defined and documented organisational structure and the flow of all documents for its various activities was also well-documented. Further, the functions and responsibilities of key management personnel were well-defined. The auditors checked the flow of documents for all important activities such as purchases, sales etc.

This gave them assurance regarding the truth and fairness of the information in the financial statements.

Diagram 3: Testing organisation structure



(f) Assignment of authority and responsibility

Under this heading **the auditor would test the following:**

- **How authority and responsibility for operating activities are assigned?**
- **How reporting relationships and authorisation hierarchies are established?**

It includes the policies and communications which ensure that all the personnel:

- Are aware of the objectives of the entity.
- Know how their individual actions will contribute to those objectives.

Example

Continuing the previous example of Skyline Ltd

The auditors of Skyline Ltd wanted to test the control environment with respect to assignment of authority and responsibility. They tested the following:

- Employees throughout the entity are assigned authority and responsibility related to their specific job functions.
- Employees are empowered, when appropriate, to correct problems or implement improvements.
- There is a structure for assigning ownership of information including who is authorised to initiate or change transactions.
- There are policies and procedures for authorisation and approval of transactions.

The auditors found that the there was no system of authorising changes in the computer programs. In addition, there was no defined authority that would be responsible for the changes. Due to this, the auditors did not receive assurance regarding the true and fair nature of the information contained in the financial statements.

If the auditor satisfies themselves that the authority and responsibility for operating activities have been assigned, it will provide them with reasonable assurance that the financial statements are true and fair.

(g) Human resource policies and practices

Human resource policies and practices relate to recruitment, orientation, training evaluating, counselling, and remedial actions. In the process of testing the control environment with respect to human resource policies and practices, the **auditor would test the following**:

(i) Standards for recruitment i.e. for jobs involving qualified individuals, whether the company has given sufficient importance to qualifications, past work experience and whether care is taken to employ individuals with a high level of integrity and ethical behaviour.

(ii) Training policies followed by the entity i.e. whether the entity has a defined training policy for all levels of employees.

If the results of testing the human resource policies and procedures indicate positive responses, the auditor can have reasonable assurance regarding the truth and fairness of the information contained in the financial statements.

4. Tests of control

To summarise, tests of control are tests conducted by auditors to gather audit evidence to test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level

Tests of control are performed by a combination of various methods, namely:

(i) Observation: the auditor observes the mail opening procedure of an entity.
(ii) Enquiry: the auditor consults the purchase manager about the method of making capital expenditure.
(iii) Inspection: the auditor checks for the signature of the person responsible for authorisation on the purchase order to ensure that the purchase order is authorised.
(iv) Re-calculation: the auditor re-calculates the sales amount on the sales invoice
(v) Re-performance: the auditor carries out a physical verification of inventory
(vi) Confirmation: the auditor gets a confirmation of balance from the accounts receivables
(vii) Analytical procedures: the auditor computes and analyses the profitability ratios of the client

Tip

You can remember the tests of control with the help of the following mnemonic:

A	**A**nalytical procedures
E	**E**nquiry and confirmation directly from a third party: Inquiry
I	**I**nspection: inspection of records and assets
O	**O**bservation
U	Re-calc**u**lation and re-performance

5. Achieving a good control environment

The existence of a satisfactory control environment is a positive factor. This will reduce the risk of misstatement. Conversely, weakness in the control environment may be a negative factor in the assessment of risk of misstatement.

A good control environment can be achieved by:

Providing discipline when employees act against organisation's values, guidance, and rules.
Adopting control measures to discover violations.

Discovering incidents of violations quickly and punishing the violators justly without delay is likely to help to reduce future occurrences.

Case Study

Ross Transporters is a transport agency. Its main line of business is hiring out its trucks. The owner has employed a manager and an assistant. The manager handles all the day-to-day operations. The manager receives orders from customers, arranges to fulfil the orders and carries out all other functions required for conducting the activities of business. The manager has the authority to sign cheques independently for values up to TZS2 million. All cheques exceeding TZS2 million are required to be signed by the manager and the owner jointly.

The owner normally visits the office every Thursday and supervises the activities. The owner always leaves one blank pre-signed cheque book with the manager, to use in case of emergencies.

Mr. Sharp is the auditor of the company and wanted to test the internal controls which were in existence in the company. The results of the tests of control were as follows:

Lack of segregation of duties

The manager was responsible for all the major activities. He carried out all the activities of receiving the orders, preparing the sales invoices, receiving the payments, maintaining the ledger, making all payments, signing cheques and so on. In the process there was no segregation of duties and ample opportunity for the manager to commit fraud.

Continued on the next page

Improper policy and procedures

The manager was given a pre-signed cheque; therefore there is an opportunity for him to write large cheques to himself.

Non-implementation of the company policies and procedures

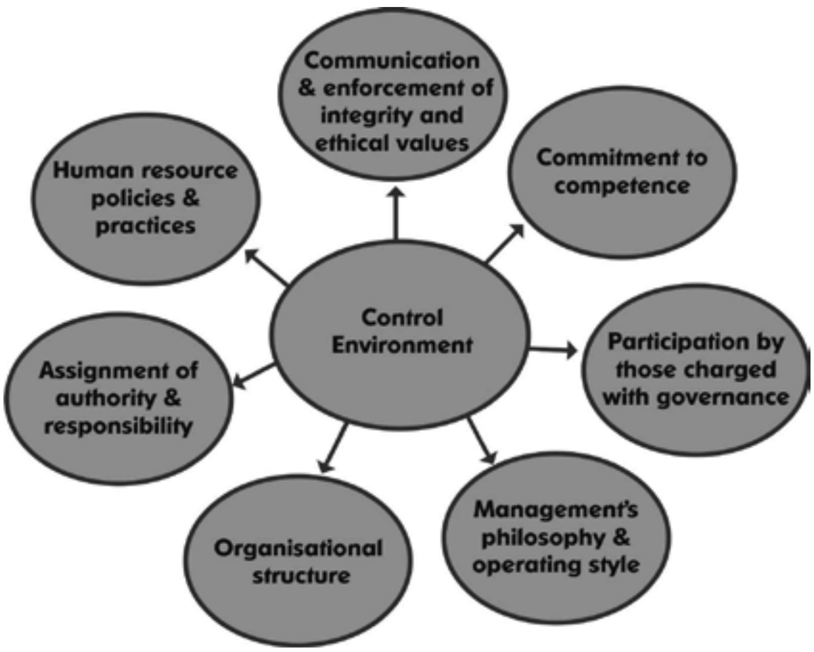
While verifying payments, the auditor noticed that, wherever payments were to be made for amounts exceeding TZS2 million, the sum was split into several, each for amounts up to TZS2 million. This allowed large amounts to be paid by the manager.

From the above observations, the auditors concluded that, in view of the irregularities in the internal controls of the company, they would verify a larger number of transactions so that they could get reasonable assurance about the truth and fairness of the financial statements.

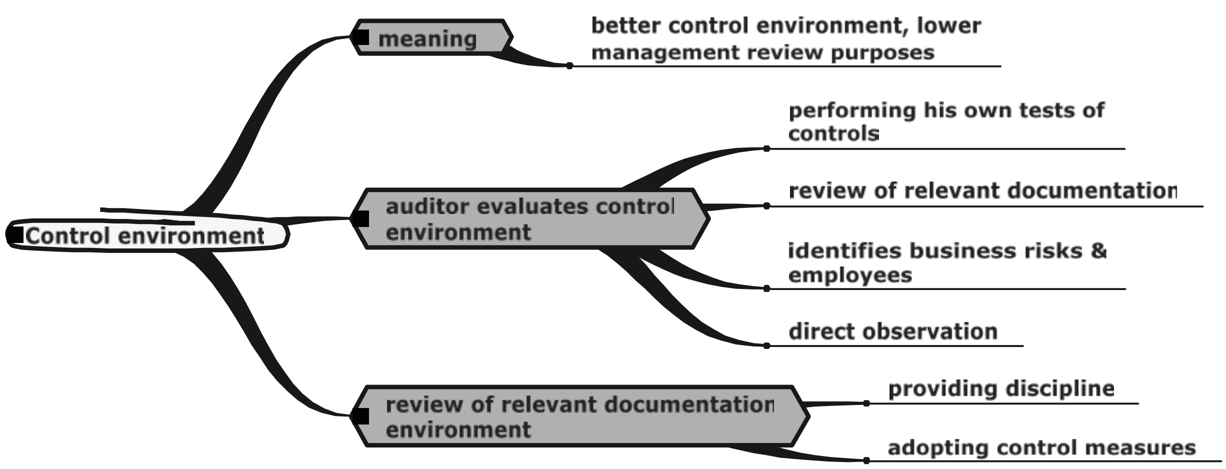
Tip

In the exam, if you are asked to comment on the strength of the control environment, you need to understand all the aspects of the control environment (which were explained above) in the scenario and then assess the environment.

Diagram 4: Components of control environment



SUMMARY



1.2 The entity's risk assessment process

Definition

A component of internal control that is the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.

IFAC Glossary of terms

Diagram 5: Testing of risk assessment process

The steps mentioned above are explained below:

1. **Identification of business risks relevant to financial reporting**

Risks relevant to financial reporting may occur when certain circumstances affect the entity's ability to record, process, summarise and report the financial data consistent with the assertions of management in the financial statements.

Example

Lily Ltd procured new accounting software in January 20X6. The company was not in a position to implement the new software until November 20X6. The accounting data for the period 1 January 20X6 to 13 November 20X6 was not updated online. While testing the accounts payable accounts the auditors noticed that due to the lack of updates to the online ledgers there were many cases where invoices had been processed twice.

This reflected the risk of incorrect balances being recorded in the supplier's ledgers and the purchases accounts. This will affect the assurance of the auditors relating to the information in the financial statements being true and fair.

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2. **The process of estimation** of the significance of the risks, assessment of the likelihood of their occurrence, and decision about actions to manage them can be understood by the following example:

Example

In the steps for testing the internal controls the auditors found that, in 100 cases out of 750, the purchase transactions had been processed twice.

This shows poor internal controls. It also indicates a **risk of overstatement of purchases**. The **auditor decided to increase the sample size** so as to ensure that purchases are not overstated (thereby **reducing the risk of misstatement**) and thereby have an increased **assurance regarding truth and fairness** of financial statements.

If the entity's risk assessment process is appropriate to the circumstances, it assists the auditor in identifying risks of material misstatement.

1.3 The information system, including the related business processes, relevant to financial reporting, and communication

An information system consists of hardware components, software, people, procedures and data. Under manual systems there will be no infrastructure or software. **The information system relevant to financial reporting objectives**, which includes the accounting system, **consists of** the **procedures and records** established**:**

- to initiate, **record, process,** and **report** entity **transactions** (as well as events and conditions).
- to maintain **accountability** for the related **assets, liabilities, and equity.**

According to ISA 315, the auditor should obtain an understanding of the information system, relevant to financial reporting, including the following areas:

1. The **classes of transactions which are significant** to the financial statements.

2. The **procedures, within both IT and manual systems,** by which those **transactions are initiated, recorded, processed and reported in the financial statements.** General IT controls and application controls are the manual and computer controls, which are relevant to a computerised environment.

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

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

5. The **financial reporting process used to prepare the entity's financial statements**, including significant accounting estimates and disclosures.

The classes of transactions which are significant to the financial statements can be understood with the help of the following example.

Example

Continuing the previous example of Goldline Ltd

During 20X5, the main class transactions of Goldline Ltd include the following:

- Sale of finished goods
- Purchase of raw materials
- Employment expenses
- Administrative expenses
- Manufacturing expenses
- Purchase of non-current assets
- Sales of non-current assets
- Transactions of share capital
- Transactions of current assets
- Transactions of current liabilities
- Transactions of loans

From the information system the auditors found out the values of the above classes of transactions.

Under sales, the organisation included local sales and export sales. The percentage of export sales was 40% of the total sales. Therefore both the classes of sales were significant. Under purchases, the organisation included local purchases and import purchases.

The percentage of local purchases was only 2% of the total purchases. Therefore the local purchases are not a significant class of transaction.

The flow of transactions, activities and documents for **purchase of non-current assets** can be understood from the following conversation:

1. Shane from the administrative department, receives a **request (raised manually)** for the **purchase of a bicycle**.	
2. Shane **verifies** that the request Is **authorised** (according to company policy). Is also supported through the **capital budget**.	
3. 'I want to buy this bicycle. Give me details of it in a **quotation**' (raised manually).	4. Harry, Sam and Jerry give quotations stating all the terms.
6. Shane prepares a **comparative analysis of all the quotations**. He prepares the **purchase order (raised through the computer system)** on Harry.	5. Harry tells Shane 'Give me a **purchase order** if you are satisfied'.
7. Shane tells Harry 'All the terms in the quotation are acceptable to me. I have dispatched the purchase order. Please send me the bicycle.'	8. Harry dispatches the bicycle.
9. Mary (from the stores department) **receives the bicycle** and prepares a **goods received note** (**raised through the computer system).**	
10.Shane **records** the receipt of the bicycle in the **asset register (recorded manually).**	11. A few days later Harry sends an **invoice.**
12.Charlie from the Accounts Department verifies the goods received note, Harry's invoice copy and the purchase order. He prepares the **journal voucher (recorded through the computer system**).	
13.On the due date, Jenny (the cashier) writes a cheque for the total amount of the invoice and sends it to Harry along with **remittance advice.**	14.Harry receives the cheque and sends a **receipt** in acknowledgement of the cheque.

The auditors would follow this audit trail in the audit of the **purchase of non-current assets** transactions.

Test Yourself 1

You are the auditor of a small manufacturing company, Dinko, that pays its staff in cash and also by bank transfer and maintains its payroll on a small stand-alone computer.

The control objectives include policies and procedures designed by management to:

Ensure regular and accurate processing and recording of payroll payments
Ensure the physical safeguarding of cash and money held in bank accounts by means of other controls
Prevent and detect fraud and error
Achieve accuracy and completeness of the accounting records
Ensure timely preparation of reliable financial information

Required:

For the payroll department at Dinko, describe the internal control environment and internal control procedures that should be in place to achieve the internal control objectives.

SUMMARY

1.4 Control activities

The **policies and the procedures** which help to **ensure that the management directives are followed** are known as **control activities**. Control activities are **applicable to both IT and manual systems**.

Control activities are to be applied at various organisational and functional levels.

Example

In the example above, for the flow of activities and documents involved in the purchase of a bicycle, the following are the control activities:

Document	Control activity
Purchase request	Whether authorised in accordance with the company policy
Price comparative sheet, quotations from prospective vendors	Whether the basis for the decision is sound
Purchase order	Whether supported by the price comparative sheet, whether authorised in accordance with the company policy
Goods received note	Raised by Mary (i.e. not by Shane, who has raised the purchase order)
Fixed asset register	Independent record is maintained and physical verification of the items in this register is independently conducted every year
Journal voucher	Prepared by Charlie (i.e. not by either Shane or Mary) after verifying purchase order, goods received note and vendor's invoice
Payment voucher	Prepared by cashier

The above table indicates the **controls relating to authorisation, performance reviews, information processing, physical controls and segregation of duties.**

According to ISA 315 examples of specific control activities include those relating to the following:

1. Authorisation

Authorisation is a preventive control. The person responsible for authorisation will inspect the document and also the supporting documents, and satisfy himself that the transaction is appropriate and valid. They then approve it by initialling and dating the document.

Example

A person authorising the payroll will review the timesheet, overtime records etc. of the employees, check the calculations and then authorise the payroll by initialling and dating it.

Every organisation must identify:

All the important transactions and processes which require to be authorised
The level of authority that is responsible for the authorisation

This will ensure that:

Important transactions and processes have the approval of officials decided by the management.
The policies of the entity have been complied with.

2. Performance review

Review of performance is another internal control activity. Management reviews the performance to know whether the results are according to expectations and whether the goals have been met. Wherever there are irregularities noticed in the performance review, management can investigate the reasons for these irregularities and take corrective action.

Performance review includes:

Comparing actual with the budgets, forecasts and prior period items (analytical review)
Relating different sets of data – operating or financial – to one another

This involves comparison of different sets of data to determine whether the financial statements indicate some irregularities.

Example

The following information relates to the wages paid by Air Cool Fans:

	20X5	20X6	Percentage of change
Wages (TZS)	12,500,000	16,500,000	32% increase
No. of workers	180	175	2.77% decrease

The above shows a comparison of the amount of wages (financial) with the number of workers (operational). It indicates that, even though there has been a decrease of 2.77% in the number of workers, the wages have shot up by 32%. This indicates that there may be an error in the data relating to either amount of wages or the number of workers. The control activity reveals that this is an area which should be looked into.

---

3. Information processing

This refers to the **variety of controls** which are **performed** to test the **accuracy, completeness** and **authorisation** of transactions in a **computerised system**.

The controls are grouped under two categories: application controls and general IT-controls

(a) Application controls

Application controls are manual or automated procedures and can be preventative or detective in nature. They relate to procedures used to initiate, record, process and report transactions or other financial data.

Application controls help to ensure that transactions are **authorised**, **complete** and **accurately recorded**.

(i) Authorised: the application controls in a computerised system which ensures that only authorised persons can use the software. For example, accounting software will enable only authorised persons to operate the software by use of a password.

(ii) Complete: the application controls in a computerised system which ensures that transactions are complete. For example, that every hourly paid employee has submitted a time sheet. Sequential numbering of the sales invoice ensures that all the sales are recorded.

(iii) Accurately recorded: the application controls in a computerised system which ensures that transactions are accurately recorded. For example, in the software for calculation of wages, any time sheet showing more than 60 hours worked in a week might be rejected because in that business 60 hours is unusually high.

(b) General IT Controls

Generally, these controls ensure control over data centre, network operations, system purchase, maintenance and change to system software, access security and so on.

For example, only authorised users will be permitted to change the software. The authorised users will be identified in the software, so unauthorised users will not have access to the software.

General controls are the **base for the functioning of the application controls**. **If general controls are effective they will ensure effective functioning of the application controls.**

(c) Physical controls

Physical controls are designed to ensure the **physical security of assets**, and include adequate safeguards such as **secured facilities over access to assets and records**; **authorisation for access to computer programs and data files**; and **periodic verification of assets.**

Example

Examples of physical controls are:

(a) Securing the assets by employing personnel to guard the assets (e.g. security guards in a warehouse)
(b) permitting access to the strong-room of a bank only to authorised persons.
(c) Placing indelible identification marks on non-current assets such as laptops.
Financial statements in respect of assets will be more reliable if the entity has effective physical controls.

---

4. Segregation of duties

These activities include **assigning** the responsibilities of **authorising transactions**, **recording transactions** and **maintaining custody of assets** to **different people.**

Example

For example, in a purchase transaction:

The purchase manager will raise the purchase order.
The storekeeper will receive the goods.
The accountant will record the purchase transaction.
The cashier will make the payment for the purchase.

Segregation of duties is carried out to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

Tip

The mnemonic 'PARIS' will help you remember the control activities.

Physical Controls
Authorisation
Review of Performance
Information Processing
Segregation Of Duties

The auditor should obtain a sufficient understanding of control activities to assess the risks of material misstatement and to design further audit procedures responsive to assessed risks.

The auditors will understand the flow of transactions and activities for various classes of transactions. They will apply selective tests to satisfy themselves that the control activities are appropriate and also in place. If the selective testing indicates that, in many cases, the authorisations of the documents do not follow company policy, this means that there is a high risk of misstatement. The auditors will then revise their audit plan to verify more transactions.

The auditor should obtain an understanding of how the entity has responded to risks arising from IT.

Example

Continuing the previous example of Goldline Ltd

Goldline Ltd, regularly transferred funds from Indo bank to Jina Bank.

While verifying the cash book of Goldline Ltd the auditors noticed the following entry:

Dr	Jina Bank a/c	TZS32 million	
Cr	Indo Bank a/c		TZS32 million

Being entry for transfer of funds from Indo Bank to Jina Bank using internet transfer.

The cheque issued from Indo bank was properly recorded in the Indo bank book. However, the entry for deposit of the cheque in Jina Bank was not recorded in the Jina bank account. Instead it was recorded in the Myna bank account.

The auditors immediately took up the matter with the management. They were informed that the matter was already being attended to by the IT department.

The auditors verify this statement and this gives assurance to the auditors of the truth and fairness of the financial information.

1.5 Monitoring of controls

Definition

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

Monitoring of controls is a component of internal control.

IFAC Glossary of terms

Monitoring of controls involves:

1. Understanding the major types of activities for monitoring internal control over financial reporting.

Example

Truefit is a shoe manufacturer. Some of the activities used by the entity to monitor internal controls were the review of:

- Internal audit reports
- Monthly MIS prepared by the entity
- exception reports generated by the entity such as the slow-moving / non-moving inventory in hand, finished goods rejected due to poor quality (where the rejections are more than the standard rejections), report of expenses incurred during the month which have exceeded the budgeted expenses etc.

The above reports enable the auditor to understand the internal controls of the entity in a better way. If the information shows that the entity has a reasonably good method of monitoring internal controls, the auditor can receive reasonable assurance regarding the truth and fairness of the information in the financial statements.

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2. Assessing the effectiveness of internal control performance on a timely basis

The testing of internal controls involves:

(a) A periodic assessment of the existing controls
(b) Making necessary modifications for changes in conditions

The following example will explain the above points:

Example

Continuing the previous example of Goldline Ltd

The auditors of Goldline Ltd, while testing the internal control systems, concentrated on imported purchases rather than local purchases since the local purchases were just 2% of the total purchase in 20X5. During 20X9, the entity found two manufacturers for its raw materials in the local market. During the quarter 1 January 20X9 to 31 March 20X9, the entity purchased 30% of its raw materials from the local market.

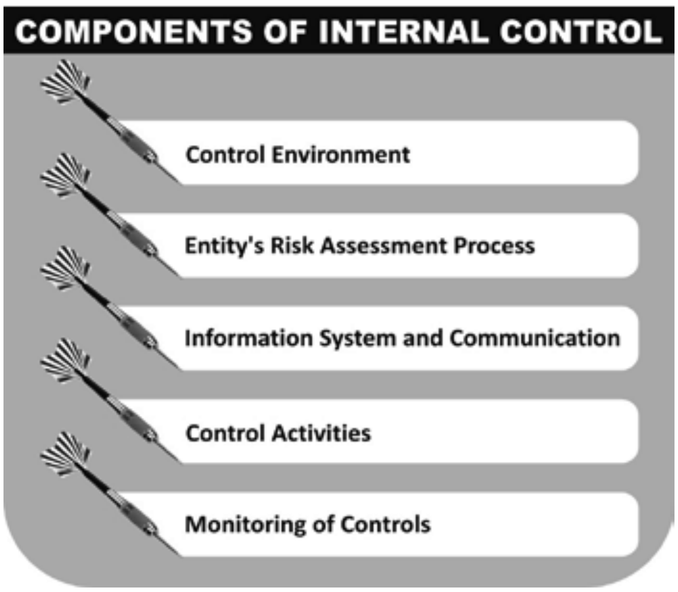
Earlier, because the purchases from the local market were small, the entity did not have a formal system for making enquiries from the market, obtaining alternative quotations, preparing a price comparative sheet and raising a purchase order.

However, in 20X9, the entity prepared a formal system for the flow of activities and transactions for local purchases. This indicates how the management made a periodic assessment of the internal control systems and made necessary changes.

This gives an assurance to the auditors regarding the true and fair view of the financial information.

The above example indicates how the monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities. The entity's information system generates most of the information used for monitoring activities.

Diagram 6: Components of internal control



2. Identify, state and explain the limitations of internal controls.

[Learning Outcome b]

2.1 Limitations of internal control

In Study Guide B1, it was explained that an effective internal control system helps to ensure that the entity is working effectively and efficiently, that all assets of the entity are properly safeguarded, that applicable laws and regulations are complied with, and that there is early detection and prevention of fraud and error.

However, the internal control system, even if well-designed and well-implemented, does not completely eliminate the possibility of fraud or error. No internal control system can be perfect due to its inherent limitations.

Limitations of the internal control components occur either on account of incorrect design of the controls, or on account of the improper implementation of the internal control systems.

1. Design of the system

The internal control system may be weak because it is not designed properly. **Even if an internal control system is operating according to its design, it may not be effective due to improper design.**

Example

The segregation of duties put in place by the management is inappropriate i.e. all responsibilities regarding receipts are given to one person and all responsibilities for payments are given to another person, it means that the person receiving the money is not only making the entries in the books but is also in possession of the cash.

This segregation is improper as the concerned person is in a position to misappropriate money. Segregation should be such that the work of one person will automatically be checked by another.

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2. Human error

Internal controls can be effective only if implemented in accordance with the way the controls are designed. For example, if a purchase order needs to be authorised by the purchase manager (as designed), this control will be effective only if the purchase manager authorises each purchase order raised by the entity.

However, internal controls are not free from human error (i.e. the purchase manager may miss out authorising a few purchase orders.) This will make the controls ineffective. Human error **might be caused due to** subjectivity in the decisions made and thus resulting in **wrong decisions or due to simple mistakes**.

Example

Jamie is the auditor of Premium Plc. During the course of the audit, he found that the internal control system was effective e.g. the computer system is designed to generate an exception report for transactions of exceptional nature (e.g. for high value purchases).

However, this system will not work effectively if there is an error in typing the amount (e.g. typing TZS5 million instead of TZS50 million). In this case, the transaction will not be recorded in the exception report and the internal control on high value transactions will fail, due to human error.

Example

Sam is the auditor of Tall Co. During the course of the audit, he found that the internal control system was adequate. The policy of the company was that every voucher exceeding TZS6 million had to be approved by two officials – the department head and the finance manager. Apparently, this policy seemed very adequate but the manager started splitting the amounts above TZS6 million and thereby, avoided taking the approval of the two officials. This meant that Sam could not rely on the proper operation of the system. Even if he used tests to ensure that the system was working properly, he would use only a few tests, therefore a complete examination was not possible.

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3. Controls are not cost-effective

Cost is a very important aspect which is considered by an entity while setting out the internal controls of the entity. Furthermore, the controls may not be cost effective for small entities. Ineffective controls, on the other hand, can lead to errors. For example, good internal control systems require segregation of duties, but this will involve employing more people and consequently will increase the expenses of the entity. Therefore, before setting internal controls, the cost of implementing internal controls should be evaluated by comparing it with the cost of risk caused due to its non-implementation. This evaluation will enable the entity to decide whether the control should be incorporated by the entity.

4. Transactions of unusual nature

Internal controls are framed in such a way that they handle daily transactions of a routine nature, under normal circumstances. However, they are not set out to handle unusual circumstances and unusual transactions. Therefore, the internal controls might not be able to deal effectively with errors in transactions of unusual nature.

5. Controls by-passed or over-ridden

Authorised persons may take advantage of their positions to manipulate records and by-pass controls. The manipulation of records may be done for personal gains or to ensure that third parties are benefited. This can lead to fraud and errors.

Example

In Sisco Ltd, the supervisor is responsible for approving the working hours recorded by employees and also for making their payments. In this case, the supervisor may manipulate the working hours of an employee to show an increased number of hours, and on payment, can share the additional wages with the employee. Hence, this is a weakness in the design of internal control systems on payment.

Management is in a position to override controls and manipulate transactions, estimates or opinions which are required for preparing the financial statements. Therefore **controls can be overridden by management.**

6. Control systems not modified on an on-going basis, to be in line with change in conditions of the entity

Entities continually change their strategies and the way they function. Therefore, the internal controls, in order to be effective, would also have to be modified. However, it is quite possible that, with a change in conditions, the controls may not be modified and therefore may become inadequate. Hence, the company has to continually assess its risks to ensure that the control system is adequate. For example, if an entity starts to export, then it would have to consider foreign exchange risks and how to control these.

On the other hand, some of the existing controls may become obsolete. For example, with the introduction of swipe machines for entry into the office premises, staff signing the attendance muster may become redundant.

Because of these limitations, even in companies with very good internal control systems, some substantive testing is always carried out.

Test Yourself 2

Smith has been appointed as the auditor for Jaguar Motors Ltd and he has to make his audit plan. He delegates it to the engagement team to assess the internal control system to decide the nature, timing and extent of audit procedures to be applied.

From the assessment of the internal control system, he finds that the internal controls are quite adequate and very effective. The audit team members therefore propose that certain areas need not be checked at all. However, Smith instructs them to carry out less extensive audit procedures for each area.

Required:

Explain whether Smith's decision to implement audit procedures is right or wrong with reasons related to fraud and errors.

Answers to Test Yourself

Answer to TY 1

The control environment relates to:

(i) Management's overall style in encouraging awareness of the need for good controls

(ii) The existence of organisational controls: e.g. review of payroll by an independent person such as the managing director, and the rotation of payroll duties amongst staff responsible for processing it. This helps to achieve all of the objectives set out in the question.

(iii) Segregation of duties and supervisory controls: to avoid the misappropriation of cash (or allegations thereof) and to avoid fraudulent collusion to create, for example, dummy employees or to make inflated payments. This prevents the loss of assets and / or inaccurate records.

Internal control procedures include:

(i) Limiting direct physical access to the cash: such as the use of a security firm to deliver cash, locking doors to areas where cash is held, keeping cash in a fire-proof safe and the protection of computer data by password controls. This will help safeguard assets and ensure the completeness and accuracy of the records and financial statements.

(ii) Controls over computerised applications, checking the arithmetical accuracy of documents and the maintenance of control accounts: this can be achieved by using timesheets or clock cards, reliable software with programmed controls for the calculation of deductions, and batch and hash totals for information that is entered into the computer system. This helps achieve orderly and efficient running of the business and accuracy and completeness of records and financial statements.

(iii) Approval and control of documents: such as the authorisation of the payroll itself, and authorisation for the bank to make transfers and to deliver cash.

Answer to TY 2

Any entity aims to have a **good internal control system** to **eliminate fraud and errors**. **A good internal system minimises the occurrence of fraud and errors, or detects them at an early stage.** However, even if an internal control system is well-designed and well-implemented, it does not completely eliminate the possibility of fraud or error. This is because of its **inherent limitations.**

Therefore Smith's decision **to carry out less extensive audit procedures for all areas** is right. Even though the internal controls are very sound and good and are functioning effectively, it is essential to verify the controls as they may fail due to their inherent limitations. This failure can lead to fraud and errors, resulting in misstatements.

The following are the some inherent limitations which justify Smith's decision with regard to fraud and errors:

1. Controls are not cost-effective

Cost is a very important aspect which is considered by an entity while setting out the internal controls of the entity. Good internal control systems require segregation of duties but this will involve employing more people and therefore increased expense for the entity. The controls may not be cost effective for small entities. Ineffective controls, on the other hand, can lead to fraud and errors.

2. Not effective in transactions of unusual nature

Internal controls are framed in such a way to handle daily transactions of a routine nature under normal circumstances. However, they are not set out to handle unusual circumstances and unusual transactions. Therefore, the possibility of fraud and errors in these transactions can occur.

3. Human error

Even if the internal control system is well-designed; if it is not implemented by the staff and management it will turn out to be ineffective giving rise to human errors and fraud. For the internal control system to work effectively, the attitude of management should also be good. An internal control system can be effective only if it is implemented by management and staff in the true spirit.

4. Possibility of circumvention of controls

Authorised persons may take advantage of their positions to manipulate records. The manipulation of records may be done for personal gains or to ensure that third parties are benefited. This can lead to fraud and errors.

5. Possibility that the person responsible could abuse the authority

Sometimes management can take undue advantage of their position and approve invalid transactions. Therefore controls become ineffective and fraud and errors can occur.

6. Possibility that, with a change in conditions, a control may not be modified and become inadequate

The controls may be functioning very effectively under the given conditions. However, if these conditions change, the controls may become inadequate and ineffective. For example, if the key personnel are changed and the new personnel do not adopt the existing controls then the controls become ineffective.

Therefore, the auditor has to keep evaluating the controls from time to time, to determine whether they are still effective under the given circumstances. If they are not effective, the controls will have to be modified. This will ensure prevention of errors and fraud.

7. Manipulation by the management:

Management is in a position to override controls and manipulate transactions, estimates or opinions which are required for preparing the financial statements. Therefore controls can be overridden by management.

8. Obsolescence of controls

Sometimes controls become obsolete and hence ineffective e.g. controls on recording accounts records manually become obsolete when the manual accounting system changes to an electronic system. The obsolete controls may be ineffective and thereby fraud and errors may occur. Therefore Smith cannot give an audit report without performing appropriate substantive procedures in all areas.

Quick Quiz

1. State whether the following are tests of control:

   (a) Observation of the payroll payment procedure.
   (b) Review of the document to ensure that it is properly authorised.
   (c) Auditor's attendance at physical inventory counting.
   (d) Enquiry of employees regarding the procedure that is followed for initiating, authorising and recording a transaction relating to purchases over TZS50 million.

2. State which of the following are the inherent limitations of an internal control system:

   (a) Not effective in transactions of usual nature
   (b) Not effective in transactions of unusual nature
   (c) Controls are not cost effective
   (d) Authorised person does not override their authority
   (e) Controls are not circumvented
   (f) Human error
   (g) Obsolescence of controls

3. Tests of control are performed to obtain audit evidence about effectiveness of the:

   (a) ______________________________
   (b) ______________________________

4. Performance of tests of control enables the auditor to:

   (a) ______________________________
   (b) ______________________________
   (c) ______________________________

5. State the stages of an entity's risk assessment process.

   (a) ____
   (b) ____
   (c) ____
   (d) ____

6. What is meant by segregation of duties?

Answers to Quick Quiz

1. (a), (b) and (d) are tests of control..

2. Inherent limitations
   (b) Not effective in transactions of unusual nature
   (c) Controls are not cost effective
   (f) Human error
   (g) Obsolescence of controls

3.
   (a) Design of the internal control system
   (b) Operation of the controls

4.
   (a) Identify the types of potential misstatements
   (b) Consider the factors that affect the risk of material misstatements
   (c) Design further audit tests i.e. substantive tests (this will be discussed in section C of the book).

5.
   (a) Entity's process for identifying business risks relevant to financial reporting objectives
   (b) Assessing the significance of the risk identified
   (c) The likelihood of their occurrence
   (d) Deciding on actions to mitigate those risks

6. Segregation of duties is a control element designed to prevent errors and frauds. The same individual should not have responsibility for all three components of a transaction cycle i.e.:

   Initiation
   Processing
   Reconciliation / review.

Where staffing levels permit, it is preferable to segregate all three components.

Self-Examination Questions

Question 1

You are newly appointed as the auditor of Macteam Ltd, a limited liability manufacturing company. It manufactures capacitors used in various electrical appliances. The company has 20 dealers spread over a wide area. The accounting system of the company is computerised with effective internal controls. The industry of Macteam is growing rapidly. The turnover of the company for the year ended 31 March 20X9 is TZS500 million and total assets TZS1,000 million.

Required:

Describe the information you will seek, and procedures you will perform in order to understand Macteam Ltd and its environment including its internal control.

Question 2

In a small garage whose dealings are in cash, the foreman orally gives the details of work done to the receptionist. The receptionist then prepares an invoice and hands it over to the customer. The receptionist also collects cash from customers against the invoices when they collect their vehicles. At the end of the day, she checks the total amount of the invoices and the total cash received, records the total cash sales in cash receipt book and deposits the total cash collected for the day in the bank.

The receptionist then hands over all the documents such as invoices, deposit slips etc. along with cash receipt book, to the accountant, who then makes accounting entries.

Required:

How can the internal control system for the above-mentioned garage be made effective with few employees?

Question 3

Using a risk analysis approach, an auditor will assess the quality of a client's control environment and internal control system in order to determine the level of detailed testing required and also to target that testing to the high risk areas that have been identified.

Required:

(a) Describe different categories of control procedures.
(b) Explain limitations of controls in an organization.

Answers to Self-Examination Questions

Answer to SEQ 1

According to **ISA 315**, the auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.

Being the first year of audit, the auditor is required to obtain an understanding of the nature of the business, the accounting system and the internal control system of the entity.

To obtain an understanding of the entity and its environment the auditor may:

(i) Refer to the notes, reports etc. of the previous auditor

(ii) Gather information from:

- Observation of various activities and operations of the entity.
- Inspection of business plan, strategy, records etc.
- Inspection of internal control manual, policy manual, code of conduct etc. if any, in writing. (being a small entity the possibility of it having these records in writing is low).
- Information on the reasons for the rapid growth in the industry.
- Information on all the laws and regulations applicable to the entity.
- Previous year's financial statements and audit report on internal control.

Internal control

Internal control is divided into five components. The auditor should understand all the five components in order to understand the internal control.

Internal control components	
Control environment	The auditor should ask for the written code of conduct, if drafted. Even if there is no written code of conduct or policies, there should be effective communication of ethical values to employees. Are the responsibilities, authority and reporting levels well-defined? Mere availability of a written code of conduct is no assurance about the effectiveness of its implementation; therefore the auditor must obtain corroborative evidence to confirm its efficiency.
Entity's risk assessment process	If there is no formal procedure for assessment of risk, the auditor should ask management, how the risk for the entity is identified and managed.
Information system, business processes and communication	The auditor should obtain an assurance that communication is effective. The auditor should also gather information about the system of financial reporting i.e. whether manual or computerised and the related controls.
Management control activities	The auditor should obtain sufficient understanding of the control activities of the entity. Segregation of duties should be possible in an entity of this size so that initiation, recording of transactions and possession of records or assets are not with the same person. However, the auditor must act with professional scepticism as the possibility of occurrence of fraud always exists.
Monitoring controls	The entity should have a good system of monitoring controls. This would give the auditor assurance that the information in the financial statements is true and fair.

Answer to SEQ 2

In the given system, the receptionist is responsible for too many functions related to cash. This may result into misappropriation of cash by the receptionist. The system can be made more effective with the same number of employees by making the following changes to the system:

(i) Invoices should be prepared by the foreman (instead of the receptionist) according to specifications of the work done and given to the receptionist. This will amount to better internal controls since the work done by the foreman is checked by the receptionist. The invoices should be sequentially pre-numbered so that later it can be ensured all have been accounted for.

(ii) The receptionist should collect cash against the invoices while handing over one copy to the customer when they arrive to collect their vehicles.

(iii) The receptionist should prepare a statement of all invoices and tally it with the cash collected during the day. This will make the internal controls more effective, since there is a cross-verification of the statement of invoices collected with the actual cash collected.

(iv) At the end of the day the receptionist should hand over the invoices, and the statement, along with the cash to the accountant who then verifies and them. This will amount to more effective internal controls since the work of the receptionist is checked by the accountant. The accountant should ensure that the invoices are numerically complete. The accountant should record the amount to be banked.

(v) The receptionist should deposit the cash collected in the bank.

(vi) The owners of the garage should perform surprise cash counts from time to time. They should also prepare a bank reconciliation statement. This will lead to more effective controls since there is a cross-verification of the cash collected and bank balance.

Answer to SEQ 3

(a) There are five different categories of control procedure:

(i) Authorisation controls

Proper authorisation controls ensure that transactions are authorised by personnel acting within the scope of their authority. Specific authorisation is granted on a case-by-case basis and may apply to both non-routine transactions (eg non-current asset purchase) and routine transactions that exceed certain limits.

Responsible and qualified staff should operate authorisation and approval controls, using supporting documentation as evidence at all times. These controls should mitigate mis-appropriation and unnecessary expenditure.

Example:
The accountant approving sales invoices should inspect orders and goods dispatch notes to confirm that the transaction is genuine and correctly raised.

(ii) Performance reviews

Management are responsible for establishing, monitoring and reviewing systems of internal controls. On a day to day basis, management must ensure that controls operate and that exceptions highlighted by the systems are investigated.

Example:
Management should exercise high level controls such as review of management accounts including sales and debtors levels and gross margins, for any signs that the company is running into difficulty.

(iii) Information processing

There are 2 types of information processing controls:

- General IT controls; and
- Application controls

General IT policies and procedures related to many applications support the general functioning of applications by helping to ensure the continuing proper operation of information systems. General IT controls, controls over development and acquisition of software etc.

Application controls typical operate at the business process level and apply to the processing of specific types of transaction eg. Invoicing customers. Application controls can be manual or computerised, depending on the application itself. They are put in place to ensure that the transaction data within an application is genuine, accurate and complete.

Example:
Computerised application control: The use of pre-numbered sales invoices. Manual application control: Performing sales ledger reconciliation.

(iv) Physical controls

Physical controls limit access to assets and important records. Physical controls are only effective if they include periodic counts of assets and comparison with the accounting records.

An organisation's resources should not only be safeguarded by appropriate levels of physical security but also by recording systems and insurance cover. A comprehensive recording system will need to be established to maintain an audit trial of the location, custody and ownership of assets. In addition, access to, and use of assets, need to be carefully controlled. It is therefore important that unauthorised access to computer systems is made as difficult as possible.

Example:
Cheques and cash received from debtors, for example, should be recorded at the time of receipt, safeguarded and banked intact on a daily basis.

(v) Segregation of duties
Segregation of duties controls are implemented to ensure that individuals are not put in a position that in the normal course of their duties they are provide with an opportunity to commit an error or irregularity and then conceal it. An example would be an individual who is responsible for processing payments to supplier, but is also able to set up new supplier accounts. In theory, they could set up a false supplier with their own bank details and make a payment to themselves.

By segregating duties the work of one individual is automatically checked by another person performing the next stage in the transaction process.

Example:
The person who records transactions in the sales ledger and the individual who posts cash receipts into the cashbook should be different people, to prevent the misappropriation of payments from debtors.

(b) The main limitations of controls are problems caused by:

(i) **Collusion.** If two staff members get together to perpetrate a fraud it ca be very difficult for management to detect it. This is often an override of the segregation of duties;

(ii) **Abuse of authority.** If staff in a positon f authority abuse their position;

(iii) **Override** of controls. Management may well be in a position to override controls or short circuit the system to hide their misconduct or competence;

(iv) **Pressure on staff.** Staff with personal or work-related pressures may act out of character and make simple errors or commit fraud;

(v) **Human error.** The most efficient system in the world will not be full-proof. Tiredness or carelessness can creep in at all levels and mistakes will go through.

SECTION B

THE NATURE AND USE OF INTERNAL CONTROLS

B3

STUDY GUIDE B3: TESTS OF CONTROLS

Get Through Intro

The extent of the effectiveness of the internal control system has a great bearing on the audit programme of an entity. The efficiency of the system in design and operation will determine the area of checking and the procedures to be applied for an effective audit.

An auditor evaluates the internal control system in the following three stages: Ascertaining the system, testing the system and evaluating the system.

Ascertaining the system: i.e. acquainting himself with the system in operation. This knowledge may be obtained through procedure manuals, discussions with various managers, etc.

Testing the system: i.e. testing the application of internal controls in practice. The auditor undertakes procedural tests in order to find out whether the controls are actually complied with. The tests conducted by the auditor are called compliance testing or tests of control.

Evaluating the system: as a result of the compliance tests, the auditor makes an assessment of how far he can rely on the internal control systems of the organisation.

In this Study Guide examples of tests of control for major transactions of an entity such as purchases, revenue, and payroll etc. have been explained. We have also provided examples of the controls which are used by auditors while testing the internal controls for transactions which are accounted for through computerised systems.

Learning Outcomes

a) Identify and explain how accounting systems and related internal controls may be identified, recorded and analysed for each of the following areas
   i. purchases and trade payables
   ii. Sales and trade receivables
   iii. Wages and salaries
   iv. tangible non-current assets
   v. Inventory
   vi. bank receipts and payments
   vii. Cash receipts and payments
b) Identify and evaluate internal controls in a scenario stating how the controls support particular aspects of reliable financial reporting and support the prevention and detection of fraud and error.

1. **Identify and explain how accounting systems and related internal controls may be identified, recorded and analysed for each of the following areas:**
   - **i. purchases and trade payables**
   - **ii. Sales and trade receivables**
   - **iii. Wages and salaries**
   - **iv. Tangible non-current assets**
   - **v. Inventory**
   - **vi. Bank receipts and payments**
   - **vii. Cash receipts and payments**

   Identify and evaluate internal controls in a scenario stating how the controls support particular aspects of reliable financial reporting and support the prevention and detection of fraud and error.

[Learning Outcomes a and b]

1.1 Transaction cycle

A **transaction cycle** refers to the **policies** and **sequence of procedures** for processing a **particular type of transaction**. An example is a student loan transaction cycle that begins with the receipt of an application and concludes with the disbursement of the loan.

A transaction / event cycle is a **stream of related data**. It is a **series of steps** taken to **get something done**, **document** and **report** it.

Transaction cycles and the corresponding control activities, in respect of major transactions are discussed below.

1.2 Control objectives

Control objectives include policies and procedures designed by management to ensure that the objectives of the internal control systems are met.

For example, the control objective for procurement would include:

1. Procuring the correct materials
2. Procuring the materials at the correct rate
3. Procuring the materials from the correct source

1.3 Control activity (i.e. internal control procedures)

The **policies and** the **procedures** which help to ensure that the management directives are followed (or the control objectives are met) are known as **control activities**. Control activities are to be applied at various organisational and functional levels. These enable the auditors to obtain reasonable assurance that the organisational goals have been met.

Tip

As discussed in Study Guide B2, control activities include:

1. **P**: **P**hysical control
2. **A**: **A**uthorisation
3. **R**: Performance **R**eview
4. **I**: **I**nformation processing
5. **S**: **S**egregation of duties

1.4 Tests of control

Tests of control are tests conducted by auditors to gather audit evidence to test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level

Tests of control are performed by a combination of various methods, namely:

1. **Observation**: the auditor observes the mail opening procedure of an entity.
2. **Enquiry**: the auditor consults the purchase manager about the method of making capital expenditure.
3. **Inspection**: the auditor checks for the signature of the person responsible for authorisation on the purchase order to ensure that the purchase order is authorised.
4. **Re-calculation**: the auditor re-calculates the sales amount on the sales invoice
5. **Re-performance:** the auditor carries out a physical verification of inventory
6. **Confirmation**: the auditor gets a confirmation of balance from the accounts receivables
7. **Analytical procedures**: the auditor computes and analyses the profitability ratios of the client

Tip

You can remember the tests of control with the help of the following mnemonic:

A	**A**nalytical procedures
E	**E**nquiry and confirmation directly from a third party: Inquiry
I	**I**nspection: inspection of records and assets
O	**O**bservation
U	Recalc**u**lation and re-performance

While performing an audit, the auditor determines whether they can rely on the internal control. To do this, they perform tests of control to determine the extent to which they can rely on each system.

For example, the internal control system for purchases, sales, procurement of non-current assets and sale of scrap are different processes. Therefore the auditor would individually test each system separately to determine the effectiveness of each system.

If the internal control system over one system is ineffective, it does not mean that the internal controls over all other functions are also ineffective and vice versa.

Tests of control are very important because, **if the controls are effective,** the auditor can **reduce the amount of evidence that they would otherwise gather** as to the completeness, validity and accuracy of account balances and classes of transactions.

Tip

How to identify control activities and tests of control?

Step	Description	Example
1	Choose one activity in the transaction cycle.	Procurement activity in the purchase cycle.
2	Identify the risk of fraud / error in that transaction	Goods may be procured at very high rates.
3	Think of the control objective to avoid the fraud / error identified in Step 2	The control objective is 'Procurement of goods at optimum rates'.
4	Identify the activity which needs to be done by the entity to meet with the control objective. Choose from 'PARIS' (Refer to Study Guide D3)	Preparation and authorisation of price comparative sheet (after obtaining comparative quotation from different vendors)
5	Identify a test of control: Choose from AEIOU	Choose a sample of purchase orders raised by the client. Inspect the related price comparison sheets to confirm whether purchase orders were raised at optimum rates.

Follow the steps mentioned above to identify other tests of control.

Note: Control objectives and control activities are set by the client. Tests of control are performed by the auditor.

1.5 Purchases and trade payables

1. Control objectives

The **general control objectives in purchase transactions** are:

(a) Procurement is made only when the requirements are genuine.
(b) Purchases are made at the most optimum prices and terms.
(c) Purchases meet the required quality standards and if substandard quality is accepted, must be at negotiated terms.
(d) Purchases are correctly accounted for.
(e) Payments are made according to agreed terms.
(f) They are procured on time
(g) The payments are made according to agreed terms.

Control objectives relate to the matters which will enable the entity to meet with the organisation objectives such as efficiency and effectiveness of operations!

2. Therefore the control objectives for the different transactions relating to purchases are as follows:

(a) Control objectives for placement of orders are as follows:

(i) Goods and services are procured only for genuine requirements.
(ii) The goods and services are obtained at optimum prices and terms.
(iii) Purchases made only from the authorised suppliers.

(b) Control objectives related to receipt of material are as follows:

(i) Goods are received as ordered / according to the specification.
(ii) The goods purchased are actually used by the organisation.
(iii) The goods are not misused or misappropriated.
(iv) The goods and services meet the required quality standards and if accepted at substandard quality, such goods should be purchased at negotiated terms.

(c) Control objectives of recording can be as follows:

(i) All the goods received are recorded correctly (including recording of the related liability).
(ii) All the related transactions during the period are recorded such as purchase returns and credit / debit notes.
(iii) Expenditure is recorded for correct amount in correct account.
(iv) Cut-off is applied correctly to the purchases.
(v) Amount of liability is reconciled with the suppliers' statements.

(d) Control objectives of payments are:

(i) Invoices paid by an entity relate to goods and services actually received.
(ii) Payment is made to suppliers on a timely basis for goods and services received by an entity.

Tip

The following table explains how the risk of material misstatement caused due to fraud and error in a manufacturing entity (in the area of purchases and trade payables) can be mitigated by the entity, by introducing control activities within the entity's processes.

For each control activity we have also identified the tests of control which will be applied by the auditor in order to confirm the efficiency of the control activities.

Risk of misstatement (caused due to error / fraud)	Control activity	Test of control
	General points	
Purchases made by persons who are not authorised.	Purchases to be made only by authorised persons.	Review organisation chart and on a random basis check the purchase orders and confirm that the purchases were made by authorised persons.
The procedure for purchase may not be in accordance with the company's policies.	The procedure for purchasing the raw materials, spare parts for the machinery, packaging material, other stationery items and general purchases for the maintenance of the head office and the sales offices to be in accordance with company policies.	Review a copy of the written policies and procedures of the organisation and observe the purchase procedure.
	Placement of Orders	
Unnecessary purchases may be made. Inventory stored by the regional sales offices may be more than required over the week.	Requisition to be authorised. Inventory at the head office to be checked before placing the purchase order. Finished goods and orders in hand at the sales offices to be checked before placing the requisition for raw material.	Take requisitions at random and verify whether they are authorised. Prepare a report of the inventory items which were procured even though they exceeded the minimum order levels. From the exception list determine: the reasons for purchase orders (POs) being raised without supporting requests whether the items purchased were lying in stock for a long period of time the value of such purchases corrective and preventive steps taken by management Review the procedure for
Purchases not made at the right prices.	Prepare a list of authorised vendors and get it approved. Send out enquiries to the authorised suppliers. Prepare a price comparative sheet. Authorisation of price comparative sheet to be obtained. Verify whether basis for decision to purchase from a particular vendor is appropriate.	Review the list of authorised suppliers At random, verify the price comparative sheet and confirm that the basis for the decision taken is appropriate. At random, verify that the price comparative sheets are authorised.
Purchases may be made by unauthorised persons.	POs to be authorised Access to PO module to be restricted by password	At random verify whether POs are authorised.
New purchase orders made without executing the purchase orders in hand.	Maintain a list of open POs From the list of open POs, take action to either get the order executed or close the PO. List of open Pos to be prepared periodically	Take the list of open POs and verify the reasons for their existence and the steps taken to either close the order or procure the materials wherever necessary.
Purchases made from unauthorised vendors.	List of authorised vendors to be prepared and approved. Make list of Pos raised on vendors who were not authorised vendors	Analyse the purchase orders according to their value and check with management the reasons for the procurement from vendors who are not authorised and also the steps taken by the company to prevent this in future.

Continued on the next page

Receipt of materials		
Goods received are not supported by a PO.	GRNs to be made only if there is an available open purchase order. The software should ensure that GRNs can be prepared only if there is an open PO for the materials. Generate an exception list from the system giving details of GRNs that were not supported by POs.	At random, examine the goods received note (GRN) and match it to the order. Take a report from the system containing the GRNs made which are not supported by relevant POs**.** Confirm from the report whether all GRNs raised during the review period had supporting purchase orders. Also verify the method of recording GRNs into the system, whether GRNs can be recorded even though the GRNs were not supported by purchase orders.
Quantity specified on the GRN may not be received.	All GRNs to be checked for receipt of quantity (signed by the clerk) in accordance with the PO. All GRNs to be checked and approved by the quality control (QC) department Prepare the list of rejected GRNs to determine whether there were any consistent defaulters in respect of wrong items or poor quality. For any purchase return a debit note to be prepared bearing the original PO number. All GRNs approved by QC to be recorded in the inventory ledger.	Verify GRNs at random to confirm that the GRNs are signed by the clerk. Make a surprise visit to the receipt section and confirm whether materials are really counted. Observe the procedure for checking material for its quantity and quality. Verify GRNs at random to confirm that the GRNs are approved by QC personnel. Make a surprise visit to the receipt section and confirm whether materials are really tested. From the list of substandard quality material / rejected material, ask the operations personnel about the preventive and corrective steps taken i.e. whether it is returned to the supplier or retained at revised prices and favourable terms
In case of emergencies, rejected materials are used for production.	Materials received to be kept in a secure area. Materials which are not of the required quality according to the order (referred as rejected henceforth) to be kept in a separate area and not mixed with other materials. Prompt action for return of rejected materials is required. A list of circumstances under which rejected material can be retained and used in production, to be prepared. Approval of authorised person to be taken for retaining rejected material.	Check whether there are any sales returns for substandard quality of finished goods made from this raw material. Verify the module in the systems and test whether GRNs not approved by QC can be recorded in the inventory ledger. Make a surprise visit to the stores and check whether materials received are kept in a secure area. Make a surprise visit to the stores and check whether rejected materials are separately stored. Generate an exception report from the system containing the list of rejected materials. The report must mention the date of rejection of materials and the date of actual dispatch. If retained, the reasons for such a decision to be verified and its approval to be confirmed.

Continued on the next page

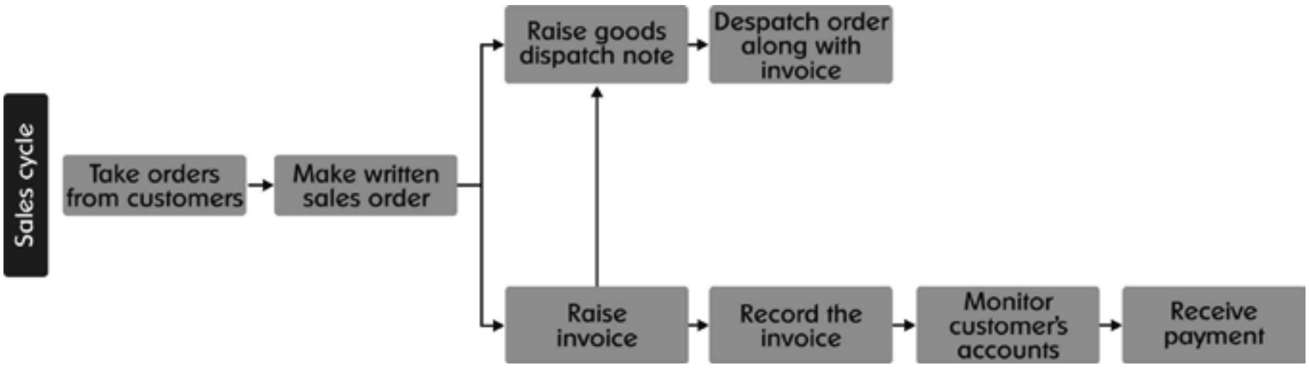
Risk	Control activity	Test of control
Recording of transactions		
Incorrect postings in the vendor ledger. Delays in recording the vendor ledger. Purchase vouchers contain wrong items and there are errors in the purchase voucher (PV). All purchases may not be recorded Purchase transactions are recorded in the correct accounting period	Chart of accounts along with codes to be in place. Control ledgers to be prepared Payable ledger controls to be reconciled regularly. Mathematical accuracy of the supplier's invoice to be verified Prepare a report of the purchase bills which were recorded in the vendors' ledger after the date of recording the purchases in the system. Purchase vouchers to be authorised by the accountant to indicate that the PV is prepared after verifying the PO, GRN and vendor's invoice. All purchase vouchers, POs, GRNs and vendors' invoices to be cross-referenced. Periodic statement of account to be taken from the vendors (to ensure that all the entries are properly recorded). Statements to be reconciled. GRN to be dispatched to the accounts department immediately after the receipt of goods and then the transaction should be recorded immediately	Review chart of accounts Verify the reconciliation. For sample of PV, recalculate to check the mathematical accuracy Review the list and ensure that all purchases where there were delays during the cut off dates are properly accounted for. Observe the procedure for recording the transaction Verify purchase vouchers at random and confirm that purchase vouchers match GRNs and POs. Check the reconciliation statement wherever the statement of accounts does not match the vendor's ledger account. Compare dates on reports to dates on relevant vouchers Compare voucher dates with the date of recording the transaction
Payment made		
Amount paid is not correct Payments are made to the wrong vendors. Payments are made before the due date and discount for early payment is not received.	Segregation of duties: the person making the payment must be different from the persons raising the PO, GRN and PV. All payments including bank transfers to be approved by an authorised person. Payments to be made against specific invoices only. All payments to be made to vendors preferably only through bank transfers. Exception report containing list of payments made before the due date for payment to be prepared. Check whether discount is received for all early payments In the case of cheque payments, cheques to be prepared by an authorised person who also verifies the supporting documents. Cheque signing and bank transfer authorities to be spelt out. Preferably two authorities to be appointed for cheques of high amounts.	Observe whether the segregation of duties is followed. Scrutinise the vendor ledger and verify randomly whether invoices to bill payments are made. Scrutinise the vendor ledger and randomly verify whether bills are paid through bank transfers. Verify the report and at random to confirm that discounts are received in the case of making payments before the due date. Verify the copy of letter / application made to the bank by the company wherein the names of the signatories are mentioned.

Continued on the next page

Risk of misstatement (caused due to error / fraud)	Control activity	Test of control
Goods returned		
Debit notes may not be recorded.	Debit notes to be sequenced. Monthly verification of any missing debit notes in the records.	Verify whether debit notes are sequenced. Check the monthly report of debit notes verified for missing numbers and check the action taken (i.e. recording the credit note).
Poor quality materials are consistently received from vendors.	Analysis of debit note to be made vendor-wise giving the particulars of the materials rejected.	Verify the list and ask management about the preventive and corrective steps taken.
Credit notes raised need to be for correct amounts.	Credit notes to be cross-referenced with original purchase vouchers.	At random verify debit notes to confirm that debit notes are cross-referenced with original purchase vouchers

1.6 Sales and trade receivables

Diagram 1: Sales transaction cycle



1. The **general control objectives in sales transactions** are:

(a) Execution of all orders
(b) Raising invoices on new customers only after checking of creditworthiness
(c) Timely execution of orders
(d) Accuracy of sales invoices matched to the orders
(e) Accurate recording of sales
(f) Collection against sales in according with the terms of the invoice
(g) No missing revenue

2. Therefore the control objectives for the different transactions relating to sales are as follows:

(a) Control objectives for receipt of order

(i) All the enquiries are recorded.
(ii) Creditworthiness of the customers is checked before executing the orders.
(iii) The quality, quantity and specifications of goods dispatched matches the sales order.

(b) Control objectives for execution of order i.e. goods dispatched and services rendered

(i) All confirmed orders are executed.
(ii) The orders are executed on time.
(iii) Goods are dispatched according to the specifications.
(iv) Sales are made at the terms favourable to the entity.

(c) Control objectives for recording

(i) Accuracy of sales invoices match the orders.
(ii) Accurate recording of sales is made.
(iii) All cash collected is properly accounted for and recorded in the entity's books.

(d) Control objectives for collections from customers

(i) Collection against sales in accordance with the terms of the invoice.
(ii) All cash to which the entity is entitled is received.
(iii) All the receipts are deposited in the bank promptly.

(e) Control objectives for cash sales

(i) To ensure that all cash to which the entity is entitled, is received.
(ii) To ensure that all such cash is properly accounted for and recorded in the entity's records.
(iii) To ensure that all such cash is banked promptly and is intact.

3. Control activities and tests of control relating to the sales system

Example

Taste Me Chocolates is a manufacturing company and its chocolates are very popular. Its outlets are all over the country. Its manufacturing unit and head office are in the same place. The sales offices and dealers are spread throughout the country.

The sales system of Taste Me Chocolates is as follows:

(a) Ordering and dispatch of chocolates

The sales offices receive orders from dealers and according to the demand, they send a weekly requisition to the head office and the head office dispatches chocolates to the sales offices. On delivery to the sales offices, delivery notes are prepared at the head office. The booking clerk at the sales offices receives the sales orders from dealers over the telephone or by e-mail, letter etc. and then prepares sales orders.

(b) Invoicing

The sales office raises invoices for the supplied goods in three copies; one is sent to the dealer, one to the head office and one is retained. The delivery notes by sales offices are also drawn in three copies and distributed in the same way.

(c) Payments

The sales are mostly on a credit basis. The payments are received in cash and cheque. Cheques are drawn in the company's account which is sent to the head office and cash is collected and sent to the head office.

(d) Pricing and credit policy

The price list is prepared by the company and it cannot be modified in any sales office. The credit limit is set by the sales manager of every sales office, according to the general conditions of the company. Where the sales system is computerised, the credit limit of the dealer is automatically checked by the system after an order is entered. The North sales office showed a considerable amount as bad debts which cannot be recovered.

(e) Other issues

The inventory which is left in that month as a result of order cancellations, is sent back to head office, so as to keep fresh inventory only. The sales offices maintain files of correspondence with dealers and ultimate consumers for their comments on the product e.g. the quality of the product. The sales offices in rural areas have a manual system whereas in the urban areas it is computerised. Rex has been appointed as an auditor of the company this year.

Required:

Explain the control activities which should be put in place in order to reduce the risk of misstatement in the sales system at Taste Me Chocolate. For each control activity, identify the tests of control which will be applied by the auditors.

Continued on the next page

Refer to the case given above:

Risk	Control activity	Test of control
	Receipt and execution of order	
All orders and enquiries received may not be executed	List of orders that are not executed to be prepared. List of enquiries which are not converted into orders to be generated from the system. Preferably orders to be received in writing. Each order or enquiry to be given a sequential number so that completeness of transactions can be verified.	From the list, enquire into the reasons for the non-execution of the order. Examine the list of enquiries which were not executed and investigate the reasons for this failure. Check whether enquiries and sales orders are sequentially numbered.
Credit limits allowed to new customers without assessing their credit worthiness or credit limits not authorised	A detailed report of the new customers, their creditworthiness and the basis on which the credit is granted should be prepared for each customer. The master file of the customer should be updated only by the authorised person decided by management. Access to the master file should be restricted.	Verify that the credit rating sheet and report detailing new customers is available on record. Prepare a report of the persons who logged into the system to update the master file for credit limits to new customers. On a sample basis, as a test check, try to update the master sheet.
Order may not be executed on time and delivery terms committed need to be met	There should be various levels of maintaining inventory and the levels should be always maintained. A list of all available items should be maintained along with their authorised price lists. The standard delivery period should be defined. Computer controls should allow certain discounts and passwords (restricted only to a few people on a need to know basis) to entitle the operator to process the discount. For non standard discounts, director must authorise by entering their password.	Compare prices on a sample of invoices to the authorised price list. On sample basis examine the terms of invoice and compare with the normal business terms. Penetration testing- On a sample basis, as a test check, try to give discounts on a fictitious invoice.
More than the required inventory held at the regional sales offices	Inventory to be checked on receipt of requisition. Exception report should make a list of circumstances when the inventory has exceeded the minimum order levels.	Check on sample basis whether, on the date the requisition was raised by the sales office, the inventory was at the re-order level. Review the exception report. From the list of inventory which exceeded the minimum order level, choose the high value items and enquire into the reasons for the excess. Also find out whether these procurements are properly authorised.
Requisition for materials to sales office may not be authorised	All requisitions need to be authorised.	Take a sample of requisitions and verify that they are authorised.
Goods dispatched without authorisation and of a quantity other than that mentioned in the	A dispatch note should be prepared and it should be authorised by the warehouse manager after comparing it with the order.	On a sample basis check goods dispatched notes for their authorisation and compare with the order and sales invoice

Continued on the next page

Risk	Control activity	Test of control
Receipt and execution of order		
Items invoiced are of poor quality or are incorrect items (i.e. not in accordance with the sales order)	Take a detailed report of sales returns made during the review period. The report should specify the reasons for the return and the actions taken by management to prevent sales returns in the future.	From the report, summarise the major items where there were errors, investigate the reasons for this and find out the preventive steps taken by management to eliminate these errors.
Sales price fixed is less than the rates specified in the standard price list	Price list should be updated only by the authorised person and access to the module of price list to be restricted to the authorised person only. Customers to be billed according to standard price list considering standard discount rates and if billed at lower rates, suitable approvals to be taken from the authorised person. Exception list should be generated / prepared for the invoices which are priced without considering the standard price list, standard discount rate and standard delivery period.	Confirm that the person who has updated the price list is an authorised person. Verify the price list and confirm that it is authorised. Examine the exception list and choose the high value items and enquire into the reasons for the discrepancy; and check for approvals.
Recording the sale		
Sales invoices may not be recorded	Invoices need to be properly sequenced. A daily sales report should be prepared and compared with the sales during the day.	Determine the missing numbers from sales invoices recorded in the system. Review reconciliation of daily report with sales on a sample basis
Theft in transit	All sales should be insured as a company policy.	On a sample basis, look into instances of theft and check whether they all were insured and claim was received from the insurance company.
Invoices may not be recorded for the correct amount or in the correct accounting period.	All invoices to be authorised. Invoices to be arithmetically checked by an independent person. Control ledgers to be prepared and matched to the receivables ledgers (sales, taxes and other charges on the sales invoice to match the ledger accounts on a monthly basis). Customer's account to be regularly sent to customers. Errors in posting from sales invoices to sales ledger to be looked into (applicable where the sales invoices are not interlinked to the accounts ledger). Delay in posting on cut off date to be verified to ensure that there is no irregularity in revenue recognition. Monthly sales according to the system match the total sales recorded each month. Integrated accounting system to ensure that there are no errors in posting. To ensure cut-off, all shipping documents should be forwarded to the accounts department for recording on a daily basis. Accounts department should record the invoices on a daily basis; as and when they are received.	Confirm recorded sales from the supporting documents. Compare dates on sales invoices with the date on which they are recorded and also with the shipping document.

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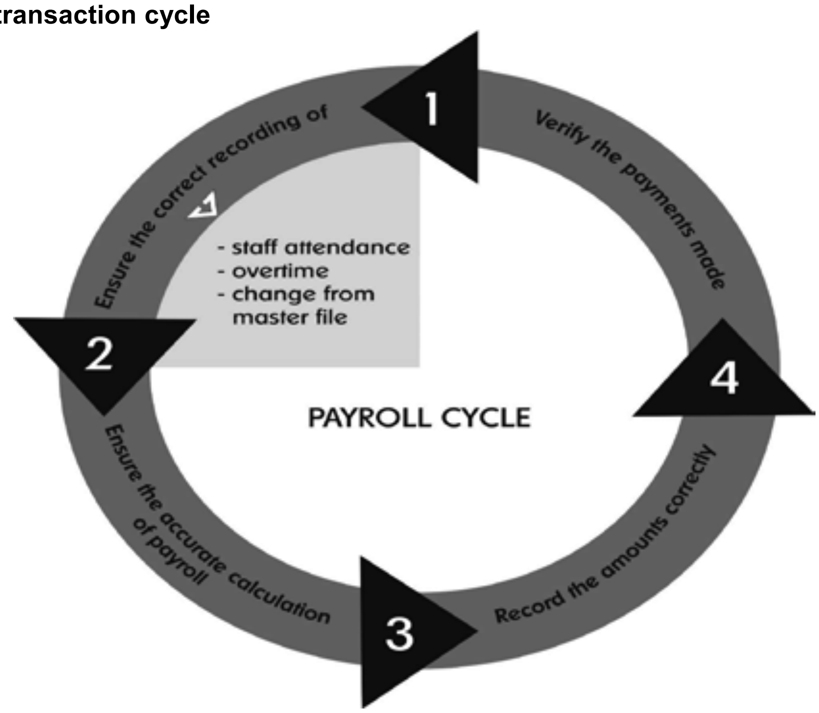
Recording the sale		
All transactions may not be recorded in the correct account	A chart of accounts along with the codes should be available Control ledgers to be prepared Periodical reconciliation of the receivables ledger and the control ledger to be made and errors in posting from sales invoices to sales ledger to be identified.	Examine a few sales invoices to check whether they are properly classified Test application controls for proper codes Check whether reconciliation is prepared regularly.
All the receipts may not be recorded or may be recorded, but not immediately when received	Segregation of duties: the person receiving the payment should be different from the person recording the sales Cash to be received only by the cashier, independent of previous processes. Maintain copy of receipts issued to customers. Cash received against sales to be recorded in a register which is checked by another person from the accounts department along with the sales invoices. Periodic statement of account to be obtained from customers.	Obtain statement of account from the customers on a periodic basis to ensure that all receipts and sales are correctly recorded. Verify whether there are any differences between the statements of account of customers. Prepare a reconciliation statement for the differences and look into the reasons and the preventive steps taken.
Bad debts due to insufficient follow-up for dues. Bad debts not authorised.	Customers' file to contain correspondence for recovery of debts. Company to have a clear policy on when dues can be converted to bad debts.	Check the follow-up file for overdue accounts. Check the authorisation of bad debts.
General		
Duties may not be properly segregated.	The functions of raising orders, requisitions, invoices, accounting of invoices and recovery of payments need to be clearly segregated.	Review organisation chart.

1.7 W a g e s and salaries

Diagram 2: Payroll transaction cycle



1. The **general control objective** is to ensure that the wages and salaries are:

(a) Paid at the authorised rates.
(b) Paid to the right people (genuine employees).
(c) Paid on time.
(d) Paid only for work done, hours worked or other agreed criteria.
(e) Correctly calculated taking into consideration the statutory and other deductions.
(f) Correctly and promptly recorded in the books.

2. Control activities and tests of control relating to the wages and salaries

Example

Taste Me Chocolates has around two thousand workers in its manufacturing unit, around 600 employees in the head office and another 2,000 employees in the sales offices all over the country.

There is a time-keeping machine to record the in time and out time. Overtime slips are authorised by the relevant department head.

The payments are calculated by the accounts department on the basis of the information supplied by the administrative department such as the timesheets, attendance records, deductions of penalties, loans etc.

The personnel department supplies the following information to the payroll department for calculation of salaries i.e. preparation of the payroll document:

- Any change in the salary package of each employee,
- Information about the attendance, timesheets, overtime, deductions etc.
- Any new appointment or termination or resignation of an employee with the salary break-up or the final settlement details.

After the calculation of the salary by the concerned person, the calculation will be forwarded to the head of the department who will ask the assistant manager to check the calculations and other details. After that, the assistant manager will approve the calculation by initialling it. The head of the department then has an overall look, test checks and approves the calculation and sends it for further approvals by the relevant directors. Finally, the payments are released as cheque and cash.

Cheques are handed over to the relevant department heads and the supervisors in the manufacturing unit. They disburse the salary and take the signature of the employees for receiving the salary in a register. Unpaid cheques are then submitted to the cashier. The cashier verifies that the number of cheques or cash packets handed over to him is equal to the number of signatures (acknowledgement for receipt of salary) missing from the salary register. Those packets can be collected by the employees from the cashier later. The internal audit department checks the payroll every month.

Required:

Explain the tests of control that Rex would apply to find the effectiveness of the payroll system and give reasons for performing such tests of control.

Risk	Control activity	Test of control
	General points	
Segregation of duties	There should be segregation of duties between the person authorising the attendance, overtime etc. calculating salary, checking payroll calculations, making payments and retaining unpaid salary and wages.	At random, verify the entire process that is followed with the written policy of the company. Review the organisation chart to confirm the segregation of duties. Observe the procedure for preparation and authorisation of the pay sheet and written policies and procedures to ensure the implementation of the segregation of duties.

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Calculation of salary and wages		
Dummy attendance may be recorded. Time recorded is not correct. Salary may be paid to persons who are not employees.	Staff attendance machine to be kept near the security gate. Staff attendance to be checked periodically. If a person forgets to bring their card, their attendance details should be approved by the department head. Starters and leavers' record should be immediately forwarded to the accounts department.	Observe the procedure of making entries using cards to ensure that the employees swipe for each in and out time. Check the instances when the attendance is approved by the department head. If this is happening repeatedly for a particular employee, the matter should be investigated, may be by checking the actual work record on those days. A random check should be performed for the salary calculation of
Calculation of salary and wages		
Overtime may be paid to unauthorised persons and when the employee has not actually worked overtime. Salary calculated may be incorrect. Changes in pay rates, overtime and holiday pay are made by an unauthorised person. Unauthorised changes are made to the payroll data in EDP.	Overtime to be authorised. All payroll data to be secured. Access to the master data and the software that calculates the salaries and wages to be restricted, may be by using passwords. Personnel records to be kept under lock and key. Salary calculations to be checked randomly. A reconciliation of current month's salary versus previous month's salary to be prepared. List of changes made to the master file to be prepared and whether the changes are authorised to be verified. To ensure that proper procedure is operating for changes in pay rates, overtime and holiday pay. Changes to the input data should be made only by an authorised person. Terminated employees to be removed from the payroll immediately after receiving information of the termination from the personnel department.	Check the authorisation for overtime at random. Check salary register for the signature of the employees receiving payments. Penetration testing: try to access the payroll data and master data and make changes. At random, verify that the salary calculations are checked by checking for the signature of the person verifying the salary calculations. At random, perform recalculations of the salaries Verify the reconciliation. Compare the previous month's total salary with the current month (or the annual salary) and investigate major increases or decreases. Confirm changes to the master file by preparing pre and post change files. At random, verify whether the changes with supporting papers and confirm that they are in order. At random, check the date of termination with the date when the name of the employee was removed from the payroll. At random, verify that the starters are getting salary only from the day when they actually joined the entity by checking number of working days considered in the salary calculation Re-perform comparison of payroll register with original batch transmittal data.
Recording of transactions and payment of wages		
	The person recording the wages must verify the wage sheet independently. Payslips to be properly sequenced. Pay lists to be authorised. Total cheque amount to match the net amount payable according to the pay sheet.	At random, verify the wage sheet to confirm that the wage sheet is authorised by the person who verifies the wage sheet. Also confirm that the wage sheet prepared is in order. Inspect and confirm that the pay list and payroll is authorised. Verify monthly payments and confirm this aspect.

Test Yourself 1

Dolas is a manufacturing company incorporated two years back. It is growing by leaps and bounds. Currently it has 30 production employees but expects the number to increase up to 90 within a year. The employees are paid on a daily basis provided the minimum working hours for the day are not less than 8 hours. Dolas is thinking of introducing a new wages and salaries system.

According to the new system, all employees will be given a swipe card. They will be required to swipe the card when they enter or leave the company premises. A report will then be generated and any discrepancies will be corrected on a weekly basis.

Using these reports, wages and salaries will be calculated for each month and payment will be made through bank transfer.

Required:

Suggest control procedures for the above.

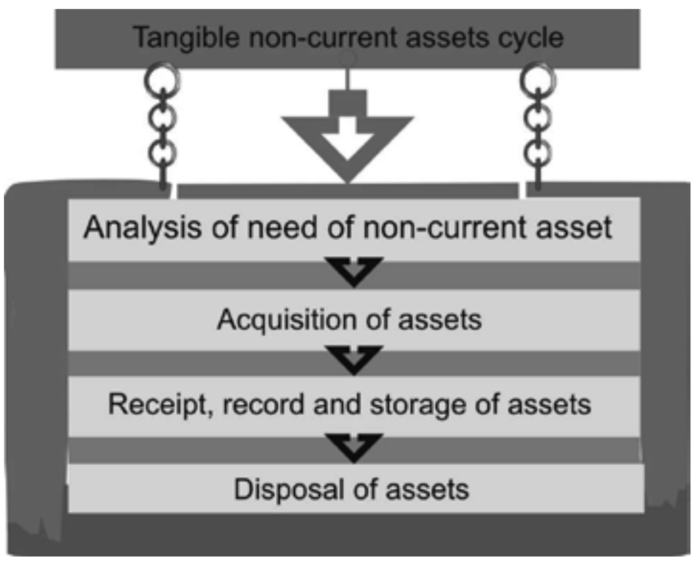
1.8 Tangible non-current assets

1. The control **objectives** relating to non-current assets are as follows:

(a) The assets are acquired only when required by the entity.
(b) The assets acquired are used only by the entity.
(c) The assets are acquired at the optimum price and terms of purchase.
(d) The purchases are authorised by a responsible and experienced person.
(e) All the purchases are recorded correctly.
(f) The assets are well protected.
(g) The assets are regularly inspected for their existence and condition.
(h) The assets are disposed of only after the approval of a responsible person (usually authorised by the board).
(i) The assets are disposed of at the best possible price.

2. Control activities and tests of control relating to tangible non-current assets

Diagram 3: Tangible non-current assets transaction cycle



Risk of misstatement	Control activity	Test of control
General points		
Unauthorised expenditures are made.	An annual budget should be prepared for capital expenditure. Budgets to be approved. Any capital expenditure exceeding the budget needs special approval of the board.	Review the budget and ensure that it has been approved. Verify the report and ask for reasons of instances where the expenditure exceeds the budget. Confirm that the excess expenditure is authorised by management and, if required, by board resolutions.
Expenditures are not authorised in accordance with the company policy.	Payments to vendors of non-current assets are made after obtaining the approval in accordance with the company policy.	View the organisation structure wherein the levels of authority for making capital and revenue purchases are clearly set out. On a random basis verify the expenses incurred during the review period and confirm that the company policies are implemented.
Acquisitions and disposals		
The organisation's policy for purchase of non-current assets may not be followed. Assets disposed or acquired without approval.	The procedure for purchase of non-current assets should include enquiry for quotations, preparation of comparative sheets etc. The non-current assets which are disposed must fetch the most optimum price. Furthermore the purchases and disposals need to be authorised in accordance with the company's policies.	On a sample basis verify the non-current assets purchased and disposed to confirm that the procedures mentioned along side have been adhered to. Ion a sample basis, inspect the invoice generated for disposal of assets with the agreements. On a sample basis, cross check the approved price with the invoices. Also perform arithmetical calculations to determine arithmetical accuracy.
Recording of transactions		
The purchase and disposals may not be recorded / correctly recorded Fixed asset register may not be updated correctly.	Purchase of non-current assets need to be correctly classified as capital expenditure. Entries for disposal of non-current assets must include entries for profit / loss on disposal of assets. Procedures should be followed while recording asset movements. The fixed assets register must match with the fixed asset account in the general ledger. The entries for depreciation must be appropriately made. Authorisation of depreciation rates.	Verify the purchase invoices on a sample basis and confirm that they are recorded as capital expenditure in the books. Verify the entries for disposal of assets with the sale agreement, the ledger accounts relating to assets and depreciation. Recalculate the amount of profit /loss on disposal and confirm that the entries are appropriately recorded. Check the payment made and whether entry is made in the books of accounts. Verify if the correct entry has been made for the asset purchased in the books of accounts. Inspect if the correct rates of depreciation have been charged i.e. whether they are based on the useful life of the assets.
Safe custody of assets		
Assets are not safe and secure	All the assets should bear a tag and identification number. Periodical physical verification of the assets to be carried out. A report of the discrepancies in the fixed asset registers to be generated. If an asset is mortgaged, fixed asset register should contain the related details. Ownership documents to be kept in safe custody.	Make a surprise visit for asset verification. Check management guidelines for verification of assets. Verify the physical count list. Verify the discrepancy report and find out the corrective steps taken. Check the ownership documents. Match the mortgage documents with the fixed asset register on a sample basis.

Test Yourself 2

Which of the following control activity relates to the disposal of assets?

A Assets which need to be disposed of should be authorised
B In computer system, authorisation number of disposal should be recorded
C Communication regarding disposed price with different customers / prospective buyers should be stored
D All of the above

1.9 Inventory

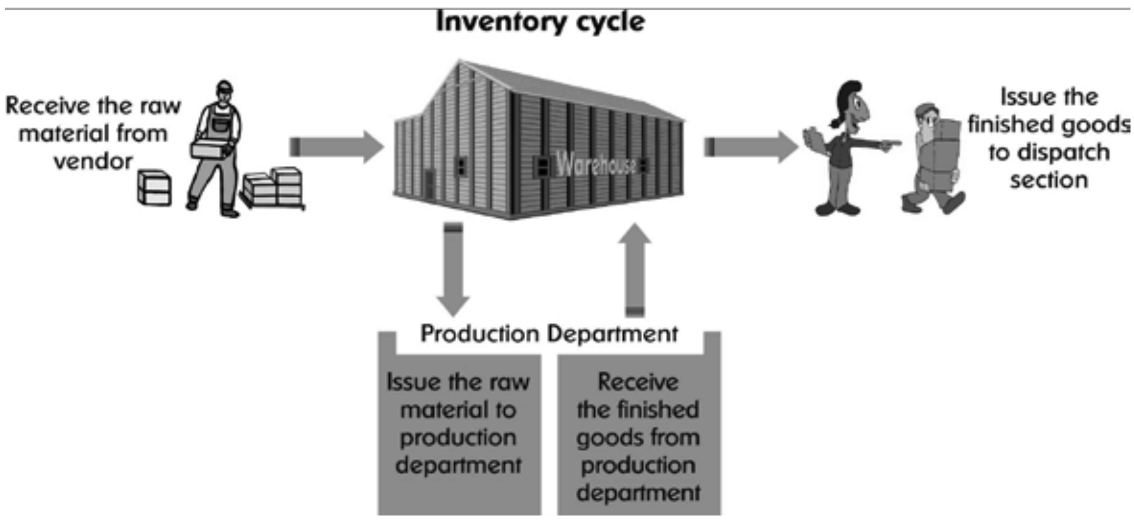
1. Control objective

The **control objectives relating to inventory** include ensuring that:

(a) Appropriate levels of inventory are maintained.
(b) Inventory is correctly recorded.
(c) Inventory records only include items that belong to the entity.
(d) Inventory records only include items that exist.
(e) Inventory records only include items that are actually held by the entity.
(f) Inventory records are accurate.
(g) All movements of inventory are recorded.
(h) Inventory is stored safely and securely.
(i) Inventory is valued correctly.
(j) Inventory quantities are maintained at efficient and economic levels.

2. Control activities and tests of control relating to inventory

Diagram 4: Inventory cycle



Example

Taste Me Chocolates maintains its inventory in a separate department i.e. the inventory department. The inventory department maintains an inventory register, which shows the opening balances for each item, purchases and the items dispatched to the relevant departments giving the available balances in the inventory department.

The inventory department is situated on the second floor and has a security guard and a fire vault system. The inventory count is taken every week and requisition is placed within fifteen days. The inventory count is taken by the accounts department and compared with the books.

Required:

Explain the tests of control that Rex would apply to find the effectiveness of the inventory system and give reasons for performing such tests of control.

Continued on the next page

Risk of misstatement	Control activity	Test of control
Inventory received		
Inventory received may not be properly counted or may not be stored properly.	The materials received need to be counted and proof of having checked the quantity needs to be made available by initialling the GRN (to confirm that materials mentioned in the GRN are actually received). Stores to be provided with suitable weighing machines and counting machines. Separate area to be marked for storing rejected materials which are to be returned to the vendor. Valuable items to be kept under lock and key. Stores to be kept under lock and key. No outsiders to be permitted to enter the stores. Only the persons who are working in the stores to be allowed access to the stores. All GRNs to be properly sequenced. Stores ledger to be properly cross-referenced. Refer to purchase cycle for additional tests of control.	Inspect the stores and confirm these aspects. Observe the procedure of counting inventory. Verify the GRN and stores ledger and confirm this.
Inventory storage and safety		
Inventory to be properly stored. Inventory recorded in the financial statements may not actually exist.	Segregation of duties: person responsible for receipt of inventory to be different from the one responsible for payment person responsible for movement of inventory to be different from the one maintaining records Inventory should be counted regularly. Entities to set up various levels of inventory such as reorder level, minimum level. No outsiders to be permitted to enter the stores. Only the persons who are working in the stores to be allowed access to the stores. Adequate security systems to be in place e.g. lock and key for valuables, CCTV in warehouse. Proper racks / shelves to be made available for storage of inventory. Racks need to mention the item numbers of the material to be stored. Inventory to be issued on FIFO basis so that stocks do not become obsolete.	Inspect the stores and confirm these aspects. Review security systems. Observe that the segregation of duties is in place and is followed. Review procedure for counting inventory. Attend inventory counting as a surprise visit.
Losses due to theft and natural disasters.	All inventories to be insured. Periodic review of the insured amount versus the actual inventory to be conducted to ensure that sufficient insurance cover is taken.	Verify the insurance policies and the report.

Continued on the next page

Risk of misstatement	Control activity	Test of control
Periodic review		
Inventory quantities have not been accurately determined.	Report of the inventory which has exceeded the reorder level needs to be generated (to ensure that inventory is not procured unnecessarily). Reconciliations of inventory records with general ledger. There should be a proper procedure in place for counting the inventory at head office and at the regional sales office together. Also, a procedure to be in place to verify inventory held with a third party or on behalf of a third party.	Check approvals for purchases that are not in line with the reorder levels set Review reconciliation Review entity's procedure Observe and check that the procedure is followed.
Slow-moving and non-moving items are not properly tackled.	Management to define the method of identifying non-moving or slow-moving stock i.e. the period of time when not used to be called slow or non-moving inventory. Management to draw up the inventory management plan for slow /non-moving items i.e. when to provided for this stock, how much to provide for and any other way of tackling such stocks.	Check the inventory policy of the company for identifying and tackling slow-moving and non-moving stocks. Find out from the responsible person how the non-moving and slow-moving items are identified. Observe the procedure for doing so. In the case of the list of slow-moving / non-moving inventory find out the action plan undertaken by management.
Periodic review		
At the year end the inventory is not counted and valued properly.	Inventory to be verified according to management policy. Surprise checks by authorised staff to be carried out. All verified items to be marked as having been counted. Inventory movement to be discouraged during stock verification. Inventory sheets to be properly sequenced. Inventory sheet to be signed by the staff that have checked the inventory. List of discrepancies in inventory to be drawn up. Actions taken for discrepancies found on inventory verification to be mentioned on the inventory discrepancy list. List to be approved.	Auditors to be present during verification of inventory to confirm these aspects. Verify the discrepancy list and find out the corrective actions taken.
Issues from stores		
Issues from stores are not properly accounted for.	Issues to be made on the basis of issue slips. Issue slips to be supported by the production plan. Exception list of issues made which are not supported by the production plan to be generated. Issue slips to be authorised by the stores officials and acknowledged as received by the authorised person from the production department. Materials issued to be counted before issue. All issue slips to be recorded online. Issue slips to be sequenced.	At random verify whether entries recorded for issues have supporting issue slips. Cross-check the issue slips with the production plan. Analyse the reasons for issues which are not in line with the production plan. At random verify the issue slips to verify these aspects. Inspect the stores and observe this aspect. Verify whether issue slips are sequenced and make an exception list of issue slips which are not recorded.

Continued on the next page

Issue of finished products		
Issues made are not correctly accounted for.	All issues to be supported by dispatch advice Exception report to be prepared for issues made which do not have reference to dispatch advice	Verify the list and find out the preventive and corrective actions taken by management.
	All sales to be updated online. Sales invoices to be sequenced.	Check the missing sales invoice numbers and corrective steps taken.
	Report of sales return due to wrong dispatches to be prepared. Refer to sales cycle for additional tests of control.	Check the report and find out the preventive steps and corrective steps taken.

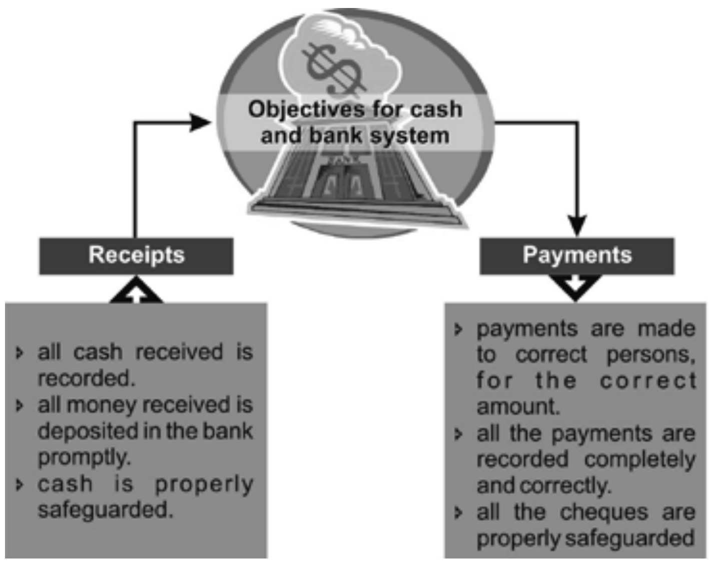
Test Yourself 3

State some of the control activities for the storage of inventory.

1.10 Bank and cash receipts and payments

1. The main **objectives** of cash and bank transactions are to ensure that:

Diagram 5: Objectives of cash and bank transactions



The revenue from every sales office is deposited in the bank on a daily basis and a report of the receipts and deposits is submitted to the head office. For any cash required (petty cash), the sales departments send requisitions to the head office and on approval by the general manager the sales departments can withdraw the amount from the bank.

2. **Control activities and tests of control relating to bank and cash**

Example

The cashier at the head office places a cash requisition for petty cash expenses every fortnight to the chief accountant who, in consultation with the general manager, approves the cash requisition and gets it authorised by the relevant director. The bills for payment are routed for approval and authorisation from the administrative department to the respective department and then to the general manager, if required. After the bills are approved by the responsible person, the administrative department submits them to the finance and accounts department for recording and payment.

Continued on the next page

In the finance department the bills are classified as those that can be paid in cash and those to be paid by cheque. On payment, the finance department intimates the accounts department about the payment. An accountant records the expenses on receipt of the approved bills from the administrative department and records payment entries when the bills are actually paid.

All the cheque books are in the custody of the finance department. The heads of the departments are not authorised to sign the cheques; the finance director is authorised to sign the cheques. They check the bills along with the supporting documents, check for the authorisation according to the company policy and then sign the cheques. Once the cheques have been signed, they are released to the third party.

Required:

Explain the tests of control that Rex would apply to find the effectiveness of the bank and cash system and give reasons for performing such tests of control.

Risk of misstatement	Control activity	Test of control
General points		
Receipts: Cash receipt and receipt by cheques		
All receipts may not be deposited in the bank immediately and may be used by staff for personal purposes.	Segregation of duties at the sales office amongst the persons responsible for collection of cash, preparing a list of receipts and depositing it in the bank A list should be prepared for daily cash sales and receipts from the customers. All receipts (cash as well as cheques) should be immediately deposited into the bank. Also, a cheque receipt register is to be maintained at the head office if cheques are directly received by the head office. The register must specify the date of receipt and the date of deposit of the cheques. Periodical management review of the register to be conducted to ensure that cheques are promptly deposited into the bank.	Check bank deposits with the list submitted by the sales offices to the head office and ensure that all the receipts are promptly deposited in the bank. Visit the sales office without prior notice and observe the procedure to ensure implementation of the segregation of duties. At random verify the cheque receipt register and supporting records to confirm that the receipt register is properly updated. Verify the cheque received register with the bank book and at random verify that cheques are promptly deposited into the bank account. Check whether a periodical review is done by the management. Refer to the sales cycle.
Custody and control of cash, cheque books and bank accounts		
Cash and cheques are not kept in a safe place. Cash may be misappropriated.	Cash and cheques to be kept in the custody of the authorised person. Access to cashier's room to be restricted. Security personnel to accompany the cashier while depositing or withdrawing cash from the bank. Unused cheques to be kept under lock and key. There should be no pre-signed cheques. A proper procedure for handling the cash keys to be devised i.e. cash box keys to be opened using two keys which are with the cashier and another official.	Observe the implementation of these activities

Continued on the next page

Custody and control of cash, cheque books and bank accounts		
High cash balances may be maintained	Maximum cash balance to be maintained needs to be decided. Any cash receipt should be deposited immediately so that there is no question of the cash balance exceeding the maximum balance. Amounts to be withdrawn from the bank only when required and approved by the authorised person.	Prepare and review a report of instances where the daily cash receipts are not deposited and as a result, the cash balance exceeds the maximum cash balance permissible. Investigate into these matters.
Cash can be misappropriated	Physical verification of cash to be conducted every week (not on any fixed day) by a person from outside the accounts department. Management to review the sheets and confirm that there were no irregularities. Cash to be suitably insured for cash in hand, and cash in transit.	Check its implementation. Verify records and confirm this aspect. Verify the insurance policy and daily cash balances during the review period and confirm whether sufficient insurance of cash is made
Recording of transactions		
All receipts and payments are recorded promptly	All cash receipts and payment to be recorded on a daily basis. The BRS to be made each month by a person other than the cashier. Special attention to be paid in the BRS to the following: if "amounts deposited but not credited by the bank" are outstanding for a long time. All entries of amounts debited by bank such as interest, commission, bank charges to be recorded after verifying their accuracy. The rates charged for these transactions need to match the original terms of the bank account.	Verify the cash docket (i.e. the break up of the cash balance currency wise) prepared daily. At random, verify that the cash receipt register matches the cash docket. Verify that the reconciliations are prepared periodically and major items or items pending for long are investigated. At random, verify these amounts charged by the bank with the supporting papers.
Payments: Cash payment and payment by cheques		
Unauthorised payments are made.	Cheques paid should be authorised.	Cheques issued should be authorised by a senior official and signed by authorised individuals within their authorised limits. For a sample payments made, confirm that supporting documents such as invoices, are available for cheques issued and match the details on the cheque.
	Cheques should be properly recorded.	Reconcile with the supplier statements. Issued cheques should be sequentially filed and an enquiry should be made into the missing numbers. Transfers made through bank accounts should also be filed and authorised. Petty cash vouchers should be sequentially numbered and recorded. Missing vouchers should be enquired into.
	Petty cash paid should be authorised and recorded.	Carry out a sample check to determine whether petty cash has been issued only in accordance with the company's policies. Furthermore verify the entry is made in the books of accounts. Verify the additions made.

Test Yourself 4

Home-maker is a furniture shop owned by Lee which was opened last year. The shop soon gained popularity and its products have become well known because of their unique designs and good quality. As a result, it has started getting a lot of orders.

In order to deal with the increasing demand, Lee wants to design internal controls for the chief items.

Required:

Suggest control activities for cash and bank transactions.

1.11 Importance of tests of control

Definition

Test of control: An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

IFAC Glossary of terms

Examples of tests of control to **prevent, detect** and **correct** material misstatement at the assertion level are as follows:

Test of control to **detect** material misstatements in the amount of bad debts	Documentary evidence of authorisation of the bad debt write-off Correspondence with accounts receivables and any press reports which give additional evidence.
Test of control to **prevent** material misstatements	Segregation of duties between the salesman who receives the sales order, sales executive who raises the invoice, cashier who collects the cheques and accounts executive who handles the accounts receivable ledger. This type of segregation of duties will prevent material misstatement in the revenue account.
Test of control to **correct** material misstatements	Preparation of a bank reconciliation statement will enable to correct any material misstatement in the financial statement with respect to bank transactions.

Auditors normally **gather evidence** regarding the **completeness, validity and accuracy of account balances and classes of transactions.**

1. In short, **if the controls are effective,** the auditor can **reduce the amount of evidence that they would otherwise gather** as to completeness, validity and accuracy of account balances and classes of transactions**.**

Example

The auditors of Jasmine Ltd, a company which manufactures perfumes, tested the internal control systems of revenue in the following manner.

	Total numbers	**Total value (TZS)**
Sales	850	755 million
Sample selected for testing controls	75	165 million

The auditors, scientifically, selected the above sample to be tested for internal controls. They noticed that there were no serious flaws in the internal control systems for the above stated sample. Hence they did not have to carry out extensive substantive procedures to support the opinion that the information given in the financial statements was true and fair.

The auditor should perform other audit procedures in combination with inquiry to test the operating effectiveness of controls. Tests of control are verified by a combination of **inquiry, observation, inspection** of the documentation and recalculation / **reperformance**.

Example

The auditors of Silverline Ltd wanted to test the controls with respect to safeguarding of the assets of the entity. They were **informed** by the administration department that everyone leaving the factory premises was checked to ensure that no property belonging to the factory was being stolen.

The auditors **observed** whether the company followed this practice. The auditors also **inspected the register** maintained by the administration department regarding items stolen from the premises which were discovered during the checking process. In this way the auditors got assurance regarding the true and fair view of the financial information.

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2. Timing of Tests of Controls

(a) **If the auditor tests controls at a particular time, the auditor only obtains audit evidence that the controls operated effectively at that time**. For example, the auditors observed the method of ensuring security in the premises of the factory by observation. This is audit evidence at the time of observation.

(b) **If the auditor tests controls throughout a period, the auditor obtains audit evidence of the effectiveness of the operation of the controls during that period**. For example, the auditor inspected the register maintained by the administration department containing cases of reported theft by employees. This is testing of controls for the entire period of review.

(c) **When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor should determine further audit evidence required for the remaining period.**

For example, the auditors checked the various activities in the procurement of raw materials with documents for the period 1 January 20X6 to 30 September 20X6 during the interim audit. Later when the auditors came for the final audit, they conducted a similar review (of the various activities in the procurement of raw materials with documents) for the period 1 October 20X6 to 31 December 20X6.

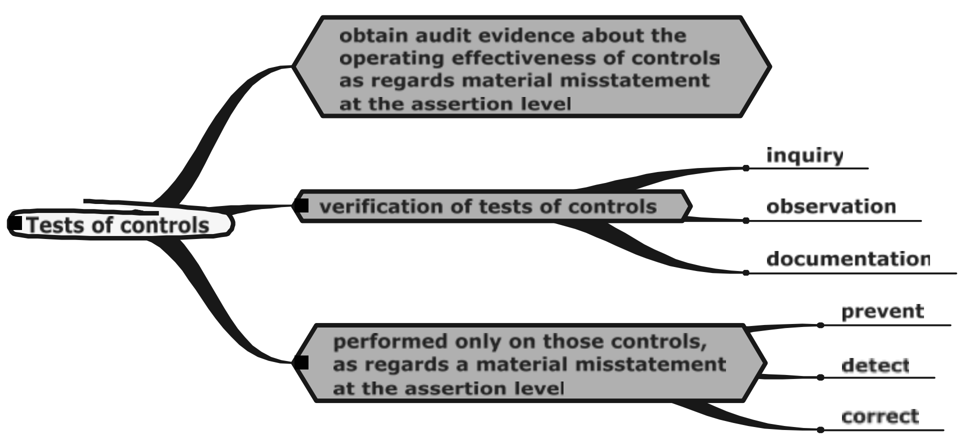
(d) Tests of controls **performed** in the **previous years** may be **relevant** to the **current year**, if they have **not changed**. However, **operating effectiveness of transactions and operations which are not significant for the operations of the entity, may be retested at least once every third year**.

(e) **Controls related to significant risks should be tested every year.**

Example

Sunrays Ltd has an internal control system which is laid out and followed by the organisation, in the area of stores operations. The auditors of the entity have carried out a detailed study of the system in 20X8. However inventory is a major component of the financial statements of the entity, therefore the auditors carried out a similar study of the internal control systems in 20X9. The study gave an assurance to the auditors about the truth and fairness of the information relating to inventory in the financial statements.

SUMMARY



Test Yourself 5

Which of the following would prove to be a suitable test of control to mitigate the risk of procuring goods which are not authorised?

A Verify with management the preventive measures taken for consistent poor quality materials received from specific vendors.
B Observe the procedure for recording purchase transaction.
C Obtain a list of GRNs from the system and verify if they are supported by a PO.
D Verify purchase vouchers at random and confirm that purchase vouchers match GRNs and POs

Test Yourself 6

Which of the following would not prove to be a suitable test of control to mitigate the risk of procuring goods which are not authorised?

A Check if sales orders are sequentially numbered.
B Check the available inventory level in the organisation
C All materials received from the factory to the sales office stores should be supported by requests
D Check if the purchase invoices received from vendors are approved.

Answers to Test Yourself

Answer to TY 1

There should be segregation of duties between the persons appointing employees, issuing swipe cards, updating master file / time recording machine, making amendments in the time recorded in case of discrepancies, calculating wages, authorising payment etc.

Issue of swipe cards should be strictly controlled. A swipe card should be given to an employee only after the employee joins the company.

In the case of employees leaving the company, the swipe card should be taken away on the day of termination of the job. Also, name of the employee should be removed from the system so that no one can misuse his card.

The unused swipe cards should be in the custody of an authorised person, different from the person responsible for adding new joinees in the system.

Amendments to the data generated by the time recording machine should be made only in exceptional cases and only if authorised by a responsible person. Access to the data should be restricted to persons at higher levels of the organisation.

A responsible person should check wage calculations i.e. hours worked, rate used, statutory deductions, deductions on account of unpaid leaves etc.

Answer to TY 2

The correct option is **D**.

Each mentioned control activities are related to the disposal of non-current asset.

Answer to TY 3

Access to store rooms should be allowed to authorised persons only.
Goods to be issued to the other departments only for the authorised requisition.
Inventory should be counted and checked for its condition regularly.
Temperature, humidity etc. should be maintained and supervised by an authorised person.
If the quantity of inventory is very high, perpetual inventory count is advisable and it should be done in such a way that all the inventory items should be counted at least once.
The counting should be done by independent persons (preferably those not working in the store rooms).
After the inventory counting, immediately the count should be reconciled with the inventory records.

Answer to TY 4

There should be segregation of duties between the following persons:

The person receiving cash.
The person depositing it in the bank.
The person recording the cash receipt.
The person in charge of the cheques.
The person responsible for signing the cheques.

All important duties should be rotated from time to time.

For each cash payment, signature of the recipient should be taken.

In the case of internet banking, the bank code should be given to only one person, in this case, Lee himself. He should not share the code in any case.

Bank reconciliation should be prepared on time and the discrepancies, if any, should be investigated from time to time.

A reconciliation of the bank statement with the suppliers' statement should also be made and discrepancies, if any, should be investigated.

Maximum petty cash balance should be decided and cash exceeding the limit should be promptly deposited in the bank.

All the receipts should be deposited in the bank and withdrawal should be made only with the authorised person's (Lee, in this case, it being a small shop) permission.

If higher amounts are withdrawn from the bank, they should be properly safeguarded and insured.

Answer to TY 5

The correct option is **C.**

The other options are incorrect because:

Option A mitigates the risk of poor quality materials consistently received from vendors.
Option B mitigates the risk of incorrect recording of purchase transactions.
Option D mitigates the risk of purchase vouchers contain wrong items and there are errors in the purchase voucher (PV).

Answer to TY 6

The correct answer is option **D.**

Checking if the invoices generated are authorised and have been approved is a test of control relevant after the order has been executed and the invoice has been raised.

The other options are incorrect because **A and C** are tests of control on sales. **B** is a test of control to mitigate the risk of overstocking of materials.

Quick Quiz

1. State the general tests of control.

2. State three controls you would set for a payroll system.

3. While checking a cash and bank system, and a sales system which numerical sequences would you check?

4. An organisation chart and written policies and procedures are necessary for an auditor to check the controls. State true or false and give reason.

5. State, in the following cases, two documents the auditor should refer to while verifying the correctness and accuracy of the following:

   (a) Purchases
   (b) Payroll
   (c) Investments
   (d) Capital expenditure

Answers to Quick Quiz

1. The general tests of control are:

   Observation
   Inspection
   Inquiry
   Re-performance of internal control

2. For a payroll system the following are examples of controls that should be set up in a wages department (three asked for):

   Payment should be disbursed by way of direct transfer to the bank accounts of the employees. Only daily wages should be paid in cash.
   Unpaid wages should be in the custody of a person independent from the one responsible for preparation of payroll and maintaining & authorising records of the employees.
   Employees wage rates should be authorised by a responsible official
   Large payments to employees should be examined
   Employees on the wages system should be compared to employees in departments to ensure that all leavers have been notified to the wages department
   For attendance and timesheets, 'clock-in' machine should be installed to note the in-time and out-time.

3. The numerical sequence for cash and bank operations is: the cash receipt numbers and bank receipt numbers which should be pre-numbered or auto generated from the computers. The numerical sequence for a sales system is the sales order number, sales invoice number, delivery note number, etc. This should be pre-numbered or auto-generated by the computer system.

4. True, The organisation chart and the written policies and procedures are necessary for the auditor to check the controls relating to segregation of duties, who is responsible for what and who is reporting to whom i.e. whether the system is such that the work is checked by independent persons.

5. The documents that a auditor should refer to for the following are (only two required in each case):

   (a) Purchases: purchase invoice, delivery note or gate order.
   (b) Payroll: payroll printout for every month, personnel files of employees, salary register of receipt of salaries, time sheets.
   (c) Investment: bank statements, bank certificates / investment certificates or any other organisation's certificate for the amount invested and yearly statements.
   (d) Capital expenditure: capital budget, vendor's invoice, purchase order, non-current asset register.

Self-Examination Questions

Question 1

State any four general considerations while framing an internal control system.

Question 2

List the internal controls to be framed to ensure the following:

(i) Terminated employees are removed from the payroll.
(ii) No unauthorised changes are made to the payroll data in EDP.
(iii) Unclaimed cheques are not misused.
(iv) All receipts through mail are properly accounted for.
(v) Sales returns relate to actual purchases and not dummy purchases.

Question 3

Heights Ltd is a small trading company. It has only two employees (Sam and Max) and an accountant in the accounts department. The duties are distributed among the employees as follows:

One employee is entirely responsible for the cash operations and another employee is totally responsible for the purchase and sales. Although allocation of duties in this manner does not ensure good internal controls, the organisation cannot afford to employ any more employees.

Required:

As the auditors of the company, suggest a suitable segregation of duties so that internal controls are effective.

Question 4

Repro Offsets prints letterheads and makes and prints envelopes of different specifications, invoices, purchase orders, books, manuals, magazines etc.

The assets of the company comprise different types of printing and cutting machinery, computers, furniture and vehicles.

Required:

State the internal controls the organisation should have to ensure smooth functioning of the business, safeguarding of the assets, prevention of fraud and error and presentation of a true and fair picture of the entity in the financial statements.

Question 5

Flora & Fauna florists sell flowers on wholesale basis. Their clients are mostly business entities and organisations. They also undertake flower arrangements and decorations for marriage parties, business seminars or any other occasion.

The orders for these kinds of services and sales are taken over the telephone or by receiving written orders or completed order forms. While taking down the orders on the telephone, the receptionist fills in the order forms giving details of the flowers and the address and account details of the customer.

The clerks input these details into the company's computer system from the order form, which is integrated with the company's inventory control system. The company's standard credit terms of payment are within one month of the order (all orders are dispatched within 48 hours) and most customers pay by bank transfer.

An accounts receivable ledger is maintained and statements are sent to customers once a month. Credit limits are set by the credit controller according to the company's norms and sometimes he has to make exceptions for clients who have a good, long-term relationship with the company, which are manually entered in the computer system. The prices of the flowers are automatically generated by the computer system.

Required:

Evaluate the sales system of Flora & Fauna for your audit and describe the kinds of internal controls you would like them to implement to make their system of receiving and processing orders more effective.

Answers to Self-Examination Questions

Answer to SEQ 1

General considerations for framing internal control system include:

No single person should have exclusive control over more than one activity / key activity of a transaction.
The duties should be segregated so that the work of one person is checked by another.
There should be rotation of duties at intervals without prior intimation.
Employees should be encouraged to take at least one day leave in a year.

Answer to SEQ 2

The internal controls to be framed are:

(a) The proper use of pre-numbered termination notice forms by the personnel department and sending a copy to the payroll department.
(b) Comparisons of payroll register with original batch transmittal data.
(c) Unclaimed wages should be recorded in a register and should be maintained by a person outside the wages department.
(d) Only an authorised person should open the mail. He should stamp the covering letters of the cheques received with the date of receipt and prepare a list of all cheques, cash etc. received. The cheques should be immediately deposited in the bank and entered into the books.
(e) The system should prepare a sales return note only when reference to a sales invoice is made.

Answer to SEQ 3

The duties of the staff can be segregated in the following manner so as to ensure effective internal controls:

Duties of Sam	Duties of Max
1. Receive and disburse cash. Prepare receipts and vouchers to be counter-signed by the accountant.	1. Maintain cash book from basic documents prepared by Sam. Reconcile the cash balance in the books with that in hand with Sam.
2. Prepare cheques to be paid to suppliers. Check the posting of invoices and payments in payables' accounts each month.	2. Receive and check purchase invoices and put them up for the accountant's approval. Maintain payables' ledger.
3. Receive cash sale proceeds and cheques for Deposit. Deposit cheques. Scrutinise receivables' accounts each month to pursue abnormal outstanding amounts.	3. Maintain receivables' ledger and bank accounts on the basis of basic documents prepared by Sam. Reconcile bank accounts.
4. Reconcile trial balance.	4. Maintain general ledger.

Answer to SEQ 4

Repro Offset should have adequate internal controls to fulfil the objectives mentioned below:

(a) For the **smooth functioning of the organisation**, the **assets** should be properly **guarded** and proper **security system** should be maintained to ensure their safety such as:

(i) Security guards or security alarms need to be fixed.

(ii) Sufficient fire extinguishers need to be installed so that if there is a fire, proper measures can be taken to control it.

(iii) The machinery needs to be maintained in such a way that it is safe from water hazards or can be moved to some other place in the case of floods.

(iv) Proper insurance cover has been taken for natural and unnatural disasters. The adequacy of the insurance cover needs to be reviewed regularly.

(v) The person from the accounts department who is responsible for making payments of the legal obligations due needs to include the due date for renewal of the insurance policy in his chart of amounts due so that insurance covers are promptly renewed.

(vi) The computers are protected with passwords and access to computers and other assets are permitted only to authorised persons.

(vii) All the assets are numbered and tagged according to the asset register.

(viii) The physical verification of fixed assets needs to be carried out at regular intervals.

(ix) Adequate regulations should be in place for assets such as computers and cars which are taken home by the staff. For example, proper security measures should be applied to prohibit them from installing any other software in the computer or from using the car for personal purposes.

(x) Computers need to be installed with proper antivirus software so as to protect them from viruses.

(b) To **prevent fraud and error**, and to **show a fair and true picture** of the statements of accounts, internal controls should be set as follows:

(i) Capital expenditure budgets should be prepared. The capital expenditure incurred should be in line with the capital budget.

(ii) Disposal of fixed assets should be undertaken when required, by a person who does not have the day-to-day responsibility of handling the records or assets.

(iii) The asset register should be reconciled with the general ledger.

(iv) A periodic verification of fixed assets needs to be carried out. Records of the verification need to be reviewed by the management, the reasons for discrepancies need to be recorded and necessary action should be taken.

(v) The assets should be checked regularly in order to calculate their useful lives, to check whether they are being depreciated at the proper rates of depreciation and to check whether they have depreciated fully.

(vi) If the assets are sold, the correct loss or profit amount needs to be recorded in the accounts books and asset register.

Answer to SEQ 5

The following are a few suggestions to make the internal control system of Flora and Fauna more effective:

(a) Although the orders are taken over the telephone, the confirmation of the order must be obtained either through a letter, email or fax. This means that there should be physical confirmation in some way.

(b) Based on the receipts of the orders, order forms should be prepared which should have details of the enquiry e.g. whether the order was received through a letter, an email or by fax.

(c) These order forms should be pre-numbered and should be forwarded to the accountant who will then raise sales invoices which also will be pre-numbered. Therefore the company ensures a control on the omission of entries.

(d) The computer system should be designed in such a way that it will not accept the entry unless the order form number is entered. This ensures that all the bills are raised and no order form is left without raising a bill.

(e) For each kind of flower there should be a unique item code.

(f) A list of item codes should be maintained for all types of flowers and decorative items.

(g) The system should be designed in such a way that it should not accept an order for wrong code numbers. The price list should be entered into the computer, as the item code of an item is entered the rate should be generated automatically and there should be an approved price list in the records.

(h) Changes to the record of price list, the item codes and the customer credit limits in the computer system should be made only by an authorised person.

(i) The computer system should be safeguarded. It should not be accessible to all. To ensure this, the computers will have passwords. The receptionist will have login rights which allow her to view the inventory and the bookings available but do not allow her to view any record. She will not have access to the price list (this should be given only to an authorised person).

(j) A list of credit limits for all customers should be prepared and entered in the system by an authorised person.

SECTION B

THE NATURE AND USE OF INTERNAL CONTROLS

B4

STUDY GUIDE B4: EVALUATION OF INTERNAL CONTROLS

Get Through Intro

An **auditor needs to rely heavily on the internal control system** of an entity, in order to complete his audit in an effective manner and within the prescribed time frame.

While assessing the internal control system of an entity, the auditor needs to **analyse** it, in order to **identify existing deficiencies**, if any. These deficiencies will **limit the extent** to which the auditor can **rely on the internal control systems.** If the internal control system cannot be relied upon, a greater amount of substantive testing will have to be carried out**.**

Learning Outcomes

a) Relate the results of internal control assessment to the design of subsequent audit procedures.
b) Identify and evaluate internal control weaknesses (deficiencies) in a given scenario explaining how these may be rectified.

1. Identify and evaluate internal control weaknesses (deficiencies) in a given scenario explaining how these may be rectified.
Relate the results of internal control assessment to the design of subsequent audit procedures.

[Learning Outcomes a and b]

Definition

Deficiency in internal control

This exists when:

1. 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
2. A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

IFAC, Glossary of terms

1.1 Deficiency (weakness) in internal control

Before deciding to rely on internal controls, the auditor should evaluate the internal controls and discover deficiencies, if any, in the internal control system. A deficiency in the system means a loophole which violates the purpose / objective of the system. This occurs when the control risk (i.e. the risk that an organisation's internal control systems do not adequately protect the organisation either because they have not been adequately designed and / or implemented) is high. As stated above, a deficiency in the system occurs, either on account of **deficiencies in the design of the internal control system**, or on account of **the non-implementation / incorrect implementation of the existing system**.

Each of these is discussed below in turn.

1. Deficiency in design of the system

The internal control system may be weak because it is not designed properly. Even if an internal control system is operating according to its design, it may not be effective due to improper design.

Example

In Sisco Ltd, a supervisor is responsible for approving the working hours recorded by employees and also for making payments to them. In this case, the supervisor may manipulate the working hours of any employee such as increase the number of hours worked by the employee and, on payment, share the money with that employee. Hence, this is a deficiency in the design of internal control system on payment.

Identification of deficiencies

The deficiencies in the system can be identified at the time of obtaining an understanding of the system or on evaluation of the system. Deficiencies in the system can be identified by

(a) Evaluation of the organisation chart

An organisation chart is a chart which explains the authority and responsibilities of various personnel in the organisation. Evaluation of an organisation chart will enable an external auditor to know who is responsible for what and who is reportable to whom. If a single person is given the responsibility to execute various stages of a transaction, this will contradict the rationale behind the segregation of duties.

The rule of the segregation of duties is that no single person should have exclusive right over any transaction.

(b) Evaluation of written policies and procedures of the entity

An auditor will examine the policies and procedures of the entity to know the procedure for carrying out a particular transaction and who is responsible for what. This will enable the auditor to point out any deficiency, which is due to the improper design of the policies or procedures.

Example

By studying the inventory count instructions given by management, the auditor knew that it did not contain instructions to stop the movement of material during the counting process, (as production could not be stopped during the inventory count).

Furthermore, management has not made any alternative arrangements for preventing double counting or non-counting of inventory issued during counting. Therefore, by reviewing the written procedures for inventory counting, an auditor will be able to point out this deficiency in the design of internal control system.

(c) Evaluation of the authorisation policy

The auditor will review whether:

(i) The authority is given for all significant transactions and processes, and
(ii) Joint authorities are given for significant transactions like signing cheques by two or more people.

Example

The policy of an entity is that:

Martin will authorise transactions up to TZS1 million,
Vera will authorise transactions from TZS1 million to TZS5 million and
Vera and Charlie will authorise transactions above TZS5 million.

This is a good authorisation policy as authority is linked to monetary terms and specific rights are mentioned. However, if the policy states that Martin, Vera or Charlie are responsible for approving all the transactions, this is not a good authorisation policy, as there is no specification given as to the authorisation level and it is not linked to the monetary terms.

(d) Evaluation of various reports

An auditor may collect information regarding deficiencies in the entity from various reports e.g.

Previous year's external auditor

From the previous year's audit file, the auditor may come across deficiencies in the internal control. They should determine whether corrective actions are taken for those deficiencies during the year.

Example

According to the previous year's audit file, internal controls in the area of preparation of the purchase vouchers was weak as there was no system of matching purchase invoices from vendors, with the proof of receipt of materials (i.e. goods receipt notes) and purchase orders. Hence, the current auditor will concentrate on assessing the effectiveness of the operation of internal controls over the purchase of material.

Internal audit report

We know that an internal audit report gives information about the effectiveness of the internal control system. From this report, the external auditor can get some idea of the deficiencies reported by the internal auditor.

Although the external auditor has to decide the extent of reliance on the internal audit report, this is the best way of identifying deficiencies in the internal control system as the internal audit report basically deals with the effectiveness of the internal control system.

Regulators' report

Sometimes regulators (Securities and Exchange Commission, Capital Markets and Securities Authority (CMSA), Bank regulators etc.) may report some deficiencies they come across while reviewing the operations of the entity.

Example

In banking companies, regulators may visit the entity and check certain functions of the entity to ascertain whether these functions are carried out according to banking regulations. While checking, they may come across certain irregularities. Therefore a report from such regulators can also help the auditor in identifying the deficiencies in the internal control system.

Examination of feedback from suppliers and customers

Sometimes suppliers and customers can also provide information regarding the internal control deficiencies noticed by them while dealing with the entity. Examination of correspondence, suggestions from suppliers and customers or customer complaints book may provide information regarding deficiencies noticed by them.

(e) Discussion with audit committee

Generally, all deficiencies are reported to the audit committee. Discussions with audit committee members will provide the auditor with information about the deficiencies in the system.

Example

Tom, the auditor of Fair Co, found a substantial increase in the scrap value, while auditing the accounts at the end of the financial year 20X8. The reason for the increase was found to be due to insufficient quality checks made on raw materials by the quality department. This indicated a deficiency in the internal controls in the area of checking raw materials. This finding was reported to the audit committee. The audit committee took up the matter with the quality department.

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2. Deficiency in implementation of the system

Example

According to the internal control system manual of Plexy Plc, the duties of the employees in the finance department should change frequently i.e. at least within two months. However, it is noticed that, for the last six months, the duties have not changed. This deficiency arises due to non-implementation of the system. However, if the internal control manual does not contain the requirement relating to the change of duties, it could be a deficiency in the design of the internal control.

Even a well-designed system cannot be effective if it is not communicated properly and implemented effectively.

Example

In a bank every employee should be assigned a separate password, which cannot be shared. The manager's password is required for withdrawals from dormant accounts (accounts in which there have not been any transactions for a long period of time). The manager has given his password to the clerk so that, even in his absence, the transactions can be processed. In this case, the clerk may withdraw the amount without the approval of the manager.

(a) Identification of deficiencies

This means that, in order to be effective, an internal control system must be well-designed, well-communicated and must operate effectively.

(b) Carry out tests of controls

Testing controls is the best way of identifying deficiencies in the system. Tests of controls include:

(i) Observation of procedures

Once the auditor has gathered information about the hierarchy of authority and responsibility, segregation of duties, authorisation levels, business processes etc. the auditor will observe various procedures and processes to confirm the effective implementation of written policies and procedures. By observing certain procedures, the auditor can identify deficiencies i.e. cases where the procedure is not followed according to the written instructions.

Example

An auditor observing an inventory count found that a person from the stores department was counting valuable inventory. This is a deficiency because a person from the stores department can misappropriate an item of inventory and count it as if it is in inventory.

(ii) Inspection of documents

This is also a method by which an auditor can test the effectiveness of the operation of controls. The auditor may inspect the documents of a sample of transactions, to determine whether they have been checked for calculations, authorised according to the requirements etc.

Example

An auditor inspects a purchase invoice to find out whether the rates, quantity, other charges, calculations etc. have been checked and authorised by a purchase manager according to the policy of the entity. The auditor discovers that some of the purchase invoices have not been authorised in cases where purchases are made when the purchase manager is out of town. This is a material deficiency because a person may make purchases for their own benefit.

(iii) Enquiry of personnel

An auditor should question personnel at various levels.

Personnel at operating level: enquiry of personnel at operating level enables an auditor to find out how the procedures are carried out and whether the personnel are following policies and procedures of the entity.
Personnel at supervisory level: enquiry of personnel at the supervisory level enables an auditor to find out whether they supervise the work according to the requirements of the policies and procedures of the entity, review exception reports and other reports regularly and take corrective action if required.

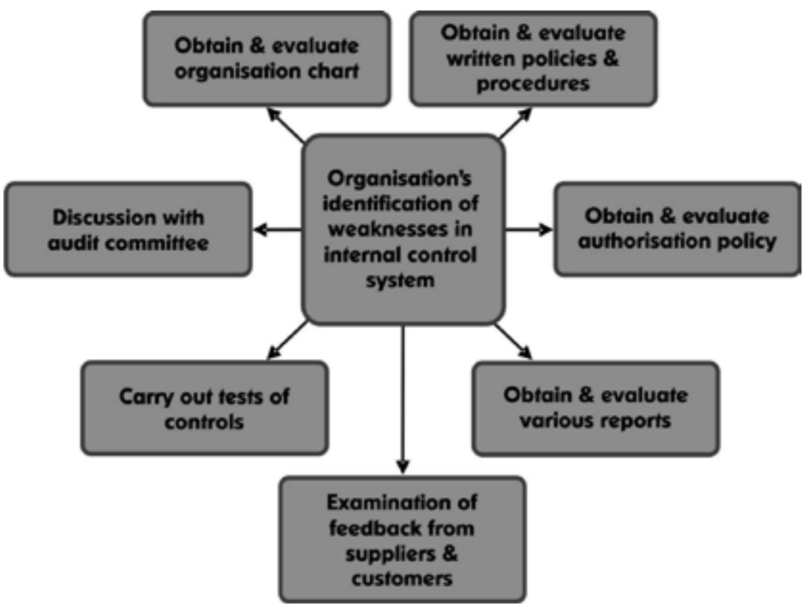
(iv) Re-performance and recalculations

An auditor can also test a control by:

Re-performing tasks (like checking whether purchase vouchers which are recorded have supporting goods receipt notes and purchase orders) and
Conducting recalculations, already performed by the internal control (like carrying out manual recalculation of interest on loan accounts already calculated by an automatic program and compare the results to confirm
The accuracy and proper working of the program.

As discussed in Study Guide A3, control risks are within the entity and cannot be controlled by the auditor. Therefore, i**n circumstances where there is high control risk, the auditor must plan and perform a much more rigorous and thorough audit in order to compensate and therefore reduce the level of the overall audit risk. Therefore evaluation of internal controls plays is very important role in ensuring that the audit risks are mitigated.**

Diagram 1: Identifying weaknesses in the internal control system



1.2 Significant deficiency in internal control

Definition

Significant deficiency in internal control – A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

IFAC Glossary of terms

Example

Examples of significant deficiencies in internal control include:

1. A manufacturing entity does not have a system of conducting quarterly / half yearly physical count of inventory. Furthermore there are many irregularities in the internal controls relating to procurement of materials. This is a significant deficiency as controls in the area of inventory are important in order to ensure accurate financial reporting.

2. The internal audit report of a retailer indicates poor internal controls in the area of cash operations. This is a significant deficiency as cash balance is a significant element of the financial statements.

Management is responsible for the design and implementation of the internal control system. It should ensure that the system works effectively and efficiently throughout the year.

An **external auditor is not responsible for detecting and reporting internal control deficiencies. However, if during the course of the audit**, i.e. while obtaining an understanding of the accounting and internal control system or while performing audit procedures, **significant deficiencies are noticed by them, they should communicate these deficiencies to t**hose charged with governance.

1. Matters to consider when determining whether a deficiency in internal control is a significant deficiency

According to ISA 265 **'Communicating deficiencies in internal control to those charged with governance and management'**, following are the examples of matters that the auditor needs to consider when they determine whether a deficiency or combination of deficiencies in internal control is called a significant deficiency:

(a) **The possibility that the deficiencies may result in material misstatements in the financial statements in the future**.

(b) **The possibility that the related asset or liability is vulnerable to loss or fraud.** For example, if the supervisor of a manufacturing set up approves the working hours of temporary staff and also makes the payment of the wages to these employees the cash related to wages is vulnerable to fraud.

(c) The **amounts in the financial statements may be exposed to the deficiencies.**

(d) The **number of activities** occurring in the account balance or class of transactions may be exposed to the deficiencies. For example, if there is a large volume of purchase transactions, there is a possibility of deficiencies being present in the internal control system related to purchases.

(e) The **importance of the controls to the process of financial reporting**, for instance:

(i) The nature of controls which are prevalent in preventing and detecting fraud.

(ii) The nature of controls used for the selection and application of significant accounting policies.

(iii) The nature of controls used for significant transactions with related parties.

(iv) The nature of controls used for significant transactions outside the entity's normal course of business.

2. ISA 265 also gives guidance to the auditors on the indicators of significant deficiencies in internal control. Following are examples of these indicators:

(a) The auditor may have previously communicated about the significant deficiencies, but the management did not take suitable remedial action.

(b) The auditor has not received a satisfactory response to important risks which were identified. For example, there are no controls on these risks.

(c) There should have been a risk assessment process within the organisation, but the auditor has found that there is no such process, which could be an indication that there are possibilities of significant deficiencies in the internal control system.

(d) There is evidence that the management has not overseen the preparation of the financial statements.

1.3 How deficiencies limit the extent of auditor's reliance on those systems

1. While deciding on an audit strategy, an auditor considers the effectiveness of internal control. The auditor evaluates the internal control system to determine the extent to which they can rely on the system. During assessment, **if they find that there are some deficiencies in the system**, first of all, they should **determine the impact of these deficiencies on the effective operation of the whole internal control system.**

Example

In the case of a hotel business, when the customer checks out of the hotel they have to settle their bill. If they leave a tip, the tip is added to the bill amount and paid by cheque, credit card or in cash. The tips collected by cheques and credit cards come to the accountant directly; however the tips collected in cash by the waiters, come to the accountant from the waiters.

Therefore there is a greater possibility of fraud where waiters collect tips in cash. Each week, the accountant divides the tip amount collected for the week equally for all the waiters and distributes it to them. However, this will not have a material impact on the whole internal control system and the auditor can still rely on the internal control system provided.

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2. If the **internal controls are not effective** and **this increases the probability of error or fraud** (misstatement), the external auditor **should increase the level of substantive procedures (will be discussed in detail in section C) to be carried out** by them because in this case, they cannot rely on the internal control system and have to collect more sufficient appropriate audit evidence.

Example

While evaluating internal controls on collection of accounts receivable, the auditor observes that the client maintains perforated counterfoils of receipts for recording cash receipts. The amount received is not entered on the counterfoils at the time of receipt but sometime later.

In some cases, it is not entered at all. This deficiency in the system may result in the failure to record or short recording of the cash received from customers. In such a situation, an auditor should carry out substantive testing to confirm the amount received from customers.

They may ask for statements from accounts receivables and perform reconciliation to confirm that all the money received from accounts receivables has been recorded accurately in the books of the entity.

1.4 Effect of fraud or error on audit strategy

Unless circumstances clearly indicate otherwise, the auditor should not assume that an instance of fraud or error is an isolated occurrence. **If the fraud or misstatement could have been prevented or revealed by the system of internal control, the auditor should reconsider their prior evaluation of the system and, if necessary, adjust the nature, timing and extent of the substantive procedures**. For this the auditor needs to consider whether the overall audit strategy as well as audit plan needs to be revised.

Example

Cathy is the auditor of Merry n May Ltd and has designed her audit procedures in such a way that she has not included any detailed substantive testing. This is because, when she reviewed the system and carried out sample testing, she found the internal controls to be effective.

During the course of the testing, she found some material misstatements in the sales day book, and so she changed her idea and performed a detailed audit procedure to determine the effectiveness of the internal controls system of Merry n May. The misstatement in the sales day book due to ineffective internal controls indicates the possibility of misstatement in other areas of operation.

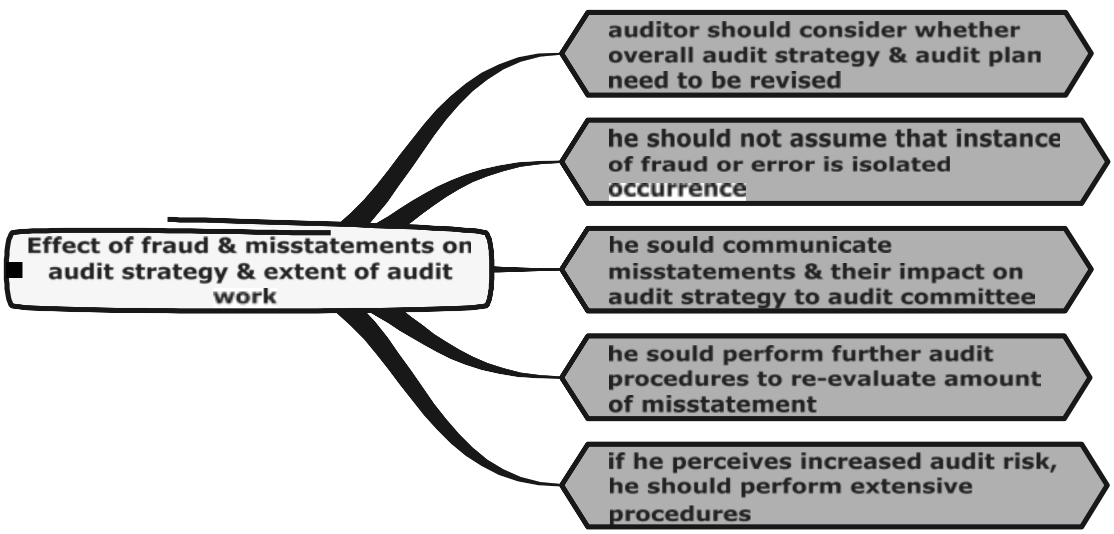
The auditor **should communicate the misstatements identified by them during the course of audit and their impact on the audit strategy to the audit committee / top management.** The audit committee should ask management to examine a class of transactions, account balances or disclosures to identify and rectify misstatements therein. After the examination and rectification by management, the auditor should **perform further audit procedures to re-evaluate the amount of misstatement.**

If misstatement or fraud is identified by the auditor, the audit risk will increase so the extent of audit evidence to be gathered must also increase in response. In this situation, the auditor will have **to perform extensive procedures to gather sufficient and appropriate audit evidence either to confirm the misstatement or to dispel it**.

Example

In the course of verification of records of the inventory management system, some receipts of material are found not to have been recorded in the stores ledger and in the bin cards. The auditors have reason to believe that more similar incidents might have taken place during the period under audit. Accordingly, they need to plan for extensive audit procedures on inventory recording.

SUMMARY



Performing modified or additional procedures will normally enable the auditor to confirm or dispel a suspicion of misstatement or fraud. Where the suspicion is confirmed, they should satisfy themselves that the effect of misstatement or fraud is properly reflected in the financial information or the error is corrected.

However, the auditor may be unable to obtain audit evidence either to confirm or dispel a suspicion of fraud. In this circumstance, the auditor should consider the possible impact on the financial information. The auditor will also need to consider the relevant laws and regulations and may wish to obtain legal advice before rendering any report on the financial information or before withdrawing from the engagement.

While considering the need to revise the audit strategy and the audit plan, the auditor should consider the materiality of the misstatements. In addition, the identification of a number of immaterial misstatements within an account balance or class of transactions may require the auditor to reassess the risk of material misstatement for that account balance or class of transactions.

Example

In Robin Plc, the auditor had considered a materiality level of TZS2 million for overhead expenses and planned his audit strategy accordingly. However, in the course of the audit, he finds that there are several errors each of which has a value of less than TZS2 million and the total impact of such errors is to the tune of TZS10 millions. Accordingly, he needs to reassess the risk of material misstatement and revise his audit plan.

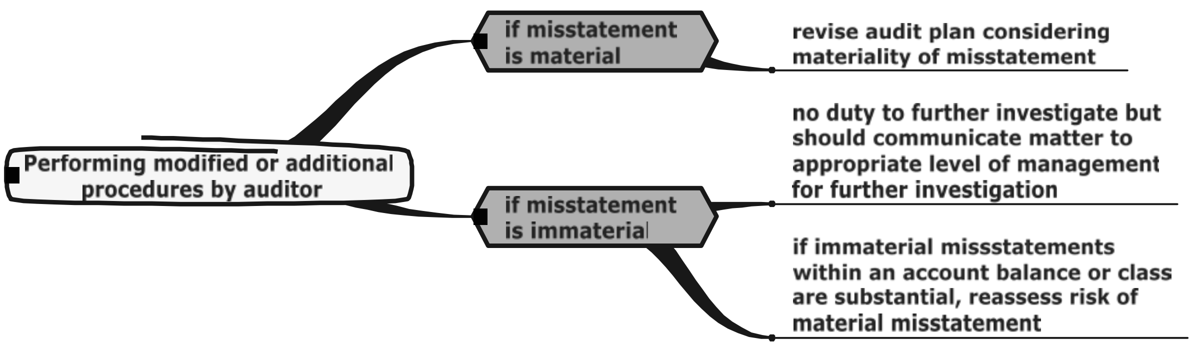
If non-compliance with the laws and regulations has no *direct* effect on the financial statements, the auditor should consult an expert to determine the effect of such non-compliance. If, in the opinion of the expert, non-compliance could have an impact on the financial statements or the going concern status of the entity, the auditor should report the matter to the audit committee / top management and should modify the report to that effect.

Example

A chemical factory operating profitably in Japan must comply with the strict regulations of Japan's Pollution Control Act. Such pollution control measures do not have any direct effect on the financial statements. However, the external auditor consulted legal experts on the issue and found out that if the company cannot comply with the pollution control regulations, it may be asked by the authority to close the factory. Considering that the issue might adversely affect the going concern status of the entity, the external auditor should modify their report to that effect.

If the misstatement is immaterial, the auditor has no duty to further investigate the matter, but they should communicate the matter to the appropriate level of management for further investigation. If management ignores the matter and does not investigate, the auditor should communicate it to the audit committee / top management.

SUMMARY



Tip

The methods of rectifying internal control deficiencies have been explained, (using scenarios) in the next Study Guide.

Test Yourself 1

Cliff is a small company, which manufactures hosiery products. It employs approximately 150 staff. Temporary factory staff are hired by the supervisor and paid weekly, according to the number of hours worked. The time is recorded by the workers and approved by the supervisor. Wages are calculated in the accounts department. Pay packets are made up in the accounts department and handed over to the supervisor who gives them to the workers.

Permanent factory staff members are paid on a weekly basis, according to the number of hours worked as evidenced by clock cards. Administration and sales staff are paid on a monthly basis. The two directors of the company are also paid a monthly salary. Payment to permanent staff, administration and sales staff and directors is made by bank transfer. You will be performing the audit of the financial statements for the year ending 31 December 20Y0.

Required:

Explain how deficiencies in the payroll system could be identified.

Test Yourself 2

Ginger Cookies Ltd is a manufacturing unit manufacturing cookies which it supplies over the country. It has regional offices which supply the cookies to retail or wholesale shopkeepers. It has appointed Jim to audit its accounts. Jim reviews the internal controls system by verifying the tests of controls and designs suitable audit procedures. He finds the sales system seems to be effective, so he plans to carry out only 10% substantive checking.

However while he is performing his tests, he discovers many errors and problems which indicate that there is a need to carry out extensive checking as the sales manager is not following and maintaining the internal control system. Jim decides to modify his audit procedures and plans to carry out extensive checking.

Required:

Explain whether Jim should only modify the audit plan for sales, as it indicates the need for extensive auditing or whether he should change his approach to the overall audit. Explain any other steps he should take.

Answers to Test Yourself

Answer to TY 1

The deficiencies in the system can be identified from the following:

1. Various reports

The auditor will then go through various reports such as the previous year's internal audit report (to find out about any deficiencies identified in the previous year's internal controls) and the regulators' report if any. He will look for the impact of such deficiencies, as stated in the reports and recommendations, if any, and their compliance.

2. Tests of controls

(a) Observation of procedures

Keeping in mind the deficiencies in the design of the internal control system over payroll, the auditor will observe the temporary workers' payment procedure without giving intimation to the supervisor. This will allow him to observe the procedure to ensure that payment is made to the concerned person only after he identifies him. Payment meant for one person should not be made to another, in case of absence of the concerned person etc.

(b) Inspection of documents

The auditor may inspect the document on which the workers signatures are taken, to ensure that payment is made only to the authorised person.

(c) Enquiry of personnel

The auditor can also make enquiries to the workers, to find out the procedure followed for payment of salaries and also for approval of timesheets of temporary factory staff. He can also make enquiries to other personnel to find out whether any fraud has been detected in any year in the area of payroll.

(d) Impact of the deficiency on the audit procedures

As stated above, there are irregularities in the design of the internal control system. However if the results of the test of control on payroll also indicate deficiencies in the implementation of the controls, the auditor cannot rely on the figures shown in the financial statements under the heading "Salaries and Wages". He will then have to carry out extensive substantive procedures.

(e) Substantive procedures

He may make a surprise visit to the sites, count the number of workers working and compare this number with the number shown on the sheet maintained by the supervisor for that day. Any fraudulent activities noticed can be brought to the attention of the management.

In order to detect the fraud of dummy workers, he can ask the supervisor to present the workers for that particular day, and try to match their signatures or thumb impressions with those on the receipts of their payments.

The list of employees against the personnel records of authorised employees should be verified. Any new employees who have joined before the payment date should be thoroughly verified.

Answer to TY 2

Jim had taken into consideration the chances of misstatements or fraud when he was assessing the risk to the entity, understanding the entity, preparing audit strategies and designing the audit procedures. So Jim was not supposed presume presence of the fraud or errors in the financial statements but, in the course of the audit, he identified some misstatements which also showed the involvement of the managerial staff.

He should therefore consider modifying the overall audit strategy as it shows that the attitude of the management towards the internal control process is poor. The discovery of misstatements and the involvement of management indicate that there may be misstatements in other areas; therefore Jim should modify his whole audit strategy.

Jim should perform further audit procedures to evaluate the quantity of misstatements and determine whether other areas of the business are similarly affected. Before modifying the audit plan, Jim should consider the materiality of the misstatements. Jim should judge the increase in risk due to the misstatements and perform extensive procedures, if required.

Therefore, as the level of identification of fraud or misstatement raises the level of audit risk also rises and so does the need to gather audit evidence. Jim must communicate all the misstatements which he discovered and their impact on his planning to those who are charged with governance, the audit committee or top management.

Quick Quiz

1. Which of the following statements describes an inherent limitation of the internal control system?

   A Copy of the goods received note handed over to the quality inspector for quality checks of inventory mentions the name of the supplier of goods
   B Internal audit is not performed on a timely basis
   C The director of a company can order a cheque to be issued without having a purchase order
   D Bank reconciliation has not been carried out

2. Mac is the sales manager who approves the sales of goods or services and is also responsible for reconciling the monthly financial reports. In the above case, there may be a case of fraud or error due to lack of:

   A Authorisation
   B Review of performance
   C Physical control
   D Segregation of duties

3. Which of the following points should be kept in mind while communicating deficiencies?

   A The level of management
   B The method of communication
   C Both A and B
   D None of the above

4. ____________________ also gives guidance to the auditors on the indicators of significant deficiencies in internal control. Following are examples of these indicators.

5. Who is responsible for the design and implementation of the internal control system?

Answers to Quick Quiz

1. The correct option is **C.**

   The director of a company obtaining a cheque without a purchase order in hand is an example of controls being by-passed due to the position that the director holds in the company.

   Option A is incorrect as it is a good control.

   Option B and D are incorrect as they can be done due to inefficient implementation of the internal control system.

2. The correct option is **D**.

   Segregation of duties ensures that an employee cannot penetrate and conceal errors or fraud in the normal course of duties. In the above case, Mac is responsible for approving sales and reconciling financial reports, which gives scope for fraud or error.

3. The correct option is **C**.

   The auditor, while communicating the deficiencies to the management, has to keep in mind both the points A and B above as both points are important.

4. ISA 265

5. Management

Self-Examination Question

Question 1

The Pagans is a club which runs a bar, restaurant and a disco. It also provides lodging and boarding facilities to its customers. Sidney is the auditor of Pagans Club and has, by carrying out test of controls, made an audit plan for performing the audit procedures regarding the inventory of the club.

In his audit plan he set the materiality levels for the audit.

During the audit of inventory Sidney found that the inventory of the bar is a very sensitive area as the committee members have a lot of influence on the sale of alcohol and cigarettes. The inventory cannot be tallied easily because purchase is made in bottles and sale is in units of volume (measures).

Inventory reconciliations are also difficult because there is lot of spillage and breakage of bottles. Vouching of sales invoices makes the auditor suspicious that that some inventories are being sold without recording them in the books.

He suspects that such malpractice takes place on a regular basis.

Required:

Explain whether or not it is necessary for Sidney to modify his audit plan and also state which matters should be investigated as they may have a material effect on the financial statements and which matters should only be reported to management for investigation

Answer to Self-Examination Question

Answer to SEQ 1

Sidney had prepared the audit plan after taking into consideration the chances of misstatements or fraud while assessing the risk to the entity, understanding the entity and preparing audit strategies and designing the audit procedures. He even fixed the materiality levels for his audit work.

However, in the course of verification he finds that the inventory needs to be checked more thoroughly as the internal controls are not effective because of persistent reconciliation difficulties. It is therefore, necessary for Sidney to modify his audit plan to include a thorough verification of inventory as it is a high risk area and will have a material effect on the financial statements.

Here, his primary objective is not to detect any fraud as this is a responsibility of management and an auditor only helps management in revealing any fraud which comes to their notice in the course of the audit. Sidney's primary objective is to obtain assurance of the true and fair picture of the financial statements. A misstatement of inventory could be material to the financial statements. Therefore Sidney should change his audit plan and strategy to check the inventory thoroughly in order to form an opinion on inventory in his report on the financial statements.

He should also consider modifying the overall audit plan as the ineffectiveness of the internal controls shows that the attitude of management towards the internal control process is not desirable. It also indicates that there may be misstatements in other areas. Therefore Sidney should modify his whole audit strategy.

Sidney should communicate all the misstatements which he has discovered and their impact on his planning to those who are charged with governance, the audit committee or top management because he will have to change his time schedule. The authority or audit committee can then ask management to pay attention to the areas of misstatements and make the necessary rectifications.

Sidney should consider the materiality of the misstatements in inventory and investigate further as required. Sidney should judge the increase in audit risk due to the misstatements and, if necessary, perform extensive procedures. As the level of identification of fraud or misstatement rises, the level of audit risk also rises and so does the need to gather audit evidence.

SECTION B

THE NATURE AND USE OF INTERNAL CONTROLS

B5

STUDY GUIDE B5: LETTER OF WEAKNESS

Get Through Intro

In order to plan an audit, **an external auditor** has to **assess the effectiveness and efficiency of the internal control system** of a client entity. While doing so, he may notice some of the deficiencies in the system.

Suppose, as an external auditor of an entity, during the course of audit, you have noticed a significant deficiency in the internal control system. Should you report this deficiency to management / those charged with governance? What further action should you take? Assuming the deficiency should be communicated to management, how should it be communicated?

This Study Guide deals with this situation and enables you to know the procedure for communication.

Learning Outcomes

a) Illustrate with examples the methods of communicating with management on:
   i. Internal control significant deficiencies and
   ii. Recommendations to overcome those significant deficiencies

1. Illustrate with examples the methods of communicating with management on:
i. Internal control significant deficiencies and
ii. Recommendations to overcome those significant deficiencies
[Learning Outcome a]

Deficiency in internal control and significant deficiencies have been explained in detail in Study Guide B4.

1.1 Communication of deficiencies

Example

During the course of the audit of Cherry Blossom, Charles, the auditor noticed that, although the supervisor is responsible for checking and signing the timesheets prepared by the workers, he often does not sign them.

This is a deficiency in the system and auditor should communicate it to the responsible person so as to avoid payments to unauthorised workers / for unauthorised hours.

This could mean that the wages expenses in the financial statements are materially misstated due to this internal control not functioning well.

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1. Method and mode of communication of deficiencies

The standard does not give any specific format for communication of deficiencies to those charged with governance. According to ISA 260, the auditor shall communicate with those charged with governance the form, timing and expected general content of communications.

When discussing communication of deficiencies to those charged with governance, some questions may come in mind such as:

How to communicate the deficiencies pointed out by the external auditor (method of communication).
When to communicate such deficiencies (time of communication).
To **whom** to communicate these deficiencies (level of management).

All the above questions will be discussed below.

(a) Method of communication

Deficiencies can be communicated either in writing or orally. The points below explain the circumstances under which they are appropriate:

(i) Written communication / management letter

The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. This written communication is made by **way of a letter called a management letter,** also called **a letter to management or letter of communication**.

The management letter enables management to take the necessary actions to remove the reported significant deficiencies in the future and make the system more effective.

The management letter contains:

Deficiencies in the system

The auditor should give details of the deficiencies noticed by him. He should also communicate the reason for the deficiencies. The reasons can be

Inadequacies of the controls
Un-required or pointless controls.

Example

If the accounting system is changed from a manual system to a computerised system, the internal control system for the manual system will become redundant for the computerised system.

The system is not properly communicated to the personnel in the organisation.

Example

In Fast Forward Plc, it is a policy that every employee should change their password every month. However, this is not communicated to the new employees joining the company. Since they are not aware of the policy they do not change their password every month. This is improper implementation of the control system due to lack of communication. This could lead to passwords being used without permission and this could have an adverse effect on the financial statements as well as the overall control environment.

While communicating the deficiencies, the auditor should clearly state that the assessment of the effectiveness of the controls is limited to those controls on which they want to rely for audit and which they have noticed during the course of the audit.

The implications of the deficiencies

The auditor should also communicate the possible consequences of such deficiencies. This will give an idea to management of how harmful the deficiency can be. The consequences of the deficiencies also help those charged with governance to decide the need to take immediate corrective action.

Example

Toy Co has no system where purchases need to be authorised. Bear works in the purchase department. She noticed that no authorisation is taking place so orders an X-box and a play station, along with 30 games. This is not a business expense but business money is used for personal use. This is obviously not acceptable and such activity must be stopped immediately as business funds are being used for improper purposes. The auditor must highlight that because of the poor authorisation system, it is possible for personal goods to be ordered and money to be misappropriated.

The recommendations suggested by the auditor

The auditor should also give recommendations as to what corrective action is to be taken to remove the reported deficiency in future.

Example

Continuing the previous example of Toy Co

The auditor should suggest that there should be a proper authorisation policy stating which people are responsible for authorisation and the limit up to which each person is authorised to approve the payment. For example, Plane should be made responsible for authorising payments up to TZS500,000 and payments above TZS500,000 should be authorised by Fox, the CEO. The person who is paying the invoices should check whether the authorised person has approved the payments.

Disclaimer

It is not the primary duty of the external auditor to evaluate the controls and find out the deficiencies in the internal control system.

Therefore the auditor should also mention in the management letter that only those deficiencies which the auditor has noticed as a result of the audit are reported in the letter, and that they have not designed their audit plan to determine the adequacy of the overall internal control system.

(ii) Oral communication

During the audit, the auditor may identify other deficiencies in internal control that are not significant deficiencies but that may be of sufficient importance to merit management's attention. The communication of other deficiencies in internal control that merit management's attention need not be in writing but may be oral. Where the auditor has discussed the facts and circumstances of the auditor's findings with management, the auditor may consider an oral communication of the other deficiencies to have been made to management at the time of these discussions. Accordingly, formal communication need not be made subsequently.

According to ISA 260, oral communication does not relieve the auditor of the responsibility to communicate the significant deficiencies in writing.

Example

During the physical verification of cash in hand, if the auditor notices that the actual cash in hand is less than the cash reflected in the books of accounts, he should immediately report the situation to the responsible authority without waiting to draft the management letter.

This will enable management to take corrective action as soon as possible. On completion of the audit, he should incorporate the point in the management letter and also the response of management on the matter when communicated orally.

(b) Time of communication

According to ISA 260, the deficiencies should be communicated on timely basis. However, no fixed timing is mentioned.

(i) Regardless of the timing of the written communication of significant deficiencies, the auditor may first communicate these orally to management and to those charged with governance to assist them in taking timely remedial action to minimise the risks of material misstatement.

(ii) The fact that the auditor communicated a significant deficiency to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If a previously communicated significant deficiency remains, the current year's communication may repeat the description from the previous communication, or simply reference the previous communication. The auditor may ask management or, where appropriate, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

In determining when to issue the written communication, the auditor may consider whether such communication would be an important factor in enabling those charged with governance to discharge their responsibilities. For listed entities in certain jurisdictions, those charged with governance may need to receive the auditor's written communication before the date of approval of the financial statements in order to discharge specific responsibilities in relation to internal control for regulatory or other purposes.

(c) Level of communication

According to auditing standards, the duty of the auditor to report on the effectiveness of internal controls is restricted to reporting to the management of the entity or those charged with governance but not to others e.g. shareholders.

In general practice, the auditor should discuss the deficiencies noticed by him and recommendations made by him with line management (those who are directly responsible for those controls / operations of the entity) before issuing the management letter. This is so that the deficiencies are communicated to those who are directly responsible for those controls so that the deficiencies can be removed in future.

Example

In Sat Co, Mandy, the Head of the purchase department is responsible for authorising payments up to TZS5 million. Payments of TZS5 million and above are to be authorised by, Gorge, the finance director and Mandy. If it is discovered that even payments above TZS5 million are authorised solely by Mandy, the auditor should first communicate this deficiency to Mandy and Gorge so that this should not happen in future.

If the deficiencies are of a serious nature, or of such a nature that the line management is responsible for the deficiency, the deficiencies should be communicated to the highest level of management e.g. the Board of Directors. The proper authority for communicating deficiencies is through the audit committee.

Example

Continuing the previous example of Sat Co

If it is found that some of the purchases authorised by the head of the purchase department are personal and paid out of the entity's money, the auditor should directly communicate this situation to the audit committee.

In the management letter, the deficiencies shall be presented in the order of **significance.**

Example

Non-current assets, receivables, inventory etc. are considered more important items than petty cash or loose tools, as misstatement in these assets is likely to have a greater impact on the reliability of the financial statements.

1.2 Examples of communication of deficiencies

1. Payroll system

Example

Nasco is a manufacturing company which has branches in different parts of the country. In its new factory in Pemba. Jill, the supervisor of the factory, is authorised to employ local people as temporary staff.

The temporary staff will be paid on the basis of a labour hour rate. They will maintain timesheets. Jill is responsible for authorising the timesheets and the working hours recorded by the staff.

The payroll is prepared in the accounts department on the basis of timesheets and at the rates prescribed by management. The supervisor, who can access the payroll, then checks the calculations and makes changes. Starters' and leavers' forms are not maintained.

A person from the accounts department makes the payments. If the wages remain unpaid, the pay packets are handed over to the supervisor, so that she can make the payment when the worker returns to work.
During the course of the audit it is found that some of the timesheets have not been signed / authorised by the supervisor.

The deficiencies of the above system shall be communicated as follows:

Letter of communication

To,

Dear Sir / madam,

We have noticed the following deficiencies in the internal control system over payroll, during the course of our audit. We have not designed the audit to discover deficiencies in the internal control system. The deficiencies stated below are those which were discovered while performing the audit.

Continued on the next page

Deficiencies	Implications	Recommendation
There is no proper segregation of duties. Jill, the supervisor, is responsible for many activities such as appointment of temporary labour, authorisation of timesheets and payment to unpaid workers.	Jill is in a position to take undue advantage of the responsibilities given to her. For example, Jill may record a dummy worker on the payroll and prepare a timesheet for that worker by herself. Since unclaimed pay packets are given to the supervisor, she can misappropriate the cash paid for that dummy worker. This misappropriation of cash is quite difficult to detect.	The supervisor should not be made responsible for activities such as appointment of staff, approval of timesheets and holding unpaid pay-packets. Instead, Jill should be asked to approve timesheets, calculation of the payroll and rest of the activities should be delegated to another person. When the activities are such that, if assigned to the same person, they may enable the person to take undue advantage of their position, then these activities should not be assigned to a single person.
Lack of Jill's signature on timesheet i.e. improper implementation of internal control system.	Due to overload, it may not be possible for Jill to authorise all the timesheets but, as a result, there is no check on the workers and they may claim wages for more hours. **This may result in payment for more hours.**	Ensure that the person responsible for authorisation of the timesheets authorises them and the accounts department cross-checks the approval.
Starters' and leavers' forms not retained.	Unauthorised people may be paid or authorised people may not be paid.	A responsible person not involved with other activities related to the payment to staff such as authorisation of timesheets, calculation of payment should sign the starters' and leavers' forms.
Jill has access to the payroll. In the whole process from appointment to payment Jill is involved and therefore at any stage he may misappropriate cash.	Jill may add a dummy employee on the payroll and produce a dummy timesheet. The payment in such a case, will remain unpaid and come to the supervisor who may then put it in her own pocket.	Access to the payroll should be restricted to the authorised person only. Access to any system should be provided only on a **need to know** basis.
Unclaimed pay packets are handed over to Jill.	As Jill has been entrusted with the authority to appoint a temporary worker and holding unclaimed cheques till they are claimed by the worker, he may take undue advantage of this situation and misappropriate cash.	Unclaimed pay packets should be kept in an independent department and should be paid only after ensuring the authenticity of the claimer.

Auditor

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2. Sales system

Example

Doll Limited is a company which buys dolls from a supplier in China. Doll Co is situated in Tanzania. The dolls come to Tanzania and they are repackaged for different markets, e.g. Rwanda, Burundi and Afirca. Doll Co's customers are big toy stores in different countries. 90% of the sales are made on credit and 10% of the sales are in cash. Orders are placed over the telephone. China receives these orders and checks whether they are within the credit limit. If the order is within the credit limit, China will raise the sales order.

The sales order is then sent to the inventory department. James from the inventory department dispatches the goods and prepares a goods dispatch note. A copy of the goods dispatch note along with the sales order is then sent to the accounts department where a sales invoice is prepared.

Ngowi from the accounts department prepares sales invoices then enters sales in the books. In the case of cash sales, Mwakasege prepares the sales receipt at the counter and collects the cash. He then enters the cash sales in the books. Sales receipts are perforated and, while preparing the sales receipt, Mwakasege fills in both the sales receipt as well as the counterfoil at the same time. The director, Mgaya, checks the credit limits every six months.

Continued on the next page

Required:

As an auditor of Doll Limited, identify the deficiencies in the system and report them to the management of Doll Limited. Also, make suggestions on how to eliminate these deficiencies.

Answer

The deficiencies in the above system shall be communicated as follows:

Letter of communication

To,
Dear Sir / madam,

We have noticed the following deficiencies in the internal control system over payroll, during the course of our audit. We did not design the audit to discover deficiencies in the internal control system. The deficiencies stated below are those which were discovered while performing the audit.

Deficiencies	Implications	Recommendations
Orders are taken over the telephone. No written orders are placed.	Since no written orders are placed, it may happen that an order is not recorded by China and Doll Co will lose sales.	**Written orders** Information may be given over the telephone but an order should be confirmed only when it is given in writing. The customers should be asked to send the orders by e-mail, letter or fax (something in writing). Otherwise they can come and fill in a sequentially numbered order form which is available with the entity. This will avoid the chance of omission of orders and also processing of the fictitious orders.
No segregation of duties. Same person receives orders, checks limits and prepares sales orders.	**Orders may be accepted exceeding the credit limit** As the same person (i.e. James),receives the order, checks the limit and prepares the sales order there is a possibility that James may not check the credit limit or, if she has a good relationship with the customer, she may prepare the order even if the order is not within the credit limit allowed to the customer.	**Segregation of duties** Segregation of duties is the basic requirement of the good internal control system. To avoid the orders exceeding the credit limit, there should be segregation of the duties between the person checking the credit limit and the person preparing the sales order. James should be asked to check limits and the sales orders should be prepared by, say, Huyang.
No segregation of duties for dispatch of goods and preparation of goods dispatch note.	**Fraud in inventory department** In the inventory department, the person who dispatches goods is also responsible for preparation of the goods dispatch note. He may actually dispatch 600 dolls and prepare a goods dispatch note for 500 dolls. He may remove the extra 100 dolls secretly and may misappropriate the money for 100 dolls.	**Segregation of duties** There should be segregation of duties between the person dispatching goods and the person preparing the goods dispatch note.

Continued on the next page

Use of perforated sales receipts.	**Fraud in cash sales** Cash sales are recorded on perforated sequentially numbered sales receipts. Mwakasege, who prepares the cash sales receipts and also receives the money, may write a lower quantity and amount on the counterfoil compared to the actual sales receipt and misappropriate the balance.	**Use of receipt books with duplicate copies** Mwakasege, who prepares the cash receipts, should be given numerically sequenced receipts books with duplicate copies, and he should be asked to put carbon paper between the two and prepare a cash receipt where the original copy will be given to the customer and the carbon copy will be kept by the entity as evidence of cash sales. Also, there should be **segregation of duties** between preparation of receipt for cash sales and receiving cash. The accounting should be computerised and, in the case of power failures, manual receipts should be maintained and should be signed by an appropriate authority. A proper check should be maintained for power failures and the receipts entered during that period. If the manual receipt book's entries do not appear in the records, this should raise suspicion.
Low frequency of reviewing credit limits.	Mgaya reviews the credit limits every 6 months. This interval is large and it may happen that a customer with a limit of, say, TZS100 million, has defaulted twice for a total amount of TZS45 million (TZS20 million and TZS25 million). Having defaulted twice, he should not be allowed further credit but will be given credit of TZS55 million (TZS100 million - TZS45 million) since he has balance in his credit limit.	To avoid this, Mgaya should review the credit limits every month. A person who has not used their full credit limit but has been unable to pay the credit taken by the due dates should not be given more credit.
Chin does not check whether the credit previous payments are made by the customers on the due dates but just checks the availability of the credit limit.	**Non-payment of sales** Continuing with the above example of TZS100 million, due to this it may happen that goods may be sold to a person who is not able to pay.	**Credit limit should be decided by the authorised person only.** Chin should be asked to check the defaults made by the customer, if any, before allowing further credit. Also the credit limits should be verified more frequently than six months, say, monthly, according to the payment record of the customer. A new customer should not be allowed to purchase on credit. A credit limit for a new customer should be decided only if the customer has paid all bills regularly for, say, the last six months.

Auditor

Quick Quiz

State true or false for the following:

1. The duty of the auditor to report the deficiencies in the internal control system is restricted to those charged with governance or management of the entity and not to others such as stakeholders.
2. It is the primary duty of the external auditor to evaluate the controls and discover the deficiencies in the internal control system.
3. Generally, in practice, auditor should discuss the deficiencies noticed by him and recommendations made by him with the line management before issuing the letter of deficiencies.
4. A management letter contains the reasons for the deficiencies, the implications of the deficiencies and recommendations by the auditor.

Answers to Quick Quiz

1. **True.** The auditor's responsibility is to express an opinion on the true and fair view of the financial statements of an entity and not to identify the deficiencies in the internal control system. However, they should communicate the deficiencies noticed while performing an audit to those charged with governance or management but not to the shareholders.
2. **False.** It is not a duty of the external auditor to identify and report internal control deficiencies. However, if, during the course of the audit, they notice some deficiencies, they should communicate them to management
3. **True.** This is because, by doing this, deficiencies will be communicated to those who are actually responsible for them. This will also enable the line management to take corrective action on the recommendations.
4. **True.** Letter of deficiencies should include the implications and recommendations in addition to reporting the deficiencies.

Self-Examination Question

Question 1

Lee, a cashier of Platinum Ltd, who receives all the cash from cash sales, keeps aside the money for petty cash for the whole month and deposits the rest in the bank. However, as noticed by Robert, the finance director, the petty cash expenses never exceed even half of the amount kept aside. Lee opens the mails and receives money orders, demand drafts, cheques etc. Sometimes, cheques sent by the customers are not even crossed. The company has an e-banking facility and the code is known only to Kent, a managing director.

However, Kent has to travel a lot to expand the business, so he has given the code to Robert, who keeps it in a locker to which Lee has access. The Suppliers of Platinum asked for bearer cheques instead of account payee cheques. The cheques are sent by post or are delivered by an employee. For some of the suppliers, the balances outstanding according to the supplier's books do not match Platinum's books. Lee is responsible for preparing the bank reconciliation statement and the reconciliation of supplier's statements.

Since he has a lot of responsibilities he could not prepare these statements in time and therefore both reconciliations were pending for more than half the year. To pay the workers' salaries, every month, a large amount is to be withdrawn from the bank. Neither the cash-in-transit nor the cash in hand is insured as Robert feels that the cash-in-transit is safe as the bank is close to Platinum Ltd and is brought by two responsible employees.

Required:

As an auditor of Platinum, identify the deficiencies in the system, their implications and make recommendations for improving the system.

Answer to Self-Examination Question

Answer to SEQ 1

Deficiencies	Implications	Recommendations
No proper segregation of duties. Lee is entrusted with many responsibilities including opening daily mails.	Lee is entrusted with many responsibilities including opening daily mails therefore he can misappropriate the cash. For example Lee may deposit a bearer cheque received through mail in his personal account and misappropriate money. In addition, he may misappropriate cash received from cash sales.	The duties of Lee should be segregated. The person opening the mail or receiving cash and cheques should not be from the accounts department. He should be a receptionist or a receiving clerk responsible only for inward and outward of mails. The person opening mails should prepare a list of mails received, record it and then hand over it to any of the cashiers responsible.
Payments are made or received by bearer cheque.	Bearer cheques drawn can be encashed by the cashier or any other employee or may be actually misplaced during transit and encashed by an unknown person.	Payments should never be made by bearer cheques, but by account payee cheque only. If any supplier demands a bearer cheque, acknowledgement of the payment of bearer cheque should be taken from the supplier.
Secret code for e-banking is not properly safeguarded.	By disclosing the code to his subordinate, Kent, the managing director, has given his subordinate a chance to misappropriate the organisation's money in the bank which is very difficult to trace later on. Lee may use the code kept in the locker and misappropriate money	The secret code / password for e-banking is confidential information Which should not be disclosed to anyone. Kent should be informed of the confidentiality of the code and told that he should not disclose it to anyone.
Bank reconciliation and reconciliation of supplier's statement were not prepared for more than half of the year.	Since the cheques given for payment of suppliers, were not account payee cheques, bank reconciliation and reconciliation of the supplier's statements is essential to ensure that the suppliers are receiving their payments. The status of the payments and receipts of the cheques received or issued is not known and so proper rectifying steps cannot be taken.	Bank reconciliation should be prepared each month. This will reveal any suspicious withdrawals or deposits. Also, the supplier's reconciliation should be prepared from time to time so that proper track of payments made and purchases will be kept.
No limit set for petty cash to be kept in hand and for withdrawal.	Often cash in hand is more than its requirement, which is quite risky. Lee has kept a large amount of cash with him. He may lend this money and earn interest on it.	All the cash received against cash sales should be deposited in the bank without keeping aside an amount for petty cash. The monthly requisition of cash should be placed with details of the estimated expenditure and the expenditure incurred in the previous month and approved. The cash should be kept in a secure cash box with a security lock whose code is known only to the cashier. The keys to the cash box should be kept only with the cashier and the authorised person.
Cash-in-transit as well as cash in hand is not insured.	As a large amount is withdrawn from the bank to pay the salaries every month, the chances of theft of cash are more.	The cash withdrawn from the bank should be properly safeguarded and should be insured.

SECTION C

THE NATURE OF AUDIT EVIDENCE AND THE SELECTION OF SUFFICIENT APPROPRIATE EVIDENCE

C1

STUDY GUIDE C1: NATURE AND QUALITIES OF AUDIT EVIDENCE

Get Through Intro

The auditor tests the validity of different assertions with the help of suitable audit procedures.

The auditor has to use professional judgment to determine the evidence to be examined before arriving at the conclusions. There are different sources and types of evidence. Which evidence is appropriate and how much evidence is sufficient? These are the issues the auditor has to decide upon.

Certain circumstances require that the audit procedures are suitably adjusted, e.g. audit of smaller entities or audit of accounting estimates.

These issues are explored in this Study Guide.

Learning Outcomes

a) State, identify and explain the different sources and quality of evidence and the methods of obtaining evidence including documenting and assessing systems and controls, tests of controls, substantive tests and analytical procedures.

b) State and identify the differences in quality and reliability of different sources of audit evidence and the efficiency and effectiveness of different methods of obtaining evidence.

1. State, identify and explain the different sources and quality of evidence and the methods of obtaining evidence including documenting and assessing systems and controls, tests of controls, substantive tests and analytical procedures.
State and identify the differences in quality and reliability of different sources of audit evidence and the efficiency and effectiveness of different methods of obtaining evidence
[Learning Outcomes a and b]

Audit evidence means all the information used by the auditor in order to arrive at the conclusions on which they form their opinion. It includes the information contained in the accounting records underlying the financial statements as well as other information. Audit evidence verifies the correctness of the assertions contained in the financial statements.

Audit evidence may be obtained from:

Audit procedures performed during the course of the audit and
Other sources such as previous audits, a firm's quality control procedures for client acceptance and continuance.

1.1 Sources and methods of obtaining evidence

The various sources and methods of obtaining evidence will be described and their relative merits analysed in turn.

1. Inspection of records or documents

Records or documents, for example, invoices, purchase journal, contracts, minutes of meetings etc. are examined to verify the assertions like ownership, occurrence. **Records or documents may be either internal to the entity** (e.g. purchase order) **or external** (e.g. purchase order confirmation). They may be in paper form or electronic form.

Advantages

(a) This audit evidence is valid evidence.
(b) It provides a strong base on which to design questions to be asked e.g. when an auditor verifies a purchase invoice, they can raise a specific question such as "why is the amount debited to an asset account rather than treating it as an expense?"
(c) The day-to-day operations of the entity would usually not be hampered by the auditor inspecting documents.

Disadvantages

(a) Some documents may contain areas where interpretation is required. E.g. a lease agreement may be a finance lease or an operating lease. Determining the type of an agreement is a task that needs special skill and knowledge.
(b) Internally generated documents are less reliable than third party.

2. Inspection of tangible assets

Assets are physically verified. This supports the assertion of existence. For example, items of machinery are physically checked with reference to their identification number and location recorded in the assets register.

Advantages

(a) It is current evidence and not evidence related to the past, hence useful.
(b) It provides a better understanding of the business by allowing the auditor to see the location and functioning of different assets.

Disadvantages

(a) Tests need to be corroborated by other evidence, since they do not confirm the other assertions like valuation and allocation and rights obligations.

Example

A car may be physically verified. However, ownership of the car still needs to be confirmed with the help of other evidence as it may be a leased vehicle or may not belong to the company at all.

(b) A client's employees may alter or move the assets when they know that the assets are going to be checked. A surprise element should be introduced to avoid this.

3. Observation

When auditors look at a process or procedure being performed by others, it is called an observation. For example, observation of the counting of inventories and the disbursement of wages to employees, the auditor observes who is performing the different tasks and what the different procedures which are being followed.

It gives evidence of the operation of controls that indirectly help in verifying other assertions, e.g. completeness, valuation, cut-off etc.

Advantage

(a) It is perhaps the only evidence that the controls are operating at present.

Disadvantages

(a) The evidence provided is restricted to the point of time when the observation takes place.
(b) Auditor's presence may influence the behaviour of client's staff. They may comply with the control procedures just to show the auditor that they are doing so.

4. Inquiry

Inquiry means **asking for information from knowledgeable persons, both financial and non-financial, throughout the entity or outside the entity.**

This kind of evidence can be used to test any assertion. However, **it is corroborative evidence which supports the conclusions drawn on the basis of other evidence.**

Example

An auditor consults the client about the method of valuation of inventories. They are told that the FIFO method is used to identify the costs and that the inventories are valued at the lower of cost or net realisable value.

The auditor cannot rely only on this answer to their inquiry. They have to test the actual calculations by re-performing the calculations on a sample selected.

Advantages

(a) Provides direct interface with the client's personnel and facilitates better understanding of the business.
(b) It is interactive and doubts can be cleared on the spot.
(c) Non-verbal communication supports verbal communication.

Disadvantages

(a) The responses which the auditor receives **may not represent an independent opinion**; they may represent the one-sided perception of an individual or management.
(b) Interviewer needs training to elicit the information. It may be necessary to adjust the style according to the interviewee.
(c) Interviewees often 'know the right answer' and this might be at odds with what is actually done.
(d) Overly aggressive questioning has the potential to alienate the auditee. If an employee goes into a defensive frame of mind, they may not give honest and objective answers.

5. External Confirmation

External confirmation is the process of obtaining and evaluating audit evidence through a representation of information or an existing condition directly from a third party in response to a request for information about a particular item affecting assertions in the financial statements or related disclosures. In deciding to what extent to use external confirmations the auditor considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.

Remember the generalizations about reliability of audit evidence. Audit evidence in the form of original written responses to confirmation requests received directly by the auditor from third parties who are not related to the entity being audited, when considered individually or cumulatively with audit evidence from other audit procedures, may assist in reducing the risk of material misstatement for the related assertions to an acceptably low level.

External confirmation as a means of obtaining audit evidence is discussed under the provisions of ISA 505. The requirement of ISA 505 is that auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion level. In making this determination, the auditor should consider the assessed risk of material misstatement at the assertion level and how the audit evidence from other planned audit procedures will reduce the risk of material misstatement at the assertion level to an acceptably low level.

Confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request is designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. Confirmations also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a “side agreement” that may influence revenue recognition.

Other examples of situations where external confirmations may be used include the following:

- Bank balances and other information from bankers.
- Accounts receivable balances.
- Stocks held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments purchased from stockbrokers but not delivered at the balance sheet date.
- Loans from lenders.
- Accounts payable balances.

The reliability of the audit evidence obtained by external confirmations depends, among other factors, upon the auditor applying appropriate audit procedures in:

- Designing the external confirmation request,
- Performing the external confirmation procedures, and
- Evaluating the results of the external confirmation procedures.

Factors affecting the reliability of confirmations include:

- The control the auditor exercises over confirmation requests and responses,
- The characteristics of the respondents, and
- Any restrictions included in the response or imposed by management.

Assertions Addressed by External Confirmations

While external confirmations may provide audit evidence regarding different assertions, the ability of an external confirmation to provide audit evidence relevant to a particular assertion varies.

External confirmation of an account receivable provides reliable and relevant audit evidence regarding the existence of the account as at a certain date. Confirmation also provides audit evidence regarding the operation of cut-off procedures. However, such confirmation does not ordinarily provide all the necessary audit evidence relating to the valuation assertion, since it is not practicable to ask the debtor to confirm detailed information relating to its ability to pay the account.

Similarly, in the case of goods held on consignment, external confirmation is likely to provide reliable and relevant audit evidence to support the existence and the rights and obligations assertions, but might not provide audit evidence that supports the valuation assertion.

The relevance of external confirmations to auditing a particular assertion is also affected by the objective of the auditor in selecting information for confirmation. For example, when auditing the completeness assertion for accounts payable, the auditor needs to obtain audit evidence that there is no material unrecorded liability. Accordingly, sending confirmation requests to an entity’s principal suppliers asking them to provide copies of their statements of account directly to the auditor, even if the records show no amount currently owing to them, will usually be more effective in detecting unrecorded liabilities than selecting accounts for confirmation based on the larger amounts recorded in the accounts payable subsidiary ledger.

It is important therefore when obtaining audit evidence for assertions not adequately addressed by confirmations, that the auditor considers other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures.

Design of the External Confirmation Request

The auditor should tailor external confirmation requests to the specific audit objective. When designing the request, the auditor should consider the assertions being addressed and the factors that are likely to affect the reliability of the confirmations.

Among factors affecting the design are:

- The form of the external confirmation request i.e. whether it is a negative or positive confirmation request,
- Prior experience on the audit or similar engagements,
- The nature of the information being confirmed, and
- The intended respondent.

It is also important in designing the request for the auditor to consider the type of information respondents will be able to confirm readily since this may affect the response rate and the nature of the audit evidence obtained. For example, certain respondents' information systems may facilitate the external confirmation of single transactions rather than of entire account balances. In addition, respondents may not always be able to confirm certain types of information, such as the overall accounts receivable balance, but may be able to confirm individual invoice amounts within the total balance.

Confirmation requests ordinarily include management's authorization to the respondent to disclose the information to the auditor. Respondents may be more willing to respond to a confirmation request containing management's authorization, and in some cases may be unable to respond unless the request contains management's authorization.

Positive and Negative Confirmations

The auditor may use positive or negative external confirmation requests or a combination of both.

A positive external confirmation request asks the respondent to reply to the auditor in all cases either by indicating the respondent's agreement with the given information, or by asking the respondent to fill in information. A response to a positive confirmation request is ordinarily expected to provide reliable audit evidence. There is a risk, however, that a respondent may reply to the confirmation request without verifying that the information is correct and the auditor is not ordinarily able to detect whether this has occurred. The auditor may reduce this risk, however, by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, but ask the respondent to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the respondents.

A negative external confirmation request asks the respondent to reply only in the event of disagreement with the information provided in the request. However, when no response has been received to a negative confirmation request, the auditor remains aware that there will be no explicit audit evidence that intended third parties have received the confirmation requests and verified that the information contained therein is correct. Accordingly, the use of negative confirmation requests ordinarily provides less reliable audit evidence than the use of positive confirmation requests, and the auditor should consider performing other substantive procedures to supplement the use of negative confirmations.

Negative confirmation requests may be used to reduce the risk of material misstatement to an acceptable level when:

- The assessed risk of material misstatement is lower;
- A large number of small balances is involved;
- A substantial number of errors is not expected; and
- The auditor has no reason to believe that respondents will disregard these requests.

A combination of positive and negative external confirmations may be used. For example, where the total accounts receivable balance comprises a small number of large balances and a large number of small balances, the auditor may decide that it is appropriate to confirm all or a sample of the large balances with positive confirmation requests and a sample of the small balances using negative confirmation requests.

Management Requests

When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain audit evidence to support the validity of management's requests. If the auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should apply alternative audit procedures to obtain sufficient appropriate audit evidence regarding that matter.

If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor's work and the auditor should consider the possible impact on the auditor's report.

In considering the reasons provided by management, the auditor should apply an attitude of professional scepticism and considers whether the request has any implications regarding management's integrity. The auditor has to consider whether management's request may indicate the possible existence of fraud or error, in which case the auditor will apply the guidance in ISA 240. The auditor will also have to consider whether the alternative audit procedures will provide sufficient appropriate audit evidence regarding that matter.

Characteristics of Respondents

The reliability of audit evidence provided by a confirmation is affected by the respondent's competence, independence, authority to respond, knowledge of the matter being confirmed, and objectivity. For this reason, the auditor should attempt to ensure, where practicable, that the confirmation request is directed to an appropriate individual. For example, when confirming that a covenant related to an entity's long-term debt has been waived, the auditor should direct the request to an official of the creditor who has knowledge about the waiver and has the authority to provide the information.

The auditor should also assess whether certain parties may not provide an objective or unbiased response to a confirmation request. If information about the respondent's competence, knowledge, motivation, ability or willingness to respond comes to the auditor's attention, the auditor should consider the effect of such information on designing the confirmation request and evaluating the results, including determining whether additional audit procedures are necessary.

The External Confirmation Process

When performing confirmation procedures, the auditor should maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of confirmation requests, and the responses to those requests. Control is maintained over communications between the intended recipients and the auditor to minimize the possibility that the results of the confirmation process will be biased because of the interception and alteration of confirmation requests or responses. The auditor should ensure that it is the auditor who sends out the confirmation requests, that the requests are properly addressed, and that it is requested that all replies are sent directly to the auditor. The auditor should additionally consider whether replies have come from the purported senders.

No Response to a Positive Confirmation Request

The auditor should perform alternative audit procedures where no response is received to a positive external confirmation request. The alternative audit procedures should be such as to provide audit evidence about the assertions that the confirmation request was intended to provide.

Where no response is received, the auditor should contact the recipient of the request to elicit a response. Where the auditor is unable to obtain a response, the auditor should resort to alternative audit procedures. The nature of alternative audit procedures varies according to the account and assertion in question.

In the examination of accounts receivable, alternative audit procedures may include:

- Examination of subsequent cash receipts,
- Examination of shipping documentation or other client documentation to provide audit evidence for the existence assertion, and
- Examination of sales near the period end to provide audit evidence for the cut-off assertion.
- In the examination of accounts payable, alternative audit procedures may include:
- Examination of subsequent cash disbursements or correspondence from third parties to provide audit evidence of the existence assertion, and
- Examination of other records, such as goods received notes, to provide audit evidence of the completeness assertion.

Reliability of Responses Received

The auditor should consider whether there is any indication that external confirmations received may not be reliable. The auditor may choose to verify the source and contents of a response in a telephone call to the purported sender. In addition, the auditor should requests the purported sender to mail the original confirmation directly to the auditor. With ever-increasing use of Information technology, the auditor should consider validating the source of replies received in electronic format (for example, fax or electronic mail).

Oral confirmations should be documented in the work papers. If the information in the oral confirmations is significant, the auditor requests the parties involved to submit written confirmation of the specific information directly to the auditor.

Causes and Frequency of Exceptions

When the auditor forms a conclusion that the confirmation process and alternative audit procedures have not provided sufficient appropriate audit evidence regarding an assertion, the auditor should perform additional audit procedures to obtain sufficient appropriate audit evidence.

In forming the conclusion, the auditor considers the:

- Reliability of the confirmations and alternative audit procedures;
- Nature of any exceptions, including the implications, both quantitative and qualitative of those exceptions; and
- Audit evidence provided by other audit procedures.

Based on such evaluation, the auditor should determine whether additional audit procedures are needed to obtain sufficient appropriate audit evidence.

The auditor should also consider the causes and frequency of exceptions reported by respondents. An exception may indicate a misstatement in the entity's records, in which case, the auditor will have to determine the reasons for the misstatement and assess whether it has a material effect on the financial statements. If an exception indicates a misstatement, the auditor should reconsider the nature, timing and extent of audit procedures necessary to provide the audit evidence required.

Evaluating the Results of the Confirmation Process

The auditor should evaluate whether the results of the external confirmation process together with the results from any other audit procedures performed, provide sufficient appropriate audit evidence regarding the assertion being audited.

Conducting External Confirmations Prior to the Year-end
When the auditor uses confirmation as at a date prior to the balance sheet to obtain audit evidence to support an assertion, the auditor obtains sufficient appropriate audit evidence that transactions relevant to the assertion in the intervening period have not been materially misstated. Depending on the assessed risk of material misstatement, the auditor may decide to confirm balances at a date other than the period end, for example, when the audit is to be completed within a short time after the balance sheet date. As with all types of pre-year-end work, the auditor considers the need to obtain further audit evidence relating to the remainder of the period.

6. Recalculation

Recalculation involves checking the mathematical accuracy of documents or records. It may be performed manually or through Computer assisted audit techniques (CAAT).

Example

Depreciation calculations are checked by the auditor's staff by recalculating.

This provides evidence for accuracy and valuation of the concerned items.

Advantage

(a) It is the most efficient method to evaluate the outcome of a process.

Disadvantages

(a) The calculation needs to be corroborated by other evidence. For example, correct calculation of depreciation will give the correct carrying value (the cost minus the depreciation). However, this may still need to be checked for impairment (reduction in the value of asset) if there is other evidence of impairment of assets.
(b) Recalculation may be complex and time-consuming e.g. actuarial calculations required for the provision of pensions to old employees.
(c) Assistance of outside experts may be needed.

7. Re-performance

Re-performance consists of the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control. The procedures or controls may be either manual or computer-based.

Example

Ageing of receivables is provided by the client to the auditors. The auditor re-performs the process and prepares an ageing analysis.

A few items of inventory are recounted by the auditor, to test check whether the count taken by the client's staff was correct.

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8. Analytical procedures

Analytical procedures consist of studies of the relationships either between the figures of financial statements or between financial and non-financial information.

These procedures may be used

(a) During the audit planning process, to help identify the areas which deserve particular attention.
(b) During the final review stage, to analyse and corroborate the audit findings.
(c) During the actual auditing, as substantive procedures.

Assertions tested by the analytical procedures are Completeness, Accuracy, Valuation and Classification

Advantages

(a) Provides a sound basis for determining the reasonableness of data
(b) Helps in assessing the need for further tests
(c) Provides a good audit planning tool since it enables the auditor to decide the relative importance and priorities of different items.

Disadvantages

(a) Unstable operating environment makes it difficult to predict relationships.
(b) Lack of availability of reliable data may limit the ability to use analytical procedures**.**

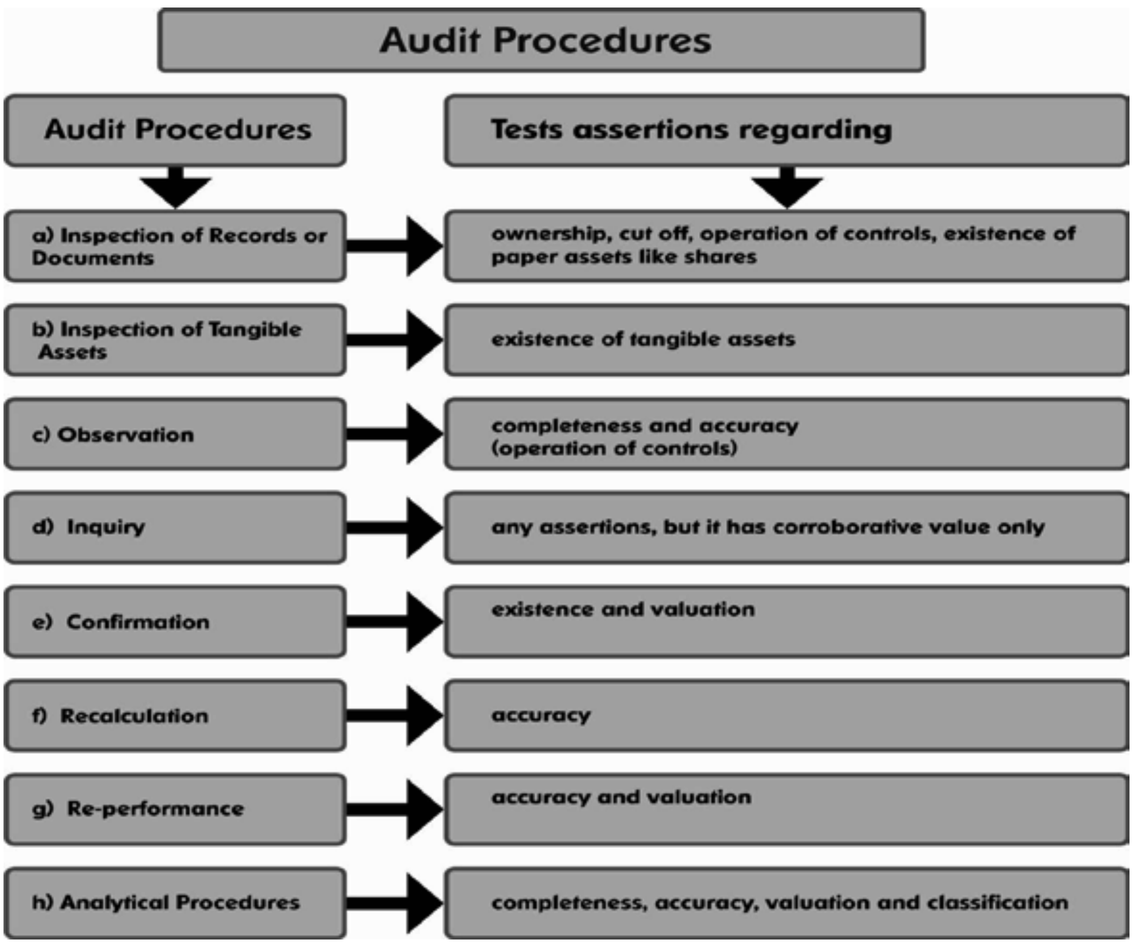
Test Yourself 1

What would be the appropriate audit procedure for the following items?
(a) To confirm if internal control operates as stated in the field of payroll
(b) To test the existence of machines
(c) To test the correctness of depreciation calculations

1.2 Audit procedures

Audit procedures are the procedures followed or methods used by the auditor during the course of audit. For example an auditor carrying out the physical count of inventory is an audit procedures. The various kinds of audit procedures can be summarised as follows:

Diagram 1: Audit procedures



You can remember the audit procedures with the help of the following mnemonic:	
A	**A**nalytical procedures
E	**E**nquiry and confirmation directly from a third party: Inquiry
I	**I**nspection : inspection of records and assets
O	**O**bservation
U	Recalc**u**lation and reperformance

1.3 Sufficient appropriate audit evidence

Definition

The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.

Sufficiency is the measure of the quantity of audit evidence. Appropriateness is the measure of the quality of audit evidence.

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Audit evidence is necessary to support the auditor's opinion and report. The quality of audit evidence is indicated by its appropriateness, i.e. whether it performs the function expected of it: supporting or negating the assertions.

1. The quality of evidence or its appropriateness depends upon

- Its relevance and
- Its reliability in supporting the classes of transactions, account balances, and disclosures and related assertions, or detecting misstatements in them.

(a) Relevance of evidence

Audit evidence is said to be relevant when it contributes to conclusions that assist in forming an opinion by the auditor.

Example

Audit procedures performed in the previous audits provide audit evidence about the entity's business, organisation structure and controls. However, due to changes in the entity or its environment, such evidence could become irrelevant. The auditor has to review the relevance of such evidence. For example, sales for the year prior to audit were through independent distributors. In the year under audit, the company started its own sales offices. Controls on sales area would have to be reviewed again; the previous year's testing would not be relevant.

(b) Reliability of evidence

(i) Evidence is more reliable when it is obtained from independent sources outside the entity e.g. confirmation of balance from a customer.

(ii) Internal evidence (evidence generated within an entity) **is more reliable when the related controls are effective.**

Example

Sales invoices are internally generated documents. They would be more reliable as evidence when the internal controls on sales are effective.

Tip

(iii) Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly or by inference.

Example

When an auditor personally observes the procedures of payroll payments, the evidence obtained on controls is more reliable than just an enquiry to the client's staff.

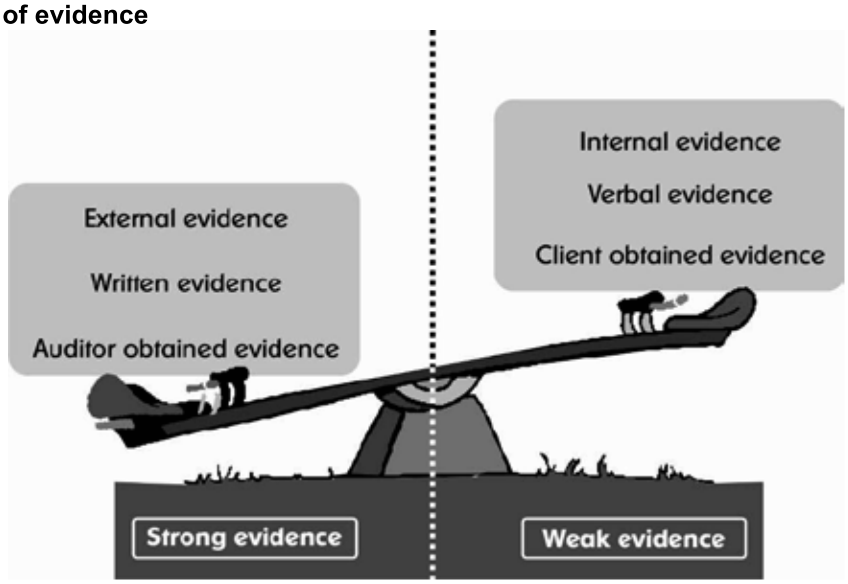
(iv) Evidence is more reliable when it exists in documentary form i.e. paper, electronic, or other media.

Example

An auditor would find the minutes of a meeting more reliable than a verbal description of what happened at the meeting.

(v) Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles.

Diagram 2: Nature of evidence



T**he quality of evidence depends upon** its relevance and its reliability in supporting the classes of transactions, account balances, and disclosures and related assertions, or detecting misstatements in them.

As discussed above, the reliability of evidence is influenced by its source, nature, and the individual circumstances under which it is obtained.

Evidence which appears strong may not be reliable unless:

It is accurate. For example a bank certificate from the client's banker confirming the client's account balance on the reporting date, may not be reliable if the amount mentioned in the bank certificate is incorrect, due to an arithmetic error in computation of the account balance.

It is complete. For example if the bank balance which is reported in the bank certificate has excluded amounts deposited in the bank during the month of March 2012, the account balance is not reliable as the account balance has incomplete information

The information is sufficiently precise and detailed for the auditor's purposes. For example, the auditor may intend to make use of the entity's performance measures for the purpose of analytical procedures, or to make use of the entity's information produced for monitoring activities, such as internal auditor's reports. In such cases, the appropriateness of the audit evidence obtained is affected by whether the information is sufficiently precise or detailed for the auditor's purposes. For example, performance measures used by management may not be precise enough to detect material misstatements.

Therefore quality of evidence is maintained only if the evidence is relevant (i.e. suitable for the audit) and reliable (i.e. evaluated by the auditor for accuracy, completeness and having sufficient details to suit the audit.

2. Sufficiency (sufficient quantity) of evidence

It refers to the value of the transactions (and the number of vouchers for each period end balance and transactions) on which audit evidence would be obtained by the auditor. In case the audit evidence is insufficient on account of difficulty in obtaining it, the implication of insufficient evidence on the audit opinion must be considered.

The following factors are to be considered in order to determine the sufficiency of evidence:

(a) Source and reliability of available information (explained above)
(b) Experience of earlier audits (the auditor would increase the quantity of evidence on period end balances and transactions where misstatements on account of fraud or error were noticed in the previous audits)
(c) Results of audit procedures (if the physical count of assets indicates anomalies, the auditor will have to increase the quantum of evidence)
(d) Risk assessment (areas where the risk of material misstatement is high need to be supported with greater quantity of evidence)
(e) Nature of accounting and internal control systems (if the results of tests of control show efficient controls, the auditor can reduce the quantum of evidence)
(f) Materiality (the quantitative and qualitative factors which determine materiality need to be considered)

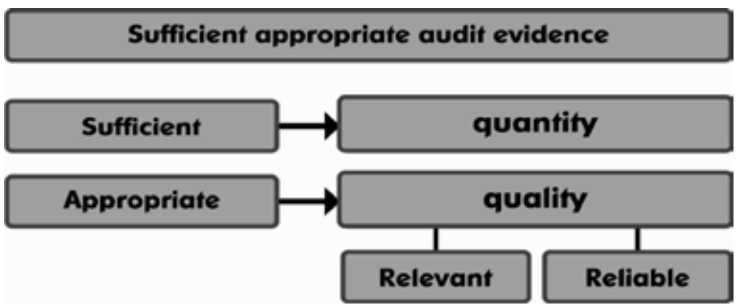
3. Interrelationship between sufficiency (quantity) and appropriateness (quality) of audit evidence

The higher the quality, the less quantity will be required. However, the auditor has to use judgment in deciding what is sufficient and what is appropriate. If the audit evidence is of a poor quality, merely obtaining more evidence may not help.

Example

Where the system is such that the accuracy of the sales invoices is not assured, it would not help to check more invoices. The auditor may have to verify alternative evidence, for example, multiplying the quantity dispatched with the average sales price, to obtain total sales.

Diagram 3: Sufficient appropriate audit evidence



Important

Sufficiency and appropriateness of audit evidence is an important part of the syllabus as the auditor will have to justify the sufficiency and appropriateness of the audit evidence on questions relating to audit procedures.

Test Yourself 2

While auditing the records of a company, you come across the following evidence:

(a) Purchase invoices without any supporting documents or reference related to the receipt of goods
(b) payroll sheets not fully linked to or reconciled with the time records.

Required:

Comment on the quality of the evidence described above and discuss what quantity of this evidence would be appropriate.

1.4 Procedures applied and quantity and quality of evidence obtained

The more appropriate and conclusive the evidence obtained, the higher the level of assurance, and vice versa.

Example

Audit evidence can come in different forms with different degrees of persuasiveness. A confirmation of the balance obtained from a supplier is more persuasive than his balance in the client's record. Although this may not be always true, in most cases it is. The professional accountant can give a higher level of assurance on the figure obtained from the client, than that obtained internally.

A high level of assurance is given in the case of reasonable assurance engagements. A moderate level of assurance is given in the case of limited assurance engagements.

Negative assurance

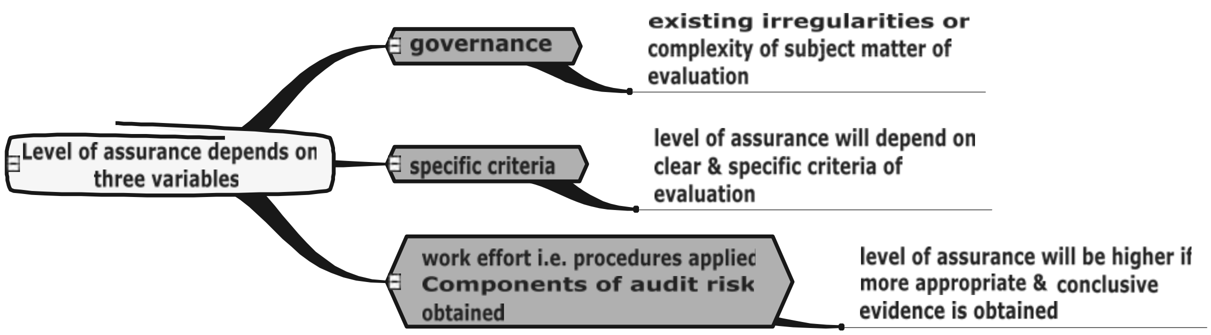
Negative assurance by a professional accountant means that **he has not come across any adversity regarding the subject matter reviewed**. It is based on the premise that sometimes you have to believe what you do in the absence of any compelling evidence to the contrary.

Example

Auditors send out letters of 'negative confirmation' to their clients' customers to verify the account balances. Such letters are sent with a request that they be returned with corrections only if they are incorrect. Such a negative assurance is not as reassuring as 'positive confirmations' in which a written and signed response is required from each customer.

However, it is better than nothing. A concern will always be, however, that the customer just could not be bothered to fill the form in, even if there is a discrepancy and hence wrong assurance may be given.

SUMMARY



Test Yourself 3

State, with reasons, whether the statements below are true or false:

(a) The level of assurance will only depend upon the complexity of the subject matter for evaluation.
(b) Negative assurance by a professional accountant means that the subject matter reviewed is not correct on the basis of the evidence collected.
(c) An audit is a type of assurance engagement under which a professional accountant provides a high level of assurance is given.
(d) The level of assurance is determined on the basis of two variables i.e. the subject matter of the assurance engagement and the specific criteria.

1.5 Documenting and assessing systems and controls

Some of the methods of evaluating and documenting the internal control systems are as follows:

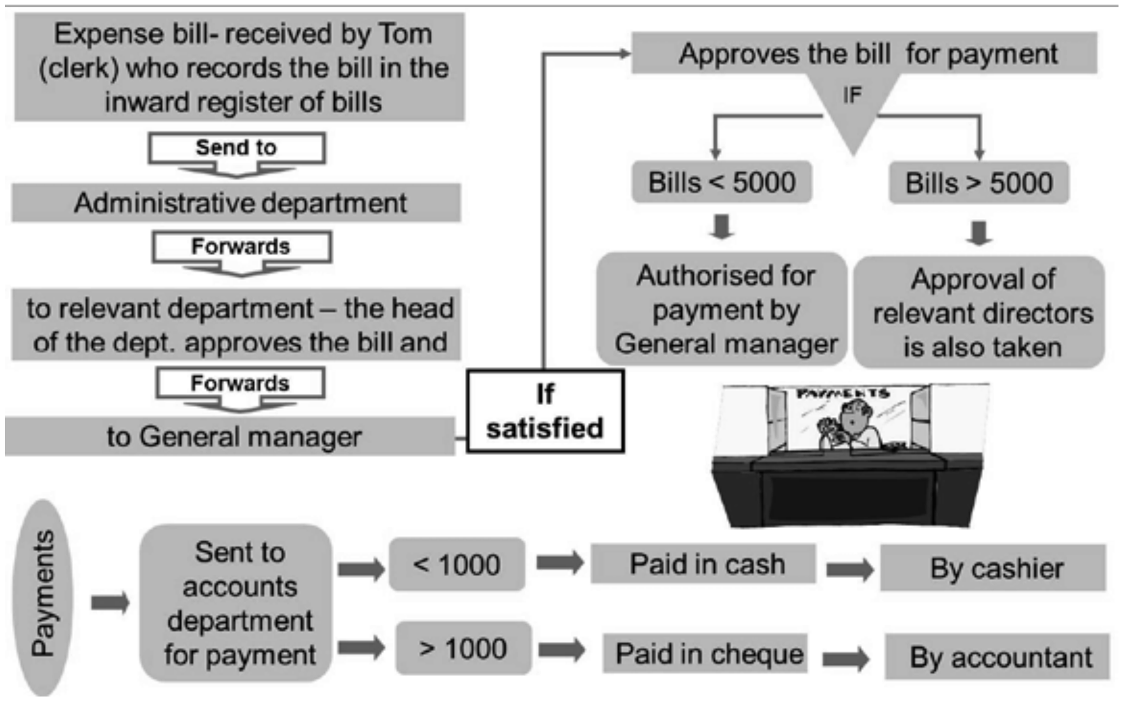
1. Narrative record

It contains written descriptions of simple control systems such as custody of cash. This technique is ideal for explaining small, simple systems descriptions, which are not covered by any other techniques.

2. Flowcharts

They are pictorial representations of document flows and internal control systems relating to the different processes which are in operation and the controls which are in place at the various stages of the process.

Diagram 4: Example for transaction flow for payments:



The above diagram provides a comprehensive view of the transaction flow for payments within an entity, the documents generated, the departments through which the documents pass the personnel responsible for authorising the bills and the flow of cash which takes place.

This kind of information provides a bird's eye view of the transactions, which in turn facilitates the evaluation of the internal controls and also offers recommendations for improvements therein.

3. Internal control questionnaire (ICQ) and internal control evaluation questionnaire (ICEQ)

ICQs contain a list of various questions which an auditor seeks to find answers to from the client, in order to assess the existence of internal controls (i.e. the design of the controls). On the other hand internal controls evaluation questionnaires (ICEQ) contain questions which look at control objectives and whether or not these are met i.e. whether there are controls which prevent or detect errors or omissions.

These are very popular methods for assessing internal controls. The ICQs and ICEQs are comprehensive and contain pre-designed questions in order to ensure that all features of the system are assessed.

The auditor has to answer "Yes" or "No" or "Not applicable" to each question. However, space may be provided below each answer for justifying answers wherever necessary.

An ICQ question could be: Are overtime hours authorised by a supervisor? YES/NO

An ICEQ question could be: Can unauthorised overtime be paid? YES/NO

ICQ's are therefore very specific and a 'YES' answer means the control is present.

ICEQs are much more open and require a greater degree of skill from the auditor. A 'NO' answer means a control is present, though the auditor would have to identify what the precise control is.
Information relating to the following matters is included the ICQs and ICEQs:

(a) Segregation and rotation of duties

(b) Maintenance of records and documents

(c) Accountability for, and safeguarding of assets

(d) Procedure for authorisations

(e) Independent checks

4. Testing accuracy

Whether the system internal control system has been recorded by narrative, flowchart or questionnaire, it must be tested for accuracy by carrying out tests of controls like a walk-through test. In this approach the auditor follows one transaction through each system, ensuring that the system has been recorded accurately at each stage. Walk through tests can also be used in subsequent years to see if the system has changed from what the auditor previously recorded. Tests of controls are explained in detail in Study Guide B3.

Test Yourself 4

Draft an internal audit questionnaire to test the internal controls in the area of:

(a) Non-current assets with respect to physical verification

(b) Travel expense reimbursement

Tests of controls are explained in detail in Study Guide B3.

Substantive procedures and analytical procedures are explained in detail in Study Guide C3.

Answers to Test Yourself

Answer to TY 1

(a) Observation would be the appropriate audit procedure for checking operation of internal control on preparation and actual disbursement of wages. Verification of the documents would provide additional evidence on whether wage rates had been authorised, hours worked approved and calculations have been checked and authorised by the competent authorities.
(b) Physical inspection of the machine would be the best audit procedure of the existence of a machine.
(c) Recalculation of the depreciation would be the preferred audit procedure to test the correctness of depreciation.

Answer to TY 2

(a) Purchase invoices without any supporting documents or reference related to the receipt of goods as well as payroll sheets not fully linked to or reconciled with the time records are evidence of poor quality. No amount of quantity would compensate for this poor quality.

Alternative additional tests may have to be designed for these items.

For the purchases

Check if Total quantities purchased x Price = Value of purchases as recorded.
Overall reconciliation of raw material quantities purchased with inventory summary.

Opening balance + Purchases - Raw material consumed according to production records = Closing balance.

(b) For the payroll sheets

Check if the ratio of payroll costs to total costs and the payroll costs per unit of production, and per employee are consistent with the past trends.
Test if the relationship of overtime costs with the production is consistent.

Answer to TY 3

(a) **False**: In an assurance engagement the level of assurance depends not only on the complexity of the subject matter of evaluation but also on the availability of appropriate evidence.

(b) **False**: Negative assurance by a professional accountant means that he has not come across any adversity regarding the subject matter reviewed.

(c) **True**: A professional accountant provides a high level of assurance on the correctness of the financial statements under audit.

(d) **False**: The level of assurance is determined on the basis of three variables i.e. the subject matter of the assurance engagement, the specific criteria and the work involved.

Answer to TY 4

1.	**Physical verification of Fixed Assets**	**Y / N**	**Detailed comments**
(a)	Does the company maintain a fixed asset register?		
(b)	Is the register annually reconciled with the financial statements?		
(c)	Does the company carry out a physical verification of the fixed assets?		
(d)	Is physical verification carried out by an independent agency?		
(e)	Is a physical verification of non-current assets carried out at least annually?		
(f)	Are discrepancies in physical verifications followed up by a responsible official?		
2.	**Travel expense reimbursement**		
(a)	Are all trips sanctioned?		
(b)	Is the itinerary of the trip mentioned in the travel sanction form?		
(c)	Does the company have formal rules for travel?		
(d)	Does the report specify the accomplishments of the trip?		
	Are all trip reports, supported with travel receipts?		
(e)	Are all the travel receipts in accordance with the company rules for example class of travel, expenses for meals		
(f)	Have there been cancellation of vouchers, which were processed and authorised for reimbursement?		

Quick Quiz

1. "Inspection of tangible fixed assets provides conclusive evidence of its ownership". True or false?

2. What kind of evidence does observation help in testing?

3. Which of the following is better evidence and why?
   (a) Internal payment voucher
   (b) Invoice from a third party

4. Financial statements are a summary of auditor's assertions. Is this true or false?

5. What are cut-off tests in relation to purchases?

6. What are the assertions represented by the figure of advertisement expenses?

Answers to Quick Quiz

1. False. Inspection provides evidence for the existence of an asset, not its ownership.

2. Observation helps in testing operation of controls.

3. Invoice from a third party is more reliable, since it is external evidence.

4. False. Financial statements are a summary of management's assertions. The auditor verifies them.

5. Cut-off tests in connection with purchases would be:

   (a) Checking that the goods received during the period immediately before SOFP date are recorded as purchases and payables.
   (b) Checking purchase invoices of a few days at the beginning of the next accounting period, to see that they do not include any purchases of the current period.

6. The figure of advertisement expenses represents the following assertions:

   (a) All the advertisements during the period are included in the figure.
   (b) They are included at the correct amounts.
   (c) They represent the advertisements for the purpose of business.
   (d) They are posted to the correct account.
   (e) They are for the right period.

Self-Examination Questions

Question 1

List the factors that influence the reliability of audit evidence.

Question 2

During the audit planning stage, you find that the overtime payment has increased by 41% compared to the previous year. The accountant of the client tells you that production and revenue are up by 20% and that there have been trends that for each 1% increase in production, there is an increase of 2% in overtime payments. Therefore, the amount of overtime is fair.

Required:

What would be your audit procedure for this matter?

Answers to Self-Examination Questions

Answer to SEQ 1

According to ISA 500, the following factors influence the reliability of audit evidence:

1. Audit evidence is more reliable when it is obtained from independent sources outside the entity.

2. Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.

3. Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

4. Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium. (For example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed.)

5. Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

6. Evidence created in the normal course of business is better than evidence specially created to satisfy the auditor.

7. The best-informed source of audit evidence will normally be management of the company (although management's lack of independence may reduce its value as a source of such evidence).

8. Evidence about the future is particularly difficult to obtain and is less reliable than evidence about past events.

Answer to SEQ 2

This is a case where substantive analytical procedures may be applied. The following steps would be taken.

1. Verify how the data of production and overtime has been worked out. See if it is accurate and reliable, if the internal controls are sound.

2. Check what the logical relationship between the two is. Is it that overtime is paid at a higher rate? Is the production efficiency the same in the overtime period as in the normal period?

3. See whether the relationship is sufficiently precise that the expected figure can be built upon it.

4. Check what the variation that can be accepted without further investigations would be. In this case, the expected increase in overtime would have been 40%. However, it is actually 41%. The difference appears to be acceptable.

After completing the above steps the difference can be accepted without further investigations.

SECTION C

THE NATURE OF AUDIT EVIDENCE AND THE SELECTION OF SUFFICIENT APPROPRIATE EVIDENCE

C2

STUDY GUIDE C2: AUDIT ASSERTIONS

Get Through Intro

Each item in the financial statements conveys certain information to you. Each piece of information is an assertion.

While most of the assertions in the financial statements are explicit, there are some assertions which are implied. They are to be understood, although not stated. Imagine a schedule of non-current assets where the company made no disclosures to the effect that the asset is used as security for a loan. In this case, there is an implicit assertion that the assets have not been provided as a security for any loan.

Before giving an opinion on the fair presentation in the financial statements, the auditor should carefully consider all the material assertions: explicit as well as implicit. The kind of evidence needed by the auditor depends upon the assertions being made.

The understanding of assertions is important for the planning and execution of the audit process.

Learning Outcomes

a) Identify and explain the assertions contained in the financial statements.
b) Evaluate audit evidence suitability to address audit assertions for different elements of financial statements.

1. Identify and explain the assertions contained in the financial statements.
[Learning Outcome a]

1.1 Meaning of an assertion

If you pick up any financial statements, you will find that they contain a large amount of information. Management conveys some information through each figure or sentence contained in the statements. This communication of information is an assertion. It may range from the figure of profit or loss to the individual line items or notes in the financial statements. **In fact, financial statements are a summary of management's assertions**.

Example

By presenting payroll expenses in the SOPL, management asserts that:

This expense was for genuine employees,
It includes the amounts incurred for the accounting period, whether paid or not,
The employees worked on the company's business.

ISA (International Standard on Auditing) 315, identifying and assessing the risks of material misstatement **through understanding the entity and its environment**, **divides assertions in the financial statements under the following categories:**

Assertions about classes of transactions and events, i.e. all elements of the SOPL like sales, purchases and events like fire, robbery etc.

Assertions about account balances at the period end, i.e. all elements of the SOFP like non-current assets, inventory, loans and payables.

Assertions about presentation and disclosure i.e. the disclosures contained in the significant accounting policies and notes to accounts like revenue recognition, use of estimates etc.

Financial statements are a culmination of the process of recording transactions and events in the books of accounts, extracting the balances from the ledger accounts and presenting them in the financial statements. Assertions may relate to any of the above mentioned stages.

1.2 Types of assertions contained in the financial statements

Assertions can be of the following types:

(a) Occurrence

The transactions and events and other matters that have been recorded:

(i) Actually took place; and
(ii) Relate to the entity.

This assertion relates to transactions and events and presentation and disclosures.

Example

When a transaction of sale worth TZS500,000 is included, it indicates that:

The goods belonged to the entity
They were actually sold to a customer
Consideration has either been received or is receivable

(b) Completeness

(i) All transactions have been recorded. No transactions have been left out.
(ii) All assets, liabilities, equity interests (capital and reserves) and other disclosures have been included in the financial statements.

This assertion relates to transaction and events, account balances at period end and presentation and disclosures.

Example

All liabilities owing at the year end are included in the financial statements.

(c) Accuracy

Amounts and other data relating to transactions and events have been recorded appropriately. This means an invoice for TZS50,000.13 is actually recorded for that amount in the accounts.

This assertion relates to transaction and events and presentation and disclosures in the financial statements.

(d) Valuation and allocation

(i) All the items in the SOFP have been included in the financial statements at appropriate amounts, according to company policy and the relevant financial reporting framework.

(ii) Any allocations or valuation adjustments required have been made appropriately.

(iii) Financial and other information are disclosed fairly and at appropriate amounts.

This assertion relates to account balances at period end and presentation and disclosures.

Example

A factory building has been included at the correct value according to the figure on the agreement for purchase. Depreciation based on a Generally Accepted Accounting Practices has been appropriately charged to the SOPL.

The calculation could be: Cost TZS10 million - Depreciation TZS2 million = Carrying value TZS8 million.

(e) Cut-off

Transactions and events have been recorded in the correct accounting period. In other words, the transactions that are recorded in the current financial year do not include any transactions relating to any other year.

Example

If title to the goods is not transferred to a customer before period end, the sale of goods is not recognised in the current year. The relevant goods are shown as inventory, at cost.

(f) Classification

(i) Transactions and events have been recorded in the proper ledger accounts.

(ii) Financial statements are appropriately presented and clearly described in accordance with company policy and the relevant financial reporting framework.

Example

An amount incurred on research is treated as a cost of sales and presented in the SOPL. The accounting policies clearly mention the treatment of the research cost.

(g) Existence

Assets, liabilities and equity interests (capital and reserves) do really exist at the SOFP date.

Example

The cost of a steel structure erected (expected to last for a few years) to display an advertisement hoarding is an asset, and disclosed in the SOFP. The steel structure shown as an asset, physically exists at the SOFP date.

(h) Rights and obligations

(i) The entity has a right to an asset. It is free to use or dispose of the asset as it sees fit.
(ii) The entity is obliged to pay the liability that is shown in the SOFP.

Example

The entity can use the steel structure (an asset) or sell it, as it has proof in the form of a purchase invoice that it owns the asset.

Amount shown as due to suppliers is actually payable to them for work carried out by them. It is not a fictitious liability.

(i) Understandability

Disclosures are clearly expressed so as to make them understandable to the users.

Example

Regarding inventories, the method of valuation is clearly stated e.g. lower of cost or net realisable value; cost being determined by the FIFO method.

Tip

Mnemonics to remember the list

You may rearrange the words, rename some (without changing the meaning) and prepare a word with the first alphabets, as follows:

Completeness
Occurrence
Measurement (Valuation and allocation)
Presentation and disclosure (Understandability)
Accuracy
Rights and obligations
Existence

This makes a word "compare"! You may link this word with the related words for the purpose of memorising this list. This will leave only the following to Cs to be remembered separately.

Cut-off
Classification

1.3 Considerations specific to public sector entities

The management of public sector entities may also assert (in addition to the above stated assertions) that transactions and events included in the financial statements have been carried out in accordance with legal, regulations or some other authority.

1.4 The following table summarises the assertions which relate to the classes of transactions, account balances, presentation and disclosures:

	Category	Transactions and events (during the period) (income + expenses)	Period end balances (assets, liabilities and equity)	Presentation and disclosure (in the financial statements)
1	Occurrence	They occurred and relate to the entity.		Disclosed events, transactions and other matters occurred and relate to the entity.
2	Completeness	All relevant transactions and events have been recorded.	All relevant assets and liabilities have been recorded.	All relevant disclosures have been included.
3	Accuracy	Amounts and other data are appropriate.		Financial and other information is presented fairly.
4	Valuation and allocation		Valuation is proper; for example depreciation, has been made correctly.	Disclosed events, transactions, and other matters are at appropriate amounts.
5	Cutoff	Recorded in correct accounting period.		
6	Classification	Recorded in proper ledger accounts.		Financial information is classified under appropriate headings.
7	Existence		Assets, liabilities and equity do exist.	
8	Rights and obligations		Entity has a right to use or dispose of asset; or an obligation to pay liability.	Entity has a right to use or dispose of asset; or an obligation to pay liability.
9	Understand-ability			The disclosures are understandable to the users.
	Mnemonic to remember this list	**COAC^2**	**CMRE**	**C^{2}OMPAR**

Test Yourself 1

A SOPL includes interest (expense) on loans of TZS7.5 million. What are the assertions represented by this figure?

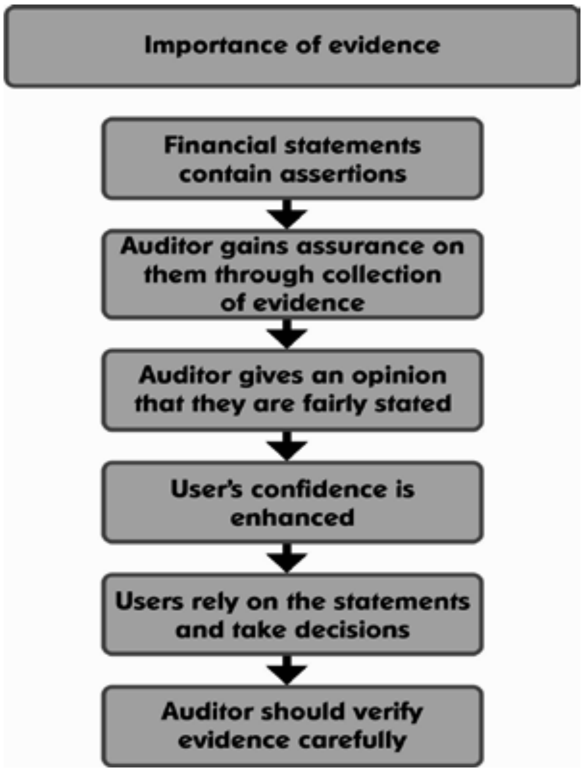
2. Evaluate audit evidence suitability to address audit assertions for different elements of financial statements.

[Learning Outcome b]

Objectives of testing

The auditors need to test all the important assertions in the financial statements before relying upon them.

Diagram 1: Importance of evidence testing



Tip

When an auditor tests evidence, they actually check the correctness of assertions contained in the financial statements.

Testing helps the auditors to form an opinion

The reliability of the evidence depends on the internal controls. Internal controls are discussed in Section C of this Study Text. Similarly, when volume is high, audit sampling is usually used. This is covered in Study Guide C3. The existence of a good internal control system enables the auditor to apply sample testing techniques or to skip the detailed checking altogether. Before relying on the system, the auditor tests whether the system is appropriate and whether it actually operates as intended. **All the tests discussed in the following paragraphs are subject to these general observations.**

Different items require different approaches. Different assertions are normally verified with the help of different evidence. However, at times, a single piece of evidence may support more than one assertion.

Example

Where only one machine is purchased, the same set of purchase order, delivery slip and invoice will support the assertions as to occurrence and accuracy.

Let us take an example from each type of testing mentioned above.

2.1 Transaction testing

When a transaction or event is tested, the auditor actually tests the assertions (COAC^2). They look for evidence related to the assertions in the transactions and events column above.

Example

Purchases in the financial statements amount to TZS5 million. Evidence will be tested to check the following assertions:

1. Occurrence

Assertion: the receipt of goods occurred.

Evidence: this can be tested with the help of signed goods receipt notes to show evidence of delivery and entries in the stores records.

Assertion: they relate to the entity.

Evidence: the purchase orders raised by the client will show the name of the supplier and the purchase invoices will show the name of the client. This is evidence that the purchases relate to the entity.

2. Completeness

Assertion: all the purchases for the period are recorded.

Evidence: it is checked whether the system ensures that all the goods received have been recorded as purchases. A sample of goods receipt notes is checked in the purchase journal and accounts payable ledger.

3. Accuracy

Assertion: purchase amounts recorded in the books of accounts are appropriate.

Evidence: these amounts are agreed with the amounts mentioned on the purchase orders, invoices and quantities received.

4. Cut-off

Assertion: the purchases appearing in the financial statements relate to the current accounting period only.

Evidence: this can be done by ensuring that all the goods received (and shown as consumed or held in inventory) up to the SOFP date are recorded as purchases whether the invoice is received or not. Transactions taking place immediately before or after the SOFP date are particularly looked into.

5. Classification

Assertion: the purchases have been recorded in the correct ledger accounts. For example, purchases of equipment should not be recorded as ordinary purchases, since equipment is an asset.

Evidence: this is tested with the help of purchase orders, goods receipts notes and purchase invoices.

2.2 Account balance testing

When an account balance is tested, the auditor tests the assertions (CMRE) behind the balance. They look for evidence related to the assertions in the period end balances column above.

Example

Trade receivables appear in the SOFP at TZS3 million. Evidence will be tested to check the following assertions:

1. Completeness

Assertion: All the receivables are included in the figure appearing in the SOFP.

Evidence: This is tested by verifying whether the system ensures that all the sales are recorded and by reviewing the receivables ledger.

2. Valuation and allocation

Assertion: Valuation is proper; allocations and adjustments, for example bad debts, have been made correctly.

Evidence: Invoice recording is tested. Receivables ledger is scrutinised. Ageing analysis is obtained. Old receivables are identified and enquired into. Bad debts and allowances for bad debts are verified.

3. Existence

Assertion: Receivables do exist.

Evidence: Statement of customers' accounts and confirmation of balances from the customers help in confirming the existence of receivables. Similarly, subsequent receipts may be tested.

4. Rights and obligations

Assertion: The entity has a right to recover the debts.

Evidence: Customer's purchase orders, proof of delivery of goods and sales invoices can be tested. These documents provide a legally enforceable right to recover the amount due against the sale of goods.

2.3 Disclosure testing

Each disclosure in the financial statements asserts something. The auditor looks for evidence related to the assertions in the presentation and disclosure column above.

Example

A company's SOFP contains non-current assets at TZS4m. Evidence relating to the disclosures made in the notes to accounts and the significant accounting policies for non-current assets will be tested to check the following assertions:

1. Occurrence

Assertion: The entity acquired or constructed all the assets. It owns the assets.

Evidence: This is covered by the assertions about transactions and events and period end balances discussed in the previous paragraphs. The auditor verifies the purchase invoices, documents of title (e.g. sale deed of premises etc.) during the year in which the assets have been acquired.

Continued on the next page

2. Completeness

Assertion: All the non-current assets are presented in the schedule at one place. All the disclosures about any charges (i.e. details of loans, if any, for which the assets have been offered as a security) and the significant accounting policies relating to non-current assets have been made.

Evidence: The register of non-current assets and the trial balance are verified to see that all the assets are covered. The register of charges is verified regarding the details of securities for loans.

3. Valuation, allocation and accuracy

Assertion: The disclosures relating to non-current assets, in the notes to accounts, have been stated at the values as required by the accepted model (cost or fair value). The appropriate amount has been allocated for depreciation or amortisation during the period.

Evidence: The amounts stated on the invoices are verified in the year of acquisition. Subsequently, the carrying values and depreciation calculations are verified. Furthermore the amounts will be tallied with the notes to the SOFP relating to non-current assets.

4. Classification

Assertion: The assets are classified under proper headings, e.g. property, plant, furniture etc. Expense items are not classified as assets.

Evidence: The account names noted on the invoices can be verified and they can be individually traced into the respective ledger accounts, since the number of additions are usually few. Repairs account is scrutinised to see if any assets have been misclassified.

5. Understandability

Assertion: The assets are disclosed in a manner that is clearly understandable.

Evidence: The SOFP schedule is cross-checked with the trial balance to see if the description conveys the meaning intended.

5. Rights and obligations

Assertion: The entity has a right to use / transfer / dispose the non-current assets.

Evidence: Purchase invoice, proof of delivery and acceptance (installation, if required) of assets can be verified to confirm that the entity has a legal right to the assets.

These documents will a legally enforceable right to use the asset.

Even where recording and balancing may be correct, improper disclosures can still distort the view. Several of the world's biggest accounting scandals involved improper classification or insufficient disclosures e.g. Enron did not disclose clearly the extent of its obligations to several of its special-purpose entities.

Test Yourself 2

You are presented with a set of financial statements which includes a figure of TZS300,000 related to trade payables. What are the assertions related to the "account balances" and how can they be tested?

Exam Focus

Questions on this topic can be both knowledge based as well as scenario based.

This topic is extremely important as you need to use the assertions on all the questions where you carry out audit procedures.

Remember you need to say that the audit procedure is carried out to test a particular assertion in the financial statements.

Answers to Test Yourself

Answer to TY 1

The figure of interest on loans represents the following assertions:

It represents the complete amount of interest accrued for the period according to the terms of loan.
It has been calculated accurately based on the agreements with the banks.
The loan has been used for the business; therefore the interest is business expenditure.
The amount is correctly classified under the appropriate ledger account i.e. finance cost.

Answer to TY 2

The following are the assertions and the related tests:

1. Completeness

Assertion: All the payables are included in the figure appearing in the SOFP.

Evidence: This is tested by verifying whether the system ensures that all the purchases are recorded and by reviewing the payables ledger. For this a sample of the invoices will be chosen.

They will be verified with the purchase day book to confirm that the invoices are recorded as purchases and also as payables.

2. Valuation and allocation

Assertion: Valuation is proper; allocations and adjustments, for example discounts received, have been made correctly.

Evidence: It is tested by verifying the sample of purchase invoices and matching:

The amounts therein with the rates applicable on the connected purchase order, and
The quantities mentioned therein on the goods received notes.

Furthermore it will be confirmed that the payments are made on the due dates (as mentioned on the purchase orders). Where payments are made by the due dates, the auditor will confirm that a discount was received.

The payables ledger will be scrutinised for old and unadjusted balances. The reasons for non-payments must be discussed with the client and if required amounts may have to be written back.

3. Existence

Assertion: Payables do exist.

Evidence: Statements from suppliers can be reconciled to suppliers' accounts. Confirmation of balances from them help to confirm the existence of payables. Similarly, subsequent payments may be tested.

4. Rights and obligations

Assertion: The entity has an obligation to pay the amounts to suppliers.

Evidence: Entity's purchase orders, proof of receipt of goods and purchase invoices can be tested.

Quick Quiz

1. Financial statements are a summary of auditor's assertions. Is this true or false?

2. What are cut-off tests in relation to purchases?

3. Identify which type of testing, i.e. transaction testing, account balance testing and disclosure testing will be carried out for the following:
   (a) Purchase of a machine
   (b) Balance in plant and machinery account
   (c) Schedule of non-current assets at the SOFP date

4. An accountant committed the following errors:
   (a) Missed out a purchase invoice
   (b) Recorded a purchase of raw material as a purchase of an asset

   Identify the assertions which are to be tested in order to minimise the chances of such errors taking place.

Answers to Quick Quiz

1. False. Financial statements are a summary of management's assertions. The auditor verifies them.

2. Cut-off tests in connection with purchases would be:

   (a) Checking that the goods received during the period immediately before SOFP date are recorded as purchases and payables.

   (b) Checking purchase invoices of a few days at the beginning of the next accounting period, to see that they do not include any purchases of the current period.

3.
   (a) Purchase of a machine transaction testing
   (b) Balance in plant and machinery account balance testing
   (c) Schedule of non-current assets at the SOFP date disclosure testing

4.
   (a) Assertions as to completeness of transaction.
   (b) Assertions as to classification of transaction.

Self-Examination Questions

Question 1

What are the different assertions regarding cash and bank accounts relating to transactions and account balances and disclosures? How would you test them as an auditor?

Question 2

Explain the assertions represented by the figure of equity in the SOFP.

Answers to Self-Examination Questions

Answer to SEQ 1

Different assertions and their testing in the field of cash and bank account are as follows:

1. Transaction testing

(a) Occurrence

Assertion: All the amounts entered in the cash book were actually received or paid.

Evidence: An auditor has to test whether the system would ensure this. Receipts and payments in a selected sample are verified and traced in the cash book.

Assertion: They relate to the entity.

Evidence: This is tested with the help of receipts and the names stated on the payment vouchers, and checked for authorisation and supporting documents attached to them.

(b) Completeness

Assertion: All the cash and bank transactions for the period are recorded.

Evidence: It is checked whether the system ensures relevant transactions are recorded in the cash book. A sample of transactions is checked in the cash book.

(c) Accuracy

Assertion: Amounts recorded in the books of accounts are accurate.

Evidence: The amounts are tested with vouchers, supporting bills etc. and authorisation.

(d) Cut-off

Assertion: The cash transactions recorded in the cash book relate to the current accounting period only.

Evidence: Usually cash transactions are recorded immediately and the physical cash balance is verified with the balance according to the cash book. Therefore, there will normally not be any problems on the cut-off related to cash transactions. However, bank transactions immediately before and after the year end are verified to see if any entries to manipulate the records have been entered. Bank reconciliation is checked for subsequent clearance of the items.

(e) Classification

Assertion: Transactions are recorded in the correct bank / cash account.

Evidence: This is tested with the help of payment vouchers, bank pay-in slips, cheque counterfoils etc.

2. Account balance testing

(a) Completeness

Assertion: All the cash and bank balances are considered.

Evidence: This is tested by verifying whether the system ensures that all the cash / bank transactions are recorded and by reviewing the cash books and ledgers.

(b) Valuation and allocation

Assertion: Valuation is proper.

Evidence: Bank reconciliations and subsequent clearance of the reconciliation items is verified.

(c) Existence

Assertion: Cash and bank balances do exist.

Evidence: Statement of bank account and confirmation of balances from the bank, and the bank reconciliation statement help in confirming the existence.

(d) Rights and obligations

Assertion: The entity has a right to recover the bank balances.

Evidence: Bank confirmation letters provide conclusive evidence.

3. Disclosure testing

(a) Completeness

Assertion: All the cash and bank balances are presented in the SOFP.

Evidence: Cash books and the trial balance are verified to see that all the accounts are covered.

(b) Valuation, allocation and accuracy

Assertion: Cash and bank balances are presented at correct values. For example, cash in transit is disclosed separately.

Evidence: Cash book and balance confirmations from bank are verified.

(c) Classification

Assertion: The cash and bank balances are classified under proper headings, e.g. cash in hand, cash at bank, overdraft etc.

Evidence: Cash book, trial balance and the letter of overdraft arrangement from the bank.

(d) Understandability

Assertion: Cash and bank balances are disclosed in a manner that is clearly understandable.

Evidence: The schedule of SOFP is verified with the trial balances and it is seen if the description conveys the meaning intended. It is seen if the overdraft and the related security offered to the bank are disclosed appropriately.

(e) Rights and obligations

Assertion: The entity has a right to recover the bank balances.

Evidence: Bank confirmation letters provide conclusive evidence.

Answer to SEQ 2

Assertions represented by the figure of equity in the SOFP are as follows:

1. **Completeness assertions:** All the equity items, for example, share capital, reserves; retained earnings are included in the SOFP.

2. **Valuation, allocation and accuracy assertions:** Valuation of capital and other components is correct. Transfers to or from reserves as required by law or decided by management have been made.

3. **Existence assertions:** Equity (in the form of net assets) actually exists. This is an all pervading assertion in the sense that the existence of all assets and liabilities will confirm the net assets i.e. equity.

4. **Rights and obligations assertion**: The entity has a right to retain the balances of equity and deal with them appropriately, e.g. distribution of dividends, issue of bonus shares, etc.

SECTION C

THE NATURE OF AUDIT EVIDENCE AND THE SELECTION OF SUFFICIENT APPROPRIATE EVIDENCE

C3

STUDY GUIDE C3: AUDIT SAMPLING

Get Through Intro

Unless a client is very small, it would be almost impossible for an auditor to check all of its transactions. Furthermore, the costs of such an audit would be too high. These days, many organisations have formal internal control procedures. If the controls are reliable, it is not necessary to check all the transactions.

For an audit assignment, the auditor wants reasonable assurance about the assertions in the financial statements. If the controls are good and if samples are selected in such a manner that they are representative of the population, then by verifying the sample, the auditor can have reasonable assurance about the population. This is the most practical way of performing audits and it has become an indispensable part of a modern day audit. The study of auditing cannot be complete unless one understands audit sampling.

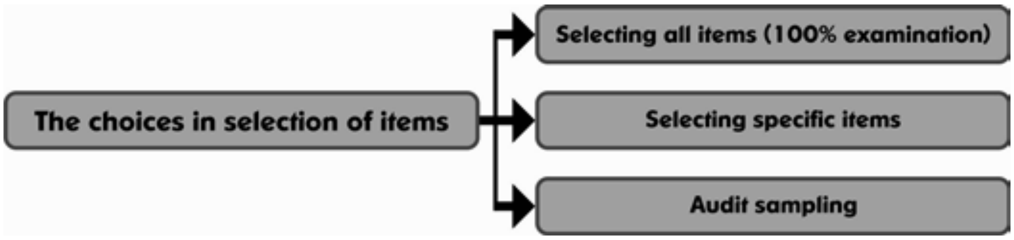
Learning Outcomes

a) Explain the sampling of documents and transactions to be used in gathering audit evidence.
b) Explain the application of statistical sampling.
c) Explain the users of computer assisted Audit techniques (CAATs)

1. Explain the sampling of documents and transactions to be used in gathering audit evidence.

[Learning Outcome a]

Diagram 1: Choices in selection of items



1.1 Audit sampling of documents and transactions

Definition

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

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

ISA 530

Whenever an auditor applies audit tests to a few cases and draws conclusions about the whole, it is said that sampling is done. The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions is known as the "population".

1.2 The need for sampling

1. Prohibitive costs

To apply audit procedures, costs have to be incurred, e.g. salaries to the staff conducting the audit. It will usually be very expensive to test every item in any large accounting population. In the above example, the cost of verifying all sales invoices would be prohibitively high.

2. Time constraint

Not only costs, but also the time spent in verification is substantial if the volume is large. There are time constraints on the completion of audit. Sampling saves time while retaining the confidence level.

3. Reasonable assurance

An audit gives reasonable assurance and not absolute assurance about the assertions contained in the financial statements. It is not necessary to verify the entire population in order to obtain reasonable assurance. Moreover, even the verification of the entire population would not give absolute assurance due to the inherent limitations of the audit. The auditor takes a calculated risk. If the sample is selected properly, sample checking usually gives the auditor reasonable assurance.

1.3 When is sampling suitable?

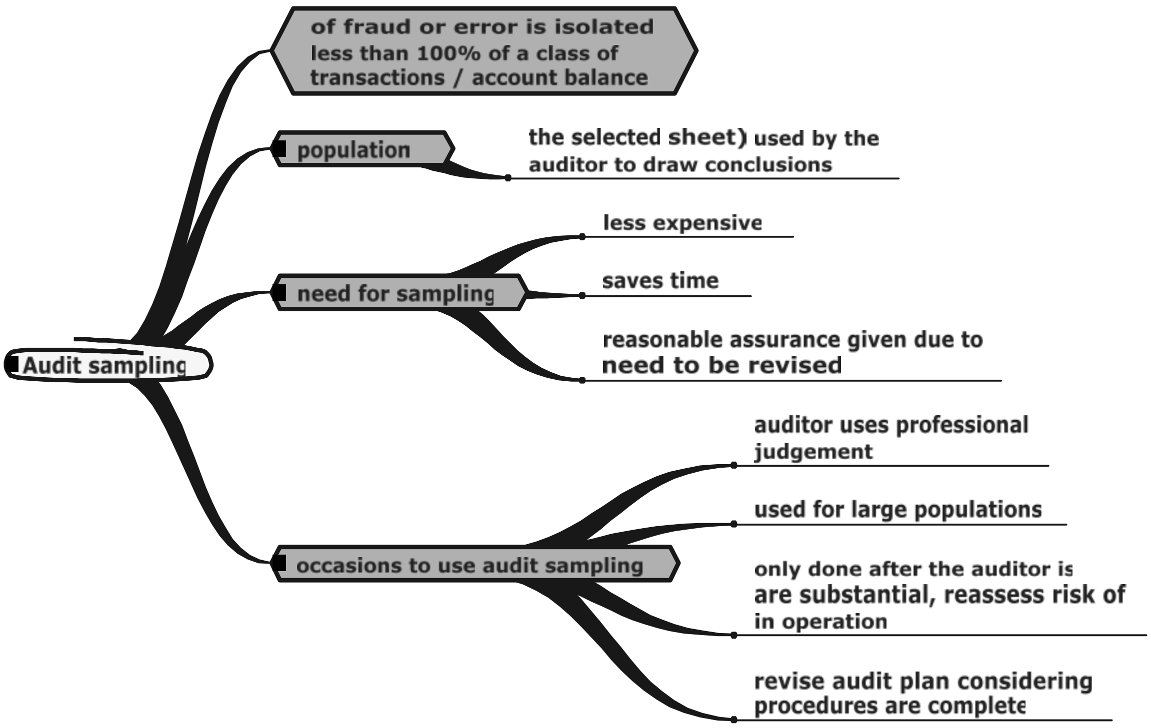
There is no requirement of any ISA to use sampling. The auditor uses professional judgment to decide whether to use sampling or not. Usually large populations are suitable for audit sampling. The auditor decides on control testing only after satisfying himself that the internal controls exist and that they are actually in operation. The possibilities of routine errors and fraud are greatly diminished if formal efficient internal controls are in place. Extensive routine checking may turn out to be a mere ritual or waste. It is useful to apply sampling techniques after analytical procedures because the analytical procedures quickly give the auditor some information about where larger samples might be required or where sampling might be inappropriate.

It is important to note that sampling is undertaken only in areas where audit risk is faced as in risk-based auditing, (which is commonly undertaken) **auditors focus on the audit risks associated with the entity** which pose the greatest risk of material misstatement in the financial statements. Audit risk models are explained in detail in Study Guide A3.

1.4 When sampling is inappropriate?

Sampling may not always be appropriate. If a population contains a low number of high value items, and other means do not provide sufficient appropriate evidence, it may be more appropriate to carry out a 100% examination. For example, if the addition of non-current assets contains only 10 invoices of high value. It will be appropriate to apply audit procedures to each of the purchases.

SUMMARY



1.5 Methods of selecting of a sample

Definition

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

A sampling approach that does not have characteristics (i) and (ii) is considered **non-statistical sampling**.

ISA 530

1. Statistical sampling

The two characteristics that are essential before a sampling can be said to be a "statistical sampling" are random selection of a sample and use of probability theory to evaluate the results.

(a) Random selection

It means that sample items are selected at random. The selection process is such that all items in the population have an equal chance of being represented in the sample. For this the probability theory is used.

(b) Systematic selection

It means that sample items are selected by using a constant interval between the selected items. The first item is selected on a random basis, and then, say, every 100^{th} item is selected. It should be ensured that the sample interval does not correspond to a particular pattern in the population.

(c) Monetary unit sampling

This method of sampling aims to ascertain the accuracy of financial accounts. The sample size selection and evaluation is in monetary terms, wherein monetary amounts are converted into units. For example a payable balance of TZS30,000 contains 30,000 sampling units. This method is generally used in testing internal controls.

The steps involved in sampling are as follows:

(i) Identifying a sample size;
(ii) Choosing the sample;
(iii) Carrying out audit procedures;
(iv) Analysing the results of the audit procedure; and
(v) Deciding the genuineness of the population.

Use of probability theory to evaluate sample results

If a sample has been selected at random then a statistical tool of probability theory can be used to evaluate the results.

2. Non-statistical sampling

As discussed above a sampling approach that does not have characteristics of a statistical sample is considered non-statistical sampling. The following are some methods of sampling used:

Example

The first ten invoices of each month are selected for checking. This is a judgemental or haphazard sampling and not statistical sampling in a strict sense.

(a) Haphazard selection

Under this method, sample items are selected arbitrarily, usually by manual choice. The objective of this selection process is that all items in the population have an equal chance of being represented in the sample. Therefore the selection process must be unbiased (i.e. the auditor must not deliberately avoid certain items) and free from predictability. The limitation of this method of selection is that there is no way to ensure that the estimates derived will be unbiased.

(b) Sequence selection or block selection

It means that sample items are selected sequentially or in a block. E.g. 100 sales invoices (Sr No 300 to 399) are selected. This kind of sample may not be representative of the population and is liable to pick items from one day or period only. Therefore this method of selection is rarely used. This method of selection can be successful only if many blocks are selected.

1.6 Differences between statistical and non-statistical sampling

Issue	Statistical sampling	Non-statistical sampling
Selection of a sample	This is taken at random or with the use of the probability theory.	This is based on the judgement of the auditor.
Evaluation of sample results	With the help of probability theory e.g. if a sample of TZS1 million has an error of TZS10,000, there is a probability that the population of TZS50 million will have an error of TZS50,000.	It is evaluated according to the judgement of an individual
Sample size	Provides a means to estimate minimum sample size, with a specified risk and precision.	Does not provide a means to estimate minimum sample size.
Risk	Provides a means to take a calculated risk, with a statistical measurement of sampling risk.	Does not provide a means to take a calculated risk.
Defensibility, in a legal case related to the quality of audit work	More defensible, since the sample selection is objective.	Less defensible, since the sample selection is subjective
Tests of controls	Statistical sampling is less suitable because the auditor's analysis of the nature and cause of errors will often be more important than the statistical analysis of the mere count of errors.	Non-statistical sampling is more suitable.
Tests of details	Statistical sampling is more suitable because statistical analysis of errors and their projection to the sample is useful in the case of details.	Non-statistical sampling is less suitable.

Test Yourself 1

The audit assistant deputed to audit a small enterprise, in a meeting for planning the audit, insists that for a small unit there is no scope for audit sampling. Do you agree?

2. Explain the application of statistical sampling.

[Learning Outcome b]

2.1 The role of sampling in obtaining audit evidence

Audit evidence is obtained by performing:

1. Risk assessment procedures

Usually, **sampling will not be used in risk assessment procedures**. Understanding an entity and its environment requires professional skills and is not suitable for sampling.

2. Tests of controls

Audit sampling for tests of controls is generally appropriate. However, non-statistical sampling may be more appropriate than statistical sampling for tests of controls because the auditor can use judgement to choose items where controls might not operate as well. For example, when a supervisor has been off work with illness, evidence that the controls have operated must be available.

Example

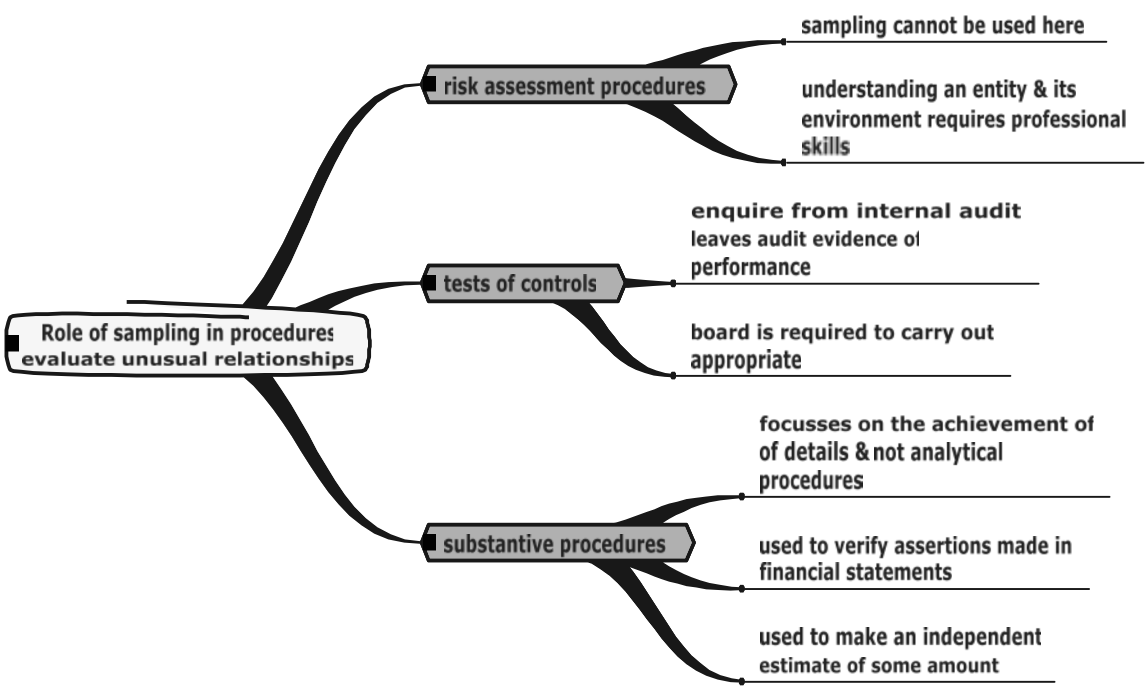
The control system of a company has a requirement that all purchase orders should be authorised by the purchase manager. When the manager authorises the purchase order, she puts her **signature on the physical copy**. The computerised system, at the same time, **records her identification based on the login ID and password** in relation to the purchase order. Since application of the controls leaves evidence, a test of control on this activity can be performed using sampling.

3. Substantive procedures

Substantive procedures consist of tests of details and analytical procedures. Audit sampling relates only to tests of details and not to analytical procedures. In connection with tests of details, sampling can be applied to:

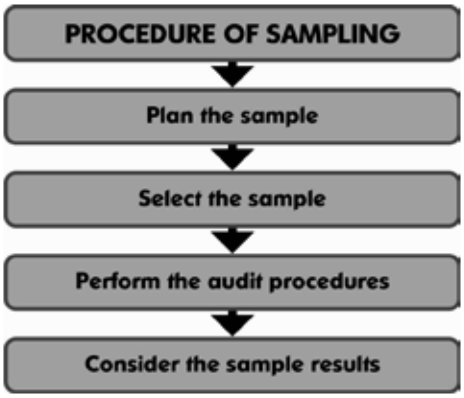
(a) Verify one or more assertions about a financial statement assertion. For example, to test the existence of payables, letters are sent to the suppliers in a sample.
(b) Make an independent estimate of some amount. For example, estimation of the value of obsolete inventories.

SUMMARY



2.2 Procedure of sampling

Diagram 2: Procedure of sampling



1. Plan the sample

(a) Population

Planning of a sample starts with ensuring that the population from which the sample is selected is appropriate and complete.

As discussed earlier, **population** means **the entire set of data from which a sample is selected** and **about which the auditor wishes to draw conclusions.**

The population should be appropriate

For example, when the objective is to test the existence of receivables, the population is the list of receivables balances for each customer.

The population should be complete

To continue the example stated above, the total of the list of receivables should be agreed to the balance in the control account. This will usually indicate that the trial balance is complete. If the population is not complete, the missing items can never be selected in the sample.

(b) Stratified population

Definition

Stratification: the process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

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Definition

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

Audit efficiency may be improved if the population is divided (stratified) between different groups on the basis of characteristics. Stratification reduces the variability of items within each group and allows the sample size to be reduced without a proportional increase in sampling risk.

Definition

An auditor knows from experience that, in a particular company, 20% of the items constitute around 90% of the value of inventory in hand. A sample is selected from this 20% and audit procedures applied. The remaining 80% of the items that constitute only 10% of the value of inventory is treated a different stratum and the auditor applies different audit procedures or decides to ignore this group of items since it is immaterial.

(c) Define what constitutes an error

The auditor considers what constitutes an error by reference to the objectives of audit procedures.

Example

In a receivables circularisation:

Customer X replies and confirms the stated balance.

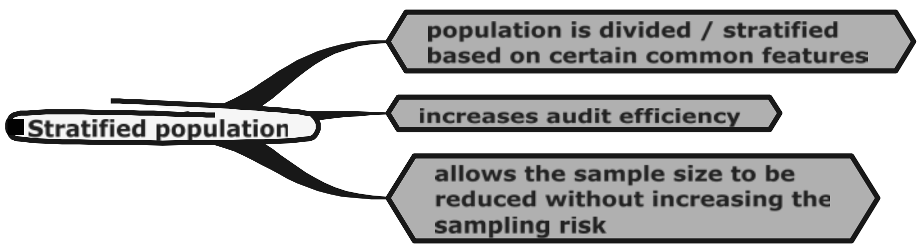
Customer Y replies but states a different balance due to a payment made by him but received by the client after the confirmation date.

Customer Z replies but states a balance that is different. Investigation shows that the client made an error recording some invoices due from Z

Regarding X there is no question of an error. Regarding Y there is an apparent difference, but it is due to an amount in transit and, within a few days, the amount will be shown as received by Y. This is not an error.

However, the difference related to Z is an error.

SUMMARY



(d) Determine acceptable or tolerable misstatement

Definition

Tolerable misstatement: a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

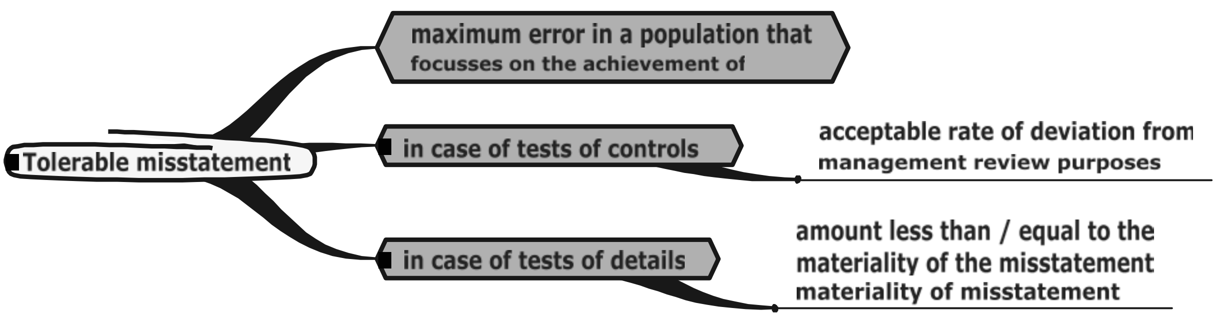
ISA 530

Therefore **tolerable misstatement** is the maximum error in a population that the auditor is willing to accept.

For tests of controls: tolerable misstatement is the rate of deviation from the prescribed control activity the auditor is willing to accept.

For tests of details: tolerable misstatement set by the auditor, will be an amount less than or equal to the materiality determined in the given area. It may be an individual amount or the total of many items. If there are errors of an amount lower than the acceptable error, the auditor would conclude that the errors are not material and the financial statements still show a true and fair view. Auditors determine this threshold on the basis of some base such as total sales or total assets etc.

SUMMARY



(e) Sampling and non-sampling risk

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

Put simply, if the auditor does not look at every item in the population, there is a risk that all the items in the sample were correct, but that there were many errors in the whole population. Alternatively, there might be many items in the sample which were incorrect – but they were the only ones in the whole population that were incorrect. The auditor has had 'bad luck' in sampling and can draw wrong conclusions as a result.

There are two types of sampling risks:

(i) Over-optimism: the risk that the auditor will conclude:

In the case of controls, that they are more effective than they actually are
In the case of test of details, that material error does not exist when in fact it does

This risk affects the effectiveness of an audit, leading to an inappropriate audit opinion.

(ii) Over-pessimism: the risk that the auditor will conclude:

In the case of controls, that they are less effective than they actually are
In the case of test of details, that material error exists when in fact it does not

This risk affects audit efficiency, leading to additional work to establish that the initial conclusions were incorrect.

Tip

Sampling risk can be reduced by increasing the sample size.

Example

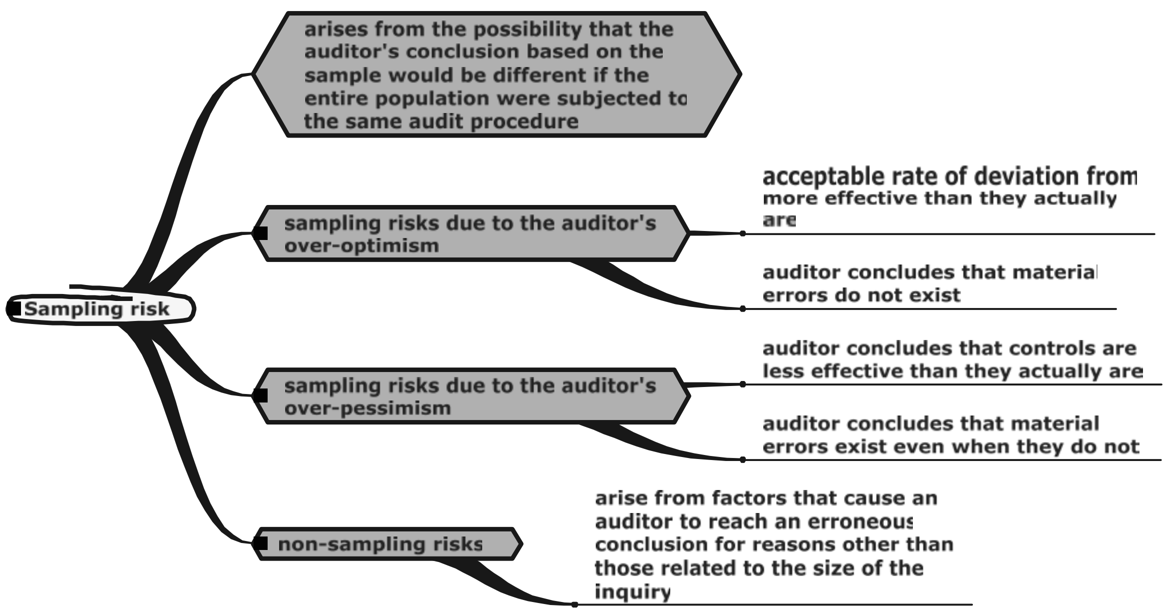
An auditor applies procedures to a sample of cheques issued to suppliers. He finds 0.10% errors in the sample. He concludes that the population also has a similar percentage of error. Determining the error to be negligible, the auditor concludes that there is no material misstatement.

However, the sample does not include a few payments where errors / fraud of a large amount took place. Therefore, the conclusion was erroneous. This is a sampling risk. There was a material misstatement, but the auditor concluded that there was not, by relying on the sample result.

Non-sampling risk arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample. For example, the auditor might use inappropriate procedures, or the auditor might misinterpret evidence and fail to recognise an error.

Non-sampling risk can be reduced by better knowledge about the client and the industry sector, better planning, better review and more experienced audit team members.

SUMMARY



(f) Determine sample size

While determining the sample size, the goal of audit sampling should be remembered. **The goal is that the sample should represent the population within the specified tolerances.**

By verifying the sample, the auditor should be able to judge the characteristics of the population and draw audit conclusions.

(g) Confidence level and sampling risks

Confidence level is **the probability that the sample will be representative of the population**. For example, a 95% confidence level indicates that in 95 out of 100 samples the sample will be representative of the population. Sampling risk is a mathematical complement of confidence level. In the above example, the sampling risk is 5%.

(h) Precision level

The precision level **specifies the range of values within which the sample estimate represents the universal characteristic.**

Example

A precision level of + / - 3% indicates that the results of the sample will vary plus or minus no more than 3% from the universe (or population).

The sample size should be determined after considering the sampling risk that an auditor is willing to accept.

The lower the sampling risk the auditor is willing to accept, the greater the sample size. There are different ways to calculate sample size.

Sample size also depends upon the expected errors in the population. When the population is expected to be error-free, a smaller sample size is justified.

However, when the auditor expects errors to be present in the population, the sample size will be larger i.e. the auditor needs to have a larger sample to assure himself that there are no errors or material misstatement.

The auditor will determine expected error after considering different factors, for example, error levels identified in the previous audits, changes in the entity's procedures, and the results of tests of control.

Published tables are available on the market which give the necessary sizes of samples for given levels of acceptable risk, and precision.

Example

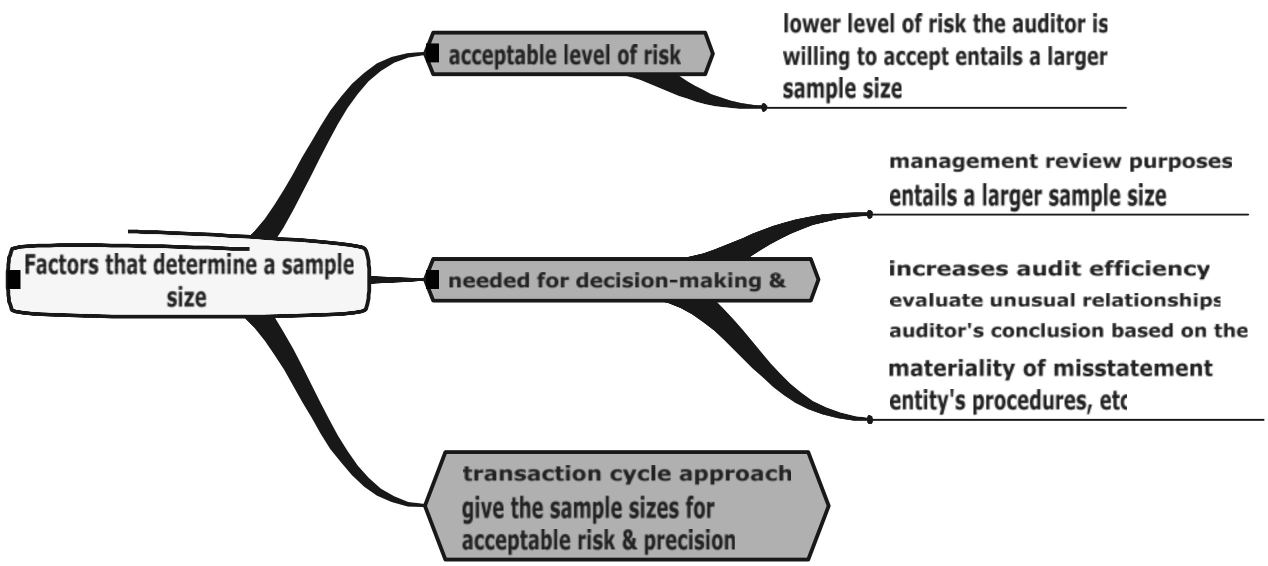
Suppose that an auditor would like a confidence level of 95%. In other words, they are willing to accept a sampling risk of 5%.

A table of sample sizes shows that, if the population size (e.g. number of purchase invoices) is 10,000, at 95% confidence level, and at precision levels of 3%, 5%, 7% and 10% the sample sizes are 1,000, 385, 200 and 99 respectively.

If the auditor aims at a 7% precision level, then they will select a sample of 200 purchase invoices out of a total of 10,000. In simple terms, this means that the auditor is willing to accept a 5% sampling risk (95% confidence).

They want to ensure that the results of the sample will vary by no more than + / - 7% from the population.

SUMMARY



2. Select the sample

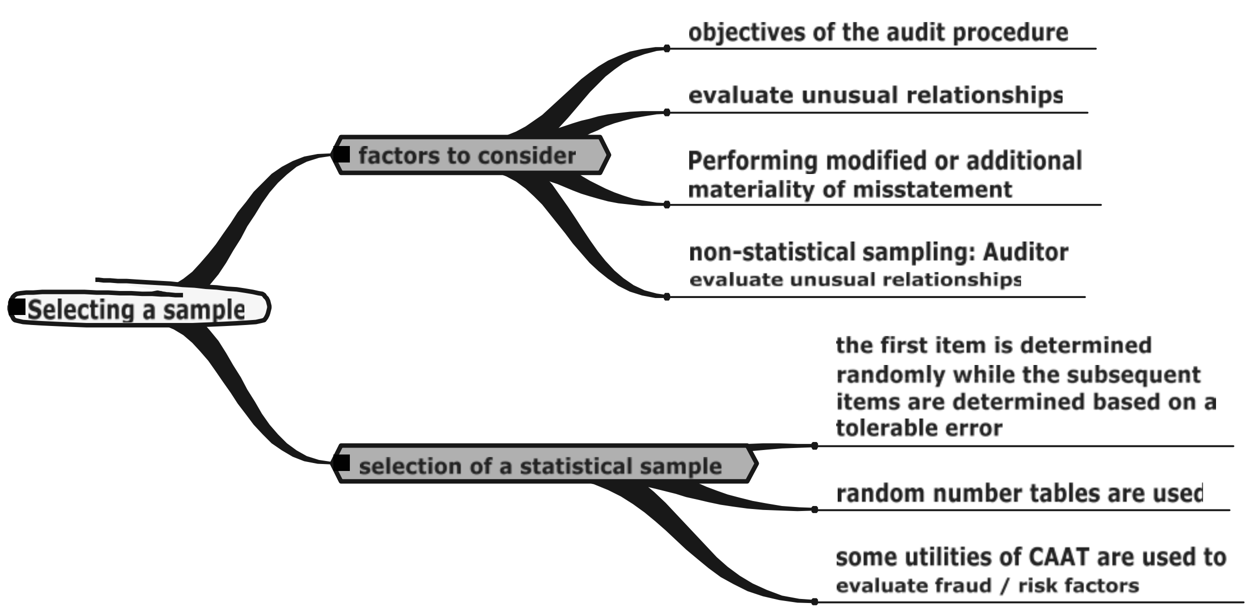
A sample should be selected keeping in mind the objectives of the audit procedure and the characteristics of the population. Statistical sampling requires that each sampling unit should have a known chance of selection. A statistical sample is selected in one of the following ways:

(a) Random number tables are used to select the items to be a sample. The items in the population have to be pre-numbered.

(b) Computer assisted audit techniques (CAAT). Audit programs can be used to select samples randomly from a population.

(c) Systematic sampling (a close approximation to pure random sampling) i.e. a random number is generated to determine which item in the population is the first in the sample. Using a sampling interval, usually based on a tolerable error, subsequent items are determined, e.g. every fiftieth item

SUMMARY

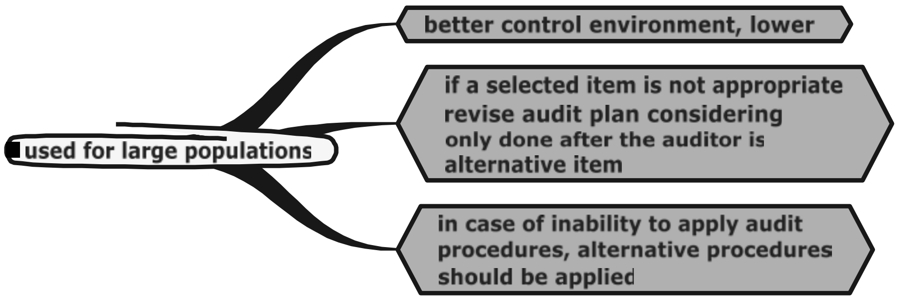


3. Perform the audit procedures

After selecting a sample the audit procedure is performed. For example, after a sample is selected for circularisation of receivables, the letters are actually prepared and dispatched. The replies are analysed.

If a selected item is not appropriate for application of an audit procedure, the procedure is usually applied on a replacement item, i.e. sometimes when the auditor is unable to apply the audit procedures, alternative procedures (which replace the originally planned procedures) should be applied.

SUMMARY



4. Evaluate the sample results

The evaluation of results is taken up in the next section.

Test Yourself 2

You are to audit tangible non-current assets. Explain which of the audit procedures are open to the sampling process.

5. Computer Assisted Audit Techniques/Tools

Computer-assisted audit techniques (CAATs) refer to the practice of using computers to automate the IT audit processes. CAATs may involves software packages that apply statistical analysis and business intelligence tools.

The traditional method of auditing allows auditors to build conclusions based upon a limited sample of a population, rather than an examination of all available or a large sample of data

CAATs, not CAATs, addresses these problems. CAATs, as it is commonly used, is the practice of analyzing large volumes of data looking for anomalies. A well designed CAATs audit will not be a sample, but rather a complete review of all transactions. Using CAATs the auditor will extract every transaction the business unit performed during the period reviewed. The auditor will then test that data to determine if there are any problems in the data

Types of CAATs
i. Audit software
ii. Test data

Audit software

Audit software is used to interrogate a client's system. It can be either packaged, off-the-shelf software or it can be purpose written to work on a client's system. The main advantage of these programs is that they can be used to scrutinise large volumes of data, which it would be inefficient to do manually. The programs can then present the results so that they can be investigated further.

These procedures can simplify the auditor's task by selecting samples for testing, identifying risk areas and by performing certain substantive procedures. The software does not, however, replace the need for the auditor's own procedures

Benefits of audit software include:

- They are independent of the system being audited and will use a read-only copy of the file to avoid any corruption of an organization's data.
- Many audit-specific routines are used such as sampling.
- Provides documentation of each test performed in the software that can be used as documentation in the auditor's work papers.

Specialized audit software may perform the following roles:

- Extracting samples according to specified criteria, such as Random, Over a certain amount, Below a certain amount or at certain dates.
- Calculating ratios and select indicators that fail to meet certain pre-defined criteria (i.e. benchmarking);
- Check arithmetical accuracy (for example additions);
- Preparing reports (budget vs actual);

- Stratification of data (such as invoices by customer or age);
- Tracing transactions through the computerized system.
- Data queries.
- Data stratification.
- Missing sequence identification.
- Statistical analysis.
- Duplicate transaction identification.

Examples of CAATs is like IDEA, ACL etc

Test data

Test data involves the auditor submitting 'dummy' data into the client's system to ensure that the system correctly processes it and that it prevents or detects and corrects misstatements. The objective of this is to test the operation of application controls within the system.

To be successful test data should include both data with errors built into it and data without errors. Examples of errors include:

- codes that do not exist, e.g. customer, supplier and employee;
- transactions above pre-determined limits, e.g. salaries above contracted amounts, credit above limits agreed with customer;
- invoices with arithmetical errors; and
- Submitting data with incorrect batch control totals.

Data may be processed during a normal operational cycle ('live' test data) or during a special run at a point in time outside the normal operational cycle ('dead' test data). Both has their advantages and disadvantages:

- Live tests could interfere with the operation of the system or corrupt master files/standing data;
- Dead testing avoids this scenario but only gives assurance that the system works when not operating live. This may not be reflective of the strains the system is put under in normal conditions.

Advantages of CAATs

- CAATs allow the audit team to test a large volume of data more accurately and quickly than if tested manually.
- CAATs decrease the scope for human error during testing and can provide evidence of higher quality.
- By using CAATs, auditors can test actual transactions within the system rather than working on printouts from spool or previewed files which are dependent on other software (and therefore could contain errors or could have been tampered with following export).
- Assuming the system remains unchanged, CAATs used in the audit of current year should bring time (and therefore cost) savings in the long term, which should be more to compensate for any set up costs.
- Auditors can utilize CAATs to test programs controls as well as general internal controls associated with computers.
- Results from CAATs can be compared with results from traditional testing. If the results correlate, overall confidence is increased.
- The use of CAATs allows audit team members more time to focus on risk areas and issues requiring judgment, rather than performing routine calculations that can be carried out by audit software.

Disadvantage of CAATs

- Setting up the software needed for CAATS in the first year is likely to be time consuming to re-expensive
- Audit staff working on audit engagement will need to be trained so they have a sufficient level of IT knowledge to apply CAATs when auditing.
- If testing is performed on data in the live system, there is a risk that live client data may be corrupted and lost.
- If the system has changed then it may be expensive and time consuming to re- design the CAATs in the next years
- If the system is not compatible with CAATs then they will need to be tailored to the system, which may be costly.
- If testing is performed on data from copies of the live files rather than the live data itself. There is the risk that these files have been affected by the copying process or have been tampered with.
- If there is not adequate system documentation available, it will be difficult to design appropriate CAATs due to a lack of understanding of the system

Answers to Test Yourself

Answer to TY 1

What the audit assistant says is not necessarily true. Whether to use sampling in an audit depends on the professional judgement of the auditor. One factor that is essential for sampling is the existence of a reliable internal control system.

If the small enterprise does not have good internal controls in certain areas, then sampling may not work in those areas. However, if there are good internal controls, sampling may be used even in a small unit.

Answer to TY 2

The following audit procedures are open to the sampling process:

(a) Tests of controls: in principle, tests of controls are open to sampling, especially when application of control leaves audit evidence of performance. Controls on purchases of new assets, their receipt and physical storage and recording can be checked with the help of a sample. However, if the items are few, it may be better to verify all the items, rather than just a sample.

(b) Tests of details: Authorisation of purchase, invoices, and inspection reports may be verified for a sample. Just like tests of controls, if the items are few, it may be better to verify all the items, rather than just a sample.

(c) Risk assessment procedures are not suitable for sampling. The auditor has to use professional expertise to assess the risk.

Quick Quiz

1. An auditor selects purchases for the first two weeks and the last two weeks of a year as part of checking cut-off procedures. Is this sampling? Is it effective?

2. A company issued share capital during the year. Can an auditor use sampling to verify the transactions?

3. The auditor desires a confidence level of 99%. This means that she is willing to accept a sampling risk of 1%. True or false?

4. What is the relationship of sampling risk with audit effectiveness and efficiency?

5. Why is it said that the sample results regarding tests of controls do not have to be projected to the entire population?

Answers to Quick Quiz

1. It is not sampling since all the items do not have a chance of selection. However, this is an effective selection since the transactions for the first and last few days of a year are important for checking cut-off.

2. The journal entries recording the issue of capital and the amounts due on allotment and calls should be checked 100%. However, cash receipts, if they are numerous, can be subject to sampling, provided the internal controls are good.

3. True, Statistical risk is a mathematical complement of confidence level.

4. The sampling risk that the auditor will be over-optimistic and wrongly interpret that tests of control exist or that material misstatements do not exist, affects audit efficiency, since it leads to inappropriate audit evidence.

5. For tests of control, the projection of a sample error to the population is not necessary since the sample error rate is also the error rate for the population.

Self-Examination Questions

Question 1

In connection with the audit of payables, explain how different factors would increase or decrease the size of a sample, for tests of control and tests of details.

Question 2

(a)
(i) In the context of ISA 530 Audit Sampling and Other Means of Testing, explain and provide examples of the terms 'sampling risk' and 'non-sampling' risk.

(ii) Briefly explain how sampling and non-sampling risk can be controlled by the audit firm.

(b) Tam Co is owned and managed by two brothers with equal shareholdings. The company specialises in the sale of expensive motor vehicles. Annual revenue is in the region of TZS70,000 million and the company requires an audit under local legislation.

About 500 cars are sold each year, with an average value of TZS140 million, although the range of values is from TZS130 million to TZS160 million. Invoices are completed manually with one director signing all invoices to confirm the sales value is correct. All accounting and financial statement preparation is carried out by the directors. A recent expansion of the company's showroom was financed by a bank loan, repayable over the next five years.

The audit manager is starting to plan the audit of Tam Co. The audit senior and audit junior assigned to the audit are helping the manager as a training exercise.

Comments are being made about how to select a sample of sales invoices for testing. Audit procedures are needed to ensure that the managing director has signed them, and then to trace details into the sales day book and sales ledger.
'We should check all invoices' suggests the audit manager.

'How about selecting a sample using statistical sampling techniques?' adds the audit senior.

'Why waste time obtaining a sample?' asks the audit junior. He adds 'taking a random sample of invoices by reviewing the invoice file and manually choosing a few important invoices will be much quicker.'

Required:

Briefly explain each of the sample selection methods suggested by the audit manager, audit senior and audit junior, and discuss whether or not they are appropriate for obtaining a representative sample of sales invoices.

Answers to Self-Examination Questions

Answer to SEQ 1

Factors influencing sample size for tests of controls

Factor	Effect on sample size
If the risk of material misstatement is reduced by the operating effectiveness of controls. For example, good controls on purchases where each purchase order is authorised by the purchase manager, goods are inspected by the quality control officer and received by the store keeper reduce a chance of material misstatement.	Increase
An increase in the rate of deviation that the auditor is willing to accept. For example, if the auditor is willing to accept higher deviation from the controls mentioned above, they would be satisfied with a smaller sample.	Decrease
An increase in the rate of deviation from the prescribed control activity that the auditor **expects to find** in the population. If the auditor expects that the deviations from control activity would be higher (but they do not accept them), then they would increase the sample size.	Increase

Factors influencing sample size for tests of details

Factor	Effect on sample size
An increase in the auditor's assessment of the **risk of material misstatement.** For example, if the auditor assesses that the risk of material misstatement has increased, they would increase the sample size (or also apply other procedures).	Increase
An increase in the use of **other substantive procedures** directed at the same assertion. For example, if circularisation is used along with verification of subsequent payments, the sample size may be lower.	Decrease
An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population.	Increase
An increase in the total error that the auditor is willing to accept (**tolerable error**)	Decrease
An increase in the amount of error the auditor **expects** to find in the population.	Increase
Stratification of the population. For example, if the payables are stratified according to values, they become more uniform, and therefore smaller samples are possible.	Decrease

Answer to SEQ 2

(a) Sampling risk

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

There are two types of sampling risks

(i) Over-optimism: the risk that the auditor will conclude

In the case of controls, that they are more effective than they actually are.
In the case of test of details, that material error does not exist when in fact it does.

(ii) Over-pessimism: the risk that the auditor will conclude

In the case of controls, that they are less effective than they actually are
In the case of test of details, that material error exists when in fact it does not

This risk affects audit efficiency, leading to additional work to establish that the initial conclusions were incorrect.

Therefore sampling risk is controlled by the audit firm ensuring that it is using a valid method of selecting items from a population and/or increasing the sample size.

Non-sampling risk

Non-sampling risk arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample. For example, the auditor might use inappropriate procedures, or the auditor might misinterpret evidence and fail to recognise an error.

Non-sampling risk can be mitigated by providing appropriate training for staff so they know which audit techniques to use, and will recognise an error when one occurs, better audit planning, better supervision and more experienced staff.

(b) The audit manager has ignored all statistical sampling techniques while suggesting that audit tests are to be applied to all sales invoices.

This approach may be appropriate for the audit of Tam because:

All the transactions need to be tested as the transactions although not large are material.

The population is comparatively small, hence it would be possible to test all transactions instead of spending time constructing a sample.

The audit senior has recommended the use of statistical sampling. This will involve a random selection of samples using the probability theory and then applying audit tests to those invoices.

This approach may be appropriate as:

The controls appear to function efficiently,

There does not appear to be a change in the internal controls,

The population is homogeneous as it is made up of similar items.

The audit junior perceives random sampling to mean a manual selection of samples. In this context they recommend the use of 'random' sampling. The approach therefore involves an element of bias and is not statistical or true 'random' sampling.

Although this approach saves times, it is not appropriate because:

The selection of samples is not statistical and will have an element of bias as samples are chosen manually and the auditor may intentionally avoid difficult items for testing.

In case a deviation or misstatement is noticed, it may be difficult to conclude that it is an anomaly as conclusions drawn from samples chosen using non-statistical methods may not provide a valid conclusion.

SECTION C

THE NATURE OF AUDIT EVIDENCE AND THE SELECTION OF SUFFICIENT APPROPRIATE EVIDENCE

C4

STUDY GUIDE C4: THE AUDIT OF SPECIFIC ACCOUNT BALANCES

Get Through Intro

In the earlier Study Guides, the assertions contained in the financial statements and related audit evidence was considered. A substantial portion of the financial statements consists of certain important items, i.e. receivables, inventory, payables and accruals, bank and cash and tangible non-current assets and long-term liabilities.

A major part of substantive procedures, therefore, relates to these items. If the procedures are understood and applied correctly to these areas, it goes a long way in enabling the auditor to form an opinion. Hence the purpose and nature of substantive procedures in these areas are explained in this Study Guide. These items have related SOPL entries. While looking into these SOFP items, their relationship with the SOPL is also explained.

This Study Guide highlights how insufficient audit evidence can lead to auditors drawing the wrong conclusions. Material fraud may remain undetected if this happens.

Learning Outcomes

a) For each of the account balances stated in this sub-capability
Identify state and explain appropriate procedures to gather evidence based upon a given scenario.
Identify and evaluate based on a given scenario including information regarding evidence obtained whether that evidence is sufficient to provide an appropriate basis for a given opinion or report.

i. Receivables
ii. Inventory
iii. Payables, accruals, provisions and contingencies
iv. Bank and cash
v. Tangible and intangible non-current assets and non-current liabilities
vi. Share capital, reserves and director's emoluments

1. For 'receivables' account balance:
i. Identify state and explain appropriate procedures to gather evidence based upon a given scenario
ii. Identify and evaluate based on a given scenario including information regarding evidence obtained whether that evidence is sufficient to provide an appropriate basis for a given opinion or report.

[Learning Outcome a]

Receivables include:

The amounts to be recovered in cash (trade receivables or loan receivables).
Services to be received in return for the prepayments made.

1.1 Direct confirmation (circularisation) of accounts receivable

1. Meaning

Definition

External confirmation: audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

ISA 505

Direct confirmations are confirmations of balances (with or without details of their components) at a given date, obtained by an auditor directly from the accounts receivables.

2. While studying the quality of audit evidence, it was noted that audit evidence is more reliable when it has the following characteristics:

It is obtained from independent sources outside the entity.
It is obtained directly by the auditor.
It exists in documentary form.
It is in the form of original documents.

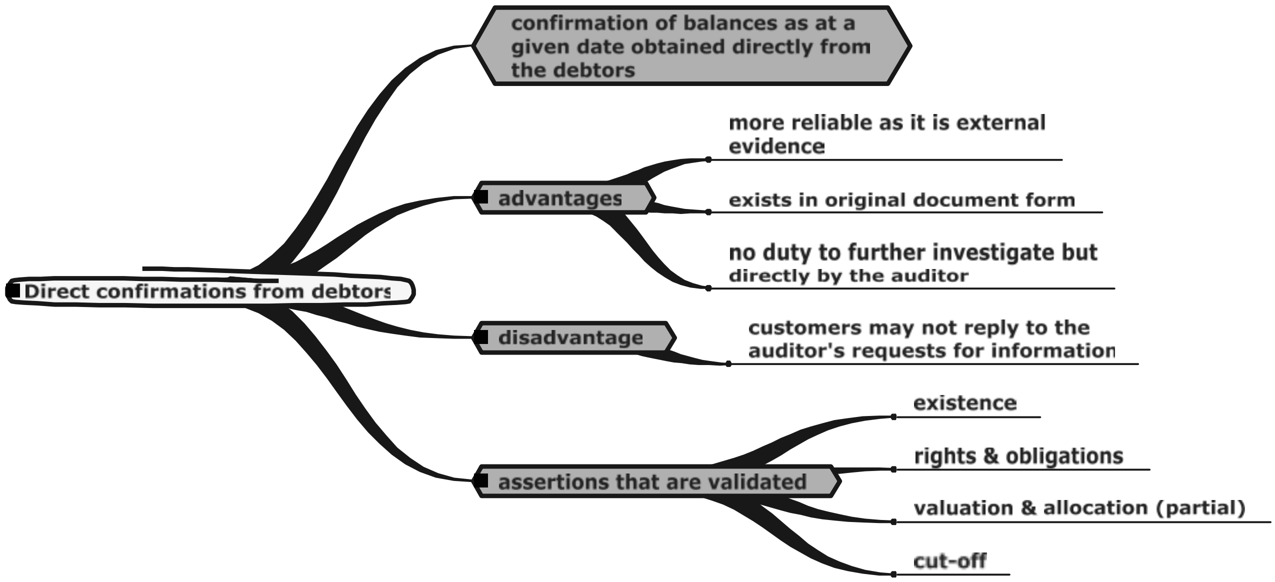
When it comes to the audit of receivables, there is one source of evidence that satisfies all the above conditions i.e. direct confirmations. The auditor **directly** obtains confirmations from account receivables (**independent sources**) in **original document** form. Usually this is applied to a sample of receivables.

3. A disadvantage of this method is that the customers may not reply to the request.

4. The assertions that are validated by direct confirmations

Assertion	Application to direct confirmation of receivables
Existence	The existence of the receivable is proved when it is confirmed by the customer replying to the receivables confirmation request. This applies when the auditor sends a positive confirmation request to the customers. On the other hand when the auditor seeks a negative confirmation request from the customer, the customer not sending out a reply means that the customer's account balance exists in the clients' financial statements. Negative confirmation explained later!
Rights and obligations	The assertion of 'rights and obligations' means that the entity has a right to the asset. It is free to use or dispose of the asset as it sees fit. The receivable confirms that the amount is owed to the entity.
Valuation and allocation (partial)	Any receivable amount which does not relate to the financial account will be disputed and the correct amount of receivables will have to be incorporated in the financial statements. This means that any allocations or valuation adjustments required in the financial statements (due to discrepancies in the recording of entries) have been made correctly. The valuation assertion is not validated fully, since it is not practicable to ask the accounts receivables to confirm detailed information relating to their **ability to pay** the account. Indeed the accounts receivables who cannot pay might respond quickly so as not to raise suspicions.
Cut-off	Transactions and events have been recorded in the correct accounting period. In other words, the transactions that are recorded in the current financial year do not include any transactions relating to any other year. The circularisation will identify reconciling items such as sales invoices/cash in transit. The auditor then confirms that the transactions are accordingly recorded.

SUMMARY



5. Circularisation Procedure

Step 1: Auditor selects a sample.

Step 2: Auditor gives client a list of selected receivables. This will include:

(a) Material balances
(b) Some random immaterial balances
(c) Nil balances (to see if customers have really stopped buying from the client)
(d) Credit balances (to identify if credit balances really exist)

Step 3: Auditor discusses and considers client's objections, if any. If management states that certain parties should not be asked for confirmations, the auditor should review whether there are valid grounds to support this. If the auditor agrees with management's stand, then they should obtain alternative audit evidence.

Example

There may be customers who are very difficult to handle and the client may request that certain ones may not be contacted. The auditor will have to decide how material they are and whether their balance can be verified by other means e.g. checking cash received from the client post year end.

Step 4: Actual request letters are prepared usually on the client's letterhead and the client's authorised person signs them.

Step 5: Auditor sends the request letters to customers.

Step 6: Customers are requested to send the replies directly to the auditor.

Step 7: Auditor records replies received and considers the accounts that do not agree with the amounts in the client's records.

Step 8: Auditor performs alternative procedures for those not replying.

Example

An auditing firm C & C Associates and Co prepares a list of customers to be circularised, prepares letters and gets them signed by the CFO of CBC Ltd. The letters are mailed by the auditor's staff. Replies are received directly by C & C Associates. They are tabulated and analysed by C & C Associates

6. The alternative procedures include:

(a) **Inspection of bank documents and cash receipt documents** for the period after the date of the financial statements, but before the date of the audit report and agree it with the receivables ledger.

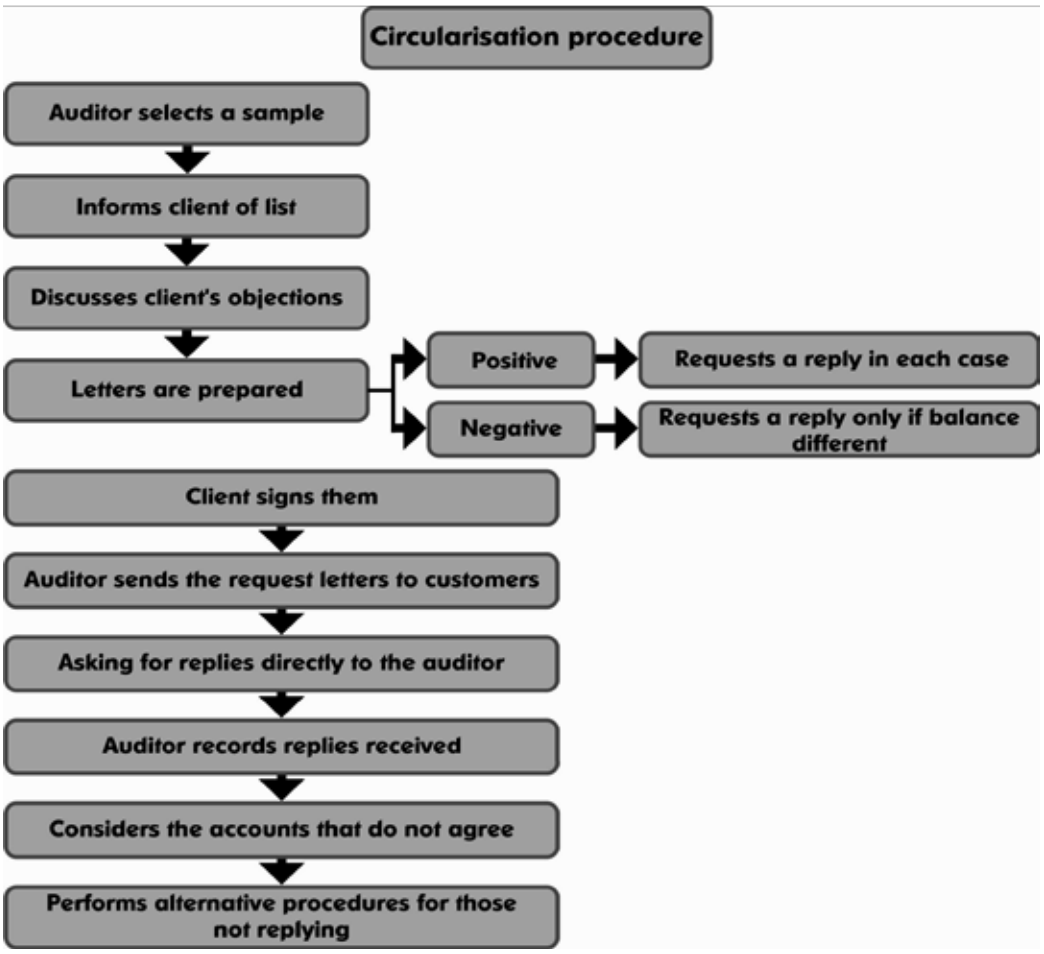
(b) **Inspect the correspondence with customers and confirm whether specific invoices have been confirmed**. If so verify the validity of the confirmations.

(c) **Verify the file for information on any disputes with the customers** on accounts receivables. If correspondence is available, verify whether allowance for doubtful debts is required.

> 'Agree it with the receivables ledger' means ensuring that it agrees with the receivables ledger. In the exam you must write the procedure as stated alongside!

(d) In case subsequent payments are made before making payments of earlier overdue invoices, inquire with management the reasons for the same. **Verify correspondence with customers** in this connection.

Diagram 1: Circularisation procedure



7. Non response and exceptions

Definition

Non-response: a failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Exception: a response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

ISA 505

There can be situations when receivables either:

- Do not respond (i.e. non-response) to the confirmation of the balance request sent by the client, or
- Confirm a balance which differs with the balance (i.e. exception) stated in the client's request letter.

(a) Reasons for exceptions

(i) Customers may net off the amounts owed with the amounts owing.

(ii) The date of the entries in the customer's books may be different from the dates on which transactions were recorded in the client's books i.e. the client may have sent monies before the date of the SOFP, whereas the client may have received the money after the date of the financial statements and therefore may have recorded the receipt of money in the following year. The auditor needs to carry out detailed cut-off testing on receipts.

(iii) There may be an error in the client's books i.e. moneys received may be recorded in the wrong customer's account. The auditor needs to check whether there are similar errors in any other customer's account.

(iv) There may be a dispute with the client. The reasons for the dispute need to be investigated by the auditor. Furthermore even provisions for doubtful debts may be required to be made.

(v) The differences in the balances may be on account of teeming and lading, intentional incorrect posting. These are indicative of fraud. At such times detailed testing would be required on cash receipts and the timing of posting the cash receipts.

(b) Audit procedures in case of exceptions

The auditor shall investigate exceptions to determine whether or not they are indicative of misstatements.

For example if the difference in the balance is on account balances and is not on account of differences in timing, it must be indicative of potential misstatements. In cases where it is indicative of misstatements, according to ISA 240, the auditor must evaluate whether this is indicative of fraud. Furthermore, it may also be indicative of a deficiency in the entity's internal controls over financial reporting.

8. Positive and negative external confirmation requests

Definition

Positive confirmation request: a request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

ISA 505

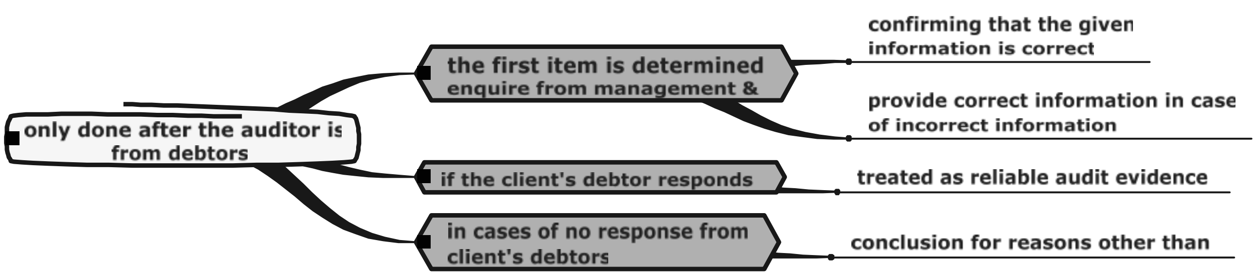
A positive confirmation request is a request asking the respondent to reply to the auditor in all cases. The respondent is expected to do this **either** by confirming that the given information is correct **or** by providing the correct information.

Example

Albert Co owes TZS 2.5 million to Tanberg Co. Tanberg's letter will request Albert to confirm the outstanding amount of TZS 2.5 million or to write the balance according to Albert's records and provide details of the items making up the difference.

A response to a positive confirmation request is usually treated as reliable audit evidence. Where no response is received to the positive confirmation request, the auditor usually contacts the recipient and seeks to elicit the response. When unable to obtain a response, the auditor designs and applies alternative audit procedures, e.g. examination of subsequent cash receipts, shipping documentation, correspondence with the customers etc.

SUMMARY



Definition

Negative confirmation request: a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

ISA 505

A negative confirmation request asks the respondent to reply only in the event of disagreement with the information provided.

Example

Continuing the above example of Albert Co,

Tanberg's letter will request Albert to reply if the balance according to Vanbert's records is not TZS2.5 million and provide details of the items making up the difference.

Negative confirmation requests are **expected to provide less reliable audit evidence than the use of positive confirmation requests**. The auditor does not know whether non-response means agreement or merely that the accounts receivables has not bothered to respond. The auditor usually considers performing other substantive procedures so as to supplement the use of negative confirmations.

When are negative confirmation requests suitable?

They can be used when:

- The assessed risk of material misstatement is lower.
- The auditor has obtained sufficient appropriate evidence relating to the efficiency of the controls.
- A large number of small balances are involved.
- A substantial number of errors is not expected.
- The auditor has no reason to believe that respondents will disregard these requests.

9. Other evidence in relation to receivables and prepayments

Purpose of substantive procedures (Assertions tested)	Audit procedures
Account balances at the period end : Tests of account balances	
All receivables are recorded. (Completeness)	Obtain a schedule of receivables and verify if the total agrees with the figure of total receivables in the trial balance. In the case of prepayments, check if the amount allocated to future periods (and hence shown as prepaid) is calculated correctly. Also, verify whether there is a valid invoice or agreement which entitles the company to the services in the future Trace the prepayments to the prepaid accounts in the SOFP. Match the total of the schedule of receivables with the sales ledger control account. Carry out analytical analysis like a comparison of the level of prepayment relating to the current period, with the prepayment relating to the earlier year. In case of material inconsistencies, the account must be checked in detail with the source document e.g. the contract. Analytical procedures
All receivables relate to the entity. (Rights and obligations)	Review the correspondence with the bank, to verify the existence of liens on the receivables. Inquire if any receivables have been factored or discounted.

Continued on the next page

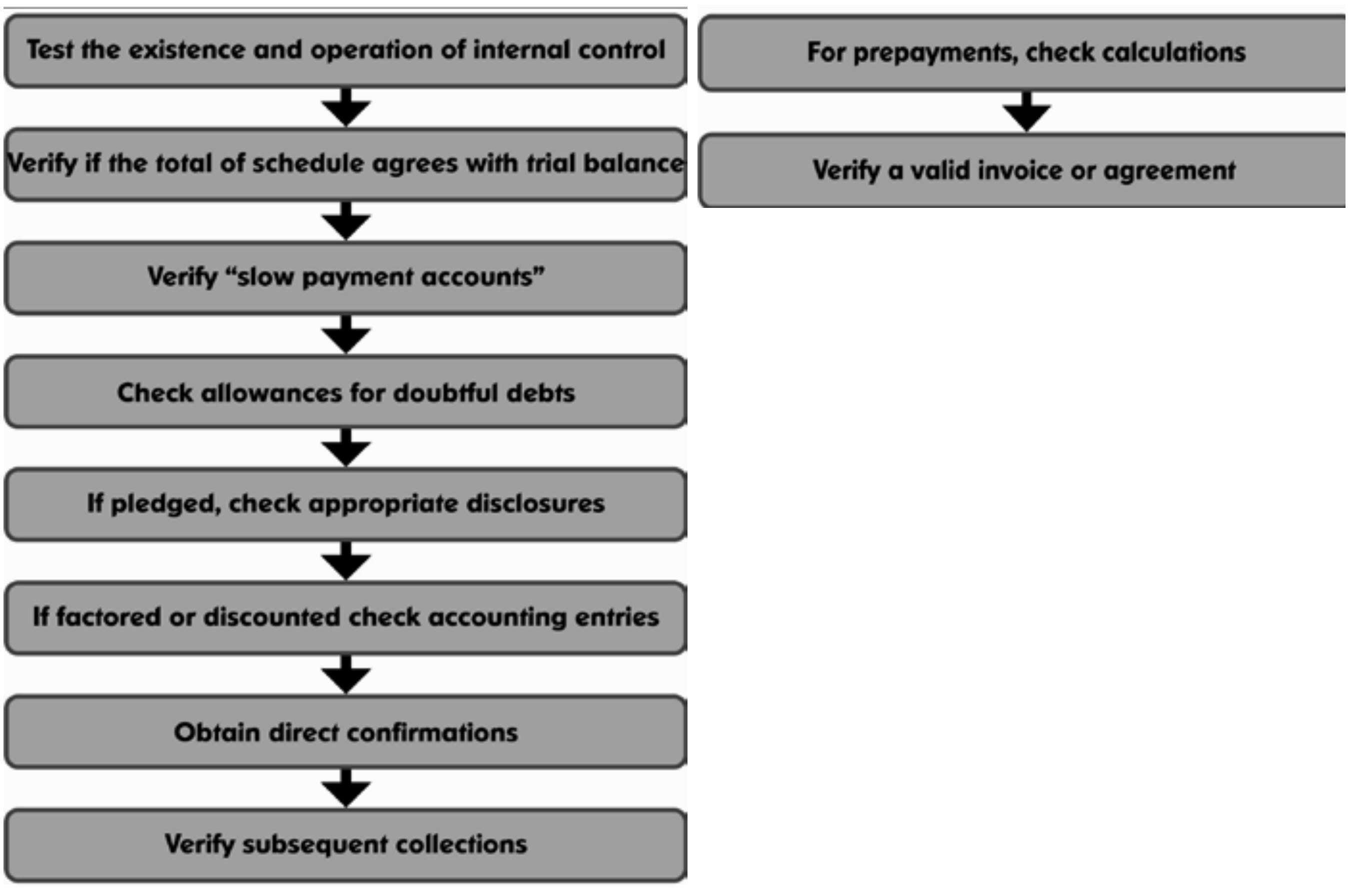
Purpose of substantive procedures (Assertions tested)	Audit procedures
Valuation is proper; allowance for receivables has been created. (Valuation and allocation)	Verify the procedures applied to identify “slow payment accounts” and set allowances for doubtful debts. Check the reasonableness of the calculations. Review the correspondence on disputed accounts receivable and old account balances that have material amounts. Verify subsequent collections. Verify subsequent credit notes, issued in relation to receivables for the current year In case any relate to pre-year end invoices Perform analytical procedures on larger balances on the receivables with the previous years and with the industry average. It includes: comparison of the receivable days receivables turnover bad debt as a percentage of sales provision for doubtful debts as a percentage of receivables. Identify inconsistencies and inquire with the management, the reasons Obtain reasons from management for material account balances which: extend normal credit terms have credit balances have unusually large balances From the list of prepayments choose a sample and recalculate the amounts allocated as receivables.
Receivables do exist. (Existence)	Obtain direct confirmations (as discussed in the previous section). In the case of confirmations not received, carry out additional procedures.
Classes of transactions : Test of the details of Transactions	These are the tests on the income statement entries!
All sales transactions that require to be recorded, have been recorded (Completeness)	Check the policies and procedures used to record sales transactions. See if appropriate internal controls exist on the activity so as to ensure that all the sales transactions are recorded. Select a sample of sales invoices for testing, from the schedule of receivables. For the sample selected, trace the shipping documents to the sales invoices, sales control and accounts receivables control accounts***. Carry out analytical analysis e.g. a comparison of the gross profit % (product wise) with that of the earlier year and with the industry average. In the case of inconsistencies, find out the reasons.
All sales transactions recorded relate to the entity and have occurred (Occurrence)	For a sample of sales transactions recorded in the ledger, trace the sales invoices to the customer’s orders and despatch documents. See if, after the reporting period, there are entries with large amounts reversing revenue recorded in the current period. This may be the result of manipulations made at the reporting period just to increase the sales revenue.
All sales amounts have been recorded appropriately (Accuracy)	**Choose a sample of sales invoices:** confirm that the rates charged are in accordance with the entity’s sales price list. recalculate the tax calculations recalculate the discounts
All sales transactions are recorded in the correct period. (Cut-off)	Check the cut-off procedures that ensure that the sales and sales returns are recorded in the correct period. This requires that the physical movements of goods and the accounting entries are fully synchronised. Verify the sales despatch notes for goods dispatched before the year end and confirm that they have been invoiced and are included in sales revenue, i.e. inspect the dates of the sales invoices with the dates of the despatch notes. Choose a sample of items in the inventory list and confirm that they have not been included under sales.

Continued on the next page

Purpose of substantive procedures (Assertions tested)	Audit procedures
All sales transactions have been recorded under the correct ledger accounts (Classification)	Enquire if any transactions represent goods shipped on consignment, and if so, whether they have been excluded from sales and the related goods have been included in inventory. Take a sample of sales invoices and confirm that they are classified under the correct account heads.
Presentation and disclosures	
All disclosures relating to receivables and sales, have been included (Completeness)	Prepare a disclosures checklist, wherein all disclosures which are relevant to receivables, must be listed. Compare the disclosures made, with the checklist.
All disclosed events and transactions relating to receivables pertain to the entity and have occurred (Occurrence, rights and obligations)	Enquire if any receivables have been pledged, factored or discounted. If pledged, check if appropriate disclosures have been made. If factored or discounted, see if accounting entries have been made.
All financial information and other matters are disclosed fairly and at appropriate amounts (Accuracy and valuation)	Examine the disclosures relating to receivables and sales and confirm that the information presented is appropriate and correct.
Information has been recorded and classified under appropriate headings. (Classification)	Take a sample of sales invoices and confirm that they are classified under the appropriate account heads.
The disclosures are understandable. (Presentation and disclosure)	Read the disclosure notes and confirm that they are understandable.

*** As we are testing the completeness of transactions, it is inappropriate to take the sample from the ledger accounts, as the sample would not take into account the sales invoices which are not recorded.

Diagram 2: Tests of receivables account balances



10. The related profit and loss section entries

The possible effects of receivables on the SOPL and the audit evidence required are as follows:

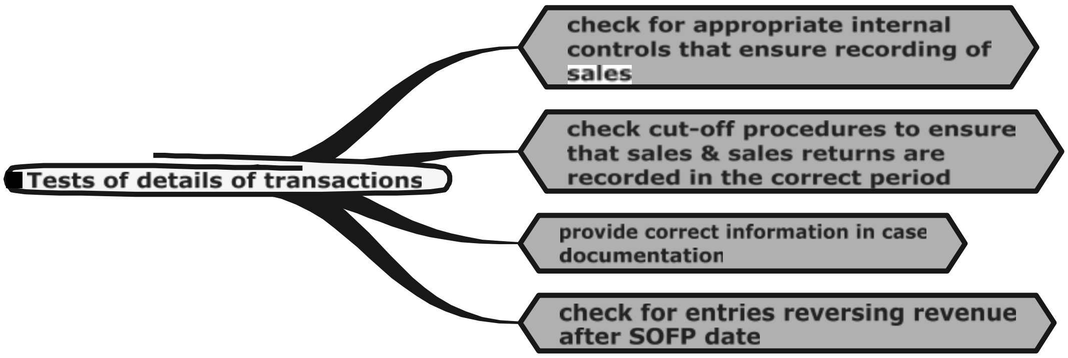
1. **Sales revenue when the credit sales are initially recorded:** review of existence and operation of internal control and testing of transactions would provide evidence about credit sales.

2. **Bad debts written off:** the validity of the calculations and the postings should be verified. Correspondence related to bad debts should be seen. If there is a court decree, calculations of bad debts should be compared with it.

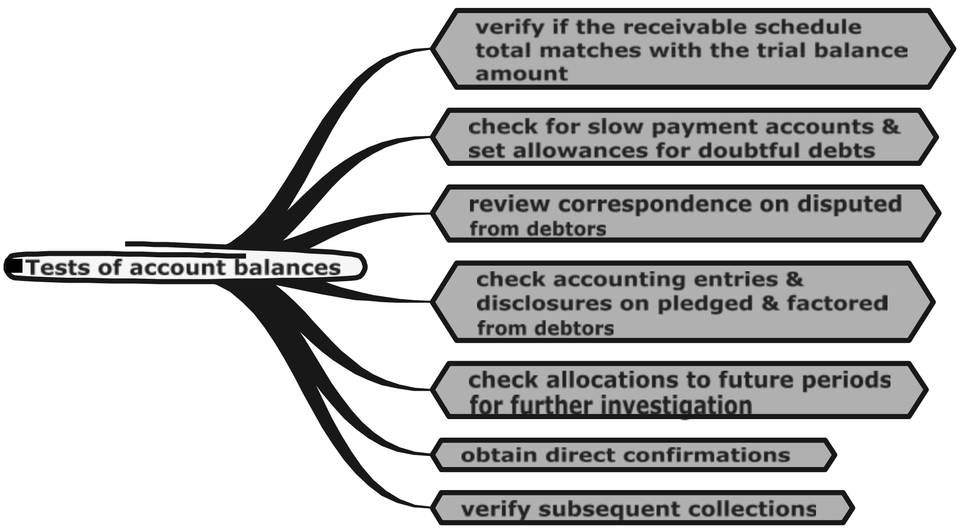
3. **Movements in the allowance for bad debts:** this is an accounting estimate. The reasonableness of estimates should be checked, in the light of the past experience.

4. **Recoveries against the bad debts previously written off:** verify the correspondence and other documentary proof.

SUMMARY



SUMMARY



Test Yourself 1

What is the difference between a positive and negative confirmation request for receivables? Which of the two is better?

2. For 'inventory' account balance:
i. Identify state and explain appropriate procedures to gather evidence based upon a given scenario
ii. Identify and evaluate based on a given scenario including information regarding evidence obtained whether that evidence is sufficient to provide an appropriate basis for a given opinion or report.
[Learning Outcome a]

2.1 Inventory is regarded as an important and high risk area of audit because:

1. It usually has a substantial effect on the profit of the entity
2. It is usually subject to an element of estimation
3. It may be complex

2.2 What is inventory?

Inventory consists of:
1. Raw materials e.g. components for electronic goods
2. Finished goods e.g. fully assembled electronic equipment such as a television
3. work in progress (goods for which the manufacturing process is incomplete) e.g. half-assembled TV sets lying on the shop floor

Tip

Control objectives relating to inventory

- Inventory contains goods of the requisite quality i.e. does not include damaged goods.
- Inventory is not misappropriated i.e. safeguarded.
- Inventory movements are accurately recorded.
- Accurate and timely information relating to inventory is available.

2.3 The purpose of substantive procedures

The purpose of substantive procedures is to test the following assertions:

1. All inventories i.e. purchases and sales are recorded. (**Completeness**)
2. All inventories relate to the entity. (**Rights and obligations**)
3. Valuation is proper (at lower of cost or net realisable value); allowance for slow moving or obsolete inventories is created. (**Valuation and allocation**)
4. Inventories exist physically. (**Existence**)
5. Entity has a right to dispose of or use the inventories. (**Rights and obligations**)
6. Information is recorded and classified under appropriate headings. (**Classification**)
7. The disclosures are understandable. (**Presentation and disclosure**)
8. Purchases and sales which are recorded relate to inventories bought and sold (**Occurrence**)

2.4 Audit evidence

According to ISA 501, if inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

- Physical count, and
- Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect the actual inventory count results.

Note that it is not the auditor's duty to perform the inventory count. It is the auditor's duty to ensure that client's staff conduct the count properly.

1. Physical count of inventories

According to ISA 501, Audit evidence-additional considerations for specific items; when inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its **existence** and **condition** by **attendance** at physical inventory counts, unless it is impracticable.

(a) **The auditor is unable to attend the physical inventory count on the date planned** due to unforeseen circumstances, they should take or observe physical counts on alternative dates. If thought appropriate, intervening transactions can be subjected to audit tests.

(b) When **attendance is impracticable, the auditor has to consider whether alternative procedures provide sufficient and appropriate audit evidence of the existence and condition of inventory**, e.g. if an auditor is engaged after the year end, and the entity has a system of perpetual inventories where the controls function efficiently.

For **inventory under the custody and control of a third party, the auditor would usually obtain direct confirmations.**

2. Attendance at the inventory count

(a) The activity of attendance at the inventory count is split into the following three activities:

Before the date of the count	Actual date of count	Post date of count
Review client's inventory count instructions: The intention should be to count each item and to count it only once. Instructions should be simple and clear. It should lay down responsibilities on different persons i.e. it should state which location will be covered by which person. it should specify the procedures to be followed and the identification marks to be made. There must be controls over used and unused stationery. Cut-off procedures must be clearly spelt out i.e. arrangements regarding the movement of inventory like dispatch and receipt of inventory before and after the cut-off date, movement of inventory between areas during the process of counting. Review the prior year's working papers relating to inventory and ascertain the areas of risk. Determine the existence of inventory held by third parties. Ensure that arrangements to obtain the certificates are made. Ascertain whether the help of experts would be required. For example if inventory includes precious stones. Based on the above mentioned observations, determine the methodology to carry out the physical verification of a	Confirm that the client's staff follow the count instructions e.g. no movement of inventory, tagging of items counted. Perform test counting from the inventories to the inventory sheets and from the inventory sheets to the inventories. Confirm that the count staff are segregating the old damaged and obsolete inventories. Confirm that the physical count inventories list excludes inventories held by third parties; instead obtain a direct confirmation from third parties for inventories held by them. Note down the last GRN and GDN numbers for the year. Ensure that all count sheets are sequentially arranged and signed by the counting staff. Obtain a photocopy of the signed inventory sheets.	Obtain the final inventory list and confirm that: the quantities match with the final count sheet obtained by the auditor during the count. the inventory is valued at the lower of cost and net realisable value. the total amount agrees with the balance in inventory account in the trial balance. third parties have confirmed the inventory balances held with them. confirm that cut-off procedures have been followed. check the adjustments made to inventories on account of discrepancies between inventory count and inventory records. Confirm the appropriateness of the reasons for the discrepancies.

Tip

Importance of year-end inventory counting to the auditors of organisations that do not have perpetual inventory systems

- Inventory counting provides the best evidence to confirm the existence of inventory.
- Inventory counting is the best way of ascertaining the quantities of inventories.
- It enables to determine the appropriate provisions which need to be made against obsolete, slow moving and damaged items.
- It provides evidence on cut-off, certain fraud and the quality of internal controls over inventory.

(b) **Perpetual inventory system** entails cyclical counting of inventory during the year. The rationale of adopting a perpetual inventory system is to control inventory. If the perpetual inventory system is adequate and is functioning appropriately in a large dispersed organisation, the auditors can rely on the records rather than a year-end count for the purposes of the financial statements

(c) Audit procedures to be performed in order to rely on a perpetual inventory system in a large, dispersed organisation

(i) To ensure that:

All inventories have been counted at least once a year

(ii) Evaluation of the quality of work includes: verification of proficiency, skills and quality of work of staff

Records relating to perpetual inventory need to be kept up to date
Inventory records need to be corrected promptly, in case of discrepancies between the physical count and inventory records

(iii) The auditor visits those locations where the value or volume of inventory is substantial, and where controls are weak

(iv) The auditor takes help from its other offices, or engages staff from other firms in order to attend inventory counts.

(v) If using other firms for inventory counting, the auditor must evaluate the quality of the work of the other firm and confirm its adequacy to justify its audit opinion.

(vi) In order to ensure adequate coverage the auditor must visit the different locations on a rotational basis throughout the year.

Important

Study the audit procedures relating to all the three stages of inventory count thoroughly. It is examined.

3. The substantive procedures and work programme relating to inventories (including their valuation) is as follows:

Purpose of substantive procedures (Assertions tested)	Audit procedures
Account balances at the period end : Tests of account balances	
All inventories are recorded. (Completeness)	Check whether all the inventories which physically exist are considered. Verify whether all the inventories that should exist actually do exist, i.e. compare the inventory count list with the inventory list in the inventory ledger and confirm that they tally. The first objective is achieved with the help of well laid out and executed physical count procedures. The second objective is achieved by the presence of an internal control which ensures that all the assets are safeguarded and that all movement of goods is controlled and recorded wherever required. **Analytical procedures** Obtain and consider explanations of significant variations in the balances from the previous periods and/or from anticipated the figures. Obtain an aged analysis of the inventories. Verify the reasons for inventories becoming slow moving or non-moving, and the

Continued on the next page

Purpose of substantive procedures (Assertions tested)	Audit procedures
Account balances at the period end : Tests of account balances	
All inventories relate to the entity. (Rights and obligations)	Confirm that inventories held by third parties are not included in the list of inventories that are physically counted at the year end. Confirm that 'bill and hold' inventories are not included in the list of inventories that are physically counted at the year end.
Valuation is proper; allowances for inventories which are slow moving have been created. (Valuation and allocation)	Confirm that the valuation is in accordance with IAS 2. Test a sample of the transactions by recalculating the valuation. If the valuation is on the basis of standard costing, test a sample of the transactions by recalculating the valuation. Inquire with management the inventories which are either slow moving or non-moving. From the inventory list carry out mathematical accuracy by multiplying the inventory quantities with the cost. Ascertain a valuation of the finished obsolete goods which are sold after the year end and whose values need to be written down. In case the quantum of non-moving material is significant, discuss with the management and ensure that sufficient allowance is made in the books. Analytical procedures: Compare the following for the current year with the previous year: inventory turnover and inventory days standard costs actual manufacturing overhead cost with budgeted standard cost gross profit ratio
Inventories do exist. (Existence)	Observe the physical verification of inventories (explained in detail below). In the case of inventory held with third parties, ensure that confirmations of balances are received directly from the third parties. Furthermore the quantities of inventories must match with the list.
Classes of transactions : Test of details of transactions	
All sales and purchase transactions that require recording, have been recorded (Completeness)	Check the policies and procedures used to record transactions related to sales, purchases, issue for production etc. Check whether the system ensures that all the transactions are recorded. Test a sample of the transactions with the documents. For example, verify goods receipts with purchase orders, goods receipt notes and purchase invoices. Verify goods sent out with sales orders, delivery notes and sales invoices.
All sales and purchase transactions recorded relate to the entity and have occurred (Occurrence)	**Discussed in detail in Learning Outcome 1**
All sales and purchase amounts have been recorded appropriately (Accuracy)	**Discussed in detail in Learning Outcome 3** **Additional procedures:** obtain a listing of inventories. cast the list to confirm mathematical accuracy. agree the totals to the general ledgers. verify the reconciliation of inventories which have differences between the physical count sheet and the inventory listing. where perpetual inventories are conducted, with the help of CAATs, agree the totals on the inventory records with the physical count.

Continued on the next page

Purpose of substantive procedures (Assertions tested)	Audit procedures
Classes of transactions : Test of details of transactions	
All sales and purchase transactions are recorded in the correct period. (Cut-off)	Check the cut-off procedures that ensure that the sales, sales returns, purchases and purchase returns are recorded in the correct period. Verify that the movement of goods and related accounting around the reporting period are properly synchronised. Note down the last document numbers (e.g. delivery note numbers) before the annual physical count. Subsequent documents should ideally be recorded in the next period. Ensure that: all goods dispatched before the year end and included in the sales revenue and receivables (or cash) are removed from inventories (delivery notes before physical count should be checked for this). all goods received before the year end have been entered in the inventory records (the goods received before the physical count should be tested for this) AND in purchases and accounts payables /purchase reserve. any goods received on consignment have not been included in inventory, because they do not belong to the client even if the goods are physically present. goods sent on consignment have been included in inventory, because they belong to the client even if they are physically outside the client's premises.
All sales and purchase transactions have been recorded under the correct ledger accounts (Classification)	**Discussed in detail in Learning Outcomes 1 and 3**
Presentation and disclosures	
All disclosures relating to inventories have been included (Completeness)	Prepare a checklist of disclosures which are applicable to inventories in accordance with IAS 2. Verify the disclosure and confirm that they are in accordance with the checklist.
All disclosed events and transactions relating to inventories pertain to the entity and have occurred (Occurrence, rights and obligations)	Inquire with management and confirm with minutes of meetings that the inventory that is pledged has the approval of the board.
All financial information and other matters are disclosed fairly and at appropriate amounts (Accuracy and valuation)	Read the disclosures and confirm that the disclosures are presented at appropriate amounts.
Information has been recorded and classified under appropriate headings and is understandable (Classification and Presentation and disclosure)	Review the disclosures and ensure that the disclosures are classified as raw materials, work in progress and finished goods. Furthermore confirm that the notes are understandable.

Example

Tomco is a trading company dealing in clothes. At 31 December 20X9:

(a) It recorded a purchase invoice for TZS500,000 on 30 December 20X9 but the goods were still lying at the supplier's premises.

(b) It accepted goods belonging to Lamco, valued at TZS1 million, for processing on its machines since it had spare capacity. Tomco is to charge TZS80,000 for this work and is to return the goods to Lamco after processing. These goods were included in the physical count at 31 December 20X9 by Tomco's staff.

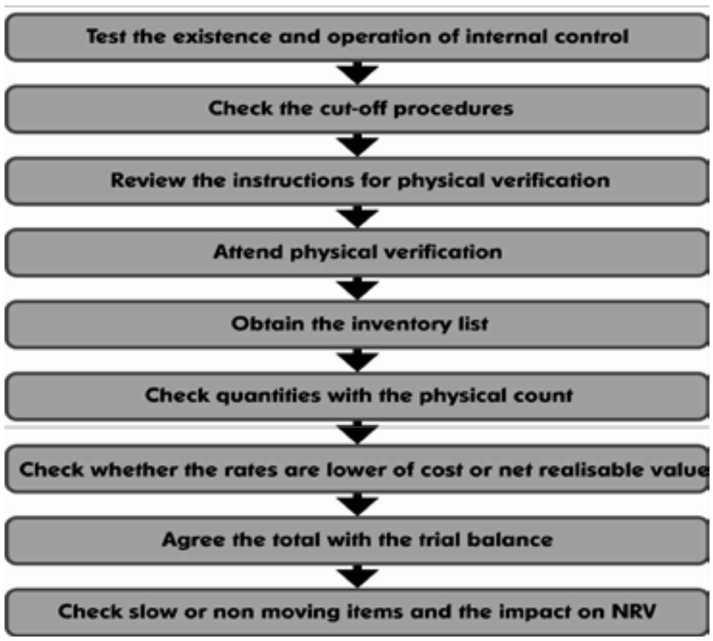
How will these items be treated for valuing inventory to be included in the SOFP at 31 December 20X9?

Solution

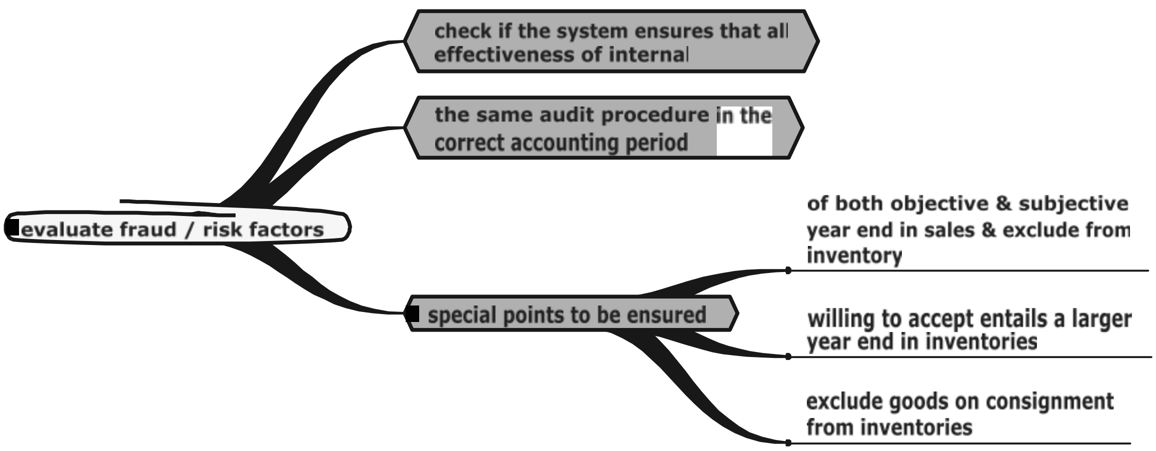
(a) If the title in the goods purchased has legally passed to Tomco, then the goods should be added to inventory in hand even if not present on Tomco's premises. Otherwise, the entry to record the purchase should be reversed.

(b) Since the goods belong to Lamco, they cannot be included in the inventory of Tomco even if they are physically present on Tomco's premises at the reporting period.

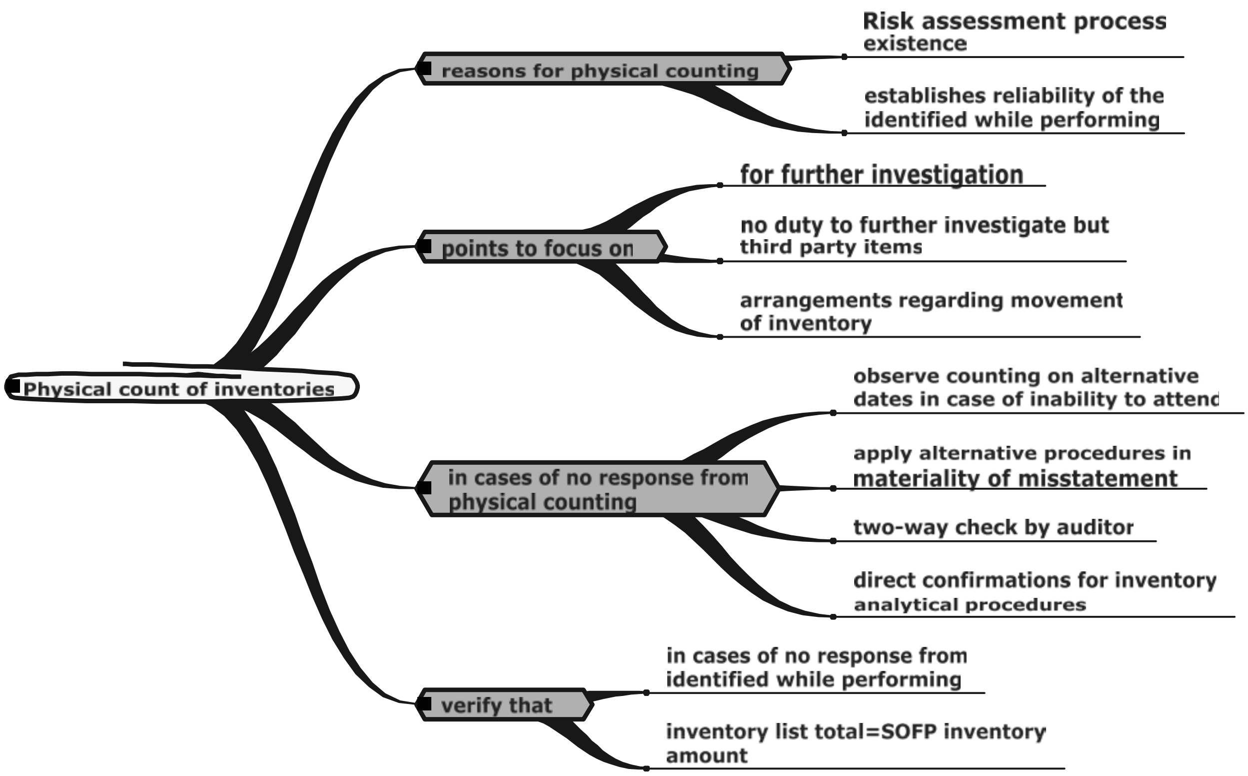
Diagram 3: Tests of inventory account balances



SUMMARY



SUMMARY



Test Yourself 2

Lasco operates from several locations and its customers and suppliers are spread all over the world. Purchase orders are prepared by the head office in Berlin but the goods are delivered at different locations according to the instructions. Sales are dealt with locally by the respective plant. What should be the audit plan to ensure appropriate cut off?

---

3. For 'Payables, accruals, provisions and contingencies' account balances:

i. Identify state and explain appropriate procedures to gather evidence based upon a given scenario

ii. Identify and evaluate based on a given scenario including information regarding evidence obtained whether that evidence is sufficient to provide an appropriate basis for a given opinion or report.

[Learning Outcome a]

3.1 Meanings

Provisions are liabilities of **uncertain timing** or **amount.**

A **liability** is a **present obligation** of the entity arising from **past events,** the settlement of which is expected to result in **an outflow from** the entity, of resources embodying economic benefits.

Trade payables (amounts to be paid towards purchase of merchandise)

Loan payables (amounts to be paid towards loan repayments / interest). This item is considered separately in Learning Outcome 5 of this Study Guide

Accruals (amounts owed towards goods and services at the reporting period but not paid or recorded in the books of accounts)

Taxes payable (income tax, vat and other taxes)

A **contingent liability** is:

(a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) A present obligation that arises from past events but is not recognised because:

(i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) The amount of the obligation cannot be measured with sufficient reliability.

A **contingent asset** is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

3.2 Supplier statement reconciliations

Reconciliation is an **explanation of the difference** between any two balances.

Example

A format of reconciliation statement with imaginary figures is given below:

In the books of Beeline

	TZS
Balance payable to Teeline according to our records	320,000
Add: Payment by chq 251037 shown by Teeline in the next year	50,000
Add: Discount against invoice no. 68 not recorded by Teeline	80,000
Balance according to Teeline's statement	**450,000**

Differences in the reconciliation would mainly consist of:

Timing differences
Errors

Payment of TZS50,000 in the above reconciliation is an example of a timing difference. This difference is removed early next year when Teeline records the item. The discount of TZS80,000 is a case of an error. The party which has committed the error should rectify it.

3.3 Significance of supplier statement reconciliations to an auditor

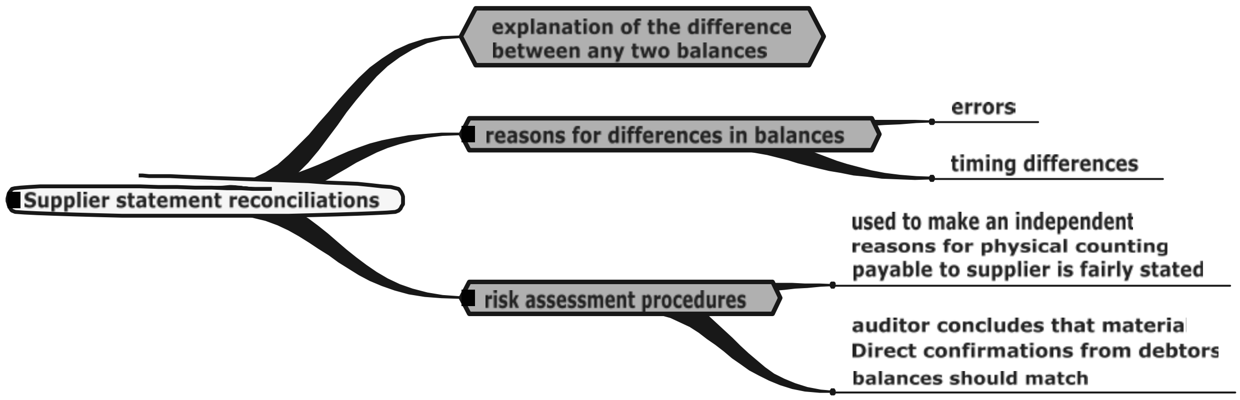
The auditor would be able to judge whether the amount shown as payable to a supplier is fairly stated. In the above example, assuming that Beeline's books are being audited, the auditor would enquire into the differences stated in the reconciliation statement. After verifying the facts, it may be found that, for example, the discount of TZS80,000 was wrongly recorded and therefore needs to be corrected by Beeline whereas Teeline has to make an entry for TZS50,000 which it has made in the next accounting period.

Balance in the books of Teeline would increase to TZS400,000 (TZS320,000 + TZS80,000). Teeline's books would also show a balance of TZS400,000 (TZS450,000 – TZS50,000) after the abovementioned entry has been made. After considering the rectifications of errors and the timing differences, **the two balances should match each other.**

3.4 Confirmation of accounts payable

Confirmation of accounts receivable was discussed in the Learning Outcome 1 of this Study Guide. All the issues stated there are also applicable to the confirmation of accounts payable, except that, instead of assets, the liabilities are to be confirmed. Negative confirmations are more acceptable for payables than for receivables. People will be willing to tell the client that they have to receive money.

SUMMARY



3.5 Obtain evidence in relation to payables and accruals

1. The purpose of substantive procedures

The purpose of substantive procedures related to payables is to test the following assertions:

(i) All payables are recorded. (**Completeness**)
(ii) All payables relate to the entity. (**Rights and obligations**)
(iii) Valuation is proper; discounts available are recorded. (**Valuation and allocation**)
(iv) Payables do exist. (**Existence**)
(v) Payables are recorded in the correct period. (**Cut-off)**
(vi) Entity has an obligation to pay money. (**Rights and obligations**)
(vii) Information is recorded and classified under appropriate headings. (**Classification**)
(viii) The disclosures are understandable. (**Presentation and disclosure**)

2. The audit procedures for testing the assertions are as follows:

Purpose of substantive procedures (Assertions tested)	Substantive procedures and work program
Account balances at the period end : Tests of account balances	
All liabilities are recorded. (Completeness)	The schedule forming part of the financial statements relating to provisions and contingent assets and liabilities should be obtained from the client. The schedule must include opening balances, movements during the current period and the closing balances. The amounts relating to opening balances should be agreed with the previous period's financial statements. Obtain a schedule of trade payables and verify if the total agrees with the figure of total trade payables in the trial balance. Trace the accruals to the expense payables accounts in the SOFP. Match the total of the schedule of trade payables with the purchase ledger control account. Carry out analytical analysis, e.g. a comparison of: Analytical procedures Current year's trade payables and accruals with the amounts applicable to the earlier year. Currents year's payables turnover and payable days with the amounts applicable to the earlier year. Balances on a sample of individual payables for the current year with the amounts applicable to the earlier year. In case of material inconsistencies, the account must be checked in detail with the source document, like the contract. Consider whether there could be any unrecorded material liabilities. Check whether the list of payables includes all: major suppliers the client dealt with during the year major suppliers from the previous year's list (The suppliers' ledger should include the accounts of all the suppliers with whom the client dealt. If the balance is zero, it may not appear in the trial balance, but still, the ledger account should be available).

Continued on the next page

Purpose of substantive procedures (Assertions tested)	Substantive procedures and work program
Account balances at the period end : Tests of account balances	
	Expected sources of finance for non-current assets, mortgages, leasing etc. (Frequently, non-current assets are acquired from borrowed funds. If the sources of funds are verified, that will help the auditor in ensuring completeness of the list. Many times the entries for these are recorded by way of journal entries and not through the bank book. Therefore, missing entries may not be found out unless checked in this manner.) Expected tax payables, for example, corporation tax, VAT etc. Expected accruals, for example, telephone, electricity, rent etc. (Tax and utility payables usually have a fixed pattern. E.g. VAT is payable every month. Hence the amount outstanding at any time would be equal to the liability for the last month). Unpaid invoices at the year end Organisations usually keep the physical copies of unpaid invoices separately. The auditor can verify the file of unpaid invoices at the reporting period with the payables at that date. suppliers who have been paid after the year end relating to the invoices before the reporting period: review correctness of tax calculations for bank loans and overdrafts, agree the balance with the bank confirmations Choose a sample of supplier's statements of accounts reperform the reconciliation to the clients' supplier's account.
All payables are the obligations of the entity. (Rights and obligations)	Trace a sample of trade payables to purchase orders, goods received notes, purchase invoices. The auditor would also have to determine whether or not settling the provisions (which are material to the financial statements) would result in an **outflow of the entity's resources** by: reviewing correspondence with banks, lawyers, insurance companies and obtaining their views reviewing the bank statements to check for any payments made after the date of the financial statements obtaining views on this matter from the legal counsel of the entity discussing with the client about their past experience (relating to their settlement) on similar provisions
Valuation of liabilities is at appropriate amounts. (Valuation and allocation)	Review correspondence on disputed trade payables and old account balances having material amounts. Verify subsequent payables. Verify subsequent debit notes, prepared in relation to trade payables for the current year. Cross check the amounts with the payables list. From the list of accruals choose a sample and recalculate that the amounts accrued is correct. Recalculating the **provisions** made and checking them for accuracy and compliance with the provisions of IAS 37 and comparing them with the previous year's provisions for consistency.
Liabilities relating to payables and accruals do exist. (Existence)	Obtain direct confirmations (as discussed in Learning Outcome 1). In case of confirmations not received, carry out additional procedures. **For bank loans and overdrafts, agree the balance with the bank confirmations.**

Continued on the next page

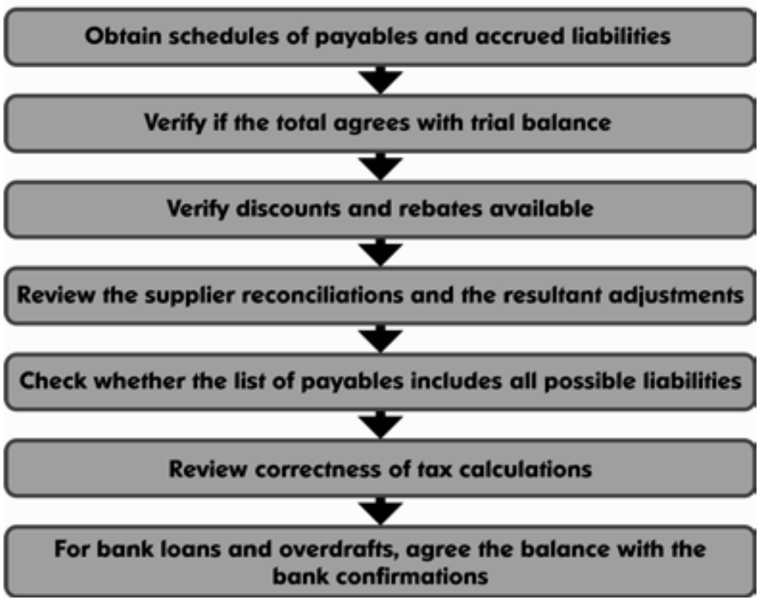
Purpose of substantive procedures (Assertions tested)	Substantive procedures and work program
Classes of transactions: Test of details of Transactions	These are the tests on the SOPL entries!
All purchase transactions that require to be recorded, have been recorded (Completeness)	See if an appropriate internal control exists on the activity, in order to ensure that all the purchase transactions are recorded. Select a sample of purchase invoices for testing, from the schedule of payables. For the sample selected, trace the connected delivery challan, purchase orders to the purchase invoices, purchase control and purchase control accounts. Carry out analytical analysis, for example a comparison of the gross profit % (product wise) with that of the earlier year and with the industry average. In case of inconsistencies, inquire the reasons.
All purchase transactions recorded relate to the entity and have occurred. (Occurrence)	For a sample of purchase transactions recorded in the ledger, trace the purchase invoices to the purchase orders and delivery notes. See if, after the reporting period there are entries with large amounts reversing purchases recorded in the current period. This may be the result of manipulations made at the reporting period just to increase the cost of
All purchase amounts have been recorded appropriately. (Accuracy)	**Choose a sample of purchase invoices:** confirm that the rates charged are in accordance with the purchase orders recalculate the tax calculations recalculate the discounts.
All purchase transactions are recorded in the correct period. (Cut-off)	Check the cut-off procedures that ensure that the purchase and purchase returns are recorded in the correct period. Verify that: the challans relating to goods received before the year end have been invoiced and are included in purchases and goods received after the year end (and the inventory count) have been included in the purchases of the next accounting period. Enquire if any transactions represent goods received on consignment, and if so, whether they have been excluded from purchases as well as inventory. See if, after the reporting period, there are entries with large amounts reversing purchases recorded in the current period. This may be the result of manipulations made at the reporting period just to increase purchases. Choose a sample of items in the inventory list and confirm that they have been included under purchases.
All purchase transactions have been recorded under the correct ledger accounts (Classification)	Take a sample of the purchase invoices and confirm that they are classified under the correct account heads.
Presentation and disclosures	
All disclosures relating to trade payables and accruals have been included (Completeness)	Prepare a disclosures checklist, wherein all disclosures which are relevant to payables, must be listed. Checking whether there are adequate disclosures (in accordance with the provisions of IAS 37) for provisions, contingent assets and contingent liabilities in the accounts. If provisions are not made due to non-availability of best estimate amounts, the auditor would check whether they are disclosed as contingent liabilities. Compare the disclosures made with the checklist.
All disclosed events and transactions relating to payables pertain to the entity and have occurred (Occurrence, rights and obligations)	Check if appropriate disclosures relating to purchases and payables have been made.

Continued on the next page

Purpose of substantive procedures (Assertions tested)	Substantive procedures and work program
Presentation and disclosures	
All financial information and other matters are disclosed fairly and at appropriate amounts (Accuracy and valuation)	Examine the disclosures relating to trade payables and purchases. Confirm that the information is presented at the appropriate amount and is correct.
Information has been recorded and classified under the appropriate headings. (Classification)	Take a sample of the purchase invoices and confirm that they are classified under the appropriate account heads.
The disclosures are understandable. (Presentation and disclosure)	Read the disclosure notes and confirm that they are understandable.

Confirmation of trade payables and reconciliations of account balances with supplier's statements are quite similar to those that apply to receivables, which are explained in Learning Outcome 1.

Diagram 4: Tests of payables account balances



3.6 Audit procedures related to contingencies

These procedures would include:

Enquiring from management, reviewing board meetings and legal expense accounts, among other tasks; and

If the audit procedures indicate the existence other material litigation or claims the auditor should seek direct confirmation (from the client's external legal counsel) on the litigation matter.

This will enable the auditor to obtain sufficient appropriate evidence relating to:
(a) Identification of potentially material litigation
(b) Claims
(c) Management's estimates of the financial implications, including costs and whether they are reasonable.

In addition, the auditor would also hold meetings with the client's lawyers in order to discuss if there is a very serious matter or where there is a disagreement between any of the parties. Written representations from management must include completeness of all the potential litigation and claims being disclosed to the auditors.

3.7 The related profit and loss section entries

The possible effects of payables on SOPL and the audit evidence required are as follows:

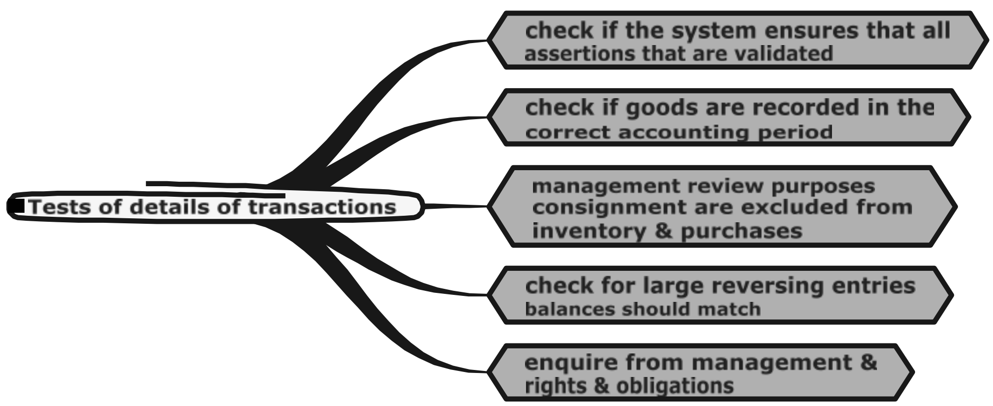
(a) **Purchase cost when the credit purchases are initially recorded:** review of existence and operation of internal control and testing of transactions would provide evidence about credit purchases.

(b) **Accruals:** accruals have a direct effect on the SOPL. Accruals at the end of year would increase the expenses / incomes whereas reversal of opening accruals reduces the expenses / incomes. The auditor should verify whether all the usual accruals have been made and the opening accruals are reversed.

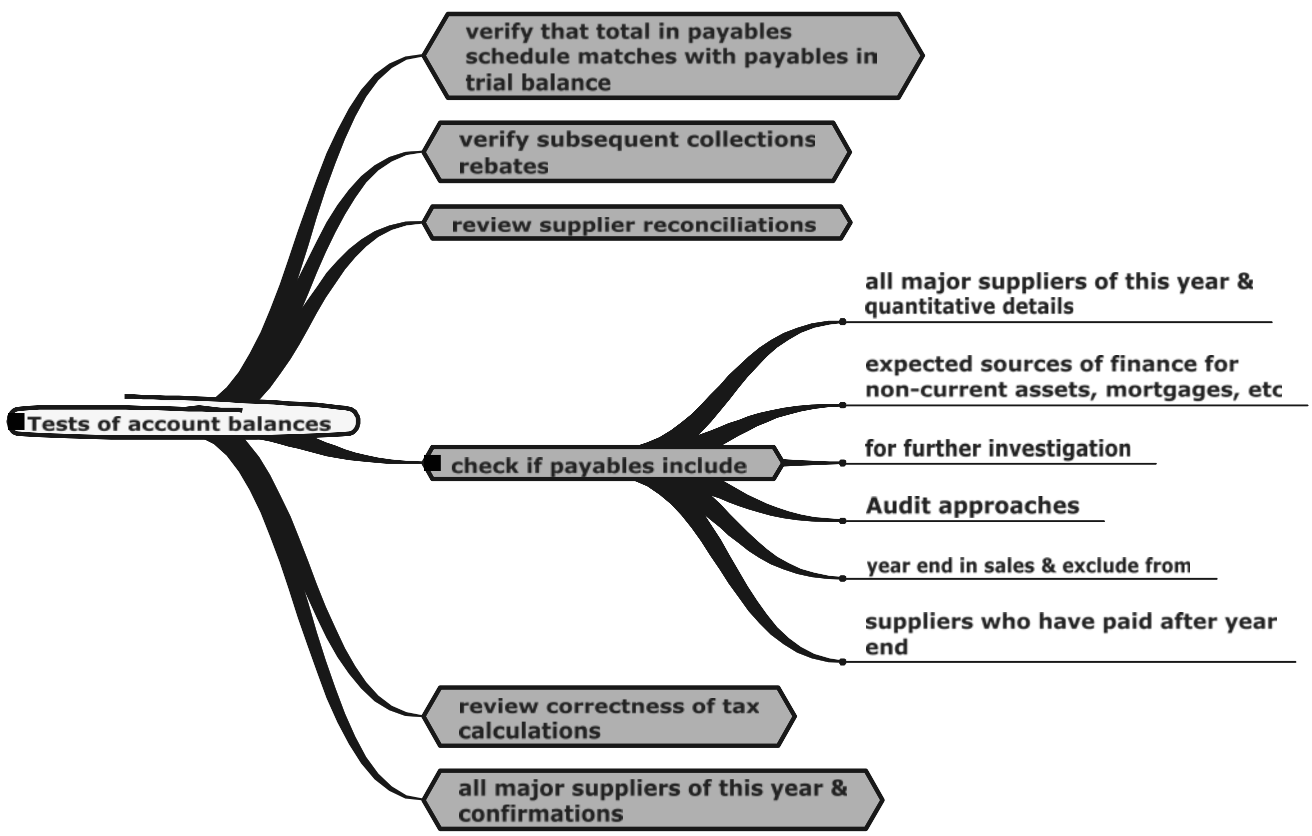
(c) **Discounts received:** discounts received from the suppliers reduce their balances and also reduce purchase cost in the SOPL. The auditor should verify whether all the discounts earned have been recorded, with the help of suppliers' credit notes, statement of accounts etc.

(d) **Payables written back:** sometimes old balances that are no longer payable are written back and shown as an income. The auditor should check the history of the related accounts and consider whether writing back is justified. It may also be the case that payables were fictitiously recorded earlier, and are being reversed now.

SUMMARY



SUMMARY



Test Yourself 3

Your client obtained suppliers' statements as part of a routine exercise. One statement shows a large difference in the opening balance for the period. The accountant contends that, since it does not relate to the current period, you may ignore it.

Required:

Is the accountant's contention correct? What should your audit strategy be?

---

4. For 'bank and cash' account balance:
i. Identify state and explain appropriate procedures to gather evidence based upon a given scenario
ii. Identify and evaluate based on a given scenario including information regarding evidence obtained whether that evidence is sufficient to provide an appropriate basis for a given opinion or report.

[Learning Outcome a]

4.1 Bank confirmation reports

It is a usual practice for banks to issue confirmation reports about the different accounts and the balances held at the given date (normally the reporting period). This confirmation is independent, third party evidence. **It is good evidence in support of most of the assertions regarding the balances with the bank**. Balances in the SOFP should match or be reconciled with the balances shown by the bank. Confirmation letters should be obtained from all banks with which the client has dealings.

Unlike external confirmations which are obtained on sample bases, bank confirmation is obtained from all the banks!

Furthermore bank confirmations are also obtained from banks where the balances show a nil balance, and on bank accounts which are closed during the financial year. A confirmation letter is also used to determine the outstanding interest, contingent liabilities, and guarantees. The procedure of obtaining a confirmation letter is similar to the circularisation procedure applicable to positive requests discussed earlier.

Elements of a confirmation letter:

(a) The client's name
(b) Account description number
(c) Balances on all bank accounts held by the client
(d) The confirmation date
(e) Details of securities given
(f) Any documents or assets held for safe custody
(g) Details of contingent arrangements- letters of credit, guarantees, forward exchange transactions

The client has to give authorisation to the bank to disclose necessary information to the auditor.

4.2 Other evidence in relation to bank

(a) The purpose of substantive procedures

The substantive procedures related to bank and cash are aimed at testing the following assertions:

(i) All bank and cash balances are recorded and include the effects of all the transactions that have occurred. (**Completeness**)
(ii) All bank and cash balances exist at the year end. (**Existence**)
(iii) All bank and cash balances belong to the entity, i.e. the entity has a right to receive money against the bank balances. (**Rights and obligations**)
(iv) Valuation is proper; the balances are fully reconciled with the bank certificates, i.e. the amounts are recoverable. (**Valuation and allocation**)
(v) Bank and cash transactions are recorded in the correct period. (**Cut-off**)
(vi) Information is recorded and classified under appropriate headings. **(Classification)**
(vii) The disclosures are understandable. (**Presentation and disclosure**)

(b) The substantive procedures and work program

(i) Tests of details of transactions

(i) See if appropriate internal control exists on the activity so as to ensure that all the bank and cash transactions are recorded. Check the policies and procedures used to record bank and cash transactions.
(ii) Check the cut-off procedures that ensure that the cash and bank transactions are recorded in the correct period.
(iii) See if, after the reporting period, there are entries with large amounts that reverse cheque receipts or payments recorded in the current period. This may be the result of manipulations made at the reporting period just to change the bank balance or the party account balance.

(ii) Tests of account balances

(i) Obtain schedules of bank and cash balances. Verify if the total agrees with the trial balance.
(ii) Verify the balances shown in bank confirmation letters with the figures in the schedule.
(iii) Review the bank reconciliations and reperform the resultant adjustments. The following are the resultant adjustments:
   For cheques deposited / issued not yet cleared, verify the clearance of the cheque from the bank statement of the next year. In case amounts are not cleared within a reasonable time, obtain
   Explanations.
   Verify the earlier month's bank reconciliation statements (BRS) with the bank statement of the last month of the year and confirm that the outstanding amounts (in the BRS) were cleared during the last month of the accounting year.
   For items in the BRS which have not been cleared, obtain an explanation from the client.
   Inspect paying- in slips to confirm that cheques shown in the BRS as cheques deposited but not yet cleared have been deposited in the bank during the period of the financial statements.
(iv) Ascertain the bank accounts which have collaterals on assets of the company. This information can be obtained by verifying minutes of the board meetings and discussions with the client.
(v) Determine whether disclosures are in accordance with accounting standards, complete and accurate.

For timing differences, for example, cheques deposited but not cleared, cheques issued but not presented etc., usually no entries are required to be made. In due course, the differences will be eliminated when the other party also records the items. Errors committed by the client have to be rectified immediately. For errors committed by a bank, the client should be advised to give appropriate intimation to the bank.

Example

Vetmaco's accountant prepared the following bank reconciliation statement:

	TZS
Balance according to our books	2,000,000
Add: Amount of rent directly deposited in bank, not recorded by us	250,000
Less: Cheque deposited but not yet cleared	(150,000)
Less: Amount wrongly debited by the bank to our account	80,000)
Balance according to bank statement	**2,180,000**

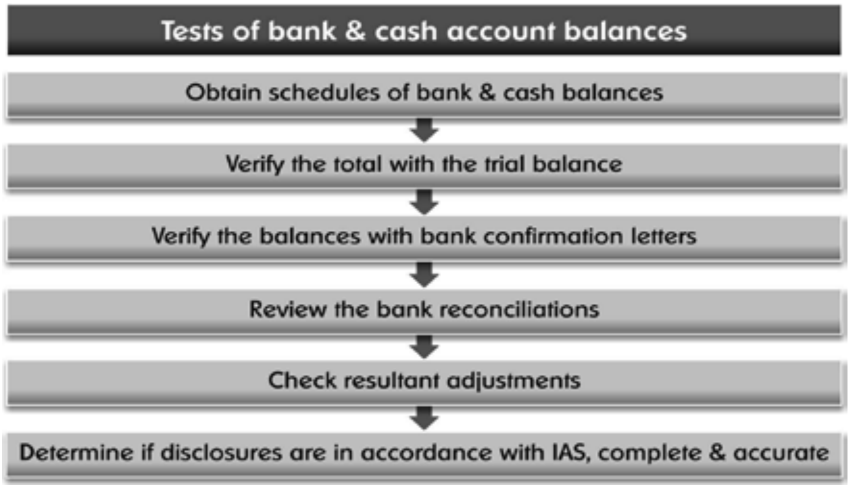
What is the true and fair amount of bank balance that should be reflected in the SOFP?

Answer

The first item (TZS250,000) is an error by Vetmaco's accountant. This error should be rectified immediately. The second item (TZS150,000) is a timing difference. Within a few days, the amount will be credited by the bank to the company's account. Nothing is to be done on this. The third item (TZS80,000) is an error committed by the bank. Vetmaco cannot correct the bank's error.

Therefore, the revised (true and fair) balance is TZS2,000,000 + TZS250,000 = TZS2250,000

Diagram 5: Tests of bank and cash account balances



4.3 Cash balance

Generally cash balance is immaterial to the financial statements. However, cash is an area which is prone to fraud, especially if the internal controls are not efficient. That is why cash verification is an important audit procedure for internal auditors.

1. The purpose of substantive procedures

The substantive procedures related to cash are aimed at testing the following assertions:

(a) All cash balances are recorded and they include the effects of all the transactions that have occurred. (**Completeness**)
(b) All cash balances exist at the year end. (**Existence**)
(c) All cash balances belong to the entity. **(Rights and obligations)**
(d) Valuation is proper. **(Valuation and allocation)**
(e) Cash transactions are recorded in the correct period. **(Cut-off)**
(f) Information is recorded and classified under appropriate headings. **(Classification)**
(g) The disclosures are understandable. (**Presentation and disclosure**)

2. Physical verification of cash

Cash balances include the hard cash, unbanked cheques, credit card slips and IOUs. That is why all cash balances need to be counted at the same time. The audit working papers relating to the cash count will include the date of the count, time of the count, name and signature of staff conducting the count and the name of the client's staff available at the count.

3. Audit procedures for cash count

(a) The auditor must verify that the cash book is complete up to the date of the count.
(b) As stated earlier, all cash must be counted simultaneously.
(c) Negotiable securities also need to be counted at the same time.
(d) Working papers must contain the details of the cash count.

4. Substantive audit procedures relating to cash

(a) At the time of the cash count

(i) count cash (as stated earlier).
(ii) Take a certificate of the cash balance from the client.

(b) At the time of finalisation

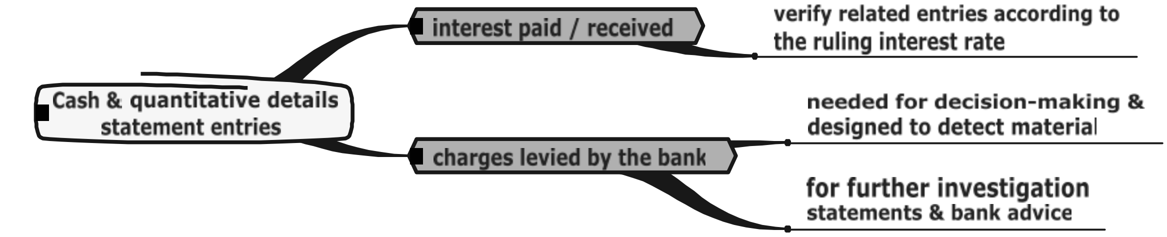
(i) Verify that the unbanked cheques have been banked at a later date. for this the bank statements of the next month must be verified.
(ii) Verify that the IOUs have got cleared within a reasonable time. This will require a verification of the vouchers which have been prepared to settle the IOUs.
(iii) Confirm that the cash balance is stated correctly in the draft financial statements.

4.4 The related profit and loss section entries

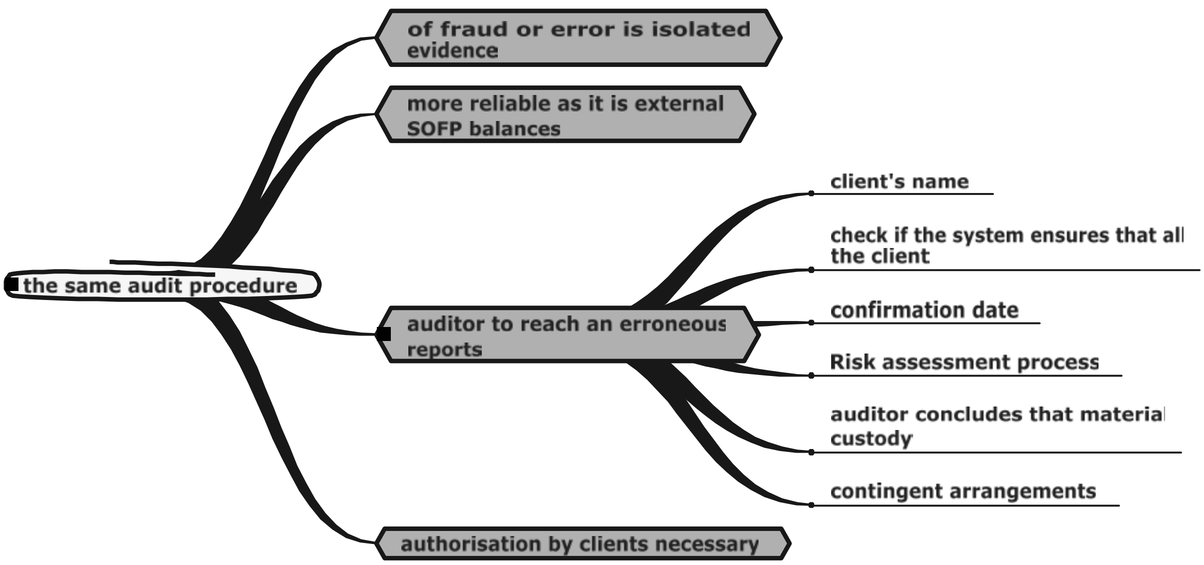
Most bank accounts (except perhaps a current account in some jurisdictions) generate interest. The SOPL will reflect the related interest income or expense. The auditor should verify these with reference to the ruling interest rates and the actual balances.

Similarly, there may be bills discounting charges, loan processing charges levied by the bank. These can be verified with the help of advice given by the bank and the bank statements.

SUMMARY



SUMMARY



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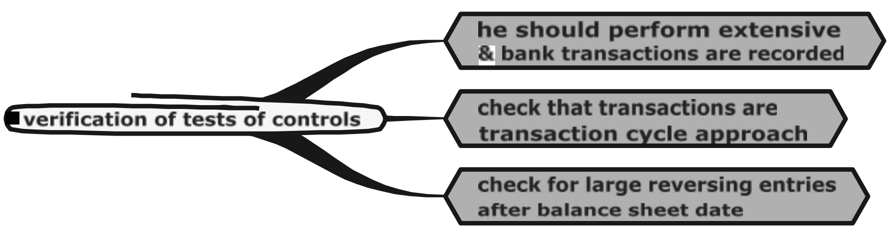

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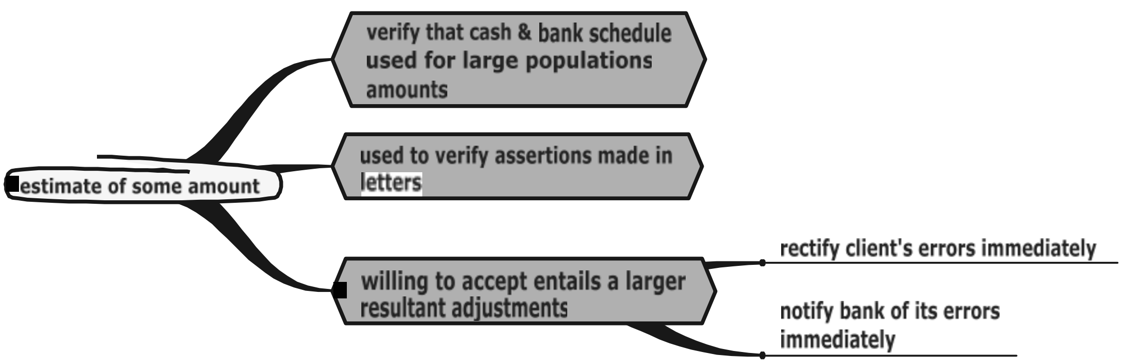


Test Yourself 4

It is said that a bank confirmation letter is a single piece of evidence which supports many assertions. What are the assertions supported by a bank confirmation letter?

5. For 'tangible and intangible non-current assets and non - current liabilities' account balance:
   i. Identify state and explain appropriate procedures to gather evidence based upon a given scenario
   ii. Identify and evaluate based on a given scenario including information regarding evidence obtained whether that evidence is sufficient to provide an appropriate basis for a given opinion or report.

[Learning Outcome a]

5.1 Evidence in relation to tangible non-current assets

1. The purpose of substantive procedures

The purpose of substantive procedures is to test the following assertions:

(i) All non-current assets purchased and disposed during the year, are recorded. **(Completeness)**
(ii) All non-current assets relate to the entity. **(Rights and obligations)**
(iii) Valuation is proper; impairment (reduction in value) and revaluation (in case the revaluation model is adopted) has been made where appropriate. **(Valuation and allocation)**
(iv) All non-current assets procured and disposed are correctly recorded. (**Valuation and allocation**)
(v) Assets exist physically. **(Existence)**
(vi) Entity has a right to dispose of or use the assets. **(Rights and obligations)**
(vii) Information is recorded and classified under appropriate headings. **(Classification)**
(viii) The disclosures relating to cost, useful life of assets, depreciation policies, procurements and disposals are understandable. **(Presentation and disclosure)**
(ix) Recorded non-current assets are in use at the year end. **(Occurrence)**

2. The substantive procedures and work program

Purpose of substantive procedures (Assertions tested)	**Substantive procedures and work program**
Account balances at the period end : Tests of account balances	
All non-current assets are recorded. (Completeness)	Verify the opening balances with the previous year's financial statements. Verify the schedule of the non-current assets and confirm that it contains the following columns: gross block accumulated depreciation net book value Confirm that the balances in the schedule match with the general ledger. Verify the physical count sheet and confirm that it tallies with the schedule. Verify the adjustments made on account of discrepancies between the physical count and the schedule; obtain the reasons for the differences and verify the documents to support the explanation. For example if the count sheet indicates an excess of a non-current asset on account of delay in recording the purchase of assets; verify the purchase bill and the entry passed to record the purchase.

Continued on the next page

Purpose of substantive procedures (Assertions tested)	Substantive procedures and work program
Account balances at the period end : Tests of account balances	
The entity has a right to all assets purchased during the year. (Rights and obligations)	For a sample of transactions, agree the cost to purchase invoice or other relevant documents. Ensure that all the relevant costs are included. (confirms rights and obligations and initial valuation) For a sample of assets, the auditor verifies: title deeds for immovable properties registration documents for vehicles invoices for moveable assets insurance policies lease documents (only in the case of assets acquired on the finance lease would the asset appear in the SOFP of a client) Verify the purchase orders for capital purchases, minutes of board meetings and invoices relating to capital purchases after the year end, and determine whether they are capital commitments. If so, use it as evidence for capital WIP and cross verify the amounts stated as capital WIP in the schedule.
Valuations of non-current assets are at appropriate amounts. (Valuation and allocation)	Check whether the depreciation rates disclosed are those actually used by re-performing the calculations; confirm whether the rates are in agreement with the statutory requirements, if any. In case of revalued assets, confirm for a sample of the assets which are revalued; that the depreciation is charged on the revalued amounts. Carry out audit procedures relating to valuation and impairment loss. (discussed in detail below) Verify the disposals of non-current assets and the accounting for profit or loss on such items. For assets which are revalued tally the amount revalued with the valuation report. Before accepting the work of an expert, evaluate the experts' work (independence, objectivity, scope of work, assumptions used) and confirm the reasonableness of the valuation. Recalculate reserve surplus. Verify the non-current asset register and confirm that all the assets are depreciated.
Non-current assets do exist. (Existence)	Confirm whether physical verification of non-current assets was carried out. (discussed in detail below)
Classes of transactions : Test of details of transactions	
All purchase transactions that require to be recorded, have been recorded. (Completeness)	Check the policies and procedures used to record transactions related to non-current assets. Check whether the system ensures that all the transactions are recorded correctly. Verify the accounts where mispostings might have occurred e.g. the repairs account may have been debited for the amount of a non-current asset purchased and vice-versa.
All purchase transactions recorded relate to the entity and have occurred. (Occurrence)	
All purchase amounts have been recorded appropriately (Accuracy)	Procedures are explained under a detailed audit plan of payables in Learning Outcome 3.
All purchase transactions are recorded in the correct period. (Cut-off)	
All purchase transactions have been recorded under the correct ledger accounts. (Classification)	Agree the breakdown of balances with the ledger balances.

Continued on the next page

Purpose of substantive procedures (Assertions tested)	Substantive procedures and work program
Presentation and disclosures	
All disclosures relating to trade payables and accruals have been included. (Completeness)	Verify draft accounts and confirm that the disclosures relating to depreciation policies, rates of depreciation, useful life of assets, revaluation, impairment loss, etc. are made in the accounts.
All disclosed events and transactions relating to payables pertain to the entity and have occurred. (Occurrence, rights and obligations)	Verify the disclosures and confirm that assets which are on lien are suitably disclosed. Obtain a certificate from the entity's solicitor providing details of assets which are on lien. Verify the statutory records to confirm that assets which are on lien are recorded.
All financial information and other matters are disclosed fairly and at appropriate amounts. (Accuracy and valuation)	Verify the disclosures and confirm that the disclosures and other matters relating to non-current assets are at appropriate values.
Information has been recorded and classified under appropriate headings and the disclosures are understandable. (Classification and Presentation and disclosure)	Prepare a checklist of disclosures which apply to non-current assets, in accordance with IAS 16. Verify the various disclosures relating to non-current assets and confirm that they are understandable and in accordance with the checklist.

3. Additional audit procedures

(a) Self constructed assets

(i) For self-constructed assets, verify the records of material issued and man-hours consumed in the construction work. (**Completeness**)
(ii) Review costs and confirm that abnormal waste and internal profits have not been capitalised. (**Valuation**)
(iii) Review costs and confirm that the borrowing cost which is capitalised under IAS 23 Borrowing costs, relate to qualifying assets as explained in IAS 16 Property Plant and Equipment. (**Valuation**)

(b) Additions to non-current assets

(i) Verify vouchers of additions to non-current assets with purchase bills, architect's / solicitor's certificates**. (Completeness and rights and obligations)**
(ii) Confirm that the capital purchases have been approved by the board. **(Completeness and rights and obligations)**
(iii) Confirm that the expenditure which is capitalised is allocated to the appropriate account head i.e. maintenance expenses, capital expenses. The capitalisation should be in accordance with the accounting policies of the entity and the accounting standards. **(Valuation and allocation)**
(iv) Cast the schedule containing the additions to non-current assets and tally the total to the general ledger**. (Completeness and valuation)**

(c) Disposal of non-current assets

(i) Verify vouchers of disposals to non-current assets with sales bills, sale deeds, date of payment, etc. **(Completeness, rights and obligations, occurrence and valuation)**
(ii) Confirm that the disposals have been approved by the board. **(Completeness and rights and obligations)**
(iii) Recalculate profit / loss on disposal.
(iv) In case of assets which were used as collaterals, the security needs to be released. This must be confirmed.

(d) Physical inspection of non-current assets

Auditor selects a sample of assets from the non-current assets register and inspects the assets physically. Some clients verify all the non-current assets physically every year. If the volume is large, the auditor may observe the inspection and supplement it with an inspection of a sample. This confirms existence.

(e) Valuation

If the cost model is selected, the carrying value should be equal to cost less the amount of accumulated depreciation and impairment loss. If the revaluation model is selected, the carrying value will be equal to the value determined by the expert, less the amount of accumulated depreciation and impairment loss after the date of valuation. Please refer to Paper B2 to revise the principles of cost and revaluation model related to non-current assets.

When the **revaluation model** is followed, the auditor:

(i) Verifies the new valuation with the valuer's report.
(ii) Confirms that all the similar assets are revalued.
(iii) Checks that the increase in value is credited to revaluation surplus.
(iv) Confirms that the depreciation charge is based on new values.
(v) Checks whether the difference between the depreciation on cost and the depreciation of revalued amount is transferred to SOCI, being a realised profit.

Example

A property worth TZS30m is revalued at TZS40m. Depreciation on cost is TZS3,000,000 and on the revalued amount is TZS4,000,000. The correct accounting treatment is as follows:

Initially, the increase of TZS10m (TZS40 – TZS30) is to be credited to revaluation surplus. Full depreciation of TZS4,000,000 is charged to the SOCI. The difference of TZS1,000,000 between the two depreciation amounts (TZS4,000,000 – TZS3,000,000) is transferred from the revaluation surplus account to the retained earnings account.

(vi) For revalued assets, ensure that correct disclosures of revaluation policy, name of the valuer etc. are made.

(f) **Impairment loss** is the excess of the carrying amount of an asset over its recoverable amount. The client has to assess whether there is an indication of impairment loss at each reporting date. If there is, the client has to estimate the recoverable amount and provide for impairment loss. The auditor verifies the assessments and calculations made by the client.

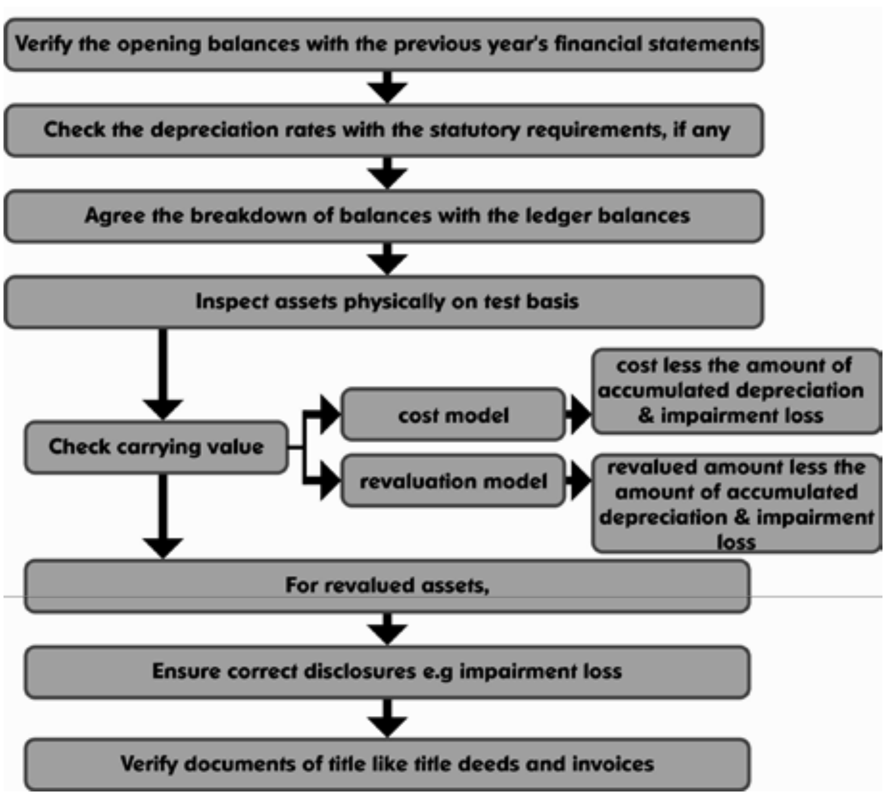
The auditor **re-performs depreciation calculations**

(a) Selects a sample from the register and re-performs calculations for the year
(b) Re-casts the list of depreciation charge of individual assets
(c) Agrees the total charge with the trial balance

As an alternative to the re-performance of depreciation, sometimes the auditor may compare the charge of depreciation with the previous year, as amended for additions or disposals of assets, revaluations or changes in the model etc.

Furthermore the auditor needs to obtain and consider explanations of significant variations in balances from previous periods and/or from anticipated figures.

Diagram 6: Tests of account balances for tangible non-current assets



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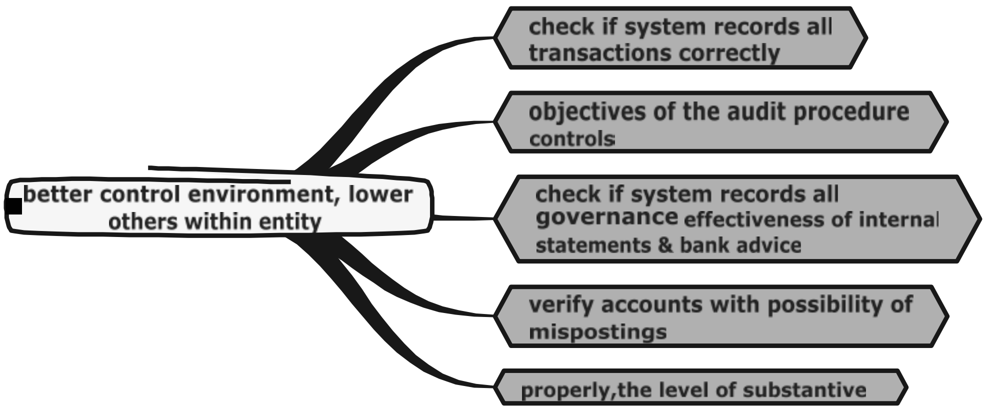

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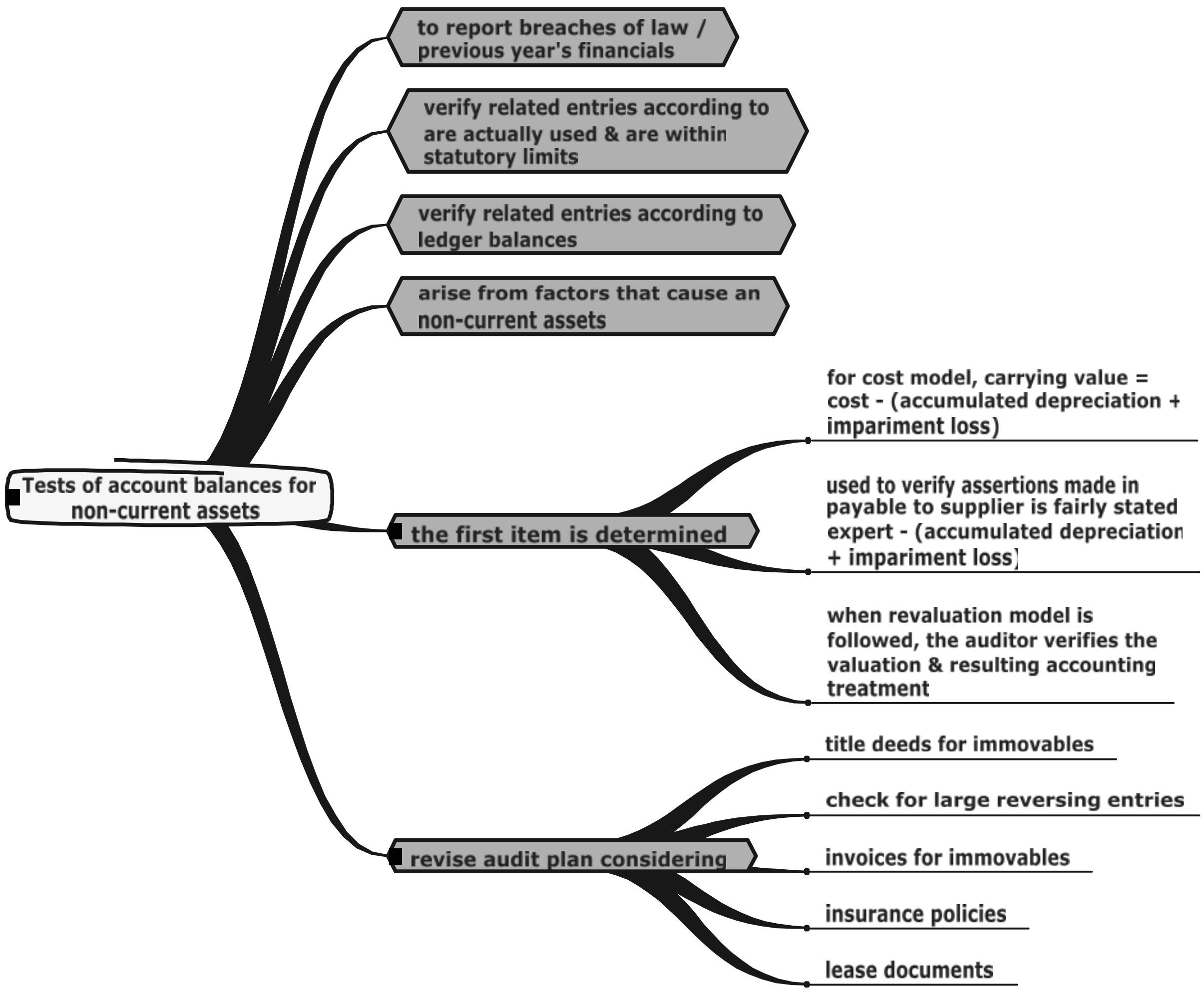


5.2 Evidence in relation to intangible assets

1. Meaning

An **intangible asset** is an identifiable non-monetary asset without physical substance

There are different modes of acquisition or generation of intangible assets, categorised as follows:

Separately acquired intangible assets i.e. Intangible assets acquired through:	**Internally generated intangible asets**
a) business combinations b) government grants c) exchange of assets	a) Goodwill or b) Other intangible assets

IAS 38 **Intangible Assets** specifies the following conditions to be satisfied by an item for it to be called an intangible asset:

2. Conditions to be fulfilled to classify an asset as an intangible asset are as discussed below:

(a) Identifiable:

(i) It should be capable of being separated from the entity, and sold / transferred. For example, import licences can be separated from the entity and sold, or transferred

(ii) It could arise from contractual or other legal rights, regardless of whether the asset is separable and transferable or not. For example, l**anding rights for aircrafts**

(b) Control over the asset

This is normally indicated by:

(i) Power to obtain future economic benefits; and
(ii) Power to restrict the access of others to those benefits.

Thus power normally stems from a legal right e.g. copyright, but the legal right is not a necessary condition, because an entity may be able to control the future economic benefit in some other way.

(c) Existence of future economic benefits

These may be seen by any one of the following ways:

(i) revenue from the sale of products or services;
(ii) Cost savings; or
(iii) Other benefits resulting from the use of an asset.

3. The purpose of substantive procedures is to test the following assertions:

(i) All intangible assets acquired and disposed during the year are recorded. **(Completeness)**
(ii) All intangibles relate to the entity. **(Rights and obligations)**
(iii) Valuation is proper for intangible assets acquired as well as impaired. **(Valuation and allocation)**
(iv) All intangible assets procured and disposed of are correctly recorded. (**Valuation and allocation**)
(v) The entity has a right to dispose of or use the intangible assets. **(Rights and obligations)**
(vi) Information is recorded and classified under appropriate headings. **(Classification)**
(vii) The disclosures relating to cost, assessment of useful life, amortisation policies, procurements and disposals during the year are understandable. **(Presentation and disclosure)**

4. Accounting treatment and audit programme

(a) IAS 38 Intangible Assets, which includes guidance on intangible assets, disallows internally generated assets to be capitalised.

(b) Goodwill

Goodwill refers to the purchase cost of an entity acquired over the fair value of the entity's net assets.

Accounting for goodwill is covered in IAS 38 Intangible Assets and in IFRS 3 Business Combinations. According to IAS 38, goodwill is to be annually tested for impairment.

Diagram 7: Accounting treatment of Goodwill

The following audit procedures are applicable while auditing goodwill:

(i) **Verifying the amount of goodwill** calculated by matching the purchase consideration to the acquisition agreement.

(ii) Recalculating the amount of goodwill and agreeing it with the amount recognised in the financial statements.
(iii) Ensuring that the goodwill calculation does not include **internally generated goodwill.**

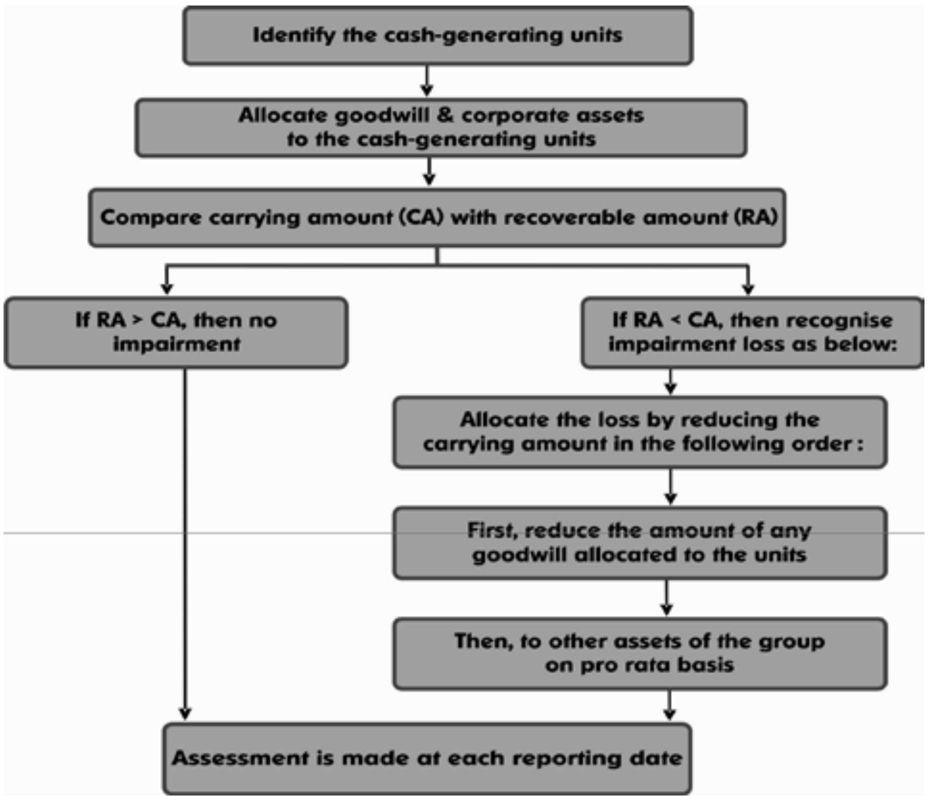
(iv) Ensuring **that goodwill is not amortised as it** is not permitted by IFRS 3.

(v) Reviewing the **calculations relating to impairment of goodwill** for accuracy and reasonableness.

4. Goodwill impairment test

Goodwill exists only when a unit works together and generates cash. IAS 36 stipulates that goodwill be linked to such cash generating units and then tested for impairment.

Diagram 8: Process of impairment testing



Audit procedures

When auditing brands, the auditor should check to see whether the brand is internally generated, and ensure that internally generated brands are not included in the brands capitalised in the financial statements.

- The initial value of purchased brands should be traced to the bank statements.
- The value should be agreed with the source document i.e. the purchase invoice or purchase agreement. It would be advisable to review the file containing all the contracts entered into by the entity during the year. This will help to ensure the assertion of completeness and valuation.
- The source document must be approved by an authorised official of the entity.
- The purchase agreements should be reviewed to confirm that the entity has the right of ownership. This will provide evidence relating to rights and obligations.
- Amortisation would have to be recalculated, provided the assets meet the conditions provided in the diagram above. The evidence relating to useful life can be obtained from the purchase agreements.
- If no active market exists for an asset belonging to a class of revalued intangible assets, the asset may be valued using the cost model. Therefore the auditor should confirm that this aspect is taken care of by the entity.
- For entities following the revaluation model, the auditing procedures relating to fair value (discussed above) must be conducted.
- For entities following the cost model, the auditing procedures relating to impairment (discussed earlier) must be conducted.

5.3 Evidence in relation to non-current liabilities

Non-current liabilities are liabilities which are due for payment after more than 12 months from the reporting period.

1. The purpose of substantive procedures

The substantive procedures related to non-current liabilities are designed to test the following assertions:

(i) All non-current liabilities are recorded. (Completeness)
(ii) All non-current liabilities relate to the entity. (Rights and obligations)
(iii) Valuation is proper. (Valuation and allocation)
(iv) Liabilities do exist. (Existence)
(v) Entity has an obligation to pay money against the non-current liabilities. (Rights and obligations)
(vi) Information is recorded and classified under appropriate headings. (Classification)
(vii) The disclosures are understandable. (Presentation and disclosure)

2. The substantive procedures and work program

(a) Tests of details of transactions

(i) Verify the recording of transactions related to loans from the loan agreements and the payment / receipt transactions.

Example

A loan processing fee may be erroneously shown as the repayment of a loan whereas it is actually an expense. Verification with the agreement would enable the auditor to verify the correctness of entries.

(ii) Verify calculations of interest (valuation). Ensure that full interest is provided for up to the year end (cut off).
(iii) Verify the schedule of loans and check the data on the schedule with the loan documents for the date of the loan, amount of loan, maturity amount, terms of interest, security.
(iv) Examine the minutes to the board for approval of the loan (rights and obligations)
(v) Recalculate the arithmetical accuracy of the schedule (valuation)

(b) Tests of account balances

(i) Obtain the balance confirmation letter from the bank or the financial institution or lenders of amounts outstanding. Determine the interest accrued and the security held (completeness, existence, valuation and accuracy).

Example

If interest accrued has not been recorded, the balance according to the client's records will not match the balance shown by the bank / financial institution.

(ii) Confirm that the loans are minuted and also tally with the cash book (existence, completeness and valuation).
(iii) Confirm that the assets that are charged are recorded in the register of charges and also notified to the registrar (rights and obligations).
(iv) Tally the balances in the schedule with the general ledger (accuracy).
(v) In the case of repayment, recalculate the amounts repaid after confirming that the repayment is in accordance with the loan agreement (valuation and accuracy).

(c) Disclosures

(i) Check if details of securities, interest rate and other important terms are fully disclosed (completeness).
(ii) Verify whether short-term and long-term parts of a liability are separately disclosed (presentation).
(iii) Verify that the disclosures are in accordance with the accounting standards (understandability).

5.4 Evidence in relation to provisions

1. The purpose of substantive procedures

The substantive procedures related to provisions are designed to test the following assertions:

(a) Completeness - all provisions are recorded.
(b) Rights and obligations - all provisions relate to the entity.
(c) Valuation and allocation - valuation is proper.
(d) Existence - liabilities do exist.
(e) Rights and obligations - entity has an obligation to pay money against the provisions.
(f) Classification - information is recorded and classified under appropriate headings.
(g) Presentation and disclosure - the disclosures are understandable.

2. Audit procedures specific to provisions

(a) The schedule forming part of the financial statements relating to provisions should be obtained from the client and must include opening balances, movements during the current period and the closing balances. Moreover, the amounts relating to opening balances should be agreed with the previous period's financial statements.

(b) The auditor should determine whether, as on the date of the financial statements, the client has a **present obligation arising from the occurrence of past events** by:
- Reviewing correspondence;
- Reviewing the source documents like invoices raised, approval of management for making provisions; and
- Discussing the matter with the client.

(c) The auditor would also have to determine whether or not settling the provisions (which are material to the financial statements) would result in an **outflow of the entity's resources** by:
- Reviewing the client's policy relating to making provisions
- Reviewing correspondence with banks, lawyers, insurance companies and obtaining their views
- Reviewing the bank statements to check for any payments made after the date of the financial statements
- Obtaining views on this matter from the legal counsel of the entity
- Discussing with the client about their past experience (relating to their settlement) on similar provisions.

(d) The auditor needs to recalculate the provisions made, check them for accuracy and compliance with the provisions of IAS 37, and compare them with the previous year's provisions for consistency.

(e) The auditor should then trace the amount of provisions to the financial statements and confirm that they agree.

(f) In addition, the following procedures should also be carried out:

Checking whether there are **adequate disclosures** (in accordance with the provisions of IAS 37) for provisions in the accounts

Considering the nature of the entity's business, the auditor must verify whether **appropriate provisions** are made. For example, the auditor of a mining company would verify whether provisions for site restoration are made for mines.

If provisions are not made due to non-availability of best estimate amounts, the auditor needs to check whether they are **disclosed** as contingent liabilities.

If subsequent events include settlement of provisions made in the current period, the sufficiency of the provisions can be cross checked. In the absence of such subsequent event, a comparison of similar provisions settled in the past can also be used as a benchmark.

The **written representation** obtained by the auditor must include matters relating to completeness of disclosures, relating to provisions in the financial statements.

5.5 The related profit and loss section entries

1. In relation to tangible non-current assets, the following entries appear in the SOPL

(a) Depreciation
(b) Impairment cost
(c) Repairs to assets
(d) Insurance of assets

Audit procedures explained above

Verification of depreciation and impairment is explained above. Insurance and repairs are verified with the help of insurance policies and invoices.

2. In relation to intangible assets the following entries appear in the SOPL

Gain on bargain purchase amount**:** negative goodwill is now referred to as **"gain on bargain purchase"**. The **revised IFRS 3 requires it to be recognised in profit or loss immediately as gain on bargain purchase. The auditor should recalculate the bargain on sale after verifying the purchase agreement and the fair values of the assets (appearing in the valuer's report).**

(a) Impairment of assets
(b) Amortisation expenses

Audit procedures explained above

3. In relation to non-current liabilities, the following entries appear in the SOPL

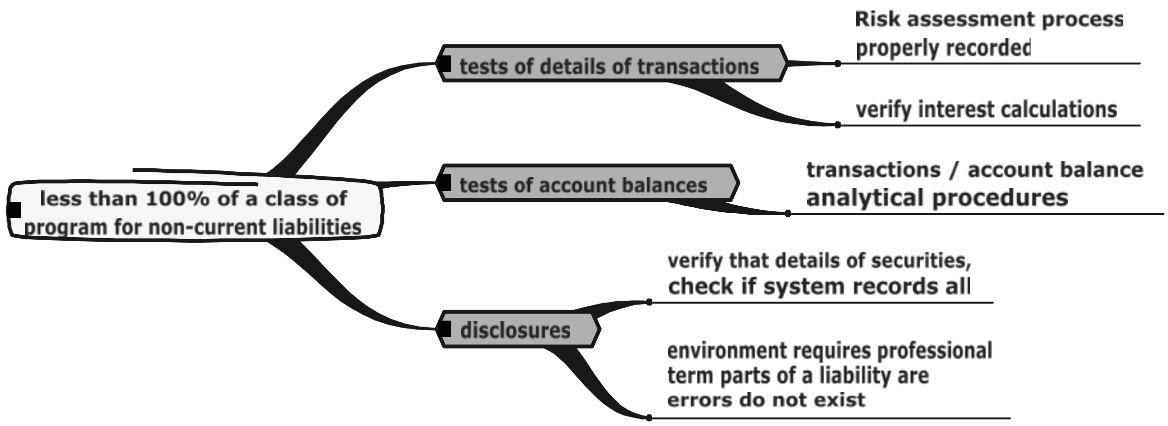
(a) Interest cost: recalculate the interest on loans taken by verifying the terms of the loan from the loan agreement. Agree the recomputed interest with the amount recorded in the financial statements.
(b) Loan processing charges: recalculate the loan processing charges incurred by verifying the terms of the loan from the loan agreement. Agree the recomputed charges with the amount recorded in the financial statements.
(c) Commitment charges in some countries (these are levied on the loan sanctioned but not utilised)

4. In relation to provisions

Provisions have a direct effect on the SOPL. Provisions at the end of year would increase the expenses, whereas reversal of opening provisions would reduce the expenses.

The auditor should verify whether all the usual provisions have been made and the opening provisions are reversed.

SUMMARY



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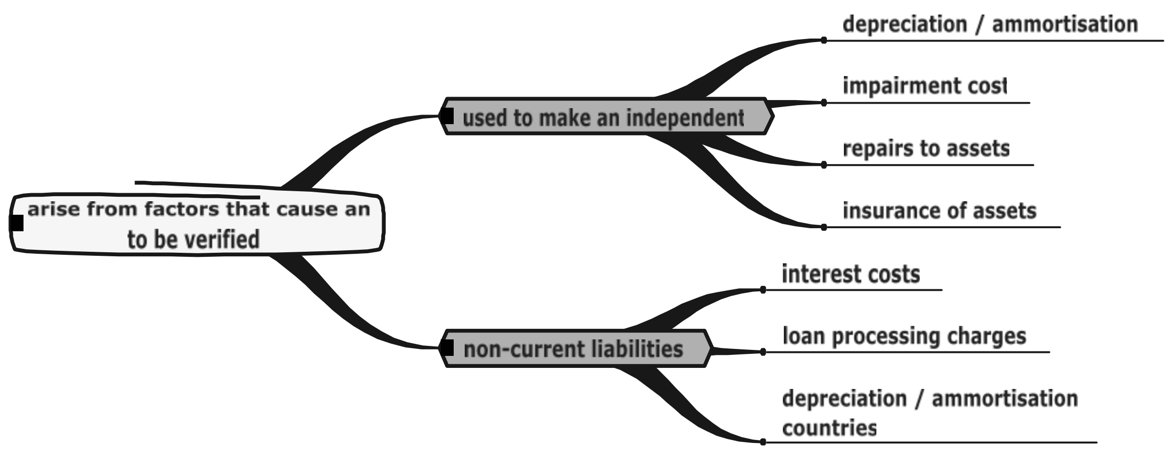

Test Yourself 5

Your client's SOFP discloses a loan obtained for construction of premises, with a balance of TZS60 million. What are the assertions and what evidence would be needed to test them?

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6. For 'share capital, reserves and director's emoluments':
i. Identify state and explain appropriate procedures to gather evidence based upon a given scenario
ii. Identify and evaluate based on a given scenario including information regarding evidence obtained whether that evidence is sufficient to provide an appropriate basis for a given opinion or report.

[Learning Outcome a]

6.1 Share capital and reserves

1. The share capital of an entity can be either equity or preference capital. It could be either issued by a newly formed company or an existing company. The shares may be issued for both cash consideration and other than cash consideration. As a minimum, the SOFP shall include line items that present the issued capital and reserves attributable to owners of the parent. **An entity** should disclose the following, either on the face of the statement of financial position or in the notes:

(a) For each class of **share capital**

(i) The number of shares issued and fully paid, and issued but not fully paid.

(ii) The par value per share, or the fact that the shares have no par value.

(iii) A reconciliation of the number of shares outstanding at the beginning and end of the period.

(iv) The rights, preferences and restrictions attaching to that class, including restrictions on the distribution of dividends and the repayment of capital.

(v) Shares in the entity held by the entity or by its subsidiaries or associates.

(vi) Shares reserved for issue under options and contracts for the sale of shares, including the terms and amounts.

(b) A description of the nature and purpose of each reserve within equity. (Reserves include revaluation reserves, retained earnings and share premium)

2. Treatment of revaluation reserve

When the asset is derecognised (sold), the revaluation reserve included in equity should be transferred directly to retained earnings. Profit or loss on sale will be calculated in the usual manner i.e. sales proceeds less carrying value (in this case, revalued).

Example

An asset had a carrying value of TZS500,000. It was revalued at TZS600,000 by crediting the increase of TZS100,000 to revaluation reserve. Later it was sold for TZS750,000.

The profit on sales is TZS150,000 (750,000 - 600,000) and it is presented in the statement of comprehensive income.

The revaluation reserve of TZS100,000 is transferred directly from the reserve account to the retained earnings.

When the asset is used by an entity, some of the revaluation reserve may be reallocated to retained earnings. In this case, the amount of the surplus transferred to retained earnings would be the **difference** between the **depreciation based on the revalued carrying amount** of the asset and the **depreciation based on the asset's original cost.**

The transfers mentioned are not **made through the statement of comprehensive income**, but directly from the revaluation reserve to retained earnings.

3. Audit procedures

Assertion	Audit procedures
Account balances at the period end : tests of account balances	
All shares issued / allotted are recorded. They are recorded at appropriate amounts. (Completeness and valuation and allocation)	The closing balance in the share capital a/c in the general ledger must be reconciled with the balances extracted from the register of members. (part of secretarial records)
The shareholders have a right to the shares allotted to them. (Rights and obligations)	Review the guidelines issued by regulatory authorities relating to issue of shares. Confirm that the relevant provisions of the Companies Act 2006 have been adhered to (e.g. whether share application forms are in the prescribed formats) at the time of issuing shares to the public. Review the minutes of the board meeting through which allotments were recommended.
Shares have been issued. (Existence)	If the share certificates have been issued, trace the particulars of the shares issued from the allotment register to the counterfoil of the share certificates.
Classes of transactions : tests of details of transactions	
All share issue entries relate to the entity and are appropriately recorded. (Accuracy and occurrence)	Verify the journal entry to confirm that the share application account has been debited and the share capital a/c has been credited. Trace a sample of entries from the cash book and journal into the ledger accounts. For a sample of entries in the register of members, trace the amount of application money received from the application forms to the cash book.

Continued on the next page

Presentation and disclosures	
All disclosures relating to share capital and reserves have been included. (Completeness)	Verify draft financial statements and confirm that the disclosures relating to share capital (i.e. allotted, issued, paid up and the various reserves) are made in the financial statements (as discussed above).
All disclosed events and transactions relating to share capital and reserves pertain to the entity and have occurred. (Occurrence, rights and obligations)	Verify the disclosures and confirm that share capital is genuinely issued / called / allotted. Confirm that the number of shares issued / allotted shown in the financial statements agree with the secretarial records i.e. register of members.
All financial information and other matters are disclosed fairly and at appropriate amounts. (Accuracy and valuation)	Verify the disclosures and confirm that the disclosures and other matters relating to share capital and reserves are at appropriate values.
Information has been recorded and classified under appropriate headings and the disclosures are understandable. (Classification and understandability)	Prepare a checklist of disclosures which apply to share capital and reserves. Verify the various disclosures relating to share capital and reserves and confirm that they are understandable and in accordance with the checklist.

6.2 Director's emoluments

1. Emoluments include compensation paid for the services provided by the directors to the company and reward for entrepreneurial contribution.

The various **components of emoluments** include:
(a) Basic salary
(b) Bonuses
(c) Share options
(d) Pension contributions
(e) Other benefits (e.g. provision of a company car, rented accommodation, health insurance etc.)

2. The Best practices in Corporate governance Code recommends a transparent procedure for policy formulation on executive emoluments and for fixing individual emolument packages. Therefore emoluments of directors are fixed by the remuneration committee which mainly exists so that the executives do not have the opportunity to decide their own emoluments.

3. Audit evidence

Assertion	Audit procedures
Classes of transactions : test of details of transactions	
All emoluments due to directors are recorded (Completeness)	Check the internal control policies and procedures applicable to the various transactions relating to directors' emoluments and payment. Ascertain by a walk through test, whether the system ensures that all the transactions are recorded. Trace a sample of the transactions recorded in the remuneration account with the recommendations of the remuneration committee. Also trace entries from the remuneration committee recommendations with the entries recorded in the remuneration account.
All directors' emoluments entries relate to the entity and are appropriately recorded. (Accuracy and occurrence)	Verify the accuracy of the emoluments recorded by recalculating the amount of emoluments applicable to the directors with the recommendations of the remuneration committee. For all performance related bonus, verify the correctness of the bonus by comparing the bonus with the achievement of the performance related targets i.e. ensure that performance related bonus is supported with appropriate achievement of targets. Loyalty bonuses are given when a person completes a certain number of years in a company. Verify the accuracy of the payments made along with adherence to the conditions of the loyalty bonus. Verify the directors' rent accounts for the directors' accommodation and trace entries therein with the approvals of the remuneration committee and also confirm the correctness of the values with the rent agreement. Verify the directors' health insurance accounts paid for the directors and trace entries therein with the approvals of the remuneration committee and also confirm the correctness of the values with the insurance policies.

Continued on the next page

Classes of transactions : test of details of transactions	
All directors' emoluments transactions are recorded in the correct period. (Cut-off)	Check the cut-off procedures that ensure that the directors' remuneration is recorded in the correct period. Verify that the remuneration relating to the period of audit has been appropriately recorded in the year. Trace a sample of entries which are due in the last month of the audit period from the remuneration committee recommendations to the entries in the remuneration account.

4. The related profit and loss section entries

All emoluments which accrue to the directors are debited to the directors' remuneration account, which is an expense in the SOPL.

Test Yourself 6

Delta Co has issued 10,000 shares at a premium TZS7,000 each.

Required:

Explain the considerations which must be borne in mind while auditing the share premium account.

Answers to Test Yourself

Answer to TY 1

A positive confirmation request asks the customer to reply to it, whatever the case, i.e. whether the balance matches or not. The respondent is expected to either indicate that the balance matches or to state the balance according to its records and give details of differences.

A negative confirmation request, on the other hand, asks the respondent to reply only in the case of disagreement with the information provided.

A positive confirmation request is usually thought to be better evidence. It gives explicit evidence. In negative confirmations, on the other hand, there is an assumption that because the customer did not reply, the balance agreed.

This is not conclusive evidence as the customer might simply not have bothered to respond. It is necessary to support negative confirmations with other corroborative evidence.

Answer to TY 2

The main purpose of cut off procedures is to synchronise the movement of goods and related accounting around the reporting period and to ensure that the transactions are recorded in the correct accounting period.

The goods receipts and issues around the reporting period should be verified with the accounting documents such as invoices to ensure this. The last documents before inventory count should be noted down. Subsequent documents should be recorded in the next accounting period unless there are valid reasons and appropriate matching entries are made.

These general principles would be applicable in the given case also. Additional care is needed to tackle the multi-location inventories because:

- There may be higher chances of goods in transit.
- If goods are invoiced by a supplier through a combined invoice and part of the goods are delivered at one location before the reporting period, but a delivery at another location is completed only after the reporting period. Assuming the whole invoice is recorded towards purchase, the second portion which is not yet delivered is treated as "goods in transit."

Answer to TY 3

The accountant's contention is not correct. The auditor gives an opinion on the fairness of the amounts stated in the SOFP, i.e. balances at the reporting period. These balances include the effect of opening balances. If the opening balance is incorrect, the closing balance will also be incorrect. The SOFP, therefore, will not be fairly stated.

The audit strategy will be to request the client's accountant to obtain the statements of account for the earlier year(s), and reconcile the account fully, without leaving any unexplained difference. If it is found that errors which have an impact on income, related to earlier year(s) are to be corrected now, they will be reflected as prior period items in the SOCI.

After resolving the differences over reconciling items, the supplier may be requested to re-submit the balance confirmation.

Answer to TY 4

The assertions supported by a bank confirmation letter are:

Existence
Rights
Valuation
Completeness

Answer to TY 5

The amount represents the following **assertions**:

The liability exists.
Valuation is proper.
The client has an obligation to pay.
The information is recorded and classified under the correct headings.
The disclosures are understandable: e.g. the nature of the security is clearly stated.
The following **evidence** can be checked:
Loan agreement

Accounting of loan repayment and interest payments. If there is a combined payment towards principal and interest then, when accounting, the principal portion should be debited to loan and the interest portion to interest cost.

Register of charges where details of securities as informed to the statutory authorities are recorded.

A loan of this type may be disbursed piecemeal. It may happen that the amount of loan is credited to the client's account after deducting charges. It should be verified if such charges are recorded as cost.

Balance at the reporting period and the nature of securities should be checked with the bank's confirmation letter.

Answer to TY 6

When the issue price of shares is more than the face value, the excess amount is considered to be the share premium. The amount of share premium received must be credited to the share premium amount. The share premium cannot be used for declaration of dividend. Instead, it should be included in the reserves and surplus.

The share premium may be set-off against the following accounts:

(a) Preliminary expenses
(b) Discount on issue of shares and debentures
(c) Premium on redemption of preference shares
(d) Issue of bonus shares to equity share holders

Therefore the auditor must ensure that the share premium account is written off only for the above mentioned reasons.

If shares are issued in the period at a premium then the auditor must ensure that the correct entries are made in cash account, share capital account and share premium account.

The auditor should also ensure that the share issue has been properly authorised according to company law and the company's constitution.

Quick Quiz

1. Why is a direct external confirmation of accounts receivable said to be good audit evidence?

2. What is suitable evidence for verifying bad debts?

3. Why are the entries for accruals reversed at the beginning of the next period?

4. A supplier reconciliation statement shows three items. One item each, representing an error is to be corrected by the supplier and the client. The remaining item is a timing difference (payment by client before reporting period is received by the supplier in the next period). Is it true that, after all these items have been acted upon, the balances according to the two records will match?

5. A company uses the cost model for the accounting of non-current assets. Depreciation is not charged on a property used for the purpose of business, in the books of accounts. The client's accountant states that it is management's decision not to charge depreciation. What is the effect on the fair presentation of the property?

Answers to Quick Quiz

1. Direct external confirmation of accounts receivable is a good audit evidence because:

   It is obtained from independent sources outside the entity
   It is obtained directly by the auditor
   It exists in documentary form
   It is in the form of original documents

2. Correspondence related to the receivables should be seen. A court order, if applicable, should be checked. Calculations of bad debts should be verified.

3. The entries for accruals, (for example telephone expenses of TZS50,000), mean that the cost accrued up to the reporting period is recognised even when the bill is not recorded. During the next period, the bill will be recorded in full (for example, TZS80,000). Unless the cost that was recorded in the earlier period is reversed, there cost will be recorded twice (TZS50,000 + TZS80,000).

4. Yes. It is true that after these items are acted upon, the two balances will match.

5. Depreciation is a way of allocating the depreciable cost of an asset over its useful life. It is necessary to charge depreciation on assets. The part of the value which is actually consumed in the process of running a business should be shown as a cost in the SOCI, by reducing it from the carrying value of the assets. If this is not done, the SOCI and the SOFP do not reflect a true and fair view.

Self-Examination Questions

Question 1

Auditor Co, while auditing the books of Masco found that, out of the receivables circularised, about one-third did not reply. What should Auditor Co do to ensure that all material audit risks are adequately addressed?

Question 2

As the leader of an audit team deputed to audit inventories, you are told by the accountant of a client that they have a well–defined system of inventory counting that has operated smoothly for many years and is carried out by experienced staff. The accountant advises you to leave the annual inventory count to him and concentrate on the other items on the audit plan so that the audit can be completed in time. Inventories form a material part of the assets of the entity. What should be your audit plan in response to the request by the accountant?

Question 3

Frilco's SOFP presented to you for audit contains the balances of property, plant and equipment. It contains some items valued at cost, others revalued at fair value. The company obtained some assets on lease. Some of these assets are treated as company's assets while others are not. Your assistant wants your assistance in planning substantive procedures in this situation. Advise the assistant about suitable procedures.

Answers to Self-Examination Questions

Answer to SEQ 1

The auditor should contact the customers by sending follow up letters and seek to elicit responses. If the customers do not respond then the auditor should consider alternative audit procedures, for example, verification of subsequent cash receipts, shipping documents, etc.

Before applying these alternative tests, the auditor should review and test the internal controls in the area in which alternative tests are to be applied. For example, if the auditor plans that a sample of shipping documents is to be verified with the entries in the sales day book, they should review and test the operation of internal controls in the field of sales. More tests of details of transactions are applied. Cut off procedures should be checked to verify that the sales are recorded in the correct period. Any reversals of large sales revenues in the next year would be investigated.

Answer to SEQ 2

When inventory is material to the financial statements, ISA 501 requires that the auditor should attend physical inventory counting so as to obtain sufficient appropriate audit evidence as to the existence and condition of inventory. Inventories are a relatively high risk area of audit since inventories affect the amount of profit, they may be complex and they are subject to estimation. The auditor should be cautious. The pronouncements of ISAs should not be disregarded.

The insistence of the client's accountant that the auditor should not attend the physical count gives rise to suspicion. As laid down in the Kingston Cotton Mills case (1896), if their suspicion is aroused, the auditor should investigate further. Numerous cases of fraud have been committed with the help of manipulated inventories. Unless the auditor takes reasonable care in performing their duties, they may be held liable for professional misconduct.

The auditor should attend the inventory count and check samples extensively as he will be suspicious of why the accountant did not want him to attend.

Answer to SEQ 3

The following procedures should be applied for the verification of non-current assets in the given case:

(a) For all the assets, generally

Check all opening balances with the previous year's audited balances

Verify additions to assets with the purchase invoices

Check addition of self-constructed assets with the purchase invoices of materials, cost allocations for labour and overhead costs

Verify additions with the approval of the board of directors

Verify depreciation rates and re-perform calculations on a test basis

If there are any disposals, check the authorisation to sell and the accounting for the sale

Check whether the assets are adequately insured

Verify the accounts where mis-postings are possible e.g. the repairs account which may contain an item of asset erroneously recorded

Physically inspect a sample of assets, to check for existence

Verify classification of assets

Check whether there is any impairment loss that needs to be provided for

(b) For the assets revalued at fair value, the following additional steps are needed

Verify the new valuations with the valuer's report

Confirm that all the similar assets are revalued

Check that the increase in value is credited to revaluation surplus

Check whether the difference between the depreciation on cost and the depreciation of the revalued amount

Is transferred to the SOCI, being a realised profit

Make correct disclosures of revaluation policy, name of the valuer etc.

(c) For the company assets obtained on lease, the following additional steps are required

Check lease agreements

Determine the type of lease agreement, i.e. whether a finance lease or operating lease

Only the assets acquired on a finance lease can be shown as the assets of the entity acquiring the asset

Check whether the balance of the lease liability at the reporting period matches the balance shown by the lease finance company, and that it is disclosed correctly in the financial statements

Once the finance leased assets are treated as the company's assets, they are considered for depreciation calculations, like the ordinary assets

Payments on account of operating lease are treated as expenses

SECTION C

THE NATURE OF AUDIT EVIDENCE AND THE SELECTION OF SUFFICIENT APPROPRIATE EVIDENCE

C5

STUDY GUIDE C5: WRITTEN REPRESENTATIONS

Get Through Intro

During the course of an audit, auditors can come across situations where, on a matter which is material to the financial statements, they are unable to gather sufficient appropriate audit evidence. How will they deal with these situations? Representation by management can be obtained as additional evidence.

Written representation is an acknowledgement of responsibility by management on certain matters, including the true and fair presentation of the financial statements.

Does this mean that it can be used as audit evidence? No, it cannot be substituted for other audit evidence that the auditor could reasonably expect to be available. However, when it is expected that no evidence other than this is available, it can be used as audit evidence.

In this Study Guide the procedure for obtaining written representation and the circumstances where it is necessary to obtain written representation will be discussed. The knowledge obtained from this Study Guide will help you in your future where you come across a situation where you need to consider obtaining written representation.

Learning Outcomes

a) Discuss the purpose of and procedure for obtaining written representations.
b) Identify the circumstances where written representations may be required stating how reliable such evidence may be.
c) Identify and evaluate the circumstances where matters need to be raised with a senior assurance team member and how this should be communicated and documented

1. Discuss the purpose of and procedure for obtaining written representations.
[Learning Outcome a]

Definition

Written representation: a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence.

Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

ISA 580

Written representation is a representation by management which can be used as audit evidence but is not a substitute for other audit evidence when that is expected to be available.

1.1 Purpose of written representation

1. Acknowledging responsibility for the financial statements by management

Preparation of the financial statements is the responsibility of management and should be acknowledged by them. **ISA 580** requires that "the auditor should obtain audit evidence that **management acknowledges its responsibility** for fair **presentation of the financial statements** and for the completeness of the information provided to the auditor.

2. Acknowledging responsibility for other matters

Written representation for any specific matter assures that management has acknowledged responsibility for the matter e.g. internal control, adjustments relating to subsequent events in the financial statements, information relating to related parties etc.

This is not however, conclusive evidence to the auditor, but at least gives reassurance that management has acknowledged its responsibility for disclosing related party transactions.

3. Used as audit evidence

Although written representation is not a substitute for audit evidence, it can be used as audit evidence where, in the opinion of the auditor, there is no sufficient appropriate evidence in existence on a matter which is material to the financial statements.

Example

In the case of contingent liabilities (e.g. liability for a law suit etc.), if an auditor cannot obtain sufficient audit evidence to confirm whether all contingent liabilities are disclosed, written representation will be used as audit evidence.

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4. Acknowledges representations previously made verbally by management

Any matter discussed between an auditor and management which management acknowledges in writing will confirm the management's contention given verbally. Therefore written representation acknowledges representations previously made verbally.

Example

An auditor could not gather evidence on whether an investment was long-term or short-term. Management told him verbally that it was long-term. This verbal statement will be confirmed by management giving the statement in a written representation letter.

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5. Minimises misunderstandings between management and auditor

If, on any matter, management wishes to clarify a misunderstanding on the auditor's behalf, it can do so by giving clarification in a representation.

Example

KKCA, an audit firm, is appointed as the auditor of a bank. One of the customers of the bank, who borrowed TZS5 million two years ago, has not paid any instalment due. The audit senior of the bank is of the opinion that the account should be classified as doubtful debts and a provision of 50% should be made. Management, in its representation letter, clarified that the account cannot be classified as doubtful because the client's business has started generating revenue from the current year and they have already given post-dated cheques to the bank. In this way, written representation clarifies the doubts / misunderstandings of the auditor.

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6. Reasonable assurance about the effective working of internal control system

Management in its representation acknowledges its responsibility for design and implementation of the internal control system. It comments on the adequacy, efficiency and effectiveness of the internal control system. Written representation provides reasonable assurance that the internal control system is effective.

Example

Management, in its representation letter, acknowledges its responsibility as follows:
"We have designed, implemented and maintained an adequate internal control structure to facilitate the preparation of reliable financial statements and adequate financial records and performance measurement data have been maintained"

1.2 Procedure for obtaining written representation

There is no procedure laid down for obtaining written representation by an auditor. It differs case by case. During the course of an audit, the auditor may note down the matters for which representation is required. An auditor may prepare a question bank of all the subject matters for which they want information from management and ask management to fill it in and sign it. Otherwise, they may discuss all the matters orally, note them down and ask management to sign and acknowledge their statement. A written representation may be in the form of a representation letter from management.

Whatever the form of a written representation, it should possess the following elements:

- It should be **addressed to the auditor**
- The representation should be **appropriately dated and signed**

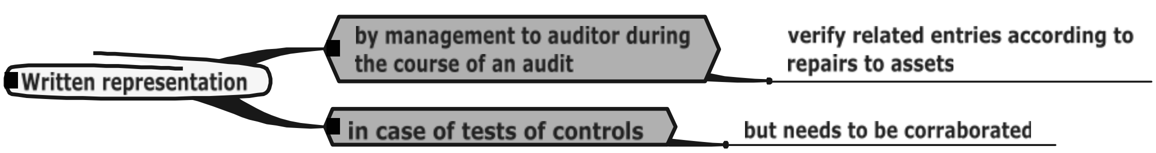
The **date of the representation** should be **as near as practicable to**, but **not after, the date of the auditor's report** on the financial statements. Furthermore, the written representation should be in respect of all financial statements and period(s) referred to in the auditor's report.

- The representation should be **signed by** those **members** of management who are responsible for the preparation of the financial statements. Generally it is signed by those members who have primary responsibility for the entity and its financial aspects such as the chief executive officer and the chief financial officer. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation of the financial statements.

- When the representation letter is written by the auditor and signed by management, the auditor should discuss the contents of the written representation letter at an early stage because directors may disagree with the matter in the letter and then the auditor has to consider it for modification.

Written representation is generally obtained for matters which are material either individually or collectively.

SUMMARY



2. Identify the circumstances where written representations may be required stating how reliable such evidence may be.

[Learning Outcome b]

2.1 Quality and reliability of written representation

Certain general comments about the reliability of audit evidence have been studied in Study Guide C2.

Representation, when in a **written** form, **is more reliable** than in an oral form. Also, written representation is obtained directly therefore it is reliable.

However, **as it is internal evidence, there is a lack of independence and therefore it is less reliable than external evidence.** As written representation is given by management, it may be argued that it comes from a responsible source and is therefore reliable. On the other hand, in cases where appropriate audit evidence is not sufficient, it is possible that management may manipulate the information it provides. Remember, this **is internal evidence, so the auditor needs to view it with professional scepticism.**

2.2 Evaluation of reliability

If a **representation** is obtained **for matters** which have a **material effect on the financial statements**, the auditor should **evaluate the reliability of the representation**. For this they should:

1. Seek corroborative audit evidence

Merely obtaining written representation does not discharge the auditor's responsibility for collecting evidence. They have to consider the reliability of the representation. This can be done by obtaining corroborative audit evidence.

Example

An auditor of Lucky Plc found that, in the month of December, overhead expenditure was very high compared to the rest of the year. In the written representation, it was stated that it is the custom in the office that, at Christmas time, a bonus is paid to the employees and therefore expenses are higher. The auditor may obtain corroborative evidence e.g. analyse the last two / three years to confirm that it is the custom of the company, or the auditor may go through the policies of the company where this custom is mentioned.

2. Evaluate consistency of the representation with other evidence, if any

(a) If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor ,needs to determine the effect that such concerns may have on the reliability of representations (oral or written).

(b) If the auditor concludes that the written representations about management's responsibilities regarding the preparation and presentation of financial statements and information provided to the auditor are not reliable, the auditor should take appropriate actions, such as issuing a modified report with a disclaimer of opinion on the financial statements.

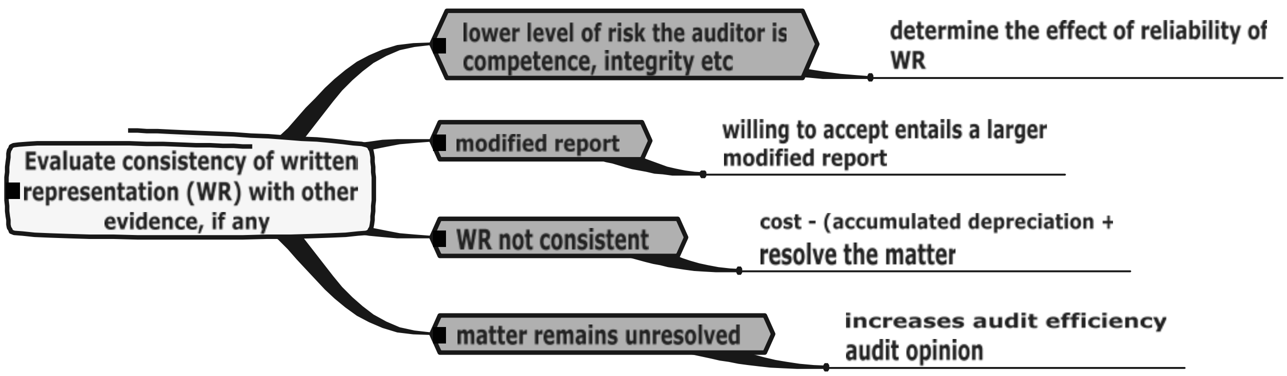
(c) If the representation is **not consistent** with other audit evidence, the auditor should perform audit procedures to attempt to resolve the matter**.** For this, the auditor should reassess the appropriateness of the risk of material misstatement on account of this inconsistency. If required, the auditor should revise the nature, timing and extent of further audit procedures.

Example

In a representation given by the management of Recky Plc, it is stated that all contingent liabilities have been properly disclosed. However, the auditor subsequently finds that a suit is pending in the court, which may result in a liability, but is not disclosed anywhere. The auditor should investigate this matter and should ask management why the suit has not been disclosed. Moreover, this will raise questions in the auditor's mind regarding the reliability of the other representations given by management. Furthermore, in this connection the auditor should seek a representation from the legal counsel of Recky as to the status of all legal suits filed, which are pending settlement.

(d) In case the matter remains unresolved, the auditor should consider its potential effect on the audit opinion.

SUMMARY



2.3 Refusal by management to provide representation

Under the following circumstances, management may refuse to provide representation:

- When it feels that, by obtaining representation from management, an auditor is trying to pass their responsibility onto management
- When management is, in fact, ignorant of the fact
- When it wants to hide something from the auditor

When management refuses to provide a representation, an auditor should:

- **Discuss the reason for the refusal** with the management.
- **Re-evaluate the integrity of management** and evaluate the effect that this may have on the reliability of representations (oral or written) obtained and of audit evidence in general (discussed in the earlier paragraph).
- **Take appropriate actions, including issuing a modified report with a disclaimer of opinion** on the financial statements.

Test Yourself 1

You are appointed as an auditor of Neuron Ltd, a company which sells electronic goods. During the audit, you find that, in the case of certain expenditure (related to repair and maintenance of a vehicle used by two of the directors) the supporting documents are not sufficient. As a result, you have decided to obtain written representation which confirms (amongst other things) that all related party transactions have been disclosed in the financial statements and that, when there is weak evidence of expenditure, the expenditure has been for the benefit of the company and not for the personal benefit of any employee or director.

Required:

Consider the reliability of the audit evidence provided by the directors in the written representation letter. You should consider whether you should rely wholly on the representations of the directors or whether you should obtain other evidence.

2.4 Matters on which written representations are obtained

In written representation, **management acknowledges its responsibility for the presentation of the financial statements** according to the financial reporting framework and for providing all necessary information and documents.

1. Management's responsibilities

(a) Preparation of Financial Statements

The auditor should obtain a written representation relating to:

(i) Its fulfilment of responsibilities as to the preparation of the financial statements in accordance with the applicable financial reporting framework, including

(ii) Their fair presentation, as set out in the terms of the audit engagement, in case it is relevant.

(b) Information Provided and Completeness of Transactions

The auditor should obtain a written representation relating to:

(i) Providing the auditor with all relevant and necessary information and documents, and
(ii) Completeness of all transactions recorded in the financial statements. This would include confirming that transactions and events have been carried out in accordance with law, regulation or other authority.

2. Other written representations

Written representations are also required on specific matters related to other ISAs. These representations are generally obtained to support other audit evidence. Examples of such representations are as follows:

(a) Internal control system

Designing an adequate internal control system and its effective implementation throughout the period is the responsibility of management and not of the auditor. ISA 240 requires that the **auditor should obtain written representation from management** that it **acknowledges its responsibility** for the **design and implementation** of **internal control** to prevent and detect error.

Example

Olivia is the auditor of a small furniture shop where all sales are cash sales and proper segregation of duties is difficult on account of cost benefit analysis. In this case, only the owner can assure her that the internal controls are working effectively to prevent and detect errors.

Therefore, she should obtain a representation from the owner that he acknowledges his responsibility for the design and implementation of the internal controls and that the internal controls are effective at preventing and detecting errors.

As long as Olivia has managed to test some parts of the internal control system, the letter will provide her with reasonable assurance of the effectiveness of the internal control system.

(b) Uncorrected aggregated financial misstatements

ISA 450 also requires an auditor to **obtain representation from management that it** believes **the effects of** the **uncorrected financial misstatements aggregated by the auditor** during the audit **are immaterial**, both individually and with respect to the financial statements taken as a whole. In this connection the auditor may consider setting a threshold for management (above which, misstatements cannot be regarded as trivial) for the purpose of the requested written representations.

If, during the course of an audit, the auditor discovers certain errors in the transaction classes or in the account balances, management should correct those errors so as to give a true and fair view of the position of the entity. However, sometimes these errors are not corrected by management on the grounds that, in aggregate, they are not material to the financial statements and do not affect the decision taken on the basis of these financial statements.

In that case, management should state in its representation that the misstatements pointed out by the auditor have not been corrected as they are not material to the financial statements and should also include a list of these misstatements in the written representation.

Example

An auditor of Excellent Plc identified the following misstatements:
An amount unlikely to be recovered from a customer of TZS50,000 (total receivables are TZS4 millions)
An overstatement of sales by TZS100,000 (total sales are TZS50 millions)

In this case, as management considers these misstatements immaterial (individually as well as collectively TZS150,000) it therefore does not correct them.

In this case, the auditor should obtain a representation from management that "We do not agree that the items mentioned above constitute misstatements because [description of reasons]"

(c) Subsequent events

In the case of subsequent events, the facts are known only to management. The auditor, although required to review the subsequent events, is not aware of them unless the entity informs them of these events.

Therefore they may obtain a representation from management in this regard. The representation obtained under ISA 560, shall confirm that the financial statements have included all adjustments and disclosures which apply to the financial statements, on account of subsequent events.

Example

If any assets have been appropriated by the government or destroyed, for example, by fire or flood after the reporting period, an auditor may discuss matters such as the productivity of the assets, their impact on the entity's going concern status etc. with management and ask for written representation.

(d) Related party transactions

In the case of related party transactions, under ISA 550, the auditor needs to obtain a representation from management that it has disclosed:

(i) The identity of the entity's related parties and all the related party relationships and transactions of which they are aware

(ii) All the related party transactions in the financial statements.

(e) Fraud

Under ISA 240, the auditor obtains a written representation from management and, where appropriate, those charged with governance confirming that they have disclosed to the auditor:

(i) The results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and

(ii) Actual, suspected or alleged fraud affecting the entity according to their knowledge.

(f) Apart from the above, written representation can be obtained in the following circumstances / for the following matters:

(i) When sufficient appropriate audit evidence is not available for any subject matter which is material

In certain cases, when other audit evidence is not available, written representation is asked for and used as audit evidence.

The matters on which written representations are obtained are as follows:

- The appropriateness of the selection and application of accounting policies
- whether matters that are relevant under the applicable financial reporting framework have been recognised, measured, presented or disclosed in accordance with that framework; for example:
  - Plans or intentions that may affect the carrying value or classification of assets and liabilities;
  - Liabilities, both actual and contingent;
  - Title to, or control over, assets, liens or encumbrances on assets, and assets pledged as collateral; and
  - aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.

Example

When an investment is held by an entity and the auditor feels that there is no evidence to confirm whether it is a long-term or short-term investment, they may seek written representation.

(ii) When it is a matter of judgment or opinion of management

The auditor should obtain representation from management when the matter is judgmental. For example, representations to support accounting estimates relevant to the financial statements.

When obtaining evidence, or evaluating judgments and intentions, the auditor may consider one or more of the following:

The entity's past history in carrying out its stated intentions.
The entity's reasons for choosing a particular course of action.
The entity's ability to pursue a specific course of action.

Example

The following illustrative letter includes written representations that are required by this and other ISAs in effect for audits of financial statements for periods beginning on or after December 15, 2009. It is assumed in this illustration that the applicable financial reporting framework is International Financial Reporting Standards; the requirement of ISA 570 to obtain a written representation is not relevant; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

Illustrative Representation Letter

Addressed to the auditor

(Entity Letterhead)

Normally, the date of audit report

(To Auditor) (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended December 31, 20XX 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, as set out in the terms of the audit engagement dated [insert date], for the preparation of the financial statements in accordance with International Financial Reporting Standards; in particular the financial statements are fairly presented (or give a true and fair view) in accordance therewith.

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 disclosures, 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)

We have no intention of closing down or discontinuing any part of the business

All known liabilities have been included in the financial statements.

[Any other matters that the auditor may consider appropriate (see paragraph A10 of this ISA).]

Continued on the next page

Information Provided

We have provided you with:

Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

Additional information that you have requested from us for the purpose of the audit; and unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.

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 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)

[Any other matters that the auditor may consider necessary (see paragraph A11 of this ISA).]

Signed by management

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3. Identify and evaluate the circumstances where matters need to be raised with a senior assurance team member and how this should be communicated and documented.

[Learning Outcome c]

Circumstances where matters need to be raised with a senior assurance team member include:

1. Non availability of sufficient appropriate audit evidence

Audit teams consist of auditors, who are assigned the task of gathering sufficient appropriate audit evidence for all elements of the financial statements. The audit evidence obtained is documented in the working papers prepared by the auditors (The record of working papers is discussed in detail in Study Guide A4). However if the audit team member does not get appropriate audit evidence or gets insufficient audit evidence, the matter will be reported to the audit senior (who heads the audit) or the engagement partner.

For example many not-for-profit and/or small organisations are less formal. When the volunteers are managing the entity, less documentation tends to be maintained. Therefore the auditor often faces the situation where source documents (like purchase invoice, expense invoice) may not be available for various transactions recorded in books of account.

This matter will be documented in the working papers and communicated by the team member to the senior verbally or through mail on an immediate basis.

2. Independence of audit team members affected

Section D of the book discusses ethical issues in detail

Like the members of many other professional bodies, accountants have a set of multiple ethical responsibilities. They are required to act ethically towards and in the best interests of their clients or employers; the accounting profession and the public at a large. However, their independence is likely to be impaired, if they face threats of violating the fundamental principles of the Code of ethics. At such times, the audit team member is duty bound to inform the audit firm / engagement partner.

For example if an audit senior inherits substantial shares of an audit client, (during the course of audit) it will cause a self-interest threat, which cannot be reduced to an acceptable level. This matter needs to be brought to the attention of the audit firm immediately.

3. Contradictory evidence obtained

Audit team members who come across contradictory evidence will act with professional scepticism and inform audit senior on the matter. For example if the auditor notices that the list of related party transactions provided by the management is not exhaustive as there are more transactions which came to light while carrying out the audit, it would be an instance of contradictory evidence. At such times, the auditor will take more care while conducting the audit on this area. However this matter will be documented in the working papers and the matter will be reported to the audit engagement partner / audit senior, while they review the auditor's work.

4. On becoming aware of existence of fraud

When the audit team notices the occurrence of fraud / fraudulent financial reporting, the matter will have to be reported immediately to the audit senior / engagement partner. For example if the auditor notices embezzlements of cash receipts, the audit team member will immediately report the matter.

There can be many more circumstances, when the audit team members communicate matters with the senior assurance team member. The above circumstances are some instances.

Test Yourself 2

Zeta Consultants is an audit firm. Alpha Ltd is its assurance client. Bela and Jane are the two junior audit staff on the audit Following are some situations which occurred, while carrying out the audit of Alpha Ltd for the year ended 31 December 2012.

1. Bela, who was auditing statutory compliances, noticed that the entity had delayed in filing the VAT Returns for the first two quarters.

2. The audit strategy and audit plan had set a materiality level of TZS120,000 for overhead expenses. However, in the course of the audit, Bela found that there are several errors each of which has a value of less than TZS120,000 and the total impact of such errors is to the tune of TZS3,500,000. Therefore Bela decided to change the audit plan to incorporate the revised materiality.

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Required:

From the scenario, identify the issues which need to be to be raised with a senior assurance team member and also discuss the method of communicating the same.

Answer to Test Yourself

Answer to TY 1

Written representation is written evidence and therefore more reliable than verbal evidence. It is generated within the entity therefore less reliable than external evidence.

It is a representation by directors who are responsible people and know the significance of the representation therefore more reliable than evidence generated by an employee of the entity. On the other hand, the evidence given by directors may be less reliable because they may intend to hide some information from the auditor.

The responsibility of an auditor cannot be shared by management and therefore written representation is not a substitute for audit evidence. Hence the auditor should obtain other corroborative audit evidence. The auditor should check whether the internal controls are in place within the entity to identify related party transactions and test a sample of related party transactions and their disclosure in the financial statements.

If the evidence obtained from these procedures does not confirm the representation by management, the auditor should also consider the reliability of other evidence obtained from management. If representation is signed by management but contradicts the evidence obtained by the auditor and the matter is material, the auditor may qualify the audit report.

Answer to TY 2

1. A delay in filing of VAT returns means statutory non-compliance with laws and regulations. Bela should record the delays in the current working papers. The same should be part of the working papers which are reviewed by the audit senior / engagement partner, during the finalisation of the audit. In short this matter need not be immediately communicated to senior assurance team members as it is a routine matter, where if the matter is communicated in advance to the senior, the audit process would be facilitated.

2. A change made to the audit plan requires the approval of the engagement partner / senior assurance team member. Therefore this matter should be communicated to the senior on priority either verbally or through E-mail and Bela can continue with the revised plan only after receiving an approval from the senior who is in charge of the audit.

Quick Quiz

1. Define written representation.

2. State whether true or false.

   (a) Written representation is a substitute for audit evidence and an auditor need not obtain other audit evidence if they have obtained written representation.

   (b) When management refuses to provide a representation and, in the opinion of the auditor, it is necessary to obtain this representation, the auditor should express a modified opinion.

3. State any three matters or circumstances where written representation is obtained.

Answers to Quick Quiz

1. IFAC defines written representation as the representation by management to the auditor during the course of an audit, either unsolicited or in response to specific inquiries.

2.
   (a) **False**
   Written representation is not a substitute for audit evidence and an auditor cannot avoid their responsibility to obtain audit evidence by obtaining written representation. However, when it is expected that, other than information from management, no audit evidence is available, written representation can be used as audit evidence.

   (b) **True**
   Where, in the opinion of the auditor, it is necessary to obtain audit evidence and management refuses to provide it, the auditor should qualify the audit report and evaluate the reliability of other representations given by management.

3. Written representation is generally obtained:

   (i) When sufficient appropriate audit evidence is not available in any other way.
   (ii) For management to acknowledge responsibility for the financial statements and for an effective internal control system.
   (iii) For management to acknowledge that all transactions are included in the financial statements

Self-Examination Questions

Question 1

When the representation is written by the auditor and signed by management, the auditor should discuss the contents of the written representation letter at an early stage.

(a) Explain why it is necessary to do so.

(b) Explain why management is sometimes unwilling to provide a written representation and describe the actions an external auditor can take if management refuses to sign a letter of representation.

Question 2

(a) You are the manager in charge of the audit of Telecom, a public limited liability company which manufactures mobiles. The audited turnover of Telecom is TZS80 million with profit before tax of TZS3 million.

At the time of the final review of the audit file, the audit team notices the following points:

Speed One

A suit has been filed by Speed One, one of Telecom's major clients. The directors of Speed One claim that the mobile phones supplied to it were not according to specification. The phone battery has a life of only one year and only professionals can change the battery. On the other hand, the directors of Telecom claim that this battery issue was discussed prior to supplying the phones and therefore the claim will not stand and need not be provided for in the financial statements.

The lawyers are unable to calculate the liability at the present time. A claim for TZS1million has been filed by Speed One. The directors' opinion is that the claim is not justified.

Depreciation

Depreciation on production equipment has been charged at 10% p.a. based on reducing balance. The treatment is consistent with prior accounting periods and other companies in the same industry. Sales of old production equipment show normal, small profits on sale. However, the audit manager, who is new to the audit, feels that depreciation is being undercharged in the financial statements.

Required:

For each of the above matters:
(i) Discuss whether or not a paragraph is required in the written representation
(ii) If appropriate, draft the paragraph for inclusion in the written representation

(b) You have drafted a letter of representation and given it to the directors of Telecom. The directors have refused to sign the letter of representation. Their argument is that the auditor has sufficient appropriate audit evidence and therefore representation is not needed.

Required:

Discuss whether the directors' argument is true or false and give reasons for your answer.

Answers to Self-Examination Questions

Answer to SEQ 1

(a) Discussion of the contents of the letter

It is important to discuss the contents of the letter at an early stage because directors may disagree with what the auditors wish them to sign. In such cases, sufficient time should be available to the auditor for negotiations to take place and the letter to be redrafted until it is acceptable to both auditor and management.

(b) Management unwilling to sign and actions if management refuses to sign

(i) Reasons for management's unwillingness to sign

Sometimes, management feels that sufficient appropriate audit evidence is available and auditors should be able to obtain it. They may feel that the auditor is trying to divide or transfer the auditor's responsibility for the audit to them.

Sometimes, management is genuinely unsure of the matters included. Management may also find that the wordings in the letter may cause it to be misinterpreted and ask for changes to the wordings.

Sometimes management tries to hide certain facts from the auditors e.g. the fact that the income recorded is incomplete, or the fact that there is an outstanding undisclosed legal claim against the company.

(ii) Action to be taken by auditor when management refuses to sign

The auditor should consult the management and note down the reasons for which management is not willing to sign. If the reason for refusal is the drafting of the letter, the auditor should redraft the letter in such a manner that management accepts the redrafted version.

If, after redrafting, management refuses to sign, the auditor should convince management to sign the letter. If management continues to refuse and the matter is critical to the financial statements, the auditor may consider qualifying the audit report with an 'except for' or even provide a disclaimer of opinion on the basis of limitation in the scope of the audit.

Answer to SEQ 2

(a) Speed One

(i) In the given situation, there is no sufficient appropriate audit evidence available to the auditor to form an opinion. The following two sources of evidence are available:

Claim by the company
Solicitor's legal advice

However, because of the dispute, it is not possible to quantify the claim. The directors of Speed One are of the opinion that the claim will not stand and therefore need not be provided for in the financial statements.

In addition, representations are taken for matters which are either individually or collectively material. Here, the amount claimed is TZS1million which is material with respect to profit before tax.

Therefore, in the above situation, it is necessary to obtain a letter of representation from management.

(ii) The paragraph to be included in the written representation letter is as follows

A legal claim is lodged by Speed One and the estimated claim amount is TZS1 million. However, the directors are of the opinion that the claim will not stand in court because the subject matter had already been discussed with the customer before delivery. Therefore no provision is made in the financial statements even if disclosure of this is required in the financial statements.

Depreciation

In the case of depreciation, it seems that sufficient audit evidence is available to the auditor. Consistency with prior period, same policy in the industry etc. constitute sufficient audit evidence obtained by the auditor. There is no excess profit or loss on sale of the asset which indicates that there is no over- or under-depreciation. This is because, if the depreciation had been overcharged, a large profit would have been earned by the entity and vice versa. Therefore there is no need to add this paragraph in the representation letter.

(b)
The argument of the directors that the auditor has sufficient appropriate evidence and therefore representation is not required is not true. First of all, the auditor does not have sufficient appropriate audit evidence for the case. Secondly, even if the auditor had sufficient appropriate audit evidence, management should acknowledge its responsibility for the preparation and presentation of the financial statements, the effectiveness of the internal control system etc.

SECTION C

THE NATURE OF AUDIT EVIDENCE AND THE SELECTION OF SUFFICIENT APPROPRIATE EVIDENCE

C6

STUDY GUIDE C6: AUDIT FINAL REVIEW

Get Through Intro

After completion of audit procedures but before forming an audit opinion on the financial statements, the auditor **needs to evaluate the findings and audit evidence** obtained to see whether they have gathered **sufficient appropriate** audit evidence to **form an opinion**.

In addition, the auditor should consider the **potential impact of uncorrected misstatements on** the **financial statements**. Uncorrected misstatements are the errors pointed out by the auditor in the financial statements for correction, but not corrected by management on the grounds of materiality.

In this Study Guide, the importance of an overall review of the evidence obtained by the auditor, and the significance of uncorrected misstatements are discussed. Read this Study Guide carefully since it provides important knowledge which will be useful for audit finalisation.

Learning Outcomes

a) Explain the need for overall review of evidence obtained.
b) Discuss the audit procedures related to performance of overall review of financial statements.
c) Explain and evaluate the significance of uncorrected misstatements.

1. Explain the need for overall review of evidence obtained.
Describe the audit procedures related to performance of overall review of financial statements.

[Learning Outcomes a and b]

1.1 Overall review of financial statements

After completing the audit work in accordance with the audit plan, a senior level auditor (e.g. an engagement partner who is ultimately responsible for a particular audit) should conduct an overall review of the financial statements. The objective of a review of financial statements is to provide the auditor with sufficient audit evidence, when taken together with the conclusions drawn from the other audit work, to form an opinion on the financial statements. This includes determining whether the information in the financial statements is properly presented and disclosed in accordance with the accounting standards, legislation and other regulatory requirements.

During the completion stage of the audit, the auditor arrives at an audit opinion after re-examining:

- The audit evidence gathered during the course of audit; and
- The final edition of the financial statements.

In short, the auditor evaluates the audit evidence to determine the sufficiency of audit evidence.

Audit procedures performed during the overall review are as follows:

Refer to Study Guides C4 for detailed discussion of this topic.

1. Review of financial statements, analytical procedures

Once the audit has been completed, the auditor needs to form an opinion on whether the financial statements comply with the applicable reporting framework, accounting standards, laws and other regulations. To do this, they should review all the findings, their working papers and the evidence gathered by performing audit procedures.

Example

Olivia, an auditor of a bank, has gone through the report issued by the banking authorities who visited the bank during the audit period. She has discovered a comment relating to non-compliance with banking rules. She will note this comment in her working papers. At the time of final review, this comment in the working papers will help her to form an opinion on the entity's compliance with the relevant laws.

During the audit completion stage, the client must prepare the final version of the financial statements. This version must contain all the adjustments relating to correction of misstatements identified by the auditor during the earlier stages of audit. Analytical procedures are commonly performed on these financial statements during the completion stage of audit. They help an auditor to assess the conclusions reached and evaluate the overall presentation of the financial statements.

ISA 520 Analytical Procedures requires the application of analytical procedures, **at the overall review stage** to conclude whether the financial statements as a whole are consistent with the auditors' knowledge of the business. If significant fluctuations are noticed, the auditor would have to make inquiries with the management and obtain sufficient appropriate evidence to support the management's responses.

Example

Julia is the auditor of Best Co. At the final review stage, she can compare significant ratios for the entity with those of other entities in the same industry or with the industry averages. The analytical procedures at the overall review stage may assist the auditor in identifying any unusual or unexpected balances or relationships that were not previously identified, and may indicate a need to obtain additional evidence. While analysing the ratios, Julia finds that the gross profit of the company is 30%, while the gross profit for the industry averages is 32%. Although there is not much difference between the two figures, she needs to keep a watch on the situation in case the gross profit decreases further to the point where the financial statements seem inconsistent with industry norms.

Therefore, the objective of analytical procedures at this stage is to enable the auditor to confirm the availability of sufficient audit evidence to address the inconsistencies identified by the analytical procedures. The use of analytical procedures helps the auditor to determine whether the conclusions reached during the audit are reasonable and whether the final audit report can be prepared.

Analytical procedures include:

- Calculation of important ratios
- Changes in products
- Product mixes
- Trends of sales, purchases, production
- Variances in consumption of materials

2. Sufficiency and appropriateness of audit evidence

An auditor should assess whether the **information gathered** and **audit evidence** obtained during the audit are **sufficient and appropriate** (i.e. of sufficient quantity and necessary quality) to express an audit opinion. For this, they should evaluate the findings and audit evidence obtained by them.

Example

Checking completeness of the recording of the receipt of fees

Richard has been the auditor of Brilliant Academy, a school, for the last ten years. It is his procedure to record the numbers of the receipts book used during the audit period. Receipt books are pre-printed and the receipts are serially pre-numbered.

While reviewing the audit evidence to consider the completeness of the receipt of fees, he checks the continuation of the book number and receipt numbers by checking the current year's and previous year's working papers.

The first receipt number used in the current year is 599 does not follow in sequential order with the last receipt of the previous year, 594, so he checks the reason for this. He discovers that 595 to 598 have been cancelled, so this will give him an assurance that the receipts have been used serially and that all are accounted for.

While reviewing the audit evidence, the auditor should review the working papers of the audit. Reviewing the working papers will enable him to understand whether the audit work has been properly planned, executed and recorded.

The audit senior must ensure that the audit documentation prepared during the completion stage of audit should include the date of review, the extent of review carried out and the name of the person who reviewed the work (requirement of ISA 230, Audit documentation).

The review ensures that:

(a) The financial statements have been prepared using **acceptable accounting policies** and are **applied consistently** and are appropriate for the entity's business

(b) The information included in the financial statements and the results of operations are **compatible** with the auditor's knowledge of the entity's business

(c) **Adequate disclosures** are made wherever appropriate

(d) The financial statements **comply with all statutory and other requirements** relevant to the entity's business

(e) The conclusions drawn on the basis of the audit procedures carried out and the overall review enable the auditors to **form an audit opinion** on the financial statements

3. Review of notes to accounts

The auditor also reviews all the notes forming part of the financial statements to confirm:

- Adherence with the applicable financial reporting framework; and
- Consistency with the financial statements.

4. Checklists

A checklist is a **set of questions which the auditor must answer** in order **to conclude** that all the necessary procedures and items have been checked while conducting the audit. A checklist acts as a reminder when carrying out an audit that all the necessary procedures have been conducted.

Checklists can be in the form of **questions** or in the form of **statements**. If the checklist is in question form, the auditor has to answer "Yes" or "No" next to the question. If the checklist is in the form of statements, the auditor must put their initials next to the statement.

The **advantages** of using an audit checklist are:

- They ensure that the audit is conducted in a **consistent and systematic manner**
- They act as a storehouse of **records for future reference**
- They can be used as a **basis** for conducting future audits

Audit checklists, however, do have their **disadvantages**. They are:

- They **cannot be used as a substitute** for audit planning
- A poorly prepared or standardised checklist which is not tailored to the needs of the client would not add any value
- The checklist may **not be able to identify weaknesses** in controls.

An example of a checklist would be a statutory disclosure checklist. This is used to ensure that all disclosures required by law have been properly made in the financial statements.

5. Other procedures

Other areas which are considered during the overall review include the following:

(a) Subsequent events

After completing the audit work but before expressing an opinion, the auditor should review all the subsequent events i.e. events after the reporting date but before the date of the audit report. The auditor should ensure that all subsequent events have been properly identified and considered for disclosure or inclusion in the financial statements.

Procedure for review of subsequent events

(i) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified

Example

In an entity there should be a procedure for identifying the long-outstanding receivables to identify any bad debts. The auditor should review whether such a procedure for identifying debts is in place in the entity. If yes, they should check whether it has been performed for the year under audit and as a result whether the appropriate bad debts have been identified.

(ii) Inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements

The auditor may make specific inquiries about the following matters.

- Whether new commitments, borrowings or guarantees have been entered into.
- Whether sales or acquisitions of assets have occurred or are planned.
- Whether there have been increases in capital or issue of debt instruments,
- Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
- Whether there have been any developments regarding contingencies.
- Whether any unusual accounting adjustments have been made or are contemplated.

Whether any subsequent events will cast a doubt on the appropriateness of accounting policies used in the financial statements. For example, the insolvency of a major customer may require reassessment of the validity of the going concern assumption.

Whether any events have occurred that are relevant to the measurement of estimates or provisions.

Whether any events have occurred that are relevant to the recoverability of assets.

(iii) Reading minutes of the meetings of the entity's management, (held after the date of the financial statements) and inquiring about matters discussed at any such meetings (for which minutes are not yet available)

Example

In a meeting conducted after the reporting period, Pogo Plc made the decision to close down one of its loss-making divisions, located at Tunica. The decision to close down this division had a material effect on the financial statements as it would affect the decisions of the readers of the statements.

The auditor has to go through the minutes of all meetings to become aware of facts like these and their implications.

(iv) Reading the latest available subsequent interim financial statements

In order to gain information on subsequent events, the auditor may go through the interim financial statements, budgets, cash flow statements and other management reports and compare these with the year end financial statements This is because, if any significant change is noticed in these two statements it may be a result of a subsequent event.

In order to make the procedures as meaningful and effective as possible, they should consult officers and executives charged with governance and ensure that the basis of preparation of the interim financial statements and the year end statements was the same.

Example

Marvin, the auditor of Nucleus Plc, compared the first quarterly financial statements for the period ended March 20X9 with the financial statements for the period ended Dec 20X8 and found a significant decrease in the long term debts. This gives an indication to the auditor that there something happened after the reporting period such as a sale of bonds.

The auditor should enquire about this decrease in the long term debts and accordingly ensure details are disclosed in the financial statements.

(v) Determination of the appropriateness of the adjustments or disclosures to financial statements, on account of the above stated audit procedures

(vi) Obtaining written representation

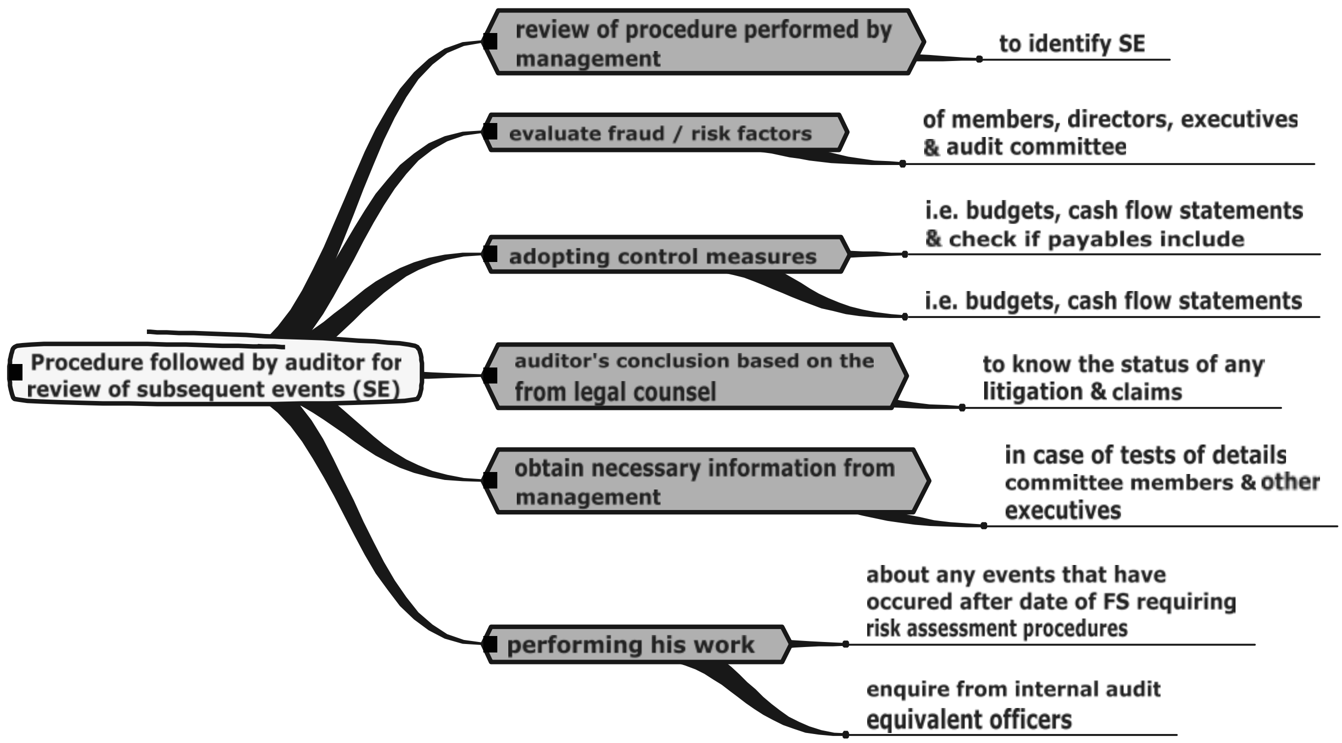
A letter of representation has to be obtained from management that **all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.** This letter should generally be **obtained from the chief executive officer, chief financial officer or officers in equivalent positions**.

The auditor might also ask the management to provide him with letter of representation for any significant information provided by management regarding subsequent events.

Example

Knet is an auditor of Theeta Plc. An earthquake occurred in the area where a warehouse of Theeta is situated. Knet asked management if any destruction of goods or damage to the warehouse occurred due to the earthquake. Management said that there was no material destruction and therefore there is no need to disclose the event in the financial statements. Knet should ask for a letter of representation from management so as to acknowledge the verbal representation.

SUMMARY



(b) Going concern status of the entity

The auditor considers whether management has reviewed the entity's going concern status appropriately before preparing the financial statements. They should check the entity's going concern status and, if any event has taken place which affects the going concern status of the entity, they should check the basis on which the financial statements have been prepared and review the disclosures made by management, the action taken by management to deal with the event etc.

The general audit procedures performed by the auditor to identify the going concern status of the company include the following according to ISA 570.

- Analysing and discussing cash flow, profit and other relevant forecasts with management.
- Analysing and discussing the entity's latest available interim financial statements.
- Reviewing the terms of debentures and loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring of the entity's lawyer regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Considering the entity's plans to deal with unfilled customer orders.
- Reviewing events after period end to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.
- Confirming the existence, terms and adequacy of borrowing facilities.
- Obtaining and reviewing reports of regulatory actions.
- Determining the adequacy of support for any planned disposals of assets.

When analysis of cash flow is a significant factor in considering the future outcome of events or conditions, the auditor considers:

(a) The dependability of the entity's information system for generating the cash flow information.

(b) Whether there is sufficient appropriate supporting evidence for the assumptions underlying the forecast.

Example

During the audit proceedings of Onward Plc, the auditor, Jack, realised that the working capital requirement of the entity had been consistently greater than the amount of cash generated by it in the past six months. This indicated that the company had negative cash flows from its operating activities. Therefore, the cash flow statements will be critical documents that Jack will have to study to investigate the reasons for the negative cash flows and their implications on the business. Jack will have to assess the reliability of Onward Plc's information systems to correctly generate such statements. If they are not reliable, he may disagree with the going concern assumption.

(c) Written representation

After completing the audit procedures the auditor should review the sufficiency and appropriateness of the audit evidence obtained. When, for any matter, it is expected that the matter is material to the financial statements, but sufficient appropriate audit evidence is not available, they should obtain written representation.

The auditor should consider the extent of reliance on the representations given by management. The auditor should check whether other audit evidence, on the matter for which representation is obtained, corroborates the representation. Sometimes, management refuses to sign a written representation. In such cases, the auditor may doubt the reliability of the audit evidence.

This is discussed in detail in Study Guide C5.

(d) Uncorrected misstatements

The auditor's responsibility for uncorrected misstatements will be discussed in the following Learning Outcome.

(e) Appropriateness of the accounting policies and consistency in implementation

The auditor should also consider the appropriateness of the accounting policies and whether they are followed consistently. They should also check if any change has been made in the accounting policy and, if so, whether it has been properly disclosed along with its implications on the profit or loss of the entity.

Example

While auditing Compact Ltd, Lara, an auditor, finds that the method of valuation of inventory has changed during the year. She should review whether appropriate disclosures have been made in the financial statements regarding the change in method of valuation of inventory and its impact on the income statement of the entity.

If these disclosures have been properly made in accordance with the requirements of the accounting standard, Lara will be satisfied with the accounting treatment and may conclude that the entity has complied with the accounting standard.

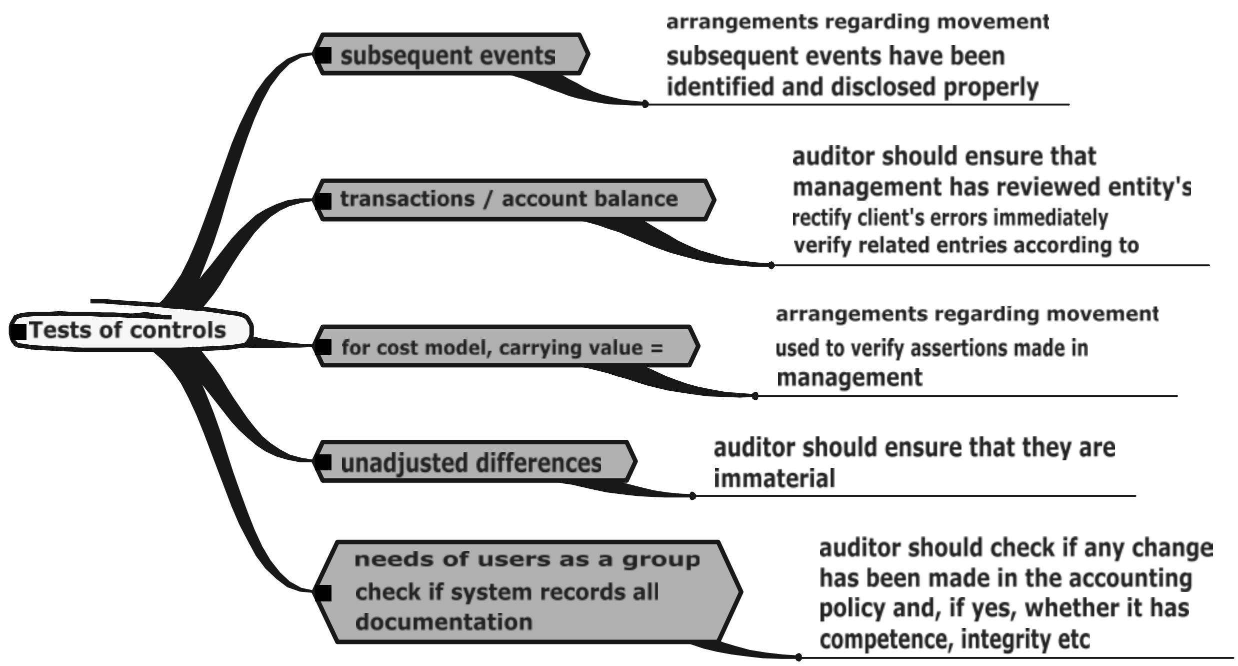
Factors to be considered by the auditor, in order to determine the appropriateness of accounting policies are as follows:

- Whether the accounting policies adopted by the entity enable the financial statements to reflect the substance of the underlying transactions and not merely their legal form.

- Whether the accounting policies adopted by the client are commonly adopted by other industries under which the client falls.

- If the applicable accounting standards are not implemented, would the financial statements still be true and fair.

SUMMARY



6. Audit clearance meeting

The audit conclusion meeting is held by the auditor with management / those charged with governance. The matters discussed in the meeting would relate to the matters discussed in this Learning Outcome and any other matters relating to the audit of the financial statements. Some of the matters discussed are the difficulties faced during the audit, ethical matters which need to be clarified, the sufficiency of the entity's internal controls, etc.

The audit clearance meeting ensures conformity between the financial statements, the auditor's report and any of the other matters discussed.

7. Purpose of overall review of evidence

(a) To form an opinion on the financial statements

As a result of the audit of the financial statements, the auditor should express an opinion on whether the financial statements, in all material respects, give a true and fair view and are presented fairly in accordance with the applicable financial reporting framework. In order to express good professional judgment on the audit work, the auditor should perform a review of the findings of the audit i.e. **appraise the quality of the work performed by their staff on each of the financial statement areas such as sales, purchases, payroll etc.** They should also determine the sufficiency and appropriateness of the audit evidence obtained during the audit. This will help them to form an opinion on the financial statements. If the completion stage of the audit is not performed appropriately, there is a risk of an inappropriate opinion being given on the financial statements.

(b) To consider the need for further audit procedures

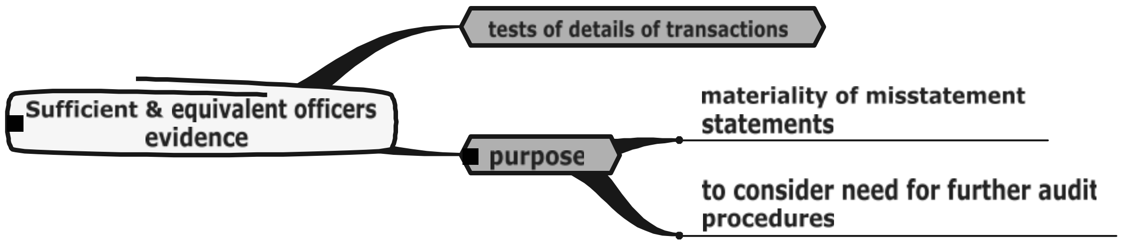
In the final review of the audit evidence obtained during the course of the audit, the auditor should consider the sufficiency and appropriateness of the audit evidence obtained. This will enable him to decide whether, on the basis of the information gathered by him, it is possible to form an opinion.

Example

Crystal Ltd, a diamond jewellery shop, has valued a particular group of items at TZS5 millions, which is material for the company. At the time of the final review, Mark, the auditor, found that there is no inventory sold out of this group, post year end. Therefore, he feels that to obtain sufficient and appropriate audit evidence he should perform further audit procedures. These audit procedures include determining the market price of similar items from competitors.

The need for further audit evidence depends on the sufficiency and appropriateness of the evidence.

SUMMARY



(c) Consistency of financial statements with auditors' knowledge of the business

Analytical procedures **at the overall review stage enable the auditor** to conclude whether the financial statements as a whole are consistent with the auditors' knowledge of the business.

(d) Consistency of financial statements with information appearing in audited financial statements

During the completion stage of audit, the audit senior confirms that the financial statements are consistent with the information appearing in the audited financial statements. Thus, this will help to confirm the genuineness of the financial statements.

(e) Coverage of audit in accordance with audit planning memorandum

During the completion of the audit, the audit senior reviews the work carried out at the earlier stages of audit and confirms that the audit has been conducted in accordance with the audit plan memorandum. This in turn will also ensure compliance of the audit in accordance with the ISAs, satisfactory completion of audit procedures, meeting with the audit objectives and the availability of working papers in line with the audit opinion.

(f) Compliance with ISA 220

The overall review of audit evidence at the completion stage of audit ensures that the basic quality requirement of ISA 220, **Quality Control for an Audit of Financial Statements** (which is a review of all audit work) is satisfied.

Test Yourself 1

Your firm has been the auditor of City Pride, a chain of restaurants, for many years. All the audit work has been completed for City Pride for the year ended 31 December 20X9.

The company intends to invest a substantial amount in opening a new restaurant during the next year and it has been negotiating with both banks and estate agents in relation to leases or purchase of property.

Required:

Describe the procedures that should be applied during the subsequent events review at City Pride

2. Explain and evaluate the significance of uncorrected misstatements. [Learning Outcome c]

2.1 Meaning

Definition

Misstatement: a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Where the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

Uncorrected misstatements: the aggregate of the errors that the auditor has accumulated during the audit and that have not been corrected.

ISA 450

It is expected that management should correct the errors identified by the auditor. However, when finalising the accounts these errors are not corrected on account of materiality. Those **errors** which are **not corrected by the entity** are called **uncorrected misstatements**.

Generally, a list of the unadjusted audit differences is attached to the written representation letter. However, this does not relieve the auditor of their responsibility for the audit.

The auditor would have to evaluate the effect on the financial statements of:

- Identified misstatements on the audit; and
- Uncorrected misstatements, **both individually as well as in aggregate.**

2.2 Significance of uncorrected misstatements

1. Additional audit procedures

Under the following cases, the auditor may extend their audit procedures to reduce the risk or ask management to adjust the financial statements.

- When an auditor concludes that the aggregate of uncorrected misstatements is material.
- When the aggregate of the uncorrected misstatements is not material but approaches materiality, and could exceed the material level when aggregated with the undetected differences.
- When the auditor wants to determine the existence of further misstatements.

If management refuses to adjust the financial statements and the auditor, as a result of extended procedures, concludes that the unadjusted difference is material, they should consider modifying the audit report. The auditor's decision on whether or not to modify the audit report is affected by the impact of the uncorrected misstatements on the financial statements.

2. Communication of uncorrected misstatements

ISA 450 requires that the auditor should inform those charged with governance of the uncorrected misstatements observed during the audit, along with their effects, either individually or in aggregate, on the opinion in the audit report. The auditor's communication shall identify material uncorrected misstatements individually. The potential implication of the uncorrected misstatements on the auditor's report also needs to be communicated. Furthermore, the auditor shall request that uncorrected misstatements be corrected.

The auditor shall also inform those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

3. Written Representation

The auditor shall obtain a written representation (containing a summary of uncorrected misstatements) from management or those charged with governance stating that they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole.

2.3 Need for evaluating the effect of uncorrected misstatements

Obtaining written representation does not relieve the auditor from their responsibility of obtaining additional evidence. The written representation needs to be corroborated. For this, the auditor should, at the time of the final review, assess whether the aggregate of the uncorrected misstatements (unadjusted differences) that have been identified during the audit is material (both individually as well as in aggregate). If it is material, they should either perform additional procedures to reduce the audit risk or ask management to adjust the differences.

Example

An auditor of Classic Plc identified the following misstatements:

- an amount unlikely to be recovered from a customer of TZS50,000 (total receivables: TZS 4 millions)
- an overstatement of sales by TZS 100,000 (total sales: TZS 50 millions)
- an overstatement of inventory by TZS 20,000 (total inventory: TZS 1.5 millions)

In this case, as management considers these misstatements immaterial, (individually as well as collectively, TZS 170,000 i.e. TZS 50,000 + TZS 100,000 + TZS 20,000) they are not corrected.

Here, the auditor should obtain a representation from management that "it believes that the effect of the uncorrected financial statement misstatements aggregated by the auditor are immaterial both collectively and individually." However, the auditor needs to evaluate the effect of the uncorrected misstatements before accepting the written representation as sufficient and appropriate evidence.

2.4 Evaluating the Effect of Uncorrected Misstatements

An auditor needs to consider materiality throughout the audit process:

- while planning;
- performing audit procedures;
- evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements; and
- while giving an audit report.

1. Reassessment of materiality

The effect of uncorrected misstatements are to be evaluated after the auditor reassesses the materiality levels set in accordance with ISA 320, at the planning stage.

(a) At the planning stage of the audit, the financial statements are generally not complete and accurate. Therefore the materiality (including performance materiality) is determined by the auditor on the basis of the provisional financial statements prepared by management. However, the auditor must evaluate the effect of uncorrected misstatements after reassessing materiality with the entity's actual financial statements.

(b) Materiality needs to be reassessed even during the course of audit if the auditor becomes aware of information which would have set the materiality at different amounts initially. For example, if the auditor's tests of control indicate significant weaknesses in some major operations of the entity, the materiality set at the planning stage would have to be reassessed.

(c) If materiality (including performance materiality) is reassessed at lower amounts, the sufficiency and appropriateness of audit evidence would depend upon not just the nature, timing and extent of audit procedures but also the extent of further audit procedures.

2. Assessment of materiality of uncorrected misstatements

To decide whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework, the auditor should assess whether the uncorrected misstatements (individually or in aggregate) that have been identified during the audit are material. For this, the following factors need to be considered:

(a) Size and nature of the misstatements

The size and nature of the misstatements need to be considered, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence. This implies that

Each individual misstatement should be evaluated for its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.

Example

Continuing the example of Classic Plc

The misstatement relating to receivables needs to be assessed as to its effect on the period end balance of the accounts receivables account (i.e. the materiality of TZS50,000 in relation to TZS4 millions). Furthermore, the misstatement relating to inventory needs to be assessed as to its effect on the period end balance of inventory (i.e. the materiality of TZS20,000 in relation to TZS1.5 millions).

(b) Offsetting of individual misstatements

An individual misstatement, which is judged to be material, is unlikely to be offset by other misstatements.

For example, if the amount of overstatement of sales is material (as in the example of Classic) the overstatement cannot be offset by an equivalent amount of expenses. However, the overstatement of the revenue of one customer can be offset with an understatement of revenue from another customer.

Therefore it may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is to be considered before concluding that offsetting even immaterial misstatements is appropriate.

(c) Qualitative nature of misstatements

While considering the potential impact of the uncorrected misstatements, the auditor should not only consider the amount but also the qualitative nature of the uncorrected misstatements. Sometimes, an unadjusted difference is immaterial considering the amount but material when the qualitative aspect is considered.

Example

The unaudited financial statements of Champion Plc show a profit of TZS0.5 million and a turnover of TZS500 million. During the course of the audit, a misstatement (overstatement of sales) of TZS10 million is noticed by the auditor. Management has not adjusted the difference in the financial statements by saying that, considering the turnover of the company, the figure is immaterial.

During their review, the auditor finds that, although the difference is immaterial by amount, if the qualitative aspect is considered, it is material. If it is adjusted, instead of showing a profit of TZS0.5 million, the financial statements would show a loss of TZS0.95 million.

In this case, the unadjusted difference is material when the qualitative aspect is considered and should be adjusted to show a true and fair view.

(d) Instances where misstatements are material

Following are some circumstances under which misstatements are considered material (either individually or when considered together with other misstatements accumulated during the audit) even if they are lower than materiality level for the financial statements as a whole:

(i) Affect compliance with regulatory requirements. For example the amount of share capital must be accurately stated i.e. if the issued share capital of TZS500,000 is misstated as TZS4,99,000.

(ii) Affect ratios used to evaluate the entity's financial position. For example gross profit ratio (GP ratio) is an important ratio to evaluate the financial position of an entity. Therefore a misstatement of revenue which is not material but affects the GP ratio would be considered material.

(iii) Affect segment information presented in the financial statements.

(iv) Relate to items involving particular parties such as members of the entity's management.

(e) Misstatements caused by fraud

According to ISA 240, the implication of a misstatement that is the result of fraud needs to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements.

3. Misstatements related to prior periods

The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. There are different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements. Using the same evaluation approach provides consistency from period to period.

Test Yourself 2

On 31 December 20X9, an inventory count was undertaken at the factory and warehouse of Rex Motors, a car manufacturer. The auditors were informed that inventory worth TZS0.95 million was in transit between the factory and the warehouse. Since the inventory was not available at either of the locations, the auditors verified the related purchase invoice and the inventory transfer document (between the factory and the warehouse).

Four days after the inventory verification, when the auditors visited the warehouse, they were informed that the inventory which was in transit on 31 December 20X9 had already been sold. The auditors then verified the lorry driver's expense report (for the transport of the inventory in transit) and the sales invoice. They also met the purchase manager, the accountant and the driver who verified the genuineness of the transaction.

On a later date, it came to light that the transaction for the purchase of inventory, transfer of inventory, transport expenses and sale had been manipulated. This happened because the purchase manager, the accountant and the truck driver had worked in tandem.

Required:

The financial statements included misstatements on account of the overvaluation of the inventory. Explain how the auditors would tackle the misstatements in the financial statements.

Audit documentation should contain sufficient information to enable an experienced auditor, who has had no previous connection with the audit, to ascertain from the audit documentation the evidence that supports the auditors' conclusions.

Documentation should include, at a minimum, a record of:

- The planning and preparation of audit objectives
- The audit programme
- The audit steps performed and audit evidence gathered
- Conclusions about the evidence gathered
- Any report issued as a result of the audit work

Answers to Test Yourself

Answer to TY 1

(a) Procedures that should be applied during the subsequent events review at City Pride

- The auditor should read the minutes of the board and various committee meetings to find out about the progress of the deal and also to identify other subsequent events, if any.
- The auditor should verify the procedure followed by management to identify and consider the subsequent events which have a material effect on the financial statements.
- The auditor should check any loan taken, asset mortgaged etc. by the entity.
- He should ask the management about the progress of the restaurant deal and also about the other events.
- The auditors should enquire into the possibility of any new share issue or loan taken to fund the expansion which may require disclosure. They may also enquire into any significant changes in the property market that might (if the supermarket properties are carried at valuation) require either disclosure or adjustment in the accounts.

Answer to TY 2

Misstatements that the auditor accumulated during the audit and that have not been corrected are known as u**ncorrected misstatements. From the scenario it is clear that the financial statements contain** u**ncorrected misstatements relating to overvaluation of inventory.** The fraud occurred because of **intentional misrepresentation by the purchase manager, the accountant and the** truck driver.

The fraud resulted in:

- **Manipulation of records** / documents: i.e. the inventory transfer document, sale document and purchase document

- **Recording of transactions without substance,** i.e. recording purchases, inventory transfer and sales as on 31 December 20X9 when the transactions did not actually take place

The auditor needs to consider materiality throughout the audit process i.e. while planning, performing audit procedures, evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and also while giving an audit report. On identification of uncorrected misstatements, the auditor may extend their audit procedures to reduce the risk of material misstatements. Alternatively, the auditor may ask management to adjust the financial statements:

- When they conclude that the aggregate of uncorrected misstatements is material; or

- When the aggregate of the uncorrected misstatements is not material but approaches materiality, and could exceed the material level when aggregated with other undetected differences.

From the above it is clear that the auditors cannot ignore the misstatements in the FS unless they are not material. However, according to ISA 450, when misstatements are caused by fraud the result of fraud needs to be considered in relation to other aspects of the audit (even if the size of the misstatement is not material in relation to the financial statements). Thus materiality is not an appropriate criterion to deal with fraud. Instead, the auditor must deal with fraud in accordance with the provisions of ISA 240.

It is **not the primary responsibility** of the **external auditor** to prevent or detect fraud or error in the financial statements. However, in the course of conducting the audit, if they come across a situation where they have reason to believe that fraud or error might exist to a material extent, they should modify their audit programme or perform additional procedures to confirm or dispel their suspicion.

Quick Quiz

1. State the purpose for review of the evidence obtained during audit.

2. What is meant by uncorrected misstatements?

3. State what actions the auditor should take in the following circumstances:

   (a) When an auditor concludes that the aggregate of the uncorrected misstatements is material but management refuses to adjust the financial statements.

   (b) When an auditor concludes that the aggregate of the uncorrected misstatements is immaterial.

Answers to Quick Quiz

1. Overall review of the audit evidence obtained during the audit is carried out to:

   - Form an opinion on the financial statements
   - Consider the need for further audit procedures

2. Uncorrected misstatements are the aggregate of the errors that an auditor discovers and which have not been corrected or adjusted in the financial statements.

3.

   (a) The auditor should consider modifying the audit report on the basis of disagreement with accounting records and the auditor.

   (b) The auditor should communicate the matter to those charged with governance.

Self-Examination Question

Question 1

You are the newly appointed audit manager of Pearce Co. Your audit team has completed the audit work according to the audit plan. You are in the process of performing an overall review of the financial statements and the audit evidence gathered during the audit.

Pearce Co is in the fashion industry and has operated for the last five years. It has opened a branch in the same city. Sales depend on the trends in the market. Therefore inventory is maintained at a low level. Sales are made directly to customers and purchases are made from five major suppliers. All sales are cash sales and purchases are made on credit.

At the year end, all inventory items are valued at cost even if they do not appear to be selling well. They should be valued at the lower of cost and net realisable value.

After the year end, the branch was closed down since it was making losses continuously.

You have communicated the errors discovered during the audit to management. They are uncorrected by management on account of immateriality to the financial statements.

Required:

State why it is necessary to conduct an overall review of the audit evidence obtained and financial statements as a whole and how this is to be performed.

Answer to Self-Examination Question

Answer to SEQ 1

First, an overall review of the financial statements is performed to check whether they have been prepared in accordance with the financial reporting framework etc.

A review of audit evidence is then carried out. This will enable the auditor to decide the extent to which the evidence can be relied on for forming an opinion on the financial statements. All the audit evidence gathered during the audit of Pearce Ltd will be reviewed.

After such a review, if it is concluded that the audit evidence is not sufficient in quantity and of appropriate quality, further audit procedures will have to be performed.

It is stated that some of the items of inventory seem obsolete. Investigations should be made as to whether any sales are made after the year end to confirm the bases of valuation. If no sales are made after the year end there might still be insufficient appropriate audit evidence.

Enquiries should be made in the market, from the competitors etc. about the market price of such items to ensure the assertion correctness and valuation of inventory.

If there are uncorrected misstatements, a representation should be obtained from management that uncorrected misstatements are not material. However, this will not relieve the auditor from responsibility for considering the materiality of the uncorrected misstatements to the financial statements.

If the auditor concludes that they are material, either individually or in aggregate, to the financial statements, management will be asked to correct them. If management refuses, and further audit procedures cannot reduce the risk of material misstatement, the auditor may consider modifying the audit report.

If the auditor finds the uncorrected misstatements to be immaterial, the misstatements should be communicated to those charged with governance.

SECTION D

PROFESSIONAL ETHICS, PUBLIC INTEREST, FUNDAMENTAL OBJECTIVES, THREATS AND SAFEGUARDS TO INDEPENDENCE

D1

STUDY GUIDE D1: ETHICAL PRINCIPLES

Get Through Intro

The codes of professional ethics that accountants are expected to abide by today are better documented and more stringently enforced than at any time in the past. Any deviation from the required standard brings with it the risk of disciplinary action being taken against the accountant by his or her regulatory body.

At some point in your career as an accountant you will find yourself in a position where your actions may inadvertently break one of these ethical principles. Therefore it is important that you understand exactly what is documented in the ethical codes and why following them is so important.

Whenever one has a conflict of interest one is torn between one side or party and another. For professional accountants conflicts of interest are a real impediment to being objective and more importantly are seen as such by third parties. Conflicts of interest therefore need to be avoided or subject to a safeguard and the position must be totally transparent.

This Study Guide will provide you with an understanding of the contents of these codes of ethics, how they are enforced and finally how they should be applied during the course of your everyday work. This Study Guide also gives the knowledge about ethical threats and safeguards, ethical dilemmas and ethical conflicts.

Learning Outcomes

a) Identify and explain in context the fundamental ethical principles.
b) Identify and explain in context the ethical threats and safeguards.
c) Identify and explain ethical issues based on the IFAC code.
d) Select suitable actions to deal with ethical dilemmas.
e) Identify and explain in context ethical conflicts as an employee and as a practising accountant.

1. Identify and explain in context the fundamental ethical principles.
[Learning Outcome a]

Like the members of many other professional bodies, accountants have a set of multiple ethical responsibilities. They are required to act ethically towards and in the best interests of the following three groups:

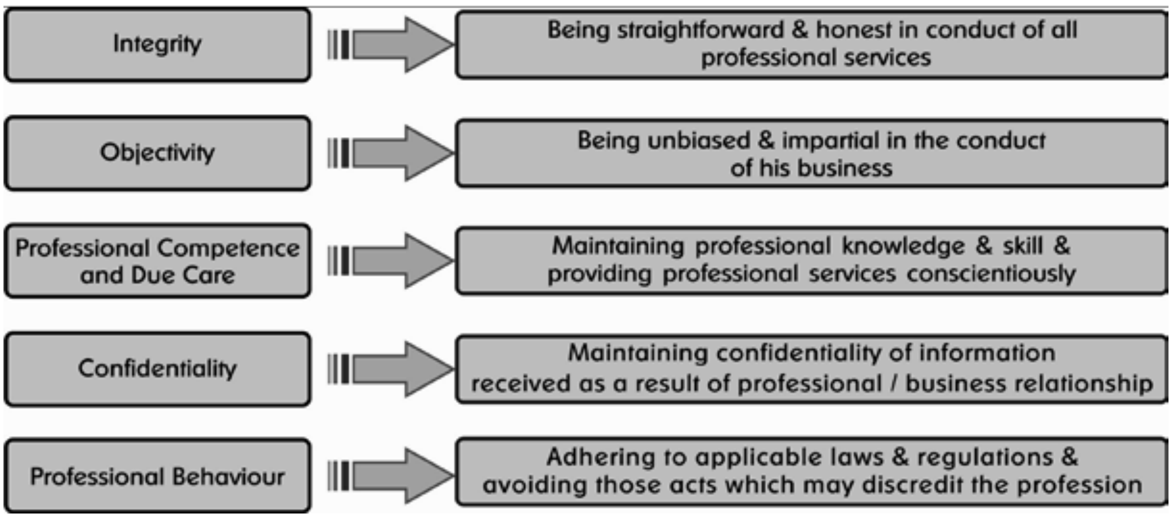
Their clients or employers;
The accounting profession and
The public at a large.

Therefore accounting body such as the International Federation of Accountants ("IFAC") publish and issue sets of ethical standards that they expect their members to live by. The IFAC has an Ethics Standards Board for Accountants to "develop and issue, under its own authority, high quality ethical standards and other pronouncements for professional accountants for use around the world".

Furthermore, according to ISAE 3000, t**he practitioner should comply with the requirements of Parts A and B of the IFAC Code of Ethics for Professional Accountants (the Code).**

These standards identify and outline 5 main principles that all members must comply with at all times.

Diagram 1: Fundamental principles of professional code of ethics



1. Integrity

This principle requires members to be "straightforward and honest in all professional and business relationships". In addition members must also not be associated with or "sign off" on any fraudulent or inaccurate financial reports and / or statements.

For this, the accountant must ensure that the financial statements and assurances provided:

(a) Are carefully prepared
(b) Do not contain information which is false or deceptive
(c) Contain information which is relevant
(d) Exclude information which is vague i.e. they must not misguide the users

In short, **integrity means acting with honesty and being fair and truthful** at all times. Integrity also means not accepting positions or situations where your integrity may be in doubt due to the behaviour of others.

It also means sticking up for what you believe in.

Example

The auditors of a pharmaceutical company noticed that out of 50% of the vouchers for development expenses, at least 40% were recorded incorrectly as revenue expenditure instead of capital expenditure (in contravention to IAS 38). The auditor therefore decided to verify all the vouchers for development expenses to ensure that all the development expenses were properly reflected in the financial statements as capital expenses.

In moral terms, **professional accountants should always be scrupulously honest**, particularly when it comes to compliance with laws.

2. Objectivity

A **professional accountant should be objective or unbiased**. For all professional decisions which are to be taken, accountants must ensure that there is no conflict of interest. Therefore, all of their findings and judgments should be based solely upon sound rationale and research.

In order to ensure objectivity, a professional accountant:

(a) Should be unbiased and impartial. This applies to accounting and audit assignments;
(b) Must avoid any relationship which will affect their professional judgement;
(c) Must not accept or offer gifts or hospitality which will affect their professional judgement.

Example

The finance manager of a company is informed by the board that he will be paid an additional 5% of his salary as a bonus, provided the financial statements reveal excess revenue so that the net profits of the company are in line with the budgeted amounts.

This is expected to ensure that the shareholders continue to remain satisfied with the company. Here, the finance manager may face a conflict of interest since he may be tempted to employ creative accounting practices in the area of revenue recognition. However, accountants are expected to act with objectivity and hence, the finance manager should refuse to do as instructed.

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3. Professional Competence and Due Care

Professional accountants must ensure they have the necessary professional skill and knowledge to handle the tasks that are assigned to them by their client. They must continuously update themselves with the latest developments with respect to knowledge and practices in the profession.

Accountant must **work meticulously and ensure that the services they provide are in accordance with the professional standards set by the relevant professional body.**

In order to ensure that they act in accordance with professional competence and due care, accountants must:

(a) Keep **their professional knowledge and skills** up-to-date

(b) **Ensure that clients or employers** are **provided** with professional services based on the **latest developments in the profession**, both legislative and technical

(c) **Provide professional services by acting conscientiously** and in accordance with applicable technical and professional standards

(d) Be **professionally competent** and make sound judgements while applying their professional knowledge and skills

(e) Ensure all their subordinates and staff have the necessary training and supervision to competently perform the tasks assigned to them

Example

For instance a tax accountant who specialises in preparing and filing individual tax returns must ensure that:

They are up-to-date on all the latest relevant tax legislations;
They devote sufficient time and attention to each tax return they work on; and
Their subordinates are up-to date and trained in applying the latest tax legislation, and are appropriately applying them when working on client returns

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4. Confidentiality

This principle requires that accountants never disclose any confidential information of their clients or organisations to any other third party unless there is a legal duty to do so or a legal right to do so. It is important to note here that an accountant is still bound by this same confidentiality principle even after they have left the employ of an organisation or are longer engaged by a client.

Confidentiality comprises the following

(a) **Non-disclosure of information**. However **information can be disclosed to a third party if the accountant has the specific authority to do so (for example a client's permission)**, or the accountant **has a legal duty or professional right** to do so.
(b) **Non-utilisation of information** to the advantage of the accountant, e.g. the auditor sells shares in the client's company after receiving confidential information about the company which will reduce the price of the company's shares.
(c) Confidentiality **of information received from a prospective client or employer**
(d) Confidentiality of **information received within the firm / organisation** where the accountant is employed from a prospective client or employer.
(e) **Maintaining confidentiality of information within the firm or client organisation**

Professional accountants **should ensure that staff and associates** respect this duty of confidentiality also.

Example

Elisante Kimaro is the auditor of a public listed company. Whilst auditing the organisation's financial statements he realises that the business will post better than expected results. This will probably cause the price of the stock to rise. However Elisante cannot pass this information on to any other third party at any time until the financial statements are published.

5. Professional behaviour

The IFAC requires that its members "should comply with relevant laws and regulations and should avoid any action that discredits the profession." This organisation also requires that their members act ethically when marketing and promoting their services. Members should not engage in any false advertising and should not slander the work of any other accountant.

Example

John is a partner with a mid-sized accounting firm. He has been approached by AMBY organisation, a large manufacturer of tyres to discuss whether he would consider taking on some audit assignments for the business.

John has heard through unsubstantiated rumours that AMBY are unhappy with their current auditor. John is eager to take on AMBY as a client but has had no experience auditing manufacturing firms.

During his discussions with AMBY, John cannot:

Claim to have any specialised expertise in auditing manufacturing organisations and
Cannot slander or unduly criticise AMBY's current auditors.

Test Yourself 1

Watson & Ruth is an audit firm. Shan, a junior audit clerk employed with the firm, has been asked to complete a complicated reconciliation (for a client) before going on examination leave. He has approached the audit partner, Mr. Watson, for help since the reconciliation is complicated and the deadline also seems unrealistic. He feels that he will require guidance to complete the complicated task correctly. Also, even if he completes the task on time, his work will not be of the required standard. The audit partner cannot help him since the audit senior is on leave and Watson has no time to supervise Shan's work and tells Shan to do his best.

Required:

Has the firm acted in accordance with the fundamental principles?

2. Identify and explain in context the ethical threats and safeguards.
Identify and explain ethical issues based on the IFAC code.
Select suitable actions to deal with ethical dilemmas.
[Learning Outcomes b, c and d]

2.1 Ethical threats to independence

Almost all accountants at some point in their career will find themselves in situations where they are in danger of violating one or more of these principles.

Therefore IFAC have developed a **conceptual framework** that will **help their members identify, evaluate and take mitigating action against all risks** that threaten compliance to these principles apart from those that are "clearly insignificant".

Documenting an exhaustive list of all situations that may cause non-compliance as well as the appropriate mitigating action is a next to impossible task (hence the need for having a conceptual framework in place). However there are five main categories of threats that could potentially cause an accountant to violate one or more of these principles.

Diagram 2: Threats to independence

1. Self-interest threat

This occurs when the accountant may be biased on account of **financial, personal or any other interest** in the client.

(a) Financial interest can occur in the following situations:

(i) Ownership in the client's equities i.e. ownership of shares in the client company.

(ii) Ownership of client's financial instruments, such as debentures or bills of exchange.

(iii) Ownership in a joint venture of the client

(iv) Administrator of any trust in which the **auditor has a financial interest** e.g. the trustee of a company acting as that company's auditor. According to the code of ethics, the assurance firm, members of the audit team (including the firm's partners) and the assurance team member's immediate family must not have a financial interest in the client company.

(v) Overdue fees i.e. The auditor will want the company to survive so that the fees do not become a bad debt.
This could lead to a more favourable audit report than justified. No further work should be done until overdue fees are settled – otherwise the situation is made worse.

(vi) Loans to or from a client. i.e. loans to audit staff members at normal terms are fine provided that it is part of the client's normal business to make loans. For example if the client were a bank. However, if the audit team were offered loans on better terms than normal, a self-interest threat would be a danger. If loans were not part of the client's normal business, they should not be accepted. Auditors would not be expected to provide loans to clients.

(b) The auditor has a **personal interest** in the client company. For example, if the auditor has a close relative who is **employed in a position of power in the client company**, such as the director. A situation such as this would involve the auditor maintaining a professional relationship together with a close personal relationship.

(c) Probable employment with client

This occurs when the **auditor expects to be employed by the client.** This would pose a threat to the auditor's independence. In this situation, the auditor would act in the client's interest rather than that of the public.

Example

David is an audit senior appointed by DPC, an audit firm, to conduct the audit of Mufindi Plc. David has come to know that Mufindi is looking for a financial advisor.

David has approached the finance director to put forward his name for the vacant post. In order to create a good impression, he did not ask the accounts manager for any explanation of contingent liabilities.

(d) Excessive dependence on client's fees

In situations where the fees received from a particular client form a significant portion of the partners' income, there would be a threat arising from the auditor's self-interest.
For example, an audit firm which receives 40% of its total income from the audit of one client faces this threat.

To mitigate this threat, IFAC code of ethics has limited the maximum fees to be received from any one client to 10% of total fees for a listed or other public interest organisation and 15% for a privately held organisation. In Tanzania however, NBAA code of ethics bylaws, 2013 has capped this threshold at 30%.

It should be appreciated that when the IFAC code is in conflict with the local (NBAA) code of ethics then the local standard prevails over the international one.

(e) Apprehension about losing the assignment

There arises a threat to the independence of an accountant if there is an apprehension that the assignment may be lost.

For example, when an auditor is worried about losing the audit assignment if they give a qualified opinion about the true and fair nature of the financial statements of an assurance client, the auditor is said to face a threat to their self-interest.

Tip

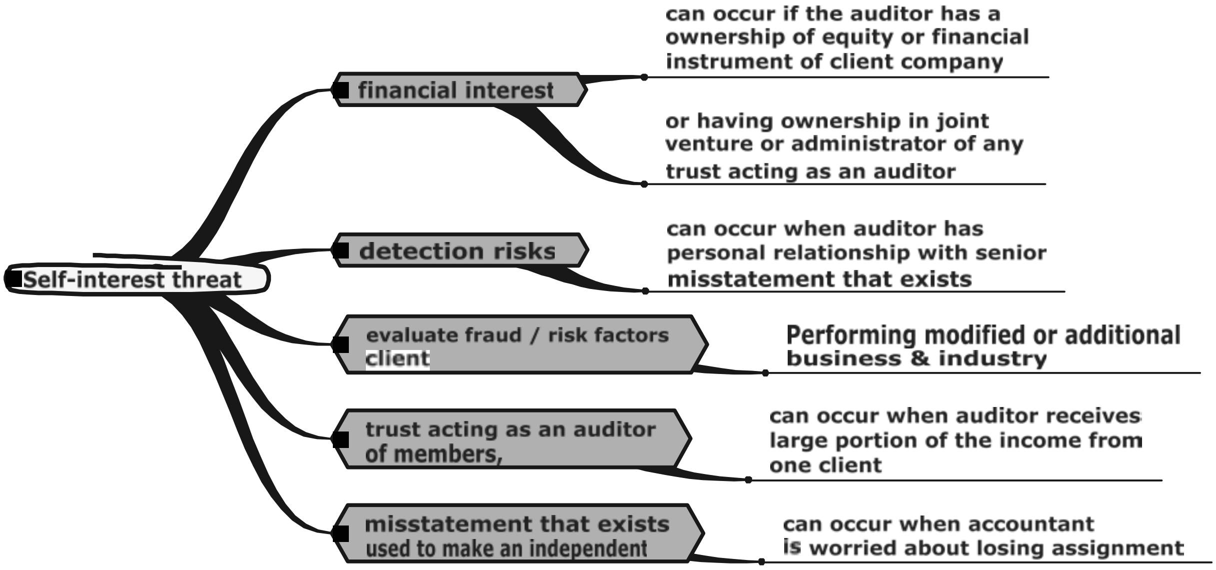
Lowballing refers to the practice of quoting fees at rates which are less than the 'market rates' charged by the predecessor firm. Such a practice causes self-interest threat as the auditor may sacrifice the quality of audit to retain clients in the hope of gaining other lucrative work.

Example

John Kaberege is the auditor of Kibaha Limited. In addition to his audit fee, John always receives free tickets to top sporting events from the organisation at the end of the audit.

The risk with this situation is that this might influence John into delivering a more favourable audit report than he would have if he did not receive any inducements at all.

SUMMARY



2. Self-review threat

Self-review threats arise when an accountant has to review and revaluate their previous own work and judgments. The risk that exists here is the temptation for an accountant to "cover up" any mistakes they may have made. Besides, it is difficult and dangerous to try to spot your own mistakes. Such an assignment would make it difficult for the auditor to maintain objectivity.

Self-review takes place in the following cases:

(a) The **auditor** is asked to **review the results of an earlier assignment carried out by the auditor** (in the capacity of either an accountant or consultant).

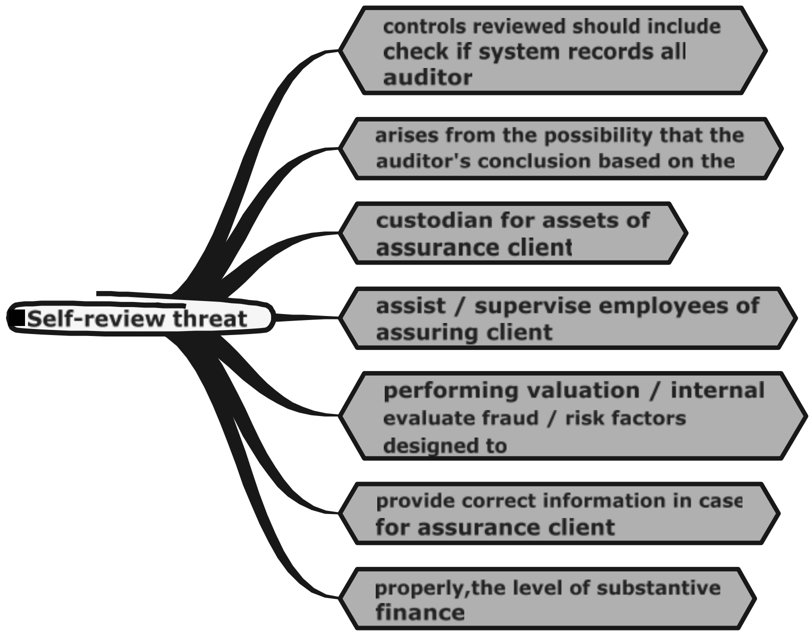
Example

Masaki LLP, an audit firm, is the ERP consultant of Kinondoni Technologies. From 20X4 to 20X5. John, an employee of Masaki LLP was involved in setting up the ERP systems in Kinondoni Technologies. In January 20Y1, Masaki LLP has been appointed as the internal auditors of Kinondoni Technologies. Masaki proposes to assign the internal audit task to John.

In this situation, John would be required to review the controls in the ERP which were set up by him. This is a self-review threat to the auditor's independence because he could face a conflict of interest.

(b) An assurance team member was formerly an employee of the client company.
(c) The auditor is involved in reporting on financial systems which they had previously designed or implemented.
(d) The auditor audits accounts prepared by a member of their assurance team.
(e) A member of the assurance team has been a director in the client's organisation.
(f) The auditor has ownership of an assurance client's assets.
(g) The auditor assists or supervises employees of the assurance client as they perform their normal activities.
(h) The auditor of financial statements performs a valuation service and the valuation is incorporated in the financial statements.
(i) The auditor of financial statements is **involved in providing internal audit services** for the same client.
(j) The auditor **recruits senior management for an assurance client**. Such appointments could pose a threat of future self-interest. However, the auditor could provide more general services such as vetting the resumes of prospective clients and short-listing candidates for interview (using criteria specified by the client).
(k) The auditor **provides corporate financial services, advice or assistance** to assurance clients e.g. underwriting or promoting client's shares.

SUMMARY



3. Advocacy threat

Advocacy threats occur "when a professional accountant promotes a position or opinion to the point that subsequent objectivity may be compromised." Here, the risk is that when the true financial position or performance of an organisation is publicly known it will contradict previous statements that the accountant has made publicly.

Advocacy threat can occur in the following situations:

(a) An assurance team member **acts as an advocate** in a client's legal proceedings.

(b) An audit team member is involved in corporate financial services such as **dealing in financial securities / shares of a client or underwriting / selling a client's shares**.

(c) The position of **company secretary can lead to an advocacy threat**. This is because the duties of the company secretary include maintaining records and registers, ensuring compliance with regulations and advising on matters of corporate governance.

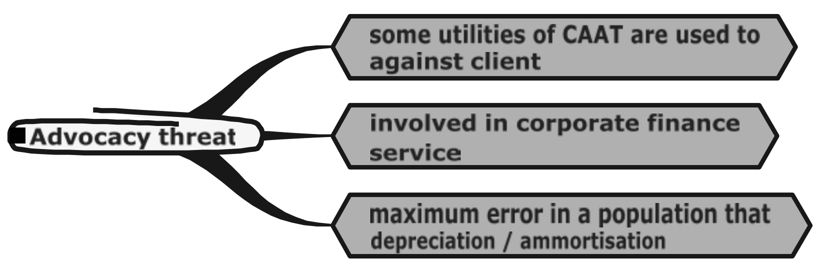
Example

Jerry Ringer is a qualified Chartered Accountant who, in addition to running his own practice, writes a weekly column in a business magazine. In one of his articles Jerry labelled the manufacturing processes used by a local organisation, Teston Inc as being "highly innovative and the way of the future."

Subsequently Jerry became Teston's statutory auditor. However during his audit work, Jerry discovered that these practices were actually not efficient or effective and had caused the organisation to go into a loss.

Therefore if Jerry reports a "true and fair" picture of Teston's financial performance he will be publicly contradicting his previous article and position.

SUMMARY



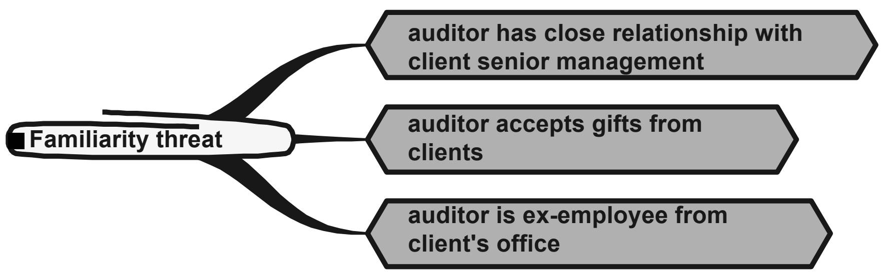
4. Familiarity threat

This is the **threat which arises when an auditor has a close personal relationship with a client, its directors, officers or employees**. Over-familiarity with a client could lead to the auditor becoming sympathetic to the client and therefore being more likely to accept the client's judgement. The attitude of professional scepticism is likely to disappear.

Familiarity threats can occur in the following situations:

(a) An assurance team member has a **longstanding business relationship with the client,** for example, if the audit partner has dealt with the client for many years. The code of ethics states that lead partners should be changed at least every five years to mitigate a familiarity threat.
(b) An assurance team member is a **close friend of the assurance client / director.**
(c) An assurance team member is **a close family member of the director / officer** (who has a significant influence on the audit) **of the assurance client.**
(d) A **former partner / senior employee** of the **audit firm is now a director for the assurance client**.
(e) An assurance team member is a close **relative of a person in a position of power** in the assurance client's organisation.

SUMMARY



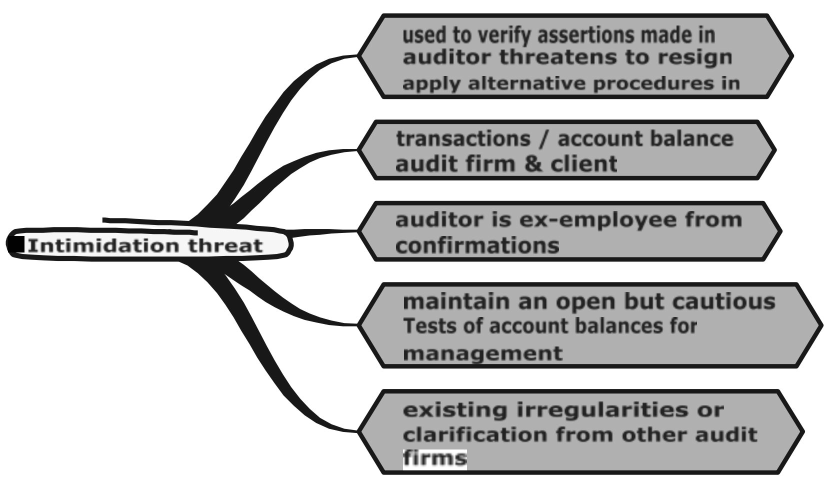
5. Intimidation threat

Intimidation threats occur "when a professional accountant may be deterred from acting objectively by threats, actual or perceived." It can also occur if an auditor believes they are being forced by the assurance client or by another interested party to give an untrue opinion.

Intimidation threat can occur in the following situations:

(a) Threat of **removal of auditor** from services due to **disagreement regarding the application of accounting standards.**
(b) Threat of **reduction in fees** if **scope of audit is not reduced.**
(c) Threat of intimidation by **litigation authorities** in situations involving litigation between the auditor or audit firm and the assurance client.
(d) Physical intimidation
(e) Threat by auditors seeking **a second opinion** from other audit firms on any matter in which they require clarification.

SUMMARY

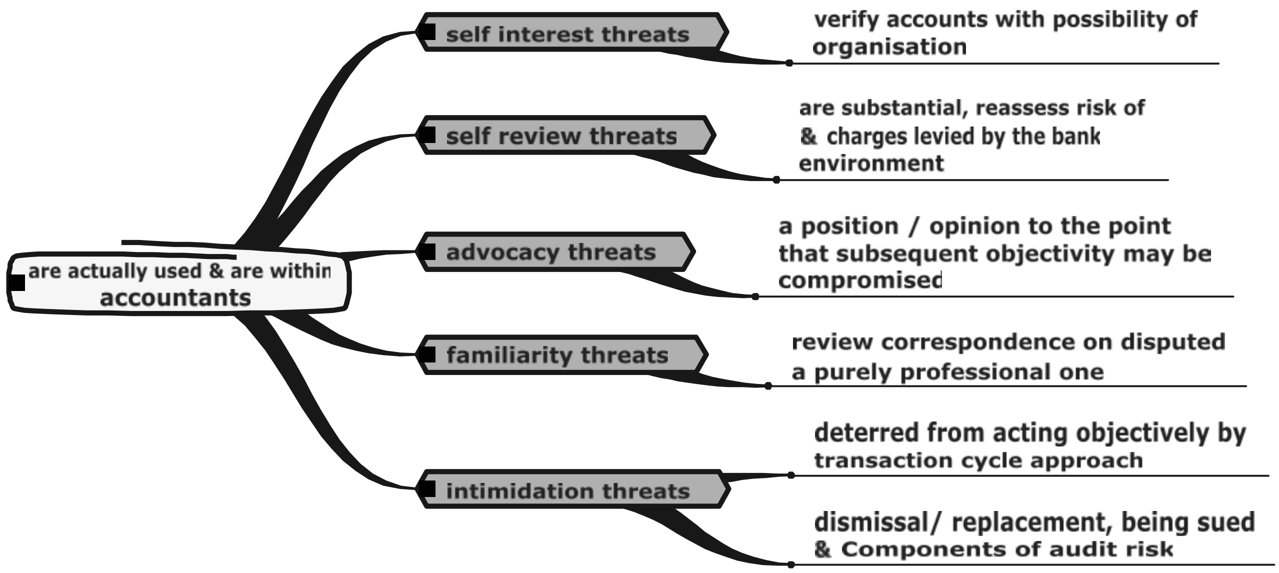


Example

Joseph Daltrey is auditing the books of Senteron Inc, an organisation that owns a large chain of retail stores. Senteron is a very important client for the firm Joseph works for. Management at Senteron wants the provision for bad debts to stand at 1%, a figure Joseph is uncomfortable with.

He points out that because the industry average is over 5% he cannot allow the organisation to use the 1% figure. Joseph is then informed that the organisation could "always find an auditor or firm that would allow it."

SUMMARY



2.2 Safeguards

Earlier, it was explained how professional accountants, and particularly auditors, are faced with numerous threats to their independence.

The ideal way to tackle this would be to avoid situations causing ethical threats. However, practically it is not possible to avoid ethical threats completely.

For example, an audit firm may be appointed to carry out external as well as internal audit, as it may not be feasible to appoint two firms for each of these functions as both functions require conduct of certain common tasks (like understanding the client's entity and environment).

If these common tasks are undertaken by two separate firms, it would mean paying two firms for the same work.

Therefore, it may be practical to appoint the same firm for both functions, provided certain safeguards are put in place. In order to manage, eliminate or reduce these threats and thereby remain objective, the accountant is required to identify those threats which are significant and apply safeguards.

The safeguards employed need to be documented by the firm.

Safeguards that may eliminate or reduce to acceptable levels the threats faced by members fall into three broad categories:

1. Safeguards created by the profession, legislation or regulation
2. Firm-wide safeguards in the work environment
3. Engagement-specific safeguards in the work environment

Each of these is explained below:

1. **Safeguards by the profession** e.g. application of accounting standards, auditing standards, peer review, code of ethics, professional qualifications and experience for entry into the profession, educational training and continuous professional development.

2. Prohibition of certain activities / non-auditing services by auditors (according to the IFAC)

The IFAC has prohibited auditors from carrying out certain activities / non-auditing services like:

(a) Undertaking management responsibilities of setting policies, directing and taking responsibility for the actions of the entity's employees, authorising or executing transactions on behalf of the assurance client, taking responsibility for designing, implementing and maintaining internal control.

(b) Assuming a management responsibility when providing internal audit services to an audit client

(c) Preparation of accounting records and financial statements

(d) Providing valuation services, if the valuation requires a significant level of subjectivity and includes items which are material to financial statements

(e) Providing corporate finance services involving promoting, dealing in, or underwriting an audit client's shares, providing litigation support

(f) Preparing or changing journal entries (without client approval), authorising or approving transactions or preparing source documents

3. Ensuring that all professional **accountants study and are tested on the importance of ethics** (thereby ensuring that professional accountants are at the very least aware of the importance of following an ethical code of conduct) and

4. Having a regulatory body that will **investigate and take disciplinary action against any accountant found guilty of ethical misconduct** (thereby helping to ensure that professional accountants will face a penalty for non-compliance with any of the five principles).

5. Instances of firm-wide safeguards in the work environment include:

(a) Leadership of the firm establishing the expectation that members of an assurance team will act in public interest

(b) Firms designating a member of its senior management to be responsible for overseeing the adequate functioning of the firm's quality control system

(c) Firms setting up a disciplinary mechanism to promote compliance with policies and procedures

(d) Firms setting policies and procedures that will enable the identification of interests or relationships between the firm or members of engagement teams and clients

(e) Firms documenting its internal policies and procedures relating to compliance with the fundamental principles

(f) Firms designing policies and procedures to implement and monitor quality control of engagements

6. Instances of engagement-specific safeguards in the work environment include:

(a) Firms having a professional accountant who was not involved with the assurance / non-assurance service review the assurance / non-assurance work performed by the auditor, or otherwise advise as necessary
(b) Audit firms discussing ethical issues with those charged with governance of the client
(c) Audit firms disclosing to those charged with governance (of the client) the nature of services provided and extent of fees charged
(d) Auditors involving another firm to perform or re-perform part of the engagement
(e) Firms rotating senior assurance team personnel

Exam Focus

For all questions relating to ethics,

Identify the fundamental principles which cannot be adhered to.
Identify the threats which will affect the auditor's independence.
Evaluate the significance of the threats identified
Suggest safeguards which can mitigate the threats.

2.3 Ethical issues / dilemmas and suitable actions to deal with ethical dilemma

1. Valuation services

The code of ethics prohibits the auditor from providing valuation services which are significantly relevant to financial statements. However, in cases whereby the auditors provide valuation services which are not significantly relevant to the financial statements, the audit firm can face the following threats:

- threat of self- interest, as the auditor faces the risk of not maintaining objectivity while providing valuation amounts which are favourable to the client, in order to continue getting future work from the client, and
- Threat of self-review, as the auditor as the auditor may have to provide an opinion on transactions of the entity, which were earlier reviewed while carrying out valuation services for the client. .

In order to reduce the threat of non-compliance with the code of ethics, the firm should incorporate the following safe guards:

- Employing a third party accountant (other than the members of the assurance team) to check the valuation carried out
- Verifying that the audit client is aware of the assumptions and methods used for the valuation
- Obtaining an acknowledgement from the client relating to responsibility for the valuation work
- Not including members of the valuation team in the audit team
- Carrying out an independent review of the auditor's work by another engagement partner

2. Internal audit services

An audit firm cannot offer internal audit services which include management responsibilities. However when internal audit services are provided in other areas (other than management responsibilities) the firm faces a threat from self-review, as the auditor may have to provide an opinion on transactions of the entity, which were earlier reviewed while carrying out internal audit services for the client.

In cases whereby the auditors provide an internal auditing service, the audit firm can incorporate the following safeguards:

- Obtaining approval of the scope and risk and frequency of the internal audit work from the audit committee, supervisory board or audit client.
- Obtaining an acknowledgement from the client that they are responsible for setting up, maintaining and monitoring the company's internal controls.
- Designating responsibility for the internal audit activities to a competent team member (preferably from senior management).
- Making the client responsible for assessing the adequacy of the internal audit procedures and the firm's recommendations to improve the existing internal controls.
- Reporting internal auditing work to the audit committee or supervisory board.
- Having different team members (and partners) for the assurance and internal audit services.

Tip

Public interest entities include:

- Listed entities
- Entities defined by regulation or legislation as public interest entities
- Entities required by legislation or regulation to be audited
- any other entity determined by the firm, to be a public interest entity on account of its large number and wide range of stakeholders.

3. Legal services

Legal services which support audit client's transactions can lead to the threats of self-review and advocacy. However, the threat can be reduced by applying the following safeguards:

- Separating the members of the assurance team and the legal service team
- Management taking decisions relating to legal services
- not appointing a firm's employee or partner as the general counsel for legal affairs for a financial statement audit client

4. Safeguards for accepting contingent fees

Auditors are not permitted to undertake audit assignments in return for contingent fees. Contingent fees refer to fees paid which are dependent on the result of the audit assignment.

Example

Britex Banks has agreed to underwrite the shares of Ranks Plc. For this purpose the bank approached Lily LLP, an accountancy firm, to 'certify' the prospectus. The success of the underwriting was doubtful since it was of a speculative nature.

Therefore the bank offered fees to the firm as a percentage of the underwriting commission. This meant that if the issue was successful in the market, the firm would get a higher amount of fees.

Fees of this sort fall under the category of 'contingent' fees.

The proposal should not be accepted by the firm because:

- The auditor might be tempted not to disclose matters which, if disclosed, would affect the sale of the securities.
- Furthermore, even if the accounts certified genuinely do not contain irregularities, the authenticity of the 'Certification' may be doubted by investors.

Furthermore **a contingent fee for non-assurance services is prohibited, if the fees are material to the firm.**

However, **in respect of contingent fees (which is not material) which is received for non-assurance services, the accountant faces a self-interest and advocacy threat.** Such a threat can be reduced by pre-determining the fee amount between client and firm.

Other threats from contingent fees depend on factors such as:

- The range of possible fee amounts
- The extent of variation in fees
- The criterion for deciding fees
- Whether the consequences of a transaction are checked by an independent third party
- The result of the assurance engagement

If the assessment of the factors above denotes that the threats are not significant, the firm can apply the following safeguards:

- Making an advance written agreement with the client as to the basis of remuneration
- Disclosing to intended users of
- Discussing the issue with an independent third party the work performed by the professional accountant in public practice and the basis of remuneration
- Setting up suitable quality control policies and procedures for the firm
- Using professionals who are not members of the audit team to perform the non-assurance service

5. Excessive dependence on client's fees

In situations where the fees received from a particular client form a significant portion of the firm's income, the dependence on that client and concern about losing the client creates a self-interest or intimidation threat.

The firm can implement the following safeguards to ensure that there is no threat to the auditor's independence:

- Increase the number of its clients.
- Get another accountant, not connected with the firm, to carry out a second review.
- Consult a third party, such as a professional regulatory body or a professional accountant, on key audit judgments.

If the firm is not able to ensure the above safeguards, the firm should refuse the audit assignment.

6. Lowballing

Lowballing refers to the practice of quoting fees at rates which are less than the 'market rates' charged by the predecessor firm.

Such a practice causes a self-interest threat as the auditor may sacrifice the quality of the audit to retain / accept clients.

Safeguards relating to lowballing

The following safeguards must be in place in the case of lowballing:

- The firm must have sufficient quality control procedures to ensure that the audit was carried out in accordance with the applicable assurance standards.
- The documentation of working papers must ensure that the firm can demonstrate that the assurance was conducted in accordance with the applicable assurance standards.
- Inform the client that the fees are discounted.

7. Financial interest

Self–interest threats exist if an audit firm or a member of the audit team or an immediate family member owns a financial interest in a client.

At such times, the following safeguards will be relevant:

- Disposing of the interest
- Having a professional accountant review the work of the member of the audit team
- Removing the individual (having the financial interest) from the audit team
- Making the client's audit committee aware of the matter

8. Auditor employed with an assurance client

Familiarity, self-review, intimidation and self-interest threats are caused when staff from the assurance firm seeks employment or attend interviews prior to the potential employment with the assurance client. The extent of the threats will depend on factors such as:

- The position the individual has taken with the client
- Any involvement the individual will have with the audit team
- The length of time since the individual was a member of the audit team or partner of the firm; and
- The former position of the individual within the audit team or firm.

Safeguards to eliminate the threats or reduce them to an acceptable level include:

- Having an independent review of the work of the former member of the audit team;

- The assurance firm having quality control procedures in place to ensure that any of its staff involved in employment negotiations with its assurance client provide advance intimation to the firm, or else they may be removed from the engagement.

Tip

If a partner or employee of the firm serves a director or officer of an assurance client, the self-review and self-interest threats would be so significant that no safeguards could reduce the threats to an acceptable level.

Accordingly, no partner or employee shall serve as a director or officer of an assurance client.

A partner or an employee of an assurance firm can join a key management position in an assurance client only after the following period of time, since the conclusion of the audit in which he was employed:

The time gap is termed as the 'cooling off' period!

For key audit partner: one audit report covering a period of not less than twelve months and the partner was not a member of the audit team with respect to the audit of those financial statements.

For firm's managing partner: one year

Furthermore if a partner or an employee joins an assurance client, he will be entitled to any benefits or payments from the firm only if it is in accordance with pre-determined arrangements.

9. Personal relationships

An intimidation threat and a familiarity threat are caused if members of the assurance team have a personal relationship with employees or key management personnel of the client.

The only way of reducing the threat to an acceptable level is by removing the individual from the assurance team.

If the threat is other than clearly insignificant some of the following safeguards should be applied as necessary to reduce the threat to an acceptable level:

Conducting independent review of the work of the member of the assurance team.
Removing the member of the assurance team with the personal relationship from the assurance team.
not involving the member of the assurance team with any significant decision-making concerning the assurance engagement.
Having quality control procedures in place (within the firm) to ensure that any of its staff having close personnel relationships with assurance clients disclose the relationship to the firm.

10. Corporate finance services

The assurance firm should not provide corporate financial services, advice or assistance to assurance clients relating to underwriting or promoting client's shares. This is because the self-review threats faced cannot be reduced to an acceptable level by safeguards. However other corporate finance services like assisting an audit client in identifying possible targets for the audit client to acquire, advising on disposal transactions, may be carried out provided the assurance keeps the safeguards like using different teams of staff.

11. Second opinion

Conflicts of interest can occur when companies seek a second opinion from professional accountants when they are dissatisfied with the assurance services provided by the existing auditors.

Example

Martha is a professional accountant providing assurance services. During her audit assignment with Landscape Developers, Martha had a dispute with the directors because she wanted to report all the segments which crossed the quantitative threshold, as required by accounting standards.

These segments included road development which was a new line of business. The company did not want this segment to be reported separately since it did not want to disclose this information. Therefore it approached Laura, another professional accountant, and sought her opinion on the matter.

Martha faces an intimidation threat because she may be forced to accept the non-disclosure, as corroborated by Laura, despite being dissatisfied with Laura's opinion. Furthermore she will also face a self-interest threat as she may not be appointed as Landscape's auditor if she does not change her opinion.

Laura faces the threat of giving an incorrect judgement if she is not provided with correct information on the matter. Laura would have to get permission from Landscape Developers to offer an opinion after obtaining all the relevant information from the company. She should communicate the matter directly to Martha only if Landscape Developers gives her permission.

Safeguards

Audit firms which provide a second opinion must:

In the absence of permission to communicate, second auditors should not offer a second opinion.

- obtain permission from the assurance client to communicate with the existing auditor
- Ensure that they obtain all the relevant facts from the assurance client
- contact the auditor and provide a copy of their opinion. This will ensure that there is no conflict of interest.

12. Changes in a professional appointment

Accepting an assignment without knowing the facts

When professional accountants in public practice are asked to replace other professional accountants in public practice, the accountant faces the threat **of accepting an assignment wherein the fundamental principles (integrity and professional competence and due care) may not be adhered to.** This could happen due to illegal activities undertaken by the client, fraudulent activities prevailing at the client, etc.

When replacing another accountant, the accountant is required to:

- Ascertain the reasons for the earlier accountant being replaced
- Ascertain whether circumstances existed which threatened the compliance with the fundamental principles
- Obtain an undertaking from the owners / officials charged with governance of the prospective client of their commitment to improve internal controls or corporate governance practices
- obtain the client's permission and communicate with the existing auditor

If these safeguards do not reduce the potential threats to an acceptable level, the accountant must refuse the assignment.

13. Actual and threatened litigation

Sometimes a client sues or threatens to sue an assurance firm if it he is not satisfied with the work done by the firm at an earlier date. The firm is then faced with self-interest and intimidation threats as it may be intimidated to provide an unmodified report, although the audit evidence available indicates that the audit opinion would require being qualified.

The significance of the threats created will depend on:

- The materiality of the litigation
- Whether the litigation relates to a prior assurance engagement

Based on the evaluation of the threats, the following safeguards need to be applied:

- Excluding the member involved in the litigation, from the assurance team
- Having an independent professional review of the work performed

However if the safeguards do not reduce the threats to an acceptable level, it would only be appropriate to withdraw from, or decline, the audit engagement.

14. Long Association of Senior Personnel (Including Partner Rotation) with an Audit Client

Familiarity and self-interest threats are created by using the same senior personnel on an audit engagement over a long period of time.

The significance of the threats will depend on factors such as:

- The period of time the individual has been a member of the audit team;
- The role of the individual on the audit team;
- The structure of the firm;
- The nature of the audit engagement;
- Whether the client's management team has changed; and
- Whether the nature or complexity of the client's accounting and reporting issues has changed.

The significance of the threats shall be evaluated and safeguards applied when necessary to eliminate the threats or reduce them to an acceptable level.

Examples of such safeguards include:

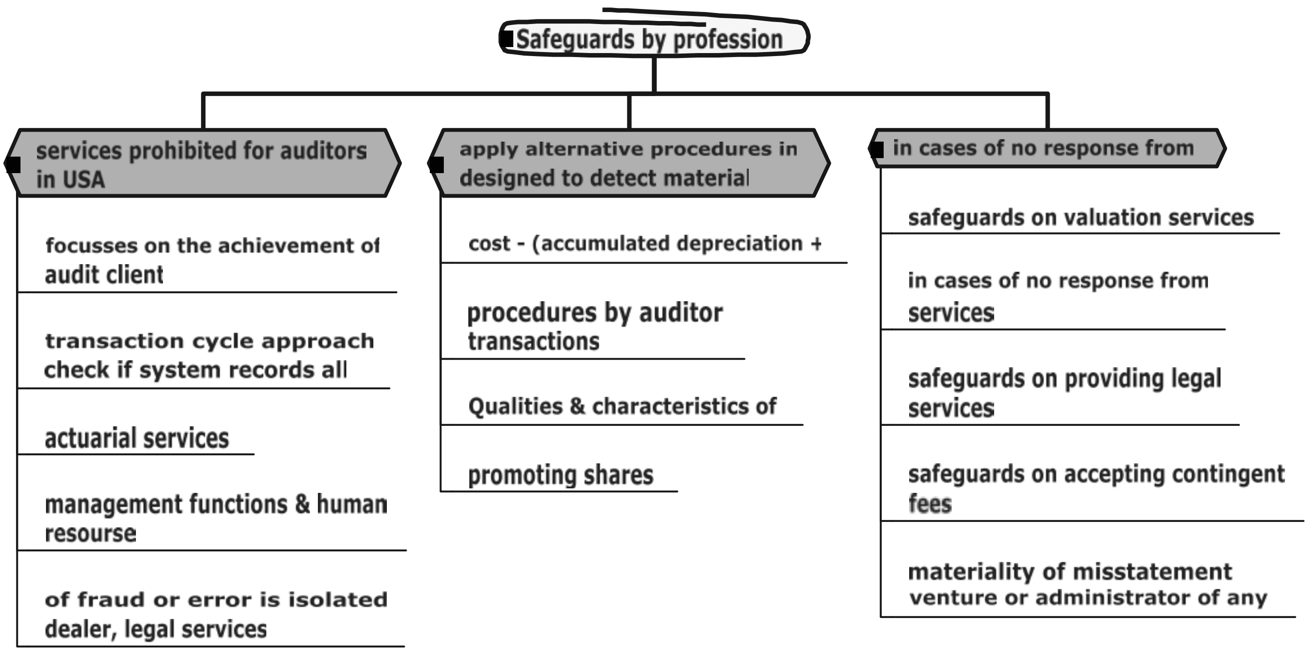
Rotating the senior personnel of the audit team;
Having a professional accountant who was not a member of the audit team review the work of the senior personnel; or
Regular independent internal or external quality reviews of the engagement.

15. Other matters

Should any of the audit team members be influenced regarding the conduct of audit by a close business relationship with the client's director / officer, (e.g. a firm acts as a distributer for the assurance client, the firm has a joint venture with the client) the firm should implement one of the following safeguards:

End the business relationship
Refuse the assurance assignment
Remove the person from the assurance team dealing with that particular assignment

SUMMARY



Test Yourself 2

Samson & Co is an accountancy firm from the Mwanza. They are the auditors for Cleaver Bankers. Samson & Co's signing partner has taken a home loan from this bank. Samson, the signing partner, is paid a fee of TZS800 million. His total fee for the year is TZS1,200 million. As of 12 February 20X7, when he signed the company's audit report, the fee remaining unpaid was TZS1,000 million.

Samson & Co has another client, Twinkletoes Ltd, a shoe manufacturer. The client has asked the firm to accept a fee to produce a cash flow forecast to be presented to their bankers:

TZS100 million if finance is obtained.
TZS12 million if no finance is obtained.

Required:

Does Mr. Samson face a threat to his independence?

Test Yourself 3

Brooks & Co is an accountancy firm from the Arusha. They carry out various assurance services. Recently they have been appointed as the auditors of Best Cars. Mr. Darwin is a professional accountant employed by Brooks & Co. He is also the brother of the executive director of Best Cars.

Required:

Should the company accept this audit assignment?

Exam Focus

Usually the questions from this Learning Outcome require candidates to explain:

- The ethical threats arising from the given scenario and
- How those threats could be mitigated.

To answer such questions, you must be able to explain:

- The type of threat faced by the auditor.
- The reason why the auditor faces the threat.
- The ways in which the auditor can mitigate the threat.

Test Yourself 4

Thomas Jeffrey is conducting a statutory audit of an organisation he holds shares of. What type of threat does this create?

Test Yourself 5

James Nealy is the auditor of an organisation that owns and operates a chain of high end luxury hotels. Whilst vacationing, he frequently stays at many of these hotels free of charge. What type of threat does this create?

3. Identify and explain in context ethical conflicts as an employee and as a practising accountant.

[Learning Outcome e]

Professional accountants in who are employees are termed as 'professional accountants in business' in the Code of ethics. They may be salaried employees, partners or director (whether executive or non-executive) working for one or more employing organisation.

> In Learning Outcome 2 we have already explained the ethical conflicts of practising accountants

3.1 Responsibilities of accountants in business / practicing accountants

Their responsibilities could include:

- The preparation and reporting of financial and other information (either solely or jointly), which both their employing organisations and third parties may rely on.
- Providing effective financial management and competent advice on a variety of business-related matters.
- Furthering the legitimate aims of the accountant's employing organisation

A professional accountant shall not knowingly engage in any business, occupation, or activity that impairs or might impair integrity, objectivity or the good reputation of the profession and as a result would be incompatible with the fundamental principles.

3.2 Threats faced

A professional accountant who is an employee of an entity also faces the threat of self-interest, self-review, intimidation, familiarity and advocacy.

Example

1. Circumstances that may create self-interest threat include:
   Holding a financial interest in, or receiving a loan or guarantee from the employing organisation.
   Participating in incentive compensation arrangements offered by the employing organisation.
   Inappropriate personal use of corporate assets.
   Concern over employment security.
   Commercial pressure from outside the employing organisation.

2. A circumstance that creates a self-review threat for a professional accountant in business is determining the appropriate accounting treatment for a business combination after performing the feasibility study that supported the acquisition decision.

3. Circumstances that may create familiarity threats include:
   Being responsible for the employing organisation's financial reporting when an immediate or close family member employed by the entity makes decisions that affect the entity's financial reporting.
   Long association with business contacts influencing business decisions.
   Accepting a gift or preferential treatment, unless the value is trivial and inconsequential.

4. Circumstances that may create intimidation threats include the threat of dismissal or replacement of the professional accountant or a close or immediate family member over a disagreement about the application of an accounting principle or the way in which financial information is to be reported.

3.3 Safeguards

Safeguards that may eliminate or reduce threats to an acceptable level fall into two broad categories:

1. Safeguards created by the profession, legislation or regulation – discussed in Learning Outcome 2; and
2. Safeguards in the work environment.

Example

Safeguards in the work environment include:
(i) The employing organisation's ethics and conduct programs.
(ii) Recruitment procedures in the employing organisation emphasizing the importance of employing high caliber competent staff.
(iii) Strong internal controls.
(iv) Appropriate disciplinary processes.
(v) Leadership that stresses the importance of ethical behaviour and the expectation that employees will act in an ethical manner.
(vi) Policies and procedures to implement and monitor the quality of employee performance.

3.4 Following are some examples of threats faced by professional accountants:

1. Potential Conflicts.

As a consequence of responsibilities to an employing organisation, a professional accountant in business may be under pressure to act or behave in ways that could create threats to compliance with the fundamental principles.

Example

A professional accountant in business may face pressure to:
(i) Act contrary to law or regulation.
(ii) Act contrary to technical or professional standards.
(iii) Facilitate unethical or illegal earnings management strategies.
(iv) lie to others, or otherwise intentionally mislead (including misleading by remaining silent) others, in particular:
    The auditors of the employing organisation; or
    Regulators.
(v) Issue, or otherwise be associated with, a financial or non-financial report that materially misrepresents the facts, including statements in connection with, for example:
    The financial statements;
    Tax compliance;
    Legal compliance; or
    Reports required by securities regulators.

The significance of any threats arising from such pressures, such as intimidation threats, shall be evaluated and safeguards applied when necessary to eliminate them or reduce them to an acceptable level.

Example

Examples of such safeguards include:

Obtaining advice, where appropriate, from within the employing organisation, an independent professional advisor or a relevant professional body.
Using a formal dispute resolution process within the employing organisation.
Seeking legal advice.

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2. Preparation and Reporting of Information

A professional accountant who has responsibility for the preparation or approval of the general purpose financial statements of an employing organisation shall be satisfied that those financial statements are presented in accordance with the applicable financial reporting standards.

The professional accountant shall take reasonable steps to maintain information for which the professional accountant is responsible in a manner that:
(a) Describes clearly the true nature of business transactions, assets, or liabilities;
(b) Classifies and records information in a timely and proper manner; and
(c) Represents the facts accurately and completely in all material respects.

Threats to compliance with the fundamental principles, for example, self-interest or intimidation threats to objectivity or professional competence and due care, are created where a professional accountant is pressured (either externally or by the possibility of personal gain) to become associated with misleading information or to become associated with misleading information through the actions of others.

The significance of the threats shall be evaluated and safeguards applied when necessary to eliminate them or reduce them to an acceptable level.

Safeguards include:

(i) Consultation with superiors within the employing organisation, the audit committee or those charged with governance of the organisation, or with a relevant professional body.

(ii) Where it is not possible to reduce the threat to an acceptable level, a professional accountant in business shall refuse to be or remain associated with information the professional accountant determines is misleading.

(iii) A professional accountant may have been unknowingly associated with misleading information. Upon becoming aware of this, the professional accountant in business shall take steps to be disassociated from that information.

(iv) In determining whether there is a requirement to report, the professional accountant in business may consider obtaining legal advice. In addition, the professional accountant may consider whether to resign.

3. Acting with Sufficient Expertise

While acting with professional competence and due care, the accountant shall ensure that they only conduct work on which they have knowledge, skill and experience. Therefore the accountant shall not intentionally mislead an employer as to the level of expertise or experience possessed, nor shall the accountant in business fail to seek appropriate expert advice and assistance when required.

Circumstances that create a threat to a professional accountant performing duties with the appropriate degree of professional competence and due care, include having:

(i) Insufficient time for properly performing or completing the relevant duties.
(ii) Incomplete, restricted or otherwise inadequate information for performing the duties properly.
(iii) Insufficient experience, training and/or education.
(iv) Inadequate resources for the proper performance of the duties.

The significance of the threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level.

Examples of such safeguards include:

(i) Obtaining additional advice or training.
(ii) Ensuring that there is adequate time available for performing the relevant duties.
(iii) Obtaining assistance from someone with the necessary expertise.
(iv) Consulting, where appropriate, with:
 Superiors within the employing organisation;
 Independent experts; or
 A relevant professional body.

4. Inducements: making offers

A professional accountant in business may be in a situation where they may be expected, or is under other pressure, to offer inducements to influence the judgment or decision-making process of an individual or organisation, or obtain confidential information.

The Code does not allow a professional accountant to offer an inducement to improperly influence professional judgment of a third party.

Test Yourself 6

Paul is the accounts manager of Mars Ltd. The company manufactures shoes. Recently the company placed an order for accessories from an Asian company. The rates quoted by the company are highly competitive and so the company has decided to go ahead with the deal.

Paul was asked to prepare the documentation for the order. Whilst reviewing the papers and discussing the matter, Paul learned that the accessories were so competitive because the company manufacturing them used cheap child labour.

The matter was discussed with the purchasing manager who informed Paul that in the Asian country child labour is legal and so the Mars Ltd is not doing anything illegal by placing the order. Paul approaches the finance director who asks Paul to ignore the issue so that the company can make a profit.

It is also intimated that Paul could lose his job should he pursue the matter.

Required:

What should Paul do?

Test Yourself 7

Bertha is a qualified accountant employed with Cool Cabs, a company which rents out cabs on a contract basis. The company's financial year ends on 31 December 20X6.

Revenues during 20X6 were lower than expected and the client's bank is concerned. In the first week of January 20X7, the company recorded good revenues.

The company, therefore, wants to record revenues for January 20X7 as revenues for 20X6. The customers, who were billed in January 20X7, have agreed to accept invoices with revised dates.

The finance director approached Bertha and asked her to cancel the invoices prepared during the first week of January and prepare fresh invoices dated 31st December 20X6. Bertha was also offered an ex gratia amount of 5% of her usual salary.

Required:

What would you advise Bertha to do?

Answers to Test Yourself

Answer to TY 1

The auditor has not acted in accordance with the following ethical principles:

(a) Integrity: the auditor is not open and honest about the situation with its client. Hence the reconciliation lacks integrity.

(b) Professional competence and due care: the junior clerk has correctly refused to do the task since he lacks the technical ability to do the work within the allotted time. He has correctly approached the audit partner for help. However, the partner does not help the clerk. This act is in **contravention to the principle of professional competence and due care** since the work is allotted to a junior who lacks the professional competence and is also not in a position to complete the work on time.

(c) Professional behaviour: the junior clerk has correctly taken up the matter with the audit partner. However, the audit partner has not acted according to 'professional behaviour'. This is because, without his guidance, the junior clerk may not be able to carry out the reconciliation work correctly.

Answer to TY 2

(a) Under normal circumstances auditors are not permitted to receive either loans or loan guarantees from clients.

However, if the auditor receives a loan from a client whose business is in offering loans (such as banks) and if the loans are paid out according to the standard lending procedures, terms and other requirements of the bank, the auditor does not face a threat to his independence.

On the other hand if the auditor receives a loan which is not in accordance with the standard terms applicable for home loans (i.e. loan amount given is higher than the loan which is normally paid out or the rate of interest charged on the loan is less than the normal interest charged, etc.) the auditor would face a threat to his independence.

(b) In situations where the fees received from the assurance client would form a significant proportion of the total fees of the individual partner, the auditor would face a threat to their independence. In this example, Mr. Samson gets a significant portion of his fees from this client. Further, his bills were unpaid for a long time as of the date of signing the audit report. Therefore, he does face a self-interest threat to his independence.

(c) Twinkle toes has offered a contingent fee which was is to be based on the process of obtaining finance. This is a case of contingency fees paid for non-audit services. The auditor would face the threat of advocacy and self-interest.

Such an arrangement would affect the independence of the auditor, but would depend on the following factors:

- The scope of fees
- The extent of variation of fees
- The criterion to decide the fees
- Whether the consequences of the transaction are checked by an independent third party
- The result of the event of the assurance assignment.

If the assessment of the above factors denotes that the threat is not significant, the firm can apply the following safeguards:

- Keep officials charged with governance, such as the audit committee, informed about the extent and nature of the fees
- Discuss the issue with an independent third party
- Set up suitable quality control policies and procedures for the firm

Although in this case given the underlying motive, the offer should be refused.

Answer to TY 3

Mr. Darwin is the brother of the executive director of Best Cars. An executive director has significant influence on the company's daily operations. Therefore, if Mr. Darwin remains as an assurance team member, **he would face self-interest and a familiarity threat.**

Hence the firm is required to assess the significance of the threat and apply one of the following safeguards in order to reduce the threat:

- Removing Mr. Darwin from the assurance team.
- Structuring the responsibilities of the assurance team in such a way that Mr. Darwin does not deal with any areas which are the responsibility of his brother. However, in this case, since Mr. Darwin's brother is the executive director of the company, there can be no such area where Mr. Darwin's auditing services could be used.

Here, the firm was aware of Mr. Darwin's relationship with its client so they were able to implement the required safeguards. However, in order to ensure that the firm does not face such a similar threat due to not being informed by its staff members about personal relationship with clients, it is recommended that the firm must implement policies and procedures which require staff to communicate to the firm's management any issue of independence and objectivity that concerns them. In this case, the firm's policies and procedures must include a provision stating that that its employees promptly report any implications resulting from changes in the employment status of their family members or other personal relations that may lead to threats to independence.

Answer to TY 4

This creates a "self-interest" threat as the auditor a has a personal link or interest in the organisation he is auditing. This type of threat means that the auditor may not be completely objective in his work and may be influenced into delivering a more favourable picture of the organisation's financial performance and condition.

Answer to TY 5

This creates a familiarity threat as well as a self-interest threat. Familiarity threats happen when an accountant's relationship with their client stops being a purely professional one. By this what is meant is that the scope of the relationship goes outside the accountant merely performing their work and then being paid accordingly.

Answer to TY 6

Step 1

Business accountants are required to **identify the ethical issue** and **the threats** which hamper them from functioning in accordance with the fundamental ethical principles. In order to identify the ethical issue, the accountant (Mr. Paul) must gather the applicable facts. The issue must be **identified clearly**.

The **issue** which is **identified** must be on account of **non-compliance of the fundamental principles**.
In this case, there is a non-compliance of integrity.

Step 2

When the ethical issue identified involves non-compliance of any of the fundamental principles, Mr. Paul must:

(i) Identify the threat i.e. whether it is self-interest, self-review, intimidation, familiarity or advocacy threat.
(ii) Assess the significance of the threat

In this case, the threat is a self-interest threat (to report profits) and intimidation threat since he is informed that he could lose his job if the matter is pursued.

If the threat is significant: determine whether there are safeguards which will eliminate / reduce the threats. Some of the safeguards which can be applied are as follows:

Policy of the company relating to child labour, safeguards in place of work, such as bringing the ethical issues to the attention of the audit committee.

If there is no policy to deal with the dilemma, additional safeguards can be applied to eliminate / reduce the threats faced by the accountant.

Step 3

For significant threats, determine whether the safeguards are in place.

If the safeguards are not in place: if the issue identified goes against any of the guidelines, or if there are not sufficient safeguards in place, the assignment which brings about the ethical issue must be refused.

In this case, the company does not have a policy relating to child labour. However, the matter must be taken up with the audit committee. If there is no suitable action taken, the accountant can reveal information through whistle blowing.

However, if a significant conflict cannot be resolved, a professional accountant can obtain professional advice from legal authorities or the relevant professional body.

Answer to TY 7

By accepting to make the required change, the accountant would not be acting objectively or honestly. This would involve acting without integrity. Bertha must refuse the ex gratia amount.

The only safeguard available in this case would be to discuss the matter with the finance director and inform him of the incorrect practice. Also, Bertha must meet the members of the audit committee and other board members and inform them of the matter.

If there is no change in the company's position, Bertha should leave the company.

Quick Quiz

1. Fill in the blanks
   (a) The principle of Integrity requires accountants to be _______________in all of their professional and business dealings and relationships.
   (b) Any of an accountant's findings and judgments should be based solely upon sound ________________.

2. State whether true or false.
   (a) Confidentiality is one of the main ethical principles that accountants must always abide by.
   (b) Accountants not only have an ethical responsibility to their clients but also to their profession and society at large.
   (c) An auditor is not responsible for evaluating the effectiveness of internal control systems.

3. List the five main categories of threats that could potentially cause an accountant to violate one or more of the main ethical principles.

4. Name all of the groups / persons accountants have an ethical responsibility towards?

5. Name the five main principles of ethics accountants are expected to abide by?

6. State the factors based on which the threat faced due to receipt of contingent fees can be assessed.

7. What is advocacy threat? Give some examples of advocacy threats.

8. Explain the self-interest threat?

9. How can accountants avoid conflict of interest when they have competing companies as clients?

10. How does a code of ethics help to resolve ethical conflicts?

Answers to Quick Quiz

1. Fill in the blanks

   (a) Straightforward and honest
   (b) Rationale and research

2. True or False

   (a) True, one of the fundamental principles
   (b) True, they are considered pillars of society
   (c) False, this is part of the responsibilities as outlined in the ISAs

3. The five main categories of threats that could potentially cause an accountant to violate one or more of these principles are:

   (a) self-interest threats (the accountant has a personal link or interest in an organisation they are auditing)
   (b) self-review threats (an accountant has to review and revaluate their previous judgments);
   (c) Advocacy threats (an accountant has promoted a position to the point their objectivity may be at risk);
   (d) familiarity threats (an accountant's relationship with their client is not a purely professional one) and
   (e) Intimidation threats (attempts are being made to deter an accountant from acting objectively).

4. Accountants have a responsibility to act ethically and in the best interests of their clients or employers; the accounting profession and the general public.

5. The five main principles are integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

6. The factors based on which the threat faced due to receipt of contingent fees can be assessed:

   Amount of fees is dependent on the result of the assurance service
   Proportionate amount of fees received according to pre-determined conditions
   Criteria to decide fees
   Involvement of third party to check the transactions independently
   The result of the event of the assurance assignment

7. Advocacy threats arise when an auditor acts as an advocate for or against an audit client's position or opinion rather than as an unbiased attester. Auditors would lose their objectivity if they became advocates their client. Examples of advocacy threats are:

   Auditor acting as an advocate for or against an audit client.
   Audit team member is involved in corporate finance services, such as financial securities or client's shares
   Position of company secretary can lead to an advocacy threat.

8. Self-interest threat occurs when auditor / accountant has a personal or any other interest in the client company, which are as follows:

   Financial interest
   Personal interest
   Probable employment with client
   Excessive dependence on client's fees
   Apprehension about losing the professional assignment

9. Accountants' firms should apply safeguards to ensure that confidential information about one client is not disclosed to the other. Therefore the firm would have to;

   Maintain strict confidentiality and procedures to prevent access to information
   Employ different team members on the audit of each of the clients
   seek impartial advice from independent accountants on critical matters

10. The code of ethics provides a framework which:

    Identifies the threats faced by professional accountants
    Evaluates the threats: such an evaluation would involve using quantitative and qualitative factors
    Responds appropriately to the threats by adopting safeguards so as to remove / reduce the threats

Self-Examination Questions

Question 1

You are a recently qualified chartered accountant and for the past two years have been operating your own practice. Business has been good and you now have a portfolio of 10 clients comprising of various small and medium sized enterprises.

You have just been approached by a large corporate, Live and Learn Inc, with an offer to be their statutory auditor. The organisation owns and operates a chain of educational and training facilities spread across the globe.

In addition, they have also said they would require you to take on various MIS consultancy assignments over the course of the year.

The remuneration offered to you by the statutory audit itself is very attractive. In addition the income from the subsequent consultancy work would mean you would be able to triple your income.

However given your limited resources, taking on this assignment would mean that you would have to let all your other clients go and concentrate all your time and effort on Live and Learn.

Required:

Explain why you should or should not take on this assignment paying particular attention to the fundamental principles of professional ethics and the conceptual framework.

Question 2

Benson & Co is an accountancy firm employing Laura and Martha, qualified systems auditors. The firm carries out assurance assignments for various clients.

1. The clients of the company are small and medium-sized. Often the audit team members offer advice to the management /employees of assurance clients regarding the journal entries to be made. They also advise management on the preparation of financial statements.

2. Benson & Co has following projects under negotiation.

   They have been offered an assignment to design a new ERP system for one of their assurance clients, Johnson Pharma, which manufactures medicines.

   Benson & Co has also received an offer from the Quick Finance Bank as external auditors. Benson & Co do not have enough staff to provide the service properly and have appointed staff on an assignment basis.

As Benson & Co is a newly established accounting firm, they are very keen to increase their client base. They have offered to carry out the assignments for annual fees of TZS120 million when the fees for the same services would normally have been TZS225 million.

Required:

(a) According to the IFAC, an auditor must not provide book keeping services such as preparation of financial statements and journal entries. Does the firm contravene the provisions of the IFAC?

(b) Assess the ethical threat faced by the company if they accept the assignment offered by Johnson Pharma.

(c) Comment on Benson & Co’s practices in accepting the assurance assignments.

Question 3

(a) Illustrate the fundamental principles of ethics, as stipulated in the NBAA code of ethics which is based upon the code of ethics published by the Ethics Standard Board for Accountants (ESBA) of the International Federation of Accountants (IFAC).

(b) You are an audit senior with the accounting firm of Mambo Associates and you are busy with the audit of Mbuga Transport Limited and the following matters have been brought to attention of the firm:

(i) The accounts clerk of Mbuga Transport resigned two months ago and has not been replaced. As a result, Mbuga Transport's transactions during this period have not been recorded and the books are not up to date. To comply with the terms of a loan agreement, Mbuga Transport need to prepare interim financial statements but cannot do so until the books are brought up to date. The managing director of Mbuga Transport wants Jacqueline to help out because she performed the audit last year. The audit partner of Mambo Associates allows Mbuga Transport to engage her for one month before the start of the annual audit.

(ii) During the annual audit of Mbuga Transport, you discovered that the company had materially understated income on last year's tax return. The client is unwilling to take corrective action. You decided to inform the Tanzania Revenue Authority.

(iii) On completion of the fieldwork for the audit of Mbuga Transport, you are offered a free holiday ticket by the managing director. He tells you that this gesture is in appreciation of a job well done. You ultimately accepted the ticket.

(iv) The managing partner of Mambo Associates is not very pleased with the time Mbuga Transport is taking to pay its audit fee for the year. He decides to take TZS.5,000,000 out of a trust fund that Mambo Associates holds on their behalf. He intends to refund it as soon as Mbuga Transport make payments of its audit fee.

Required:

In respect of each of the four situations, (i) to (iv) outlined above, identify any ethical issues involved and assess whether or not there has been a violation of ethical conduct. (Support your answers by making reference to the relevant professional standards).

Answers to Self-Examination Questions

Answer to SEQ 1

Taking on the assignment will provide you with the opportunity to triple your income without having to make any additional investments.

However before accepting any assignment you must look at not only this opportunity but also whether anything in the nature and scope of the assignment will cause you to violate any of the five main ethical principles.

These principles are:

1. Integrity;
2. Objectivity;
3. Professional Competence and Due Care;
4. Confidentiality and
5. Professional Behaviour

The one principle that is in danger of being violated by taking this assignment is the objectivity principle. The objectivity principle states that accountants must not accept any assignments where the potential exists for there to be a conflict of interest.

In this particular scenario given that 100 percent of your revenue will be derived from only one client there is a significant potential for a conflict of interest to exist. This is because you in effect will have more of an employee - employer relationship with Live and Learn rather than an auditor-client one. This in turn may jeopardise your independence (and subsequently objectivity) as the danger exists that you may be influenced into delivering a more favourable picture of the organisation's financial performance and condition.

The IFAC ethical code states that the maximum percentage of total turnover that auditors can receive from one client is 10% for a listed or Public Interest Company and 15% for a privately held organisation.

Lastly, it is increasingly considered best practice around the world for accountants to not accept any other types of assignments from clients whose financial statements they are auditing. Therefore despite however lucrative taking the assignment from Live and Learn may be, it should be respectfully turned down.

Answer to SEQ 2

1. The firm must have a code of ethics which highlights how important it is for the firm to maintain independence at all times so that public interest is served. The code must be discussed with employees and the management must set an example by practising the ethics set out.

2. The firm must have clear policies to monitor the quality of their services, such as collection of proper records to support attestations, documentation containing the records which are reviewed and a third party review / independent accountant review wherever and whenever applicable.

3. The code of ethics and conduct must incorporate the firm's policies to identify threats to its independence, methods of evaluating the threats and safeguards that may be applied to eliminate / reduce the threat.

4. The firm must have policies and procedures to ensure the "independence" policies of the firm are adhered to. For example, every employee whose close relation changes employment to an attestation client, should report whether this change effect on this "independence".

5. The firm's policies must include a system of identifying interests or relationships between the firm or its partners and professional staff and clients.

6. The firm must have separate partners and team members for attestation and non-attestation work.

7. The firm must follow the practice of prompt communication of a firm's policies and procedures, and any changes to them, to all partners and professional staff.

8. The firm's policies must incorporate a system of monitoring the firm or partner's reliance on revenue from a single client and should implement the necessary safeguards to counteract an excessive reliance.

9. The firm must have designated management personnel to oversee the capacity of the firm's quality control systems.

10. The firm must have a mechanism which monitors compliance with policies and procedures.

11. The firm must have a policy which allows effective communication with members of the audit committee on matters relating to independence.

12. The firm must have a policy of communicating with the audit committee about the nature of the services that are or will be provided and the fees to be charged.

13. The firm must have a policy of rotation of senior team members of the attest team.

14. Company's procedures should ensure that members of the attest team do not assume responsibility for management decisions for the attest client.

15. The firm must be staffed with experts in accounting, auditing, independence and reporting matters who can help attest assignment teams who assess issues that are highly technical or require a great deal of judgement and who can also resist undue pressure from clients when the accountant disagrees with the client about such issues.

Answer 3

(a) (i) Integrity – A professional accountant should be straightforward and honest in all professional and business relationship.

(ii) Objectivity – A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments

(iii) Professional competence and due care – The client should receive competent professional service in line with applicable technical and professional standards

(iv) Confidentiality - A professional accountant should not disclose information to their parties without proper or specific authority unless there is a legal or professional right or duty to disclose.

(v) Professional behaviour – A professional accountant should comply with the relevant laws and regulations should avoid any action that discredits the profession

(b)

(i) The ethical issues here are those of independence and professional competence. Ethical codes permit the provision of write-up services to private company audit clients and in exceptional circumstances only, which would appear to be the case here, to public company audit clients. However it is important that the service does not require any member of the practice to make executive decisions on behalf of the client. A fundamental ethical requirement is that Jacqueline is to be assigned to the job, she must be competent to perform the required service.

(ii) The ethical issues here relates to the confidentiality of information acquired in the course of providing professional services to a client. In this situation there is no direct action that Mambo Associates could take and audit seniors actions certainly represents a breach of client confidence. The appropriate course of action would have been for audit senior to draw the matter to the attention of the partners who should attempt to persuade management to take corrective action. Pressure could be applied by way of requiring that an appropriate contingent liability for unpaid taxes be disclosed in the interim financial statements. As a last resort the firm should consider the desirability of a continued association with a client in the light of doubts as to the integrity of management.

(iii) The ethical issue here is that of whether the acceptance of a gift prejudices the appearance of independence.
Unless the value of the gift is clearly insignificant it should not be accepted. If the gift is accepted by audit senior it could give the impression that audit senior has not been objective and impartial in performing his duties or that in future his objectivity would be impaired.

(i) The ethical issue here relates to the duty of care that accountants have with respect to handling clients' monies.

The partner's behaviour in this situation appears to be unethical. The client's trust fund should not be used for unauthorised purposes.

SECTION D

PROFESSIONAL ETHICS, PUBLIC INTEREST, FUNDAMENTAL OBJECTIVES, THREATS AND SAFEGUARDS TO INDEPENDENCE

D2

STUDY GUIDE D2: PROFESSIONAL ETHICS

Get Through Intro

Businessmen have to make decisions that sometimes have moral or ethical dimensions. Professional accountants may be involved in the decision-making process or be in a position where they need to consider ethical issues. Ethics and morals are both concerned with what is right and wrong.

Business ethics is concerned with doing the right thing, however what is right for the business may not be right for all stakeholders and for society. As professional accountants we play a role in business decision making and in presenting information internally and to the outside world. Our ethics and morals are bound up with those of the businesses we work in and work for as clients.

There are many different views on how societies and economies do operate and should operate. This Study Guide builds a framework to analyse and understand these different perspectives in order to understand where we are and possibly where we want to be.

Professional ethics includes specifically the codes that professional accountants should follow. The profession has to date, largely paid attention to stewardship reporting rather than forward looking statements and the extension of reporting into social and environmental issues, though this is a changing position as corporate reporting has moved on.

Professional accountants are required ethically to consider the public interest beyond the interests of their employers or clients in some situations. Actions and decisions can be 'improved' and that is an objective of our study. We do have to accept that some people and some people in some situations may not have morals or may ignore morals.

Many companies have codes of ethics and many companies publish their codes of ethics but many companies still face critics who question attitudes and practice in employment, market competition abuse, transparency of reporting, social and environmental responsibilities and the sale of ethically unacceptable products. Some even question whether making profits can ever be ethical.

Codes are designed to set rules or give guidance so that ethical behaviour is not merely cultural but subject to systems and controls. Accountants are also professionals and subject to their own codes and controls. So this study guide also provides the issues behind ethical codes for companies and for the profession and goes behind the words to the meaning and reasoning

This Study Guide requires an open mind as it looks at some interesting issues.

Learning Outcomes

a) Explain the importance of professional ethics.
b) Explain the differences between rules based and principles based approaches to professional ethics.
c) Identify and explain in context the meaning of public interest.

1. Explain the importance of professional ethics.

[Learning Outcome a]

1.1 Meaning of professional ethics

Ethics is an important branch of philosophy. It involves the study of the values of people, groups and society. It **covers concepts such as right and wrong and responsibility** Ethics is underpinned by morality, indeed ethics could be seen as the application of morality.

Morality is synonymous with norms, values, and beliefs embedded in social processes that define right and wrong for an individual or community. **Ethics deals with the study of morality** and the application of reason to elucidate specific rules and principles that determine right and wrong for any given situation.

Professional bodies like IFAC, ICAEW usually set out codes of conduct or ethics for their members to adhere to. The body can institute disciplinary action against those who infringe the rules.

Professional ethics includes specifically the codes that professional accountants should follow. **The codes begin with fundamental principles that are beyond question and** then are **followed** by a **conceptual framework of guidance** to determine responses but written in such a way that does not compromise compliance with the mandatory fundamental principles.

The IFAC code includes five fundamental principles:

The fundamental principles are discussed in detail in Study Guide D1.

1. **Integrity:** implying absolute honesty and straightforwardness and particularly an unwillingness to be associated with dishonest or untruthful reporting.

2. **Objectivity:** implying an attitude of mind that does not allow bias, conflict of interest, undue influence or pressure to override professional or business judgment. Objectivity in reporting is paramount and requires independence of mind to apply generally accepted accounting principles to support, for example, truth and fairness.

3. **Professional competence and due care:** including the upholding of standards at all times.

4. **Confidentiality:** implying that except where the public interest demands it client and employers affairs shall not be disclosed.

5. **Professional behaviour:** avoiding anything that brings discredit to the profession.

1.2 Importance of professional ethics

1. Ensures accountants provide quality work and act in public interest

Professional ethics for accountants are regulated through codes such as the IFAC ethical code. The IFAC code is underpinned by the concept that accountants should provide quality work in the public interest. This recognises our professional role as upholders of principles of transparency, integrity and total honesty across a variety of internal and external financial informational provision roles. The public expectation is that we protect their interests by ensuring objective reporting within generally accepted accounting principles, standards and laws. For example, according to the Code of Ethics, all audit firms are required to set up policies and procedures to implement and monitor quality control of engagements.

2. Provides guidance to accountants to act with independence

It is also important to see ethical codes and rules in the context of laws. In Tanzania, the requirements of the Companies Act relating to auditors' independence are still very limited requiring only that the auditor is appointed by a majority vote of shareholders, that disclosure is made of both audit fees and fees for other services and that auditors cannot leave or be removed without appropriate communication to shareholders. Independence is strengthened in law by giving auditors the right to all information necessary for their audit and by creating a criminal offence where directors deliberately or recklessly mislead auditors. The law only allows registered auditors to perform audit work and recognises certain bodies as professional bodies that can issue qualifications. Independence is further strengthened by the rules relating to removal. Detailed independence requirements are not stated within the law .

3. Provides public assurance about accountant's work

Ethical codes should not be seen as useful but should be seen as essential in giving **public assurance** that accountants and auditors are capable, competent, trustworthy, honest and sufficiently independent to provide the **objectivity** that is essential in underpinning corporate governance transparency, effective audit and challenge to the powers and potential abuse by directors.

4. Reminds accountants of their obligations

Sadly, history tells us that a minority of accountants has fallen short in ethical standards and need the spirit in writing to remind them of their obligations and to provide the backdrop of standards that underpin **compliance monitoring**, **investigation** and **disciplinary processes**.

Test Yourself 1

JK Consultants is the auditor of SV Engineers, an auto spare parts manufacturer. During the annual audit of the entity, the firm had the following practices:

1. The firm introduced a second partner review on all its assurance engagements.
2. The firm also introduced a policy through which each of its employees chosen for assurance work provides a declaration of not holding shares of the assurance client and not having any personal or any other professional relationship with the assurance client.

Required:

Explain how the above policies are beneficial to S V Engineers.

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2. Explain the differences between rules based and principles based approaches to professional ethics.

[Learning Outcome b]

Professional accountants can face conflicts of interest whilst acting in accordance with the principles set out in the code of ethics. For example, an auditor owns substantial number of shares in the assurance company. In such a situation, the auditor faces a conflict of interest due to a self-interest threat.

Conflicts of interest can be determined by identifying potential threats to the fundamental principles of integrity, objectivity, confidentiality, professional behaviour, competence and due care. For example, a threat to objectivity may be caused when an auditor holds a substantial number of shares in the assurance client's organisation. A conflict may arise between accountant and client.

2.1 The ethical conflict can be resolved using either of two **approaches of professional ethics: rules-based or principles-based**.

1. Rules-based approach

A rules-based approach **sets out rules which accountants are required to follow in all situations**. This involves determining every possible conflict of interest faced by the accountant and finding a solution as laid down by the regulatory authority.

2. Principles-based approach

A principles-based approach has no set standards. It gives guidelines on the principles that need to be applied when resolving conflict of interest. The choice of the method of resolving the conflict rests with the accountant.

Example

Accountants in the US are bound to act according to the provisions of the Sarbanes-Oxley Act. They are clearly not permitted to undertake internal auditing services if they are auditors of financial statements for the same client.

On the other hand, accountants in the Tanzania have to abide by the IFAC Code of Ethics and NBAA bylaws. They are allowed to undertake internal audit as long as they do not assume a management responsibility (for example, setting internal audit policies or taking part in the strategic direction of internal audit activities) when providing internal audit services to an audit client. Therefore, before undertaking an internal audit service, the firm should make an assessment of the nature of the work and be convinced that it would not amount to assuming management responsibility.

(a) The IFAC code offer guidelines on resolving ethical conflict situations.

Example

Ross and Moss are auditors of financial statements for Mars Ltd. They have recently been approached by their client to conduct an internal audit for the company. The internal audit services would not amount to assuming management responsibilities.

The auditors face an ethical conflict of interest since, in the course of carrying out the audit of financial statements; they would have to review their own work in the course of an internal audit. In this case, there is a threat of self-review.

The IFAC has given guidelines on the safeguards which need to be in place in order to avoid such a threat. Some of the safeguards are:

- Obtain an approval of the scope of the audit from the audit committee / supervisory board
- Obtain an acknowledgement from the client that they are responsible for setting up, maintaining and monitoring the company's internal controls.

The auditor can look to these safeguards for guidance.

However, the audit firm can put additional safeguards into place (those which are not considered in the IFAC code of ethics). Such as, if a firm has its own policy not to conduct internal audit services for clients for whom they are the external auditors, they would ensure that there are no threats of self-review.

(b) The IFAC code of ethics focuses on serving public interest.

(c) The IFAC code specifies that accountants face different threats under different circumstances. Therefore, it is impossible to predict all possible threats and the safeguards necessary to remove them. The code, therefore, acts as a guide for some conflicts of interest. However, other threats should be resolved by the accountant who should always bear in mind the duty to act in the public interest.

Example

Competitors as clients

If a firm has Coca-Cola and Pepsi as their clients, they could face conflict of interest. Such a situation would require the firm not to act in any way which would compromise the interests of either company.

The firm should apply various safeguards so that information pertaining to one of the clients is not disclosed to the other. The firm would have to maintain:

(a) Confidentiality: the principle which is an essential aspect of independence. In this case, the firm must take care that the staff members involved in the assurance assignments maintain strict confidentiality.

(b) Separating team members: the firm would have to employ different team members on each audit. If, despite the above safeguards, there is a significant threat to the auditor's independence, the firm would have to resign from one of the companies.

(c) Notifying both clients of the audit assignments with the competitor company

(d) Procedures to prevent access to information for non-authorised staff

(e) Seeking advice from independent third party accountant

If the firm is unable to reduce the conflict of interest by applying the above safeguards, the firm would have to resign from at least one of the assignments.

(d) The code of ethics provides a framework to:

(i) Identify the threats faced by professional accountants: accountants are required to determine the potential threats that they may face.
(ii) Evaluate the threats: threats are to be evaluated in order to decide whether the threats are significant or not. Such an evaluation would involve using quantitative and qualitative factors.
(iii) Respond appropriately to threats by adopting safeguards so as to remove or reduce threats.

The guidelines above will enable accountants to maintain their independence.

Example

Benson & Co is an accountancy firm employing Laura and Martha, qualified systems auditors. For one of the clients of the firm which is medium-sized, the audit team members offer advice to the management /employees of assurance clients regarding the journal entries to be made. They also advise management on the preparation of financial statements.

(a) **According to the IFAC, under no circumstances should the auditor**:
Prepare source documents such as Journal vouchers
Authorise transactions

However, in respect of the medium-sized companies, the auditor is often asked for advice on various accounting procedures. This is because the client company may not have sufficient number of qualified accountants. Therefore Benson & Co cannot avoid such a situation.

However the firm needs to put in place the following safeguards:
Seek approval from the clients for such kind of work
Depute staff members who are not in the assurance team for such advice
Ensure that members of the audit team neither record nor authorise the journal entries

(b) **The firm is required to ascertain the significance of the threat caused by providing such a service**. If the threat is significant, the firm needs to apply the following safeguards in order to reduce the threat level:
The **client** must give his **acknowledgement for establishing and monitoring organisation's system & controls**.
To design and implement the processes of the hardware or software system, even though the audit client designates a competent employee, the **senior management of the client** organisation, should **take the responsibility** of making all **management decisions.**
The implementation of the **system** needs to be **designed according to the capability of the client.**
The audit **client is responsible for the operation of the system** (hardware or software) and the data used or generated by the system.
The firm must assign different team members and partners for both the assignments i.e. design of the ERP and assurance. This will also ensure that both teams have separate reporting lines.

However, if the threat is significant despite applying the above safeguards, Benson & Co must refuse the assignment.

A principles-based approach is also known as the conceptual framework approach. Listed companies based in the UK, Singapore etc. practise the conceptual framework approach.

Advantages of a conceptual framework approach

The advantages of this conceptual framework approach are that:

The principles-based standards set out in the code are **flexible**, hence they can be applied to the varying situations faced by professional accountants.
It **avoids technical evasion** of detailed rules.
It can be **used globally.**
It can be **applied in a changing environment**.
It recognises that **judgements can be subjective** (a principles-based approach understands that there can be different solutions to the same problem after adopting appropriate safeguards).

Advantages of rules-based approach to ethical conflict resolution (over principles based approach)

(a) **Easy to adopt:** a rules-based approach clarifies ways of dealing with ethical conflicts and is, therefore, easy to follow.

(b) **Easy to modify: a rules-based approach to ethics is easy to modify whenever appropriate.**

Disadvantages of rules-based approach to ethical conflict resolution (over principles based approach)

(a) **May not offer solution to all situations of ethical conflict:** a rules-based approach involves determining every possible situation of conflict faced by the accountant and providing a solution to each threat.

It is, therefore, exhaustive and gives little attention to any area left out unless the rules are amended.

(b) **Judgements cannot be always objective:** in situations where there is an ethical dilemma, different people can find different solutions after adopting different safeguards. Therefore, it may be difficult to comply with actions mentioned in the code of ethics based only on rules.

2.2 The following are the advantages and disadvantages of a principles-based approach:

1. Advantages of principles-based approach to ethical conflict resolution (over rules based approach)

(a) Offers easy solutions to resolve ethical conflict

The principles-based approach focuses on an objective to ensure that the independence of a professional accountant is not breached. It offers solutions to many ethical conflicts. Furthermore, it recognises that there are many areas in which accountants can ethical dilemmas. Although the solution to all situations is not made explicit, if the accountant follows the objective of independence, the principle would have been adhered to. In short, this approach can **easily adapt to changes.**

(b) **Recognises that judgements can be subjective:** A principles-based approach understands that there can be different solutions to the same problem after adopting appropriate safeguards.

Example

The auditor of a software company in Romania notices that 60% of the company's purchases were pirated. In Romania there is no law against piracy.

The auditor can do either of the following:

Give a clear assurance report; or
Disclose the fact in the audit report (i.e. the origin of the purchases)

---

2. Disadvantages of a principles-based approach to ethical conflict resolution (over rules based approach)

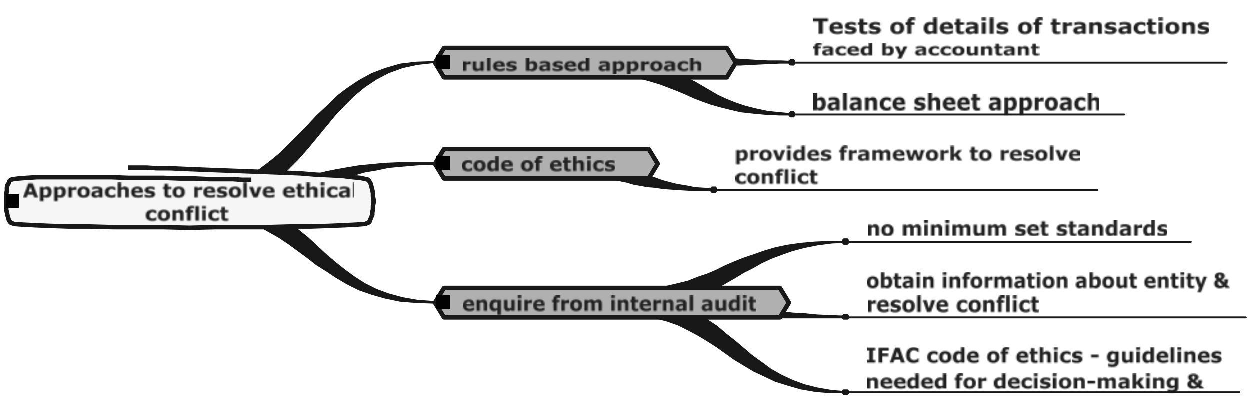
(a) **Does not offer perfect solutions:** a principles-based approach focuses on the objective of maintaining accountants' independence. Therefore, there is no perfect solution to any ethical dilemma as the same problem can have a variety of solutions.

(b) **May not adapt to all regions:** international codes such as that of the IFAC does not take differences in regional and cultural practices into account.

(c) **Not enforceable in law:** it is difficult to legally enforce the adoption of ethical resolution by this approach because the adoption of this approach is voluntary.

However, when ethical decisions need to be taken, a principles-based approach rooted in objectives should be preferred to a rules-based approach

SUMMARY



3. Identify and explain in context the meaning of public interest.
[Learning Outcome c]

3.1 The public interest

1. Meaning of public Interest

Public interest is explained in Study Guide A5

Public interest refers to the general good of ordinary people as well as the shareholders of a particular company.

2. Public interest and companies

(a) Quality of financial reporting

The accounting decisions of companies affect various stakeholders such as investors, accounts payables, employees, customers and the government. The financial problems of companies such as Enron and WorldCom have demonstrated how the groups and individuals affected by accounting decisions include not just the traditional view of stakeholders but also the average man and woman on the street. Hence, there is a **clear public interest in the quality of financial reporting.**

Transparency is essential to the operation of financial markets and concealment of financial results, position and risk misleads investors, accounts payables and puts people's jobs, pensions and investments of all types at risk.

Example

In the US, the Sarbanes-Oxley Act was introduced into legislation by the House of Representatives. This was because the Senate was concerned about the fact that CEOs, CFOs and boards were not expressly accountable for the financial statements and management estimates published by their companies. This Act is a specific rules-based approach and a requirement by all corporations operating in the US. It confers special responsibility and expectations on public accounting firms and auditors, the Securities Exchange Commission, and state legislatures to police the Act.

(b) Public interest versus minority interest

Public interest must serve minority interest. For example, a company which offers inequitable voting rights would be said to act against minority interest and the public interest. This is because all the equity shareholders of the company must have the same rights.

(c) Actions must not harm society

Acting in the public interest means **not carrying out any act which harms society**. For example, a company must practise safety norms in the workplace, and follow community health and sanitation practices so that its employees remain healthy.

Inevitably productive activities involve costs to society as well as benefits whether conducted by companies or government agencies or even charities and whether in a capitalist or socialist state. We all have to accept that the public interest can be harmful, hospitals pollute, schools use valuable resources, charities are not always the best employers and taxation can have negative effects on economies and societies. Overall our world is not a place of equality and the actions of one or more persons can impact negatively on others.

Example

Best Petronex, a petrochemical manufacturing company in the Tanzania, has the following environmentally-friendly policy relating to the discharge of waste into the sea:

With a view to reducing the discharge of waste into the sea, the company re-routes the air compressor cooling water to its desalination plant. For efficient disposal of the oily wastes, the company uses an incinerator with pollution control facilities.

(d) Compliance with the relevant laws

Acting in the public interest would involve compliance with all relevant laws which apply to the company. For example, laws relating to direct taxes, indirect taxes, labour laws and stock exchange regulations.

3.2 Accountants and public interest

Some argue that public interest equates to welfare of society and as such accountants may be said to be acting against the public interest in some aspects of their work.,

Inevitably given our role this means that accountants are acting in the interests of individuals such as shareholders and clients and not necessarily always in the welfare interests of the society as a whole.

The accounting profession is involved in providing various services such as financial accounting, management accounting, taxation services, consultation and auditing.

As professional accountants we take on a public interest role in our role as accountants. Some matters of public interest relating to our role are fundamental and relate to integrity objectivity and due care in our work. These matters are so fundamental that we do not think of them in terms of public interest as such. These matters underpin the workings of economic systems, economies fall apart without trust and integrity, objectivity and transparency are the foundations of trust.

Therefore, while taking on any of the roles mentioned above, the accountant must ensure that the fundamental principles that give rise to trust are met.

1. Accountants can act against the public interest in the following situations

(a) Self-interest of accountants taking precedence over shareholders' interest

This occurs when the accountant decides to act in contravention of the set rules. This may be due to self-interest taking precedence over the public interest. The consequences of acting against the public interest could be the liquidation of the company.

Such situations go beyond merely acting in self-interest since they involve corruption and fraud. Accountants earn fees or receive salaries and bonuses and that is self-interest however there are sufficient safeguards to allow such self-interest to exist.
Contravention of rules or laws is likely to be considered immoral and is an abuse of self-interest since it is selfish. There is a difference between a selfish act and acting in self-interest.

Example

Harris Collections had over 20 department stores in the Tanzania during April 20X0. Within the following six months, i.e. by 31 January 20X1, the half-yearly profit had declined by 48 per cent. However, the board discovered that management had deliberately provided them and the public a false view of the financial position of the company over the previous six years. The company created artificial profits by acquiring new stores and revaluing assets upwards. In total, Harris paid around TZS2,000 million for assets that it recorded in its accounts at over TZS12,000 million. Even the profits were manipulated by understating outstanding expenses. During the six- month period, the CFO, the CEO and chairman had personally traded heavily on the stocks of the company in the stock market and made good returns.

The CFO played a major role in falsifying accounts and reports.

The liquidator of Harris Collections declared in 20X3 that there was no prospect of shareholders recovering any money from the liquidation. In the above situation, the officials of the company allowed their self-interest to override the interests of the investors and shareholders of the company. Ultimately they were in fact selfish and corrupt and broke laws relating to theft that is immoral.

(b) Acting according to the culture of the company without adopting the professional code of conduct

Sometimes accountants and auditors are influenced by the culture prevalent in the client / employer's organisation. In the process, they tend to forget that they are bound to act in accordance with the professional codes set for them and thereby act against the public interest.

(c) Auditor acting in self-interest so as to ensure income from non-audit services

Sometimes auditors act against the public interest so that they can be assured of good income from the client for non-audit services.

Example

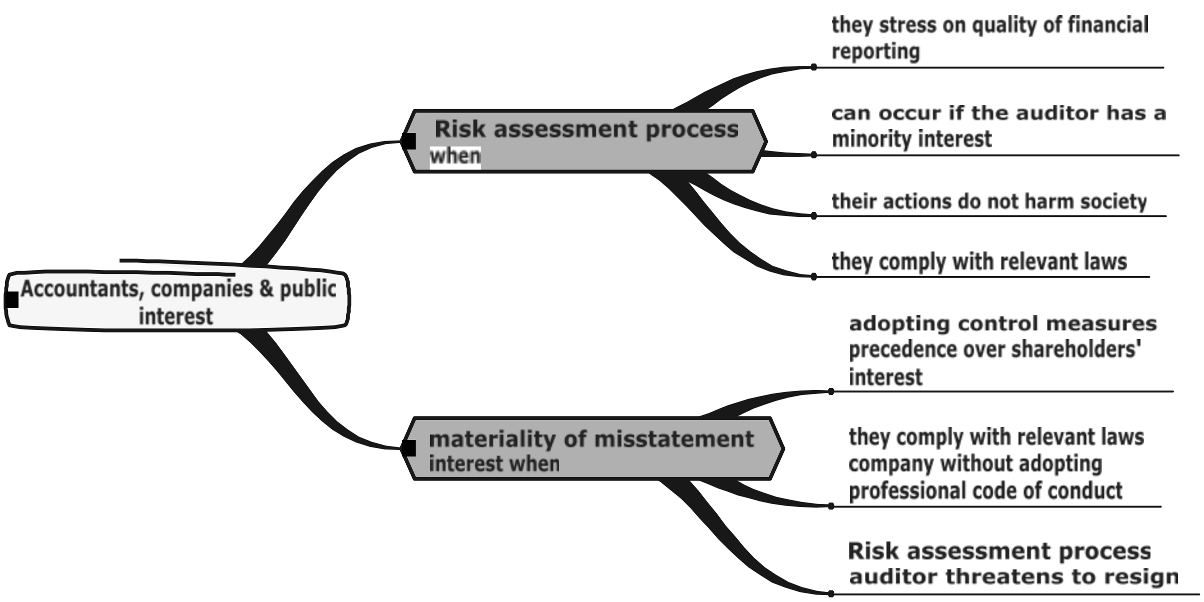
Roy & Co is the auditor of Stars Limited which manufactures custom-made transformers. The auditors also provide the following non-audit services to the company: maintaining of costing records and systems and IT consultancy. The auditors receive very good fees for the non-audit services. The total consultancy fees exceed the audit fee.

During 20X6, the auditors identified material misstatements of profits and assets and knew that there was a risk of business failure. Under pressure from the directors and with a threat of losing substantial fees the auditors signed unmodified audit reports.

Subsequently the company failed with losses for investors, accounts payables, pension scheme members and employees.

The failure to qualify was of course contrary to the principle of objectivity since they were not independent and their integrity was lacking since they disregarded the fundamental ethical principles. Ultimately they failed to protect the public interest.

SUMMARY



2. Acting in public interest

When professionals act in the best interest of the client, society and also comply with the legal as well as ethical requirements; they are said to act in public interest.

Some of the ways in which an accountant can act in the public interest are as follows:

(a) Disclosure of information

There are two key situations to consider:

Acting as an auditor
Acting as an accountant as employee or firm

When acting as auditors accountants may obtain information during the course of their work that gives rise to suspicions or is firm evidence of fraud, unlawful acts or other matters that may need to be reported to shareholders or to a regulatory authority or made public. Auditors are however required to act in accordance with their legal authority and responsibility and also within their contract with the company.

An auditor, in the Tanzania for example, is under a legal duty to report his opinion on the truth and fairness of the financial statements and whether they are properly prepared in accordance with the law, including standards. There are also specific disclosure requirements relating to proper accounting records, directors transactions and obtaining information and explanations where the auditor is not satisfied on such matters.

To go outside or beyond the scope of any of these responsibilities may put the auditor in breach of contract and at risk of being sued. To disclose some matters in the audit report may be outside the scope of the report and to report matters directly to shareholders directly may be inappropriate.

Auditors may use the ‘public interest’ argument as a justification for disclosing unlawful acts or fraud or related risks to a regulatory authority but would generally ask their client to do so first and only disclose if that is not done. Public interest generally means a situation where failure to disclose would cause damage or losses to the public. Where matters relate to the financial statements or have material implications for the position or results disclosed in the financial statements then the auditor will find disclosure simpler. Where matters are less directly connected to his work it is less likely that he should inform a third party.

When acting as an accountant in compilation procedures for financial statements or other financial reports or in carrying out related work it may also be the case that unlawful acts, fraud or other matters come to the attention of the accountant. Unlike an auditor an accountant does not have legal duties to report as such but as a professional accountant we must always consider our fundamental ethical principles of integrity, objectivity, due care, professional behaviour and confidentiality.

An accountant can refuse to carry out or be involved with unlawful acts and will always uphold objectivity in reporting. His difficulty arises where matters need to be disclosed to a regulatory authority or made public in the interests of the public since to do so may be in breach of confidentiality requirements. If an employer or client fails to make appropriate disclosures an accountant may decide to report matters to a regulator in the ‘public interest’ in the same way as for an auditor.

In all cases it is advisable to take legal advice and in the case of an accountant who ‘whistleblows’ it is advisable to remember the practical consequences for future work and employment as well as ones ‘public duty’ as perceived.

Accountants and auditors should also bear in mind the power of resignation in putting pressure on employers and clients to do the right thing. This is considerably more powerful for an auditor since his work is regulated.

Increasing disclosure of matters such as business performance and prospects, internal control and risk and of going concern evidence has put more pressure on directors to disclose however auditors have a lesser responsibility for such matters since as in the Tanzania it is generally a responsibility to report failures to disclose in accordance with the Tanzania Professional ethics Code that is relevant. The US Sarbanes-Oxley requirements create considerably greater opportunity to make disclosures because of the additional legal responsibilities upon directors and auditors.

Example

During the course of his audit an auditor identifies serious weaknesses in risk management processes and internal controls that could cause losses to members of the public who pay deposits into the trading company that is his client. There is no evidence of fraud and no matters that materially affect the current results and financial position. The auditor is considering disclosure in the ‘public interest’ since he believes there are risks of future losses.

After taking legal advice the auditor decides to resign and inform shareholders and accounts payables of his reasons in his legally required statement of reasons for resignation. The auditor is confident that this will put matters in the public domain.

(b) Development of high quality international standards to act in public interest

Accountants are guided by professional bodies such as the IFAC. Such bodies believe that an open and transparent dialogue is critical to the development of high quality international standards in the public interest.

Example

The IFAC serves the public interest by:

(i) Developing, encouraging and retaining professional standards which are of high quality and can be applied globally

(ii) Promoting the convergence of professional standards such as auditing, ethics, assurance and public and private sector financial reporting standards

(iii) Working continuously to improve the quality of auditing and financial management

(iv) Encouraging the values of the accountancy profession

Despite this it should be borne in mind that critics see the pace of change towards greater disclosure of matters such as internal control risks, business risks, going concern risks and the inclusion of more forward looking statements of performance is slower than would be required in the 'public interest'.

(c) Other points to ensure that accountants act in public interest

Accountants can be encouraged to act in the public interest by the following means:

(i) **Compliance with accounting standards** so as to protect public interest.

(ii) Professional bodies clearly **defining regulations so as to guide accountants** to act in the public interest.

(iii) Professional bodies such as the IFAC and ICAEW can **inform the public about the actions** expected from the members of the accounting bodies so as to **act in the public interest**.

(iv) Professional bodies can have a **strict process** so as to identify breaches of the public interest.

(v) **Breaches due to unprofessional behaviour** must be subjected to suitable **disciplinary action**.

(vi) Accountancy firms can develop and **implement codes of business conduct** or professional codes of ethics. Such codes specify what is right and wrong and thereby guide accountants to act in an ethical manner and in the interests of the public.

Test Yourself 2

Jack Jones is a qualified accountant employed in the treasury department of Frock Limited. Jack has seen documentation transferring large sums to and from the company bank account around the year end and believes that the managing director and financial director are window dressing the financial statements and may possibly be fraudulently taking money out of the company fearing that it might collapse. Jack believes that the auditors are not going to take any action since they may have been misled. The company employs 200 people and has many small customers who have paid in advance for products and services.

Required:

(a) Is there a public interest here?
(b) Should Jack make his views known to someone within the company?
(c) What can Jack do if he wishes to protect the public interest?

Answers to Test Yourself

Answer to TY 1

The policies of the audit firm will help the entity in the following ways:

1. Second partner review will ensure that the audit firm provides quality work to the client. This in turn will improve the quality of the financial statements. Therefore the users of financial statements will be more confident of the financial statements and their economic decisions made by them using the financial statements.

2. The declaration policy of the company will ensure that the audit team does not include members having financial and personal relationship with the client. Therefore the auditors will be independent of the client. This will improve the public confidence on the audited financial statements.

Answer to TY 2

(a) Since there is a potential loss to members of the public or external stakeholders then there may be a public interest and an accountant may regard this as overriding obligations of confidentiality.

(b) Jack should either confront the directors themselves or may approach a non-executive director. He should avoid being associated with fraud and may resign.

(c) If he wishes to he can inform regulators or crime authorities and whilst he has some legal protection he may find this comes at a cost when he tries to get future work that is his moral decision.

Quick Quiz

1. Which of the following is not true in connection with the word 'ETHICS'?

   A Ethics is a branch of philosophy.
   B Ethics involves the study of the tradition and values of a person or group.
   C Ethics is an unwritten law which is the same for any society / people of the society.
   D Ethics covers concepts such right and wrong, good and evil and responsibility

2. Explain briefly what is meant by public interest.

3. How can the accounting profession be encouraged to act in the public interest? Explain briefly.

4. Which of the following statements is incorrect?

   A Codes of ethics are intended to clarify corporate values, reinforce the company's commitment to act with integrity and provide guidance in dealing with ethical concerns.
   B Ethics deal with the way people interact with each other.
   C Openness and honesty in business dealings enhances the company's reputation.
   D Ethical codes do not contribute to an increase in the value of shares or to the long-term sustainability of the business.

5. How can accountants avoid conflict of interest when they have competing companies as clients?

6. How does a code of ethics help to resolve ethical conflicts?

Answers to Quick Quiz

1. The correct option is **C**.

   Ethics varies from person to person, organisation to organisation, country to country. For example, discrimination on the basis of either gender or age is not only illegal in Tanzania but also considered highly unethical but in some countries, organisations frequently post job vacancies for which only candidates of a certain age or gender may apply.

2. Although there is no clear cut definition of acting in the public interest we can explain it as follows;

   It means to act in the interest of the welfare of the public.

   A decision which serves the interest of the maximum number of persons is said to be in the public interest.

   Acting in the public interest also means acting to uphold human rights.

3. Accountants can be encouraged to act in the public interest by the following means:

   Compliance with accounting standards so as to protect the public interest.
   Professional bodies can clearly define regulations in order to guide accountants to act in the public interest.
   Professional bodies such as the IFAC and the ICAEW can inform the public about the actions expected from the members of the accounting bodies to act in the public interest.
   Professional bodies can have a strict process so as to identify breaches of the public interest.
   Breaches for unprofessional behaviour must be subjected to suitable disciplinary action.
   Accountancy firms can develop and implement codes of business conduct or professional codes of ethics. Such codes specify what is right and wrong and thereby guide accountants to act in an ethical manner and thereby act in the interest of the public.

4. The correct option is **D**.

   The code of ethics contributes to an increase in the value of shares or to the long-term sustainability of the business.

5. Accountants' firms should apply safeguards to ensure that confidential information about one client is not disclosed to the other. Therefore the firm would have to;

   Maintain strict confidentiality and procedures to prevent access to information
   Employ different team members on the audit of each of the clients
   Seek impartial advice from independent accountants on critical matters

6. The code of ethics provides a framework which:

   Identifies the threats faced by professional accountants
   Evaluates the threats: such an evaluation would involve using quantitative and qualitative factors
   Responds appropriately to the threats by adopting safeguards so as to remove / reduce the threats

Self-Examination Question

Question 1

"Accountants are involved in the creation of wealth but do little to secure a more equal distribution of wealth indeed their alignment to providers of capital is against the public interest."

Required:

Critically evaluate the above statement.

Answer to Self-Examination Question

Answer to SEQ 1

Accountants either as independent firms or as employees provide considerable advice and input into business processes and decisions and are as such key players in the creation of wealth for shareholders and capital providers including themselves. Accountants also provide input into the setting of laws, regulations, standards and codes that underpin transparency processes in reporting and in broader processes of professional ethics.

Accountants are therefore part of business and part of the checks and balances of successful responsible, honest business that consider risks and the impact of business more broadly on society. The role of audit whether external or internal is a particularly important element of independent assurance of processes and information and a critical part of the checks and balances. Growth in economies and wealth creation comes from successful business and public enterprises and accountants provide added value in this context. Some however would criticise accountants as having a narrow view since they focus on financial and economic wealth rather than simple welfare and happiness. Some argue the accounting profession is value laden and supportive of capitalists and capital rather than people and the planet, or sometimes acts against the interests of labour and society by aligning itself with business.

It is generally acknowledged that economic growth brings benefits even by those who see happiness and sustainability as components of true and beneficial growth. It is also difficult to argue that firms within a largely capitalist environment have contributed massively to economic growth, innovation, choice and success. However growth has often resulted in an additional uneven distribution of incomes and wealth beyond that still resulting from inheritance and land ownership. Rewards to capital and entrepreneurship exceed rewards to working labour. Accountants as key players in business can be seen as part of the process that provides return to capital, indeed accounting focuses attention on profit rather than towards rewards for other providers of value added or social and environmental issues.

Securing a redistribution of income and wealth through government intervention is a policy that has many supporters but one where others argue pragmatically about how far and how quickly it can be done whilst still retaining a free market system. Accountants in their role as professionals, whatever their political persuasions, do not get involved in normative moral arguments regarding redistribution, accountants merely comply with laws including those relating to progressive taxation, windfall taxes, market interventions and legal restrictions such as minimum wages and equality laws. Accountants do not act against the public interest even in focusing upon profit since that is the legal framework within which they work either as preparers or auditors of financial reports. When laws change then accountants will change.

SECTION E

REPORTING

E1

STUDY GUIDE E1: AUDIT REPORTS

Get Through Intro

Globalisation in businesses has increased the importance of consistency in reporting. This is because the financial statements that are published by any entity are read by people all over the world. In such circumstances, if the reports do not follow certain set rules of reporting the readers will not be able to understand the content.

This rule also applies to audit reports. They have to be written in a specific style and format to enhance their understandability for readers on a global level. Standard reporting procedures are necessary to ensure that an audit report is not misleading.

This Study Guide discusses and analyses the conclusions from evidence accumulated in an audit and the format and content of modified as well as unmodified audit reports in detail.

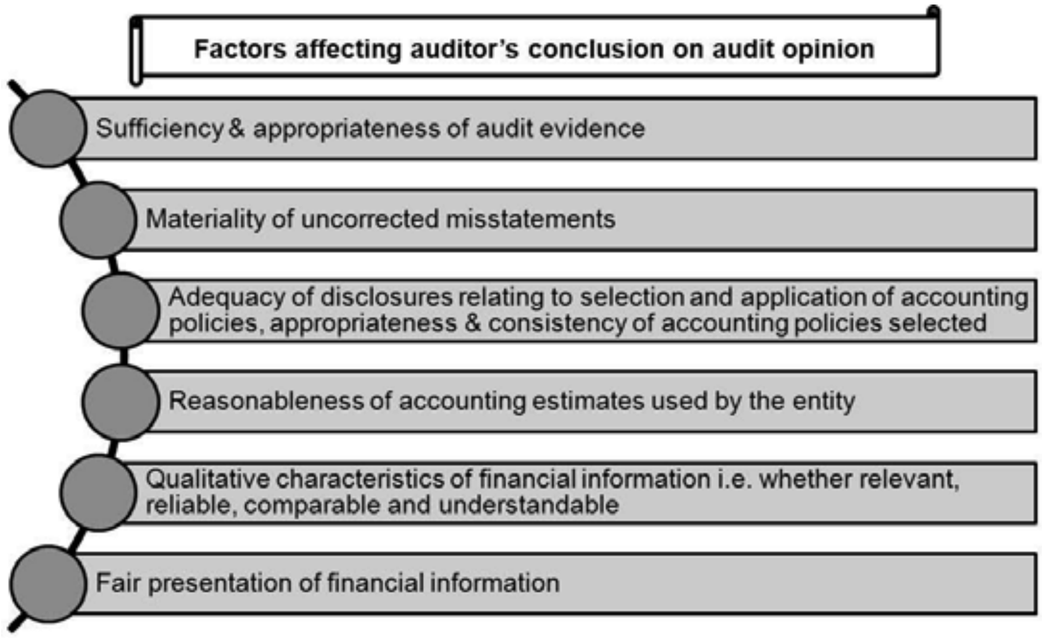
Learning Outcomes

a) Make conclusions from evidence accumulated in an audit.
b) Develop an appropriate audit opinion given the circumstances of an audit.
c) Draft audit reports based on opinions reached.
d) Identify and explain the meaning of expectation gaps in the context of audit and assurance assignments and their implications for the profession, including fraud, going concern, internal control and risk issues.

1. Make conclusions from evidence accumulated in an audit.
[Learning Outcome a]

The **auditor's conclusion** on the audit opinion would be based on the following factors:

Diagram 1: Factors affecting auditor's conclusion on audit opinion



1.1 Availability of sufficient and appropriate of audit evidence
This is discussed in detail in Study Guide C1.

1.2 Materiality of uncorrected misstatements
This is discussed in detail in Study Guide C6.

1.3 Adequacy of disclosures relating to selection and application of accounting policies
This is discussed in detail in study guide C4.

1.4 Appropriateness of accounting policies selected and consistency of the entity's accounting policies with the applicable financial framework

The auditor should also consider the appropriateness of the accounting policies and whether they are followed consistently. They should also check if any change has been made in the accounting policy and, if so, whether it has been properly disclosed along with its implications on the profit or loss of the entity.

Example

While auditing Compact Ltd, Lara, an auditor, finds that the method of valuation of inventory has changed during the year. She should review whether appropriate disclosures have been made in the financial statements regarding the change in method of valuation of inventory and its impact on the income statement of the entity. If these disclosures have been properly made in accordance with the requirements of the accounting standard, Lara will be satisfied with the accounting treatment and may conclude that the entity has complied with the accounting standard.

Factors to be considered by the auditor, in order to determine the appropriateness of accounting policies are as follows:

- Whether the accounting policies adopted by the entity enable the financial statements to reflect the substance of the underlying transactions and not merely their legal form.
- Whether the accounting policies adopted by the client are commonly adopted by other industries under which the client falls.
- If the applicable accounting standards are not implemented, would the financial statements still be true and fair.

1.5 Reasonableness of accounting estimates used by the entity

1. Accounting usually involves the recording of precise amounts. However there are certain items that are based on estimates and not precise amounts.

Definition

Accounting estimate: an approximation of a monetary amount in the absence of a precise means of measurement.

ISA 540

Accounting estimates are approximations. Approximations are often made in conditions of uncertainty regarding the outcome of events. When transactions involve precise amounts and are supported by specific documents, verification is relatively easier. However, **this comfort is not available in the case of accounting estimates.** There is greater risk of material misstatement. Therefore greater care is needed when auditing them.

The auditor has to design and perform **further audit procedures** to **obtain sufficient appropriate audit evidence** as to whether:

- The **accounting estimates are appropriate**.
- They **are appropriately disclosed**.

Tip

This concept applies to amounts measured at fair value where there is an estimation uncertainty, as well as for other amounts that require estimation.

Example

Accounting estimates are regularly used for the following items:

- Allowance for bad debts
- Determination of useful lives for calculating depreciation
- Inventory valuation
- Deferred tax
- Provision to meet warranty claims

2. Risk assessment procedures

Risk assessment procedures are used to assess the risks of material misstatement in relation to accounting estimates. They enable the auditor to understand the nature and types of estimates which the entity has. Based on this understanding, the auditor will plan the nature, timing and extent of further audit procedures.

According to ISA 540, risk assessment procedures include an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

(a) The requirements of the applicable financial reporting framework

By obtaining an understanding of the requirements of the applicable financial reporting framework the auditor can identify:

- The relevant recognition criteria or methods to be used, in order to measure accounting estimates. For example 'IAS 38 Provisions, contingencies and liabilities' prescribes the recognition criteria for accounting of provisions like allowance for bad debts.
- Certain conditions that permit or require measurement at a fair value, for example, valuation of non-current assets at fair value in case the entity adopts the revaluation model for valuation of non-current assets.
- Required or permitted disclosures.

The above information will also enable the auditor to determine whether the applicable financial reporting framework has been applied appropriately.

(b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements.

In obtaining this understanding, the auditor will make inquiries to management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

Inquiries of management may include whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- The terms of transactions that gave rise to accounting estimates have changed.
- Accounting policies relating to accounting estimates have changed, as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

(c) How management makes the accounting estimates, and an understanding of the data on which they are based, including:

(i) The method, including where applicable, the model used in making the accounting estimate For example the method of determining the valuation of slow moving inventory.

(ii) Relevant controls: the auditor obtaining an understanding of:

- The experience and competence of those who make accounting estimates.
- The review and approval of accounting estimates.
- The segregation of duties between:
- Those committing the entity to the underlying transactions and
- Those responsible for making the accounting estimates

For example, the estimation of the useful life of non-current assets is assigned to experts who are independent of the entity.

(d) The assumptions underlying the accounting estimates

Matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates include:

- The nature of the assumptions, including which of the assumptions are likely to be significant assumptions. For example discount rate used in the calculation of post-employment benefits.
- How management assesses whether all relevant assumptions have been taken into account.
- Where applicable, how management determines that the assumptions used are internally consistent.
- The nature and extent of documentation, if any, supporting the assumptions.

Example

Due to the auditor's understanding of the industry in which the entity operates, they know that a particular machine is going to be obsolete within the next 3 years. As originally estimated, the machine still has 5 years of life remaining. The auditor would expect that the depreciation amount is adjusted because of the lower remaining life.

(e) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why.

In case management has changed the method for making an accounting estimate, it must be able to demonstrate that the new method is more appropriate.

Example

If management changes the basis of making a provision for non-moving inventory from a fixed rate (predetermined by the management) to net realisable value (by ascertaining the market value) the auditor may challenge whether management's determination of the amount of provision is reasonable.

(f) Whether, and if so how, management has assessed the effect of estimation uncertainty.

Matters that the auditor may consider include:

Whether management has considered alternative assumptions or outcomes. For example, performing a sensitivity analysis to determine the effect of changes in the assumptions on an accounting estimate.

How management determines the accounting estimate when analysis indicates a number of outcome scenarios. For example the determination of the discount rate, in the calculation of post-employment benefits.

3. Identifying and assessing the risks of material misstatement

The auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate. The factors which affect the degree of estimation uncertainty associated with an accounting estimate include:

The extent to which the accounting estimate depends on judgment.

The sensitivity of the accounting estimate to changes in assumptions.

The availability of reliable data from external sources.

In case the estimation uncertainty associated with an accounting estimate is assessed as significant, the auditor will determine whether this amounts to significant risk.

4. Responses to the assessed risks of material misstatement

The auditor is required to carry out one or more of the following:

(i) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.

Transactions or events after the period end but before completion of the audit may provide audit evidence about an accounting estimate made by management. This process may reduce or even remove the need to review and check the estimation procedures.

Example

Management expects that in litigation against a defaulting customer, about 60% of the amount due (e.g. 60% of TZS1 million) will be received, and the remaining amount (TZS0.40 millions) will be bad. The litigation proceedings are completed before completion of the audit, and the actual bad debt is determined at TZS0.45 millions. The auditor accepts this as the correct amount of bad debt, and they need not check the earlier estimate made by management.

(ii) Test how management made the accounting estimate and the data on which it is based.

Example

While auditing a warranty provision, the auditor would evaluate if the data of sales relating to products still within the warranty period at the period end agrees with the information contained within the sales order processing module. Furthermore, they would check if the data is analysed product-wise, in case the warranty claims for different products show different trends.

(iii) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.

Example

If the estimate for the provision for doubtful debt is based on examination of aged receivables analyses, it is important that the analyses are accurately produced.

Further Substantive Procedures to Respond to Significant Risks

In case the auditor assesses that accounting estimates give rise to significant risks, the auditor shall evaluate the following:

This is in addition to substantive procedures performed

(i) how management has considered alternative assumptions or outcomes, why it has rejected them,
(ii) whether the significant assumptions used by management are reasonable, and
(iii) management's intent to carry out specific courses of action and its ability to do so.

In case the auditor considers that the management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if necessary, develop a range with which to evaluate the reasonableness of the accounting estimate.

Disclosures Related to Accounting Estimates

The auditor shall obtain sufficient appropriate audit evidence that the disclosures in the financial statements related to the accounting estimates are correct.

In case of accounting estimates that give rise to significant risks, the auditor shall evaluate the adequacy of the disclosure of their estimation uncertainty.

Indicators of Possible Management Bias

The auditor shall review the judgments and decisions made by management in the making of accounting estimates in order to identify the existence of indicators of possible management bias.

Written Representations

The auditor shall obtain written representations from management whether they believe significant assumptions used in making accounting estimates are reasonable.

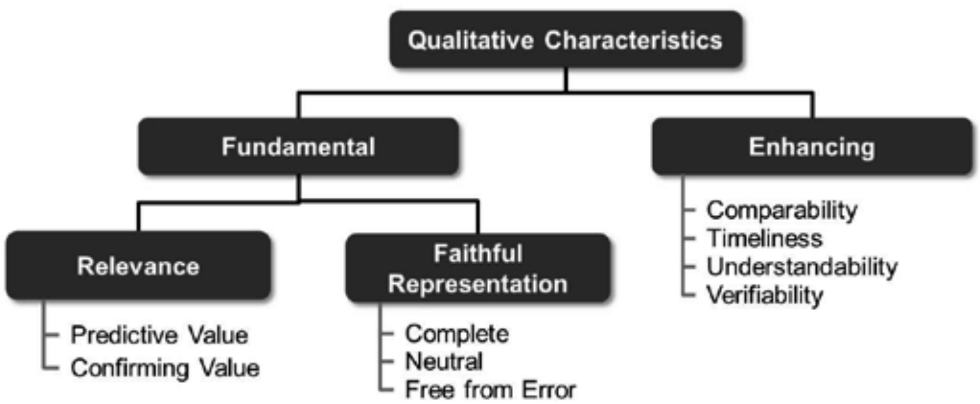
Test Yourself 1

You are requested to verify if the allowance for reducing inventory to its realisable value is reasonable.
Required:
Suggest suitable procedures to accomplish this.

1.6 Qualitative characteristics of financial information i.e. whether relevant, reliable, comparable and understandable and fair presentation of financial information

The qualitative characteristics have been explained in detail in Study Text B2.

Diagram 2: Qualitative characteristics of financial information



2. Develop an appropriate audit opinion given the circumstances of an audit.
Draft audit reports based on opinions reached.
[Learning Outcomes b and c]

ISA 700 states that the auditor's report should contain a clear expression of the auditor's opinion on the financial statements.

When the audit is conducted in accordance with ISAs it leads to consistency in reporting and offers credibility to the audit reports on a global level. It also improves the understandability of the audit reports for the readers.

ISA 700 sets out the requirements for the content of the audit report.

2.1 Format and content of the audit report

ISA 200 states that the purpose of the audit is to enable an auditor to express an opinion on the financial statements. The audit report of an independent auditor should be given in a uniform format so that it helps the readers to understand and identify any unusual circumstances.

ISA 700 requires the following layout for the audit report:

1. Title

The report should have a title **clearly stating** that it is an independent auditor's report. The title can be written on the report as "Independent Auditor's Report".

This title **indicates that the audit has been conducted according to the relevant ethical requirements** that are applicable to an independent auditor. It also distinguishes the report from any other audit report that might be given by others.

Example

An entity is subject to two kinds of audit. One is the internal audit and the other is the external audit. Accordingly, two types of reports are generated for the entity. One is the internal auditor's report and the other is the external auditor's report. In this case it is very important that the independent auditor's report should have a clear title that indicates that it is an independent auditor's report so there is no confusion.

---

2. Addressee

The audit report should be addressed to the persons according to the terms of the engagement of the independent auditor with the entity.

Law or regulations generally specify the persons to whom the auditor's report must be addressed. They are applicable within their area of jurisdiction.

The audit report is generally addressed to:

To the **shareholders.**
(sometimes) **those charged with governance** such as the directors; or

3. Opening or introductory paragraph

The introductory paragraph of the auditor's report should include the following matters:

(a) The **name of the entity** whose financial statements have been audited.
(b) The **fact that the statements have been audited.**
(c) The **title** of each of the financial statements that comprise the entire set of the financial statements audited.
(d) **Reference** to the summary of the significant accounting policies and explanatory notes.
(e) **Date and period** of audit covered.

Example

The introductory paragraph will be stated as follows:

We have audited the accompanying financial statements of Straight Ltd which comprise the SOFP as at 31 December 20Y0, the related SOCIs, the statement of changes in equity and cash flows for the year then ended and a summary of the significant accounting policies and other explanatory notes.

---

4. Management's responsibility for the financial statements

The auditor's report should clearly state the **responsibility of the management for the preparation and fair presentation of the financial statements** according to the applicable international financial reporting standards**.** Management here means those charged with governance and having the responsibility for the preparation of the financial statements.

The auditor should describe management's responsibility in detail and state that it includes:

- The responsibility of the management towards the preparation of the financial statements in accordance with the applicable financial reporting framework
- The responsibility for such **internal control** as it determines necessary to enable the preparation of financial statements that are free from material misstatement**,** whether due to fraud or error.

This restricts the auditor's responsibility to the audit of the financial statements.

When management prepares the financial statements in accordance with IFRSs then it is their responsibility to prepare statements that fairly present the financial position, financial performance and cash flows of the entity in accordance with the IFRS. It is their **responsibility to design, implement and maintain internal controls** relevant to the preparation and fair presentation of the financial statements that are free from material misstatement.

5. Auditor's responsibility

The auditor's report should disclose the auditor's responsibility clearly in the audit report. This disclosure should state that their responsibility is to express an opinion on the financial statements based on the audit procedures carried out by them.

According to ISA 700, the auditor's report should **clearly state** the following matters:

- The **audit was carried out in accordance with the ISAs** and these require the auditor to comply with ethical requirements.
- **Reasonable care has been exercised while planning the audit procedures** and the audit has been performed in such a way as to obtain reasonable assurance that the financial statements are free from material misstatements.
- An **audit involves procedures to obtain audit evidence** regarding the amounts and disclosures in the financial statements.
- The **audit procedures followed by the auditor depend on their judgement**. This judgement includes assessment of the risk of material misstatements. In this assessment, the auditor considers the internal controls existing in the entity. The auditor includes a statement on the effectiveness of the internal controls only when there is an explicit requirement.
- An **audit involves evaluation of whether proper accounting policies have been used,** the accounting estimates made are reasonable and the presentation of the financial statements is appropriate.
- **The auditor believes that sufficient audit evidence has been obtained** in order to make an opinion on the financial statements.

Such a disclosure in the auditor's report assures the readers that the proper procedures have been followed by the auditor and increases the reliability of the audit report.

The sample of auditors' report given below contains the matters explained above.

6. Auditor's opinion

This is the most important paragraph of the report since it states the **auditor's observations** on the financial statements. The auditor can either express **an unmodified or a modified opinion** on the statements based on their assessment of the true and fair presentation of the financial statements.

In an **unmodified audit opinion**, i.e. that the accounts are true and fair, the auditor should disclose the following:

- 'The **financial statements present fairly**, in all material respects according to the applicable financial reporting framework', or
- 'The financial statements give a **true and fair view** of the financial position of the company….. in accordance with (the applicable financial reporting framework)'.

Reference to the financial reporting framework should **identify the country of origin or jurisdiction of the reporting standards** if the International Financial Reporting Standards or International Public Sector Accounting Standards are not used in reporting.

The auditor can identify the reporting frameworks in the following manner:

"In accordance with International Financial Reporting Standards" or

"In accordance with accounting principles generally accepted in Country X"

The auditor's report should also **identify the applicable legal and regulatory requirements applicable to the area of jurisdiction**.

These can be expressed in terms such as:

"in accordance with International Financial Reporting Standards and the requirements of Country X Corporations Act"

7. Other Reporting Responsibilities

The **auditor might have certain additional responsibilities which require him to report on supplementary matters along with the financial statements**, apart from the audit of the financial statements. For example, the auditor may be required to comment on the adequacy of the accounting books and records maintained by the entity. In such a case, the auditor should report on these matters in a separate report or in the auditor's report if the standards or laws require or permit it.

Example

Andrew is the auditor of Yanky Plc. The audit engagement with the company requires that the auditor has to express an opinion on the effectiveness of the internal controls along with the financial statements. In this case, the auditor should express an opinion on the effectiveness of the internal controls in a separate paragraph in the auditor's report or in an entirely separate report itself.

The paragraph will be stated as follows:

"In our opinion, the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of the Company as of 31 December, 20Y0, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards."

In our opinion the internal control systems prevalent in the entity are relevant to the preparation and fair presentation of the financial statements.

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8. Auditor's signature

The audit report should be signed in the **name of the audit firm**, the **personal name of the auditor** or both, as appropriate according to the laws applicable to the jurisdiction. Certain jurisdictions may also require the auditor to mention the fact that the firm or the auditor is recognised by the proper licensing authority in the jurisdiction or the auditor's professional accountancy designation.

9. Date of the report

The date of the audit report should be the **date when the auditor has obtained sufficient appropriate audit evidence** based on which they can give an opinion on the financial statements. This audit evidence includes the evidence that a complete set of financial statements has been prepared by management and that management takes responsibility for the preparation.

The date of the audit report is very important since it informs the readers that the auditor has considered the effects of all the events and transactions that happened up to this date.

10. Auditor's address

The report should **name the location, country or the jurisdiction where the auditor practices**.

Example

Unmodified audit report

Full sample of unmodified audit report

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Financial statements are audited and not just reviewed

Specifies the period of the Statements Audited

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31. 20X1. and the income statement. statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Gives readers comfort that professional standards are used

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 Re ortin Standards, and for such internal control as managemen determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Need to show different responsibilities

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.

Work performed

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 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 we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Most important line of a report! Overall the whole audit is conducted for this one line

Opinion

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

State that the standards are followed

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]
[Date of the auditor's report]
[Auditor's address]

Illustration 1 given in ISA 700

Test Yourself 2

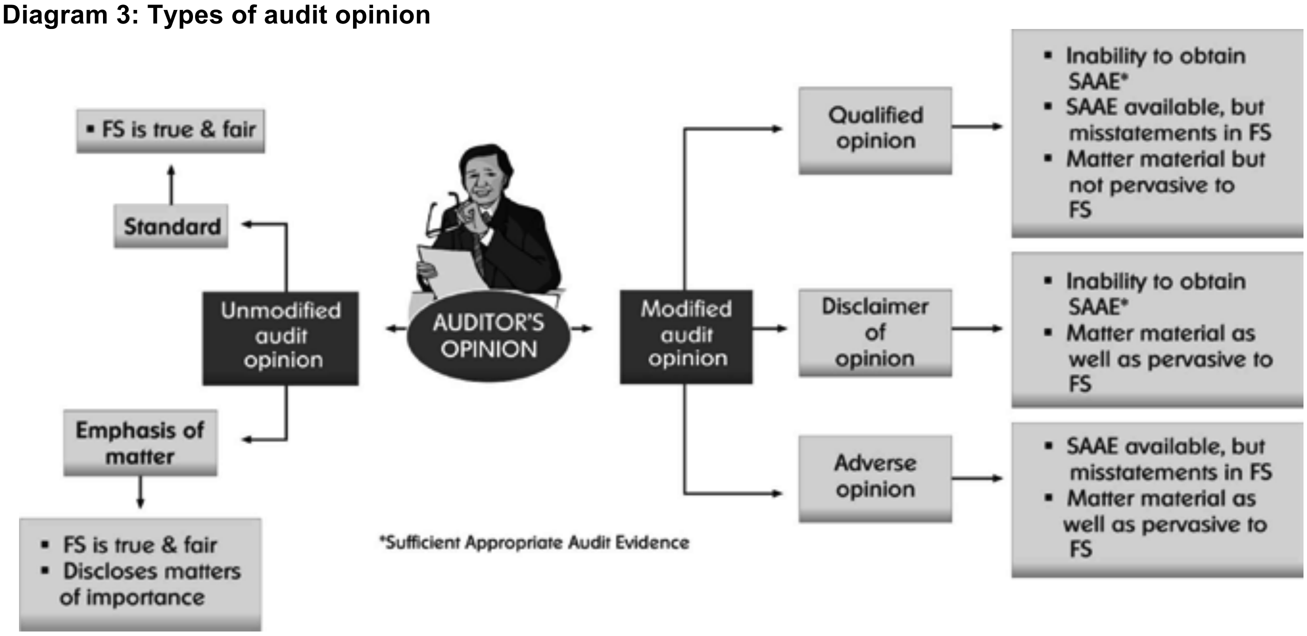
The audit report of Stellar Plc contains the following in the "Basis of opinion" paragraph

"We planned and performed the audit so as to obtain as much information and explanation as possible given the time available for the audit. We confirm that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. The directors however are wholly responsible for the accuracy of the financial statements and no liability for errors can be accepted by the auditor. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the company's annual report."

Required:

Identify and explain the errors in the above extract.

Diagram 3: Types of audit opinion



An auditor's report can be divided into two broad categories. It is either an unmodified opinion or a modified opinion.

2.2 Unmodified audit opinion

An audit report contains an unmodified audit opinion when the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework and represent a true and fair view of the entity.

An unmodified audit opinion therefore concludes that the auditor has obtained reasonable assurance that the financial statements as a whole are free from material misstatements. In short when the factors relating to the **auditor's conclusion** on the audit opinion (discussed in Learning Outcome 1) are satisfied, the auditor would provide an unmodified audit opinion.

1. Standard unmodified opinion

A standard unmodified opinion is issued when the auditor feels that the financial statements show a true and fair view and no material misstatements exist. The unmodified audit opinion is illustrated in Learning Outcome 1.

2. Emphasis of matter paragraph (matters that do not affect the auditor's opinion, ISA 706)

Definition

A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

ISA 706

It is possible that the financial statements which have been audited are true and fair and comply with all legislation. However, the auditor may still feel that there is an important matter that the shareholders should be aware of.

In this case, the auditor can make a reference to the matter in an extra **'emphasis of matter paragraph'.** It is important to note that this is **not a qualified opinion;** it is merely the auditor pointing out an important point. This point will already have been disclosed in the financial statements (probably in a note) but the auditor is worried that it might be overlooked by users of the financial statements. Therefore, it is highlighted in the audit report.

Example

Examples of **circumstances where the auditor may consider it necessary to include an emphasis of matter paragraph** are:

- When the auditors find that there is a threat to the going concern status of the entity and it has made adequate disclosures regarding the threat in its financial statements.
- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- When a major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

Format and content of the emphasis of matter paragraph

The layout of a report having an emphasis of matter will be on the same lines as an unmodified report explained in Learning Outcome 1.

It contains the following matters:

1. Title
2. Addressee
3. Opening or introductory paragraph
4. Management's responsibility for the financial statements
5. Auditor's responsibility
6. Auditor's opinion
7. Emphasis of Matter
8. Other Reporting Responsibilities
9. Auditor's signature
10. Date of the report
11. Auditor's address

When an auditor includes an emphasis of matter paragraph in their report, they should:

(a) Include it immediately after the Opinion paragraph in the auditor's report;
(b) Use the heading "emphasis of matter," or other appropriate heading;
(c) include in the paragraph a clear reference to the matter being emphasised and where the relevant disclosures that fully describe the matter can be found in the financial statements; and
(d) Indicate that the auditor's opinion is not modified in respect of the matter emphasised.

Example

An illustrative emphasis of matter paragraph is given below:
Emphasis of Matter

Without qualifying our opinion, we draw attention to Note X in the financial statements which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

This clearly shows that the emphasis of matter paragraph is not a qualified opinion, but because the matter being discussed is important, it was necessary to highlight it in the auditor's report.

Example as given in ISA 570

If an auditor feels that a matter should have been disclosed in the financial statements (such as a reference to a going concern problem) and the matter is not disclosed, then an emphasis of matter paragraph will not correct this. **Emphasis of matter emphasises something properly disclosed in the financial statements.**

2.3 Modifications in an auditor's opinion can be mainly due to:

- The financial statements containing a material misstatement
- The auditor being unable to obtain sufficient appropriate audit evidence

Uniformity in the form and content of each type of the modified audit reports enhances the user's understanding of such reports.

If a material matter is not disclosed, then the auditor's opinion will be modified (qualification, adverse or disclaimer).

Circumstances when a modification to the auditor's opinion is required

The auditor's opinion in the audit report is modified when:

- The audit evidence obtained by the auditor indicates that the financial statements as a whole are not free from material misstatements; or
- The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatements.

Definition

Modified opinion: a qualified opinion, an adverse opinion or a disclaimer of opinion.

ISA 705

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1. Qualified Opinion

Definition

Pervasive: a term used, in the context of misstatements or an ability to find sufficient appropriate audit evidence, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

Pervasive effects on the financial statements are those that, in the auditor's judgment:

(i) Are not confined to specific elements, accounts or items of the financial statements;
(ii) If so confined, represent or could represent a substantial proportion of the financial statements; or
(iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.

ISA 705

The auditor shall express a **qualified opinion** under the following circumstances:

- Inability to obtain sufficient appropriate audit evidence; or
- Sufficient appropriate audit evidence available, but misstatements in financial statements material although not pervasive.

Each of these is explained in turn below:

(i) Inability to obtain sufficient appropriate audit evidence

The auditor is unable to obtain sufficient appropriate audit evidence on which to base their opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Inability of the auditor **to obtain sufficient appropriate audit evidence** arises when the scope of the auditor's work has been limited in some way.

It **may be due to** the following reasons:

- **Limitations imposed by management**, i.e. the entity imposed certain conditions on the auditor because of which they could not perform the necessary audit procedures e.g. the entity did not allow the auditor to send letters to their clients so the auditor could not confirm the existence of receivables.
- **circumstances relating to the nature or timing of the audit work**, i.e. the auditor is unable to perform the proper procedures due to circumstances beyond their control e.g. they were appointed after the year end inventory verification was over and hence they cannot vouch for its accuracy and existence in any way.
- **Circumstances beyond the control of the entity**, e.g. the records of the entity have been destroyed and

  The auditor cannot verify the details from any other available means.

If the inability to obtain sufficient appropriate audit evidence is **material but not pervasive** (i.e. the limitation affects one area of the financial statements and is material, but does not render the whole financial statements misleading) then the auditor **issues a qualified opinion** in the following manner.

Example

Extracts from auditor's report

Auditor's Responsibility

We believe that the audit evidence 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 SOFP as at 31 December 20X8, and ABC's share of XYZ's net income of XYZ 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 as at 31 December 20X8 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 present fairly, in all material respects, (or give a true and fair view of) the financial position of ABC Company as at 31 December 20X8, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Illustration 3 in ISA 705

(ii) Sufficient appropriate audit evidence available, but misstatements in financial statements material although not pervasive

Material misstatement of the financial statements may arise in relation to:

- **The appropriateness of the selected accounting policies**. For example, the valuation of inventories at cost instead of the lower of cost or net realisable value as prescribed by IAS 2, Inventories.
- **The application of the selected accounting policies**. For example, the valuation of non-current assets is done using the cost model for one financial year, and in the next year the same assets are valued using the revaluation model. Furthermore, during the third year, the cost model is adopted to value the same non-current assets.
- **The appropriateness or adequacy of disclosures in the financial statements**. For example the financial statements of a manufacturing company prepared under IFRSs, do not include all of the disclosures relating to revenue recognition and non-current assets.

There may be a situation where the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in aggregate, are material, but not pervasive to the financial statements. At such times a qualified opinion is expressed.

Example

Extracts from auditor's report

Auditor's Responsibility

We believe that the audit evidence 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 SOFP 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 effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of ABC Company as at December 31, 20X8, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Illustration 1 in ISA 705

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2. Disclaimer of opinion

These points have been explained in paragraph 1 above!

A disclaimer of opinion is provided under the following circumstances:

- When the **auditor is unable to obtain sufficient appropriate audit evidence** on which to base their opinion, and;
- The **limitation is pervasive enough to cause the financial statements to mislead** then the **auditor issues a disclaimer**.

Example

Extracts from audit report

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with 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

The company's investment in its joint venture XYZ (Country X) Company is carried at xxx on the company's SOFP, which represents over 90% of the company's net assets as at December 31, 20X8. We were not allowed access to the management and the auditors of XYZ, including XYZ's auditors' audit documentation.

As a result, we were unable to determine whether any adjustments were necessary in respect of the company's proportional share of XYZ's assets that it controls jointly, its proportional share of XYZ's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, and the elements making up the statement of changes in equity and cash flow statement.

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.

Illustration 4 in ISA 705

A disclaimer of opinion is also made when under multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

This is under rare circumstances

3. Adverse Opinion

An adverse opinion is expressed when **the auditor, after obtaining sufficient appropriate audit evidence, concludes that misstatements, individually or in aggregate, are both material and pervasive to the financial statements**. It means that the audit evidence indicates that the financial statements as a whole are not free from material misstatement

Example

Auditor's Responsibility

We believe that the audit evidence 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 20X8 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 consolidated 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 present fairly (or do not give a true and fair view of) the financial position of ABC Company and its subsidiaries as at December 31, 20X8, and (of) their financial performance and their cash flows for the year then ended in accordance with International Financial Reporting Standards.

Illustration 2 in ISA 705

(i) Description of auditor's responsibility when the auditor expresses a qualified or adverse opinion

The description of the auditor's responsibility must state that the auditor believes the audit evidence they have obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion. (Refer to above example)

(ii) Description of auditor's responsibility when the auditor disclaims an opinion

The following amendments are needed:

- Amendments to the introductory paragraph of the auditor's report to state that the auditor was engaged to audit the financial statements.
- Amendments to the description of the auditor's responsibility and to the description of the scope of the audit to state the matters given in the following example:

Example

"Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with International Standards on Auditing. However, because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion."

2.4 Other matters paragraph

Definition

A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

ISA 706

This paragraph is used when the auditor considers it necessary to make the readers of the financial statements aware about matters which are relevant to their understanding of the audit or the auditor's responsibilities or the audit report.

For example, if an entity prepares its financial statements under IFRSs and US GAAPs, the auditor may include an Other Matter paragraph in the auditor's report, referring to the fact that another set of financial statements has been prepared by the entity in accordance with US GAAP and that the auditor has issued a report on these financial statements.

This paragraph is included immediately after the Opinion paragraph and any Emphasis of Matter paragraph, or elsewhere in the auditor's report if the content of the Other Matter paragraph is relevant to the Other Reporting Responsibilities section.

2.5 The following table summarises the contents of the various types of audit reports:

Sr No	**Unmodified audit opinion audit report**	**Emphasis of matter audit report**	**Modified opinion audit report**	**Audit report containing Other matter paragraph**
1.	Title	Title	Title	Title
2.	Addressee	Addressee	Addressee	Addressee
3.	Opening or introductory paragraph	Opening or introductory paragraph	Opening or introductory paragraph	Opening or introductory paragraph
4.	Management's responsibility for the financial statements	Management's responsibility for the financial statements	Management's responsibility for the financial statements	Management's responsibility for the financial statements
5.	Auditor's responsibility	Auditor's responsibility	Auditor's responsibility	Auditor's responsibility
			Basis for adverse opinion / qualified opinion / disclaimer of opinion	
6.	Auditor's opinion	Auditor's opinion	**adverse opinion / qualified opinion / disclaimer of opinion**	Auditor's opinion
7.	-	**Emphasis of Matter**		**Basis of accounting**
8.	Other Reporting Responsibilities	Other Reporting Responsibilities	Other Reporting Responsibilities	**Other matter**
9.	Auditor's signature	Auditor's signature	Auditor's signature	Auditor's signature
10.	Date of the report	Date of the report	Date of the report	Date of the report
11.	Auditor's address	Auditor's address	Auditor's address	Auditor's address

The above table indicates that items mentioned under serial numbers 1 to 5 and 9 to 11 above are common for all types of reports. The matters that differ in the reports relate to the auditor's opinion, basis of audit opinion, emphasis of matter and other matter paragraphs.

2.6 Communication with those charged with governance

The following table summarises the matters communicated with those charged with governance:

	If the auditor expects to **include an Emphasis of Matter or an Other Matter paragraph** in the auditor's report	If the auditor expects to **modify the opinion** in the auditor's report
Matters communicated	The matter and the proposed wording of this paragraph.	The circumstances that led to the expected modification and the proposed wording of the modification.

Continued on the next page

Reasons for communication	Enables those charged with governance to be: made aware of the nature of any specific matters that the auditor intends to highlight in the auditor's report. provided with an opportunity to obtain further clarification from the auditor where necessary.	Enables the auditor to: give notice and the reasons (or circumstances) for the modification(s) to those charged with governance. confirm matters of disagreement with management. obtain further information and explanations from those charged with governance, in respect of the matter(s) giving rise to the expected modification(s).

Test Yourself 3

Croquet Plc appointed Henry as its auditor to audit the financial statements for the year ended 31 December 20X9. According to the terms of engagement, there were restrictions imposed on him for the verification of the inventory. The set of records maintained were also inadequate since there was no supporting documentation for the figures of the receivables as well as the payables for the last six months. However, Henry still accepted the appointment since it was required by the statute.

Required:

Draft a modified audit report that Henry will issue in this case.

---

3. Identify and explain the meaning of expectation gaps in the context of audit and assurance assignments and their implications for the profession, including fraud, going concern, internal control and risk issues.

[Learning Outcome d]

The expectation gap is the gap between an auditor's actual standards of performance and what the public expects of his performance.

An auditor's actual standards of performance are the **standards set by various statutes**, laws, generally accepted audit standards, accepted accounting standards etc.

The public means the **company, its shareholders, officers, employees, bankers, vendors, customers**, etc. The public is generally not aware of the auditor's actual standards of performance and the scope of his work. Therefore, there is always a difference between the auditor's performance and the public's expectations of the auditor's performance.

Example

Peoplesoft Ltd was engaged in the recruitment of personnel to the hotel industry in China. It appointed Lee as an auditor for its Chinese division. Lee gave an unmodified report for the year 20X8.

After 6 months, the accounts executive, Andrew, noticed that Neil, an employee in the accounts department, had forged signatures on cheques and made fraudulent withdrawals from the bank over the last 15 months. The total value of the fraud was estimated at TZS10 millions.

Lee had carried out the audit according to the Generally Accepted Auditing Standards. He had maintained professional scepticism while conducting the audit and since he did not come across any circumstances which indicated a possibility of fraud, he verified transactions on a test check basis (in accordance with ISA 500). He also verified the bank reconciliation statements.

However, Peoplesoft filed a suit against Lee for performing the audit negligently by giving an unmodified report. Peoplesoft was under the impression that Lee had checked 100% of the vouchers and therefore the accuracy was assured.

This gap between Lee's performance according to the auditing standards and Peoplesoft's belief is known as the expectation gap.

Expectation gaps in the context of audit and assurance assignments and their implications for the profession, including fraud, going concern, internal control and risk issues.

1. **Public expects that the** primary responsibility of the financial statements lies with the auditors.

However, the financial reporting framework suggests that the preparation of the financial statements is the responsibility of management and should be acknowledged by them.

2. Public expects that auditors certify financial statements i.e. give complete assurance that financial statements are accurate.

However the auditing standards require auditors to express an opinion on whether the financial statements are true and fair. It is also practically difficult for an auditor to certify the financial statements due to limitations of audit (like auditors conducting audit on transactions on sample basis rather than on 100% transactions) caused by the huge volume of transactions and the limitations of internal controls.

3. The going concern assumption is one of the fundamental assumptions based on which the financial statements are prepared and therefore it is critical in deciding the valuation methods for assets and liabilities of the business. Therefore public expects that the auditor makes an independent assessment of going concern status of the entity, at the time of audit.

However IAS 1(Revised 2003) 'Presentation of Financial Statements' and ISA 570 require that, along with the preparation of the financial statements, management should **make an assessment** of an **enterprise's ability to continue as a going concern.** ISA 570 states that the auditor should **evaluate management's assessment** of the entity's ability to continue as a going concern.

The auditor's responsibility is:

- to **consider the appropriateness of management's use of the going concern assumption** and consider whether there are material uncertainties about the entity's ability to continue as a going concern.
- to decide **whether there is a material uncertainty** that might affect the going concern status of the entity.
- to consider the **implication of the going concern status** on the auditor's report.

Although it is the responsibility of the auditor to assess management's use of the going concern assumption, they are **not responsible for predicting future events or conditions.** Therefore, the audit report cannot be considered a guarantee of the entity's ability to continue as a going concern.

4. Public expects that the auditor forms an opinion on the effectiveness of risk and control procedures.

Therefore the auditor is not required to form an opinion on the **effectiveness of corporate governance procedures or the risk and control procedures.**

Public expects that internal controls can help an entity get to where it wants to go, and avoid setbacks and surprises along the way.

Internal control can help an entity to:

- Achieve its performance and profitability targets, and prevent loss of resources
- Ensure reliable financial reporting
- Ensure that the enterprise complies with laws and regulations, avoiding damage to its reputation and other consequences

Unfortunately, some people have greater, and unrealistic, expectations from internal controls. Internal controls face the following limitations:

- Internal controls cannot ensure an entity's success, i.e. they cannot ensure the achievement of basic business objectives or the survival of the company.

- Effective internal control can only help an entity to achieve these objectives; it can provide management information about the entity's progress, or lack of it, toward its objectives. However, internal control cannot change an inherently poor manager into a good one. What's more, changes in government policy or programmes, competitors' actions or economic conditions are usually beyond management's control.

Internal control cannot ensure the reliability of financial reporting and compliance with laws and regulations. An internal control system, no matter how well conceived and properly operated, can provide only reasonable, and not absolute, assurance to management and the board regarding the achievement of an entity's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These include the fact that wrong decisions can be taken and that breakdowns can occur because of a simple error or mistake.

Additionally, **controls can be circumvented by the collusion of two or more people,** and management has the ability to override the system.

Another limiting factor is that the **design of an internal control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs.** Therefore, while internal control can help an entity achieve its objectives, it is not a panacea.

Test Yourself 4

(a) Smith was the auditor of Bright Bankers for the year 20Y0. The audited financial statements contained a note that the cash balance as at 31 December 20Y0 had not been verified by him. He had relied on a certificate from the management in this regard, since, during the course of audit, the auditors had verified cash twice and found no discrepancy. The shareholders of the bank raised the issue at the AGM.

(b) Smith is also the auditor of RX Systems, which is an IT-based company. The company carries out most of its transactions through cheques. While auditing, Smith followed the same method of verifying cash as practised in Bright Bankers (i.e. Smith did not carry out the physical verification of cash on the date of the SOFP but rather during the course of audit and did not find any variation between the physical cash and the cash book balance). The company's board of directors wanted the auditors to justify their audit evidence.

As a policy, Smith follows the above method of audit evidence since he has only four employees who normally visit clients on the last day of the year to verify cash.

Required:

Explain the expectation gap and justify your answer.

Answers to Test Yourself

Answer to TY 1

Review and test the process used by management to develop the estimate

The following steps are suggested:

1. Risk assessment procedures

According to ISA 540, the risk assessment procedures include an understanding of the following:

(a) The requirements of the applicable financial reporting framework:
IAS 2 Inventories provides guidance on the write-down of inventory to net realisable value. The auditor needs to understand the provisions of IAS 2 in this connection.

(b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements.

The auditor needs to inquire from the management about the conditions or events that have occurred which give rise to the need for the write-down of inventory to net realisable value.

(c) How management makes the accounting estimates, and an understanding of the data on which they are based, including:

The method used in making the accounting estimate. For example the method of determining the items of inventory which need to be written down, i.e. those inventories which are either damaged or have become wholly or partially obsolete or if their selling price has declined.
Relevant controls: the auditor obtains an understanding of the review and approval of accounting estimates.

2. Responses to the Assessed Risks of Material Misstatement

The auditor is required to carry out one or more of the following:

(a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.

Subsequent movements in the relevant items can be traced to find the actual proportion which became unsellable. The items in inventory which have been identified for write down will be verified with the inventory records of the period after the date of the financial statements, but before the date of the audit report. The sales invoices will provide evidence of the sale price of these items. Based on this the net realisable value can be derived.

(b) Test how management made the accounting estimate and the data on which it is based.

The auditor would:

Evaluate whether the data related to inventory on which estimates are based is accurate, complete and relevant e.g. a particular lot of chemical material, around 25% of the inventory is identified as being unsellable. Verify if this is based on accurate, complete and relevant data.

evaluate whether the data collected is appropriately analysed and projected to form a reasonable basis for making estimates e.g. if the past averages of chemical L are being applied to another chemical Z, it should be checked if the chemical properties of the two are similar.

If the amount of the allowance is material, then consider obtaining the opinion of an expert.

Test the calculations related to past averages and their applications for future estimates.

Compare the previous estimates of allowance with actual results.

Consider management's approval procedures: who calculates the allowance, approves the allowance.

3. Disclosures Related to Accounting Estimates

The auditor will obtain sufficient appropriate audit evidence that the disclosures in the financial statements related to accounting estimates are correct.

In case of accounting estimates that give rise to significant risks, the auditor will evaluate the adequacy of the disclosure of the estimation uncertainty.

Answer to TY 2

ISA 700 requires that the audit report should contain a clear written expression of opinion on the financial statements taken as a whole and that the audit report should clearly state whether the financial statements are prepared following the financial reporting framework (financial reporting framework used in preparation of the financial statements).

The audit report should also contain a paragraph that states the auditor's responsibility towards the audit of the financial statements. They have to obtain sufficient appropriate audit evidence before they express an opinion on the financial statements. The given extract contains the following errors:

The auditor in this case has stated in the audit report that time was a factor in obtaining information and explanations. This implies that certain matters may be incomplete that would have been complete had time permitted. It is the responsibility of the auditor to plan the audit in such a way that they can obtain sufficient evidence before they express an opinion on the financial statements. They should not stop the procedures just because they ran out of time.

The disclaimer regarding the errors can be helpful in limiting the auditor's liability. However, it should not be written in the basis of opinion paragraph as it severely limits the responsibility of the auditor. It might also imply that the auditor has not carried out their job well or has done little or no work.

The auditor does not have the responsibility to audit the entire annual report. Therefore it is inappropriate to refer to a disclosure made in the annual report. Reference should only be made regarding the statements audited, i.e. the financial statements.

Answer to TY 3

When the audit engagement is such that it imposes restrictions on the audit work, the auditor should not accept such an engagement since it interferes with their independence as an auditor and their ability to collect sufficient appropriate audit evidence. In the given case, Henry has accepted the audit engagement since it is required by the statute even though there are significant restrictions on his audit procedures.

Henry will issue a modified audit report in the following manner:

Independent auditor's report

[Appropriate Addressee]

Report on the Financial Statements

"We were engaged to audit the accompanying financial statements of Croquet Plc, which comprise the statement of financial position as of 31 December 20X9, and the income statement, statement of changes in equity and statement of cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph: see example in Learning Outcome 1 above).

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with 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

The financial statements include receivables amounting to ----- for the year ended 31 December 20X9. We did not verify the records relating to receivables due to limitations placed on us by management.

We were unable to satisfy ourselves as to the receivables and payables position by other audit procedures. As a result we were not able to confirm the accounts receivable and payable positions.

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.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]
[Auditor's signature]
[Date of the auditor's report]
[Auditor's address]

Answer to TY 4

(a) The cash balance certified by the bank's management can never be accepted as audit evidence. This is because the cash balance of a bank forms a significant portion of the financial statements of a bank. Hence, the likelihood of misappropriation of a significant part of the funds by the management always exists. Professional scepticism demands that the auditor is aware of the importance of verifying the cash of a banking audit client and conducts a physical verification of the cash on the last day of the financial year. Hence, there is an expectation gap because the auditors have not adhered to the generally accepted auditing standards.

(b) The cash balance certified by the management can be accepted as audit evidence. This is because the cash balance of RX will not form a significant portion of financial statements. Hence, there is no risk of material misappropriation of cash by the management. Professional scepticism demands that Smith makes the right judgement about the sufficiency of the audit evidence. At RX, the auditors had previously verified the cash during audit and found no discrepancy. Considering the facts, it appears that Smith has made the right judgement.

Hence, there is an expectation gap because the audit committee's expectations from the auditor are beyond the accepted standards of auditing.

Quick Quiz

1. State the eight important points in the layout of the audit report.

2. **ISA 700,** requires that the audit report should clearly state whether the ______________________ are prepared following the ______________________ framework.

3. According to ISA 700, the auditor's report should describe that the audit involves:
   (a) ______________________ to support the financial statement amounts and disclosure are followed.
   (b) Assessing the ______________________ used in the preparation of the financial statements.
   (c) Assessing the ______________________ made by management in the preparation of the financial statements.
   (d) Evaluating whether the presentation of the ______________________.

Answers to Quick Quiz

1. Important points in the layout of the audit report are:

   Title
   Addressee
   Opening or introductory paragraph
   Scope paragraph
   Opinion paragraph
   Date of the report
   Auditor's address
   Auditor's signature

2. Financial statements, financial reporting

3.

   (a) Procedures to obtain audit evidence
   (b) Accounting principles
   (c) Significant estimates
   (d) Financial statement appropriate

Self-Examination Questions

Question 1

Baby Bliss Pvt Ltd is an entity producing baby products such as nappies, soap, hair oil, shampoo, massage oil, health tonics etc. Rachael is appointed as the auditor of the company. She has completed the audit procedures and is now preparing the audit report.

The following points are noted by her during the course of her audit. she observes that the valuation of work in progress has not been made and, on enquiry, it is explained to her the valuation is very complicated and time-consuming and that there is not much difference between the opening and closing inventory of work-in-progress (WIP). Therefore management has refused to take the help of an expert for this purpose.

Required:

State, with reason, whether there is a need for Rachael to give a modified audit report for the above matter and, if so, what sort of report would be suitable.

Question 2

You are the newly appointed audit manager of Pearce Co. Your audit team has completed the audit work according to the audit plan. You are in the process of performing an overall review of the financial statements and the audit evidence gathered during the audit.

Pearce Co is in the fashion industry and has operated for the last five years. It has opened a branch in the same city. Sales depend on the trends in the market. Therefore inventory is maintained at a low level. Sales are made directly to customers and purchases are made from five major suppliers. All sales are cash sales and purchases are made on credit.

At the year end, all inventory items are valued at cost even if they do not appear to be selling well. They should be valued at the lower of cost and net realisable value.

After the year end, the branch was closed down since it was making losses continuously.

You have communicated the errors discovered during the audit to management. They are uncorrected by management on account of immateriality to the financial statements.

Required:

State why it is necessary to conduct an overall review of the audit evidence obtained and financial statements as a whole and how this is to be performed.

Answers to Self-Examination Questions

Answer to SEQ 1

Rachael should issue a modified audit report when she is unable to obtain sufficient appropriate audit evidence.

Assuming that the amount of inventory is material, in the given case, it is **necessary to give a modified audit opinion** as the WIP has not been valued. It is essential to value the WIP, however complicated its calculation may be. If the calculations are very large and complex and cannot be performed by employees with accuracy or they are very time-consuming and the auditor himself is not able to do them, then the work should be given to an expert.

Rachael should add a paragraph in the opinion section of the report, stating that the valuation of WIP has not been carried out due to its complex nature that the auditor was unable to do it and that management has refused to engage an expert. The auditor should prepare a qualified report as to this part or issue a disclaimer if the problem is judged to be pervasive as she cannot make any comment on the valuation of WIP due to the limitation imposed on her by the company.

Answer to SEQ 2

First, an overall review of the financial statements is performed to check whether they have been prepared in accordance with the financial reporting framework etc.

A review of audit evidence is then carried out. This will enable the auditor to decide the extent to which the evidence can be relied on for forming an opinion on the financial statements. All the audit evidence gathered during the audit of Pearce Ltd will be reviewed. After such a review, if it is concluded that the audit evidence is not sufficient in quantity and of appropriate quality, further audit procedures will have to be performed.

It is stated that some of the items of inventory seem obsolete. Investigations should be made as to whether any sales are made after the year end to confirm the bases of valuation. If no sales are made after the year end there might still be insufficient appropriate audit evidence. Enquiries should be made in the market, from the competitors etc. about the market price of such items to ensure the assertion correctness and valuation of inventory.

If there are uncorrected misstatements, a representation should be obtained from management that uncorrected misstatements are not material. However, this will not relieve the auditor from responsibility for considering the materiality of the uncorrected misstatements to the financial statements. If the auditor concludes that they are material, either individually or in aggregate, to the financial statements, management will be asked to correct them. If management refuses, and further audit procedures cannot reduce the risk of material misstatement, the auditor may consider modifying the audit report. If the auditor finds the uncorrected misstatements to be immaterial, the misstatements should be communicated to those charged with governance.

SECTION F

PUBLIC SECTOR AUDITING

F1

STUDY GUIDE F1: PUBLIC SECTOR AUDITING

Get Through Intro

So far, we have discussed the different features of statutory audit which apply to the audit of any organisation. However, the auditors of public sector undertakings have a wider scope of work, like confirming that the operations of the public sector organisations are efficient and effective.

The National Audit Office of Tanzania (NAOT) is the Supreme Audit Institution of the United Republic of Tanzania (URT). This Study Guide focuses on the legal audit environment and various aspects of public sector auditing in Tanzania.

Important

The following sources have been used to explain the given Learning Outcomes.

- Constitution of the United Republic of Tanzania
- Tanzania public audit act 2008
- INTOSAI standards

Learning Outcomes

a) Identify the role of Controller and Auditor General (CAG).
b) Explain the legal environment in which the CAG and auditees function.
c) Explain specific considerations for public sector auditing.
d) Explain the role of INTOSAI.
e) Value for Money Audit

1. Identify the role of Controller and Auditor General (CAG).
Explain the legal environment in which the CAG and auditees function.
[Learning Outcomes a and b]

The CAG is appointed by the President of the United Republic of Tanzania.
The CAG regulates The National Audit Office of Tanzania (NAOT), which is the Supreme Audit Institution of the United Republic of Tanzania.

Audit mandate
The constitution, by virtue of article 143 of the Constitution of the United Republic of Tanzania and Sec.32 (4) of the Public Audit Act No.11 of 2008, the Controller and Auditor General is the statutory auditor of the all public authorities or bodies.

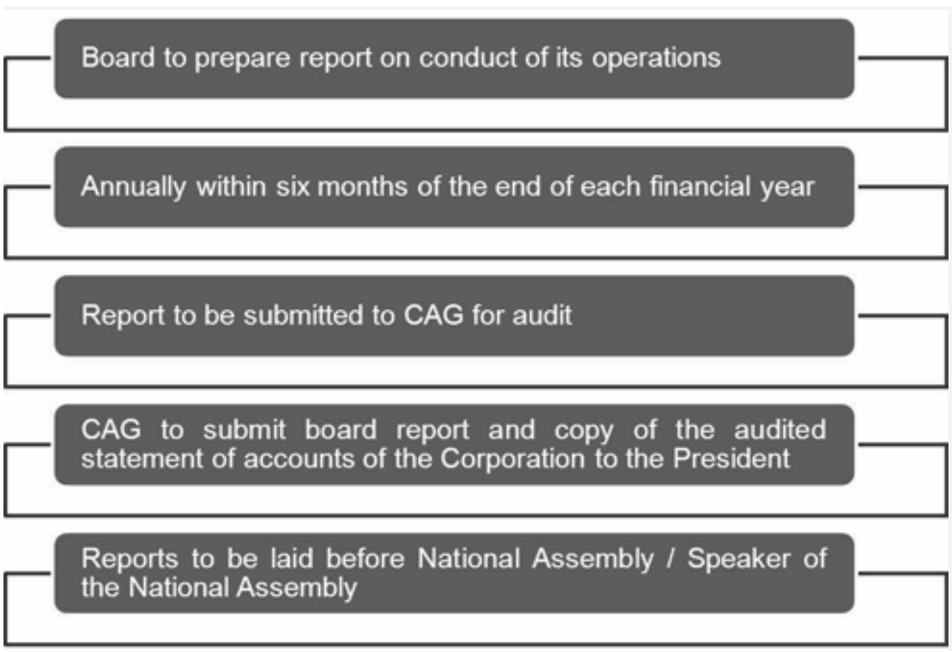
However, in accordance with Sec.33 of the Public Audit Act No.11 of 2008 the CAG may authorise a qualified auditor to carry out an audit on his behalf.

1.1 Role of CAG

The CAG is appointed by the President of the United Republic of Tanzania since its adoption of the Republican constitution.

The CAG regulates The National Audit Office of Tanzania (NAOT), which is the Supreme Audit Institution of the United Republic of Tanzania. The accounts of the Corporation shall be audited by the Controller and Auditor-General.

Diagram 1: Reporting responsibilities of the CAG



Article 143 (5) of the Constitution of URT (United Republic of Tanzania) of 1977 empowers the CAG to audit the accounts of public authorities and other bodies in which the Government has more than 50% shareholding.

The role of the CAG can be further clarified through the functions and responsibilities stipulated in sections 11 and 12 of the Public Audit Act 2008, which mandate the following:

<table>
<tr><th>Functions of the Controller and Auditor General</th><th>Responsibilities of the Controller and Auditor General</th></tr>
<tr><td>1. The CAG shall examine, inquire into and audit the accounts submitted to him as required under the Public Finance Act, Local Government Finances Act and any other written laws and perform any other functions which he is authorized to perform by or under this Act.

2. In exercising his functions or inquiry, examination and audit of accounts, the CAG shall satisfy himself that-

(a) all accounts have been kept in accordance with generally accepted accounting principles as required by relevant laws;
(b) all reasonable precautions have been taken to safeguard:
(i) the collection of revenue; and
(ii) the receipt, custody, disposal, issue and proper use of public property, and that the laws, directions and instructions applicable thereto have been duly observed.
(c) all expenditure of public monies has been properly authorised and applied to the purposes for which they were appropriated and that the laws, directions and instructions applicable thereto have been duly observed and provide an effective check of the assessment and collection of revenue; and
(d) economy, efficiency and effectiveness have been achieved in the use of public resources.</td><td>In addition to the functions assigned to the CAG by the Constitution, the CAG shall:
(a) be responsible for examining, inquiring into, auditing and reporting on the accounts of:
(i) all Ministries, Independent Departments of Government, Agencies and their accounting officers;
(ii) local Government Authorities and their accounting officers;
(iii) all persons entrusted with the collection, receipt, custody, issue, sale, transfer or delivery of any stamps, securities, stores or other public properties;
(iv) all public authorities and other bodies;
(v) any public authority or public body which receives funds from the Consolidated Fund or from public monies for a public purpose;
(vi) any public authority or public body which is authorized by law to receive money for a public purpose; and
(vii) any public authority or public body required by law to be audited by the CAG.
(b) conducting any other audit as provided in this law or other written laws.</td></tr>
</table>

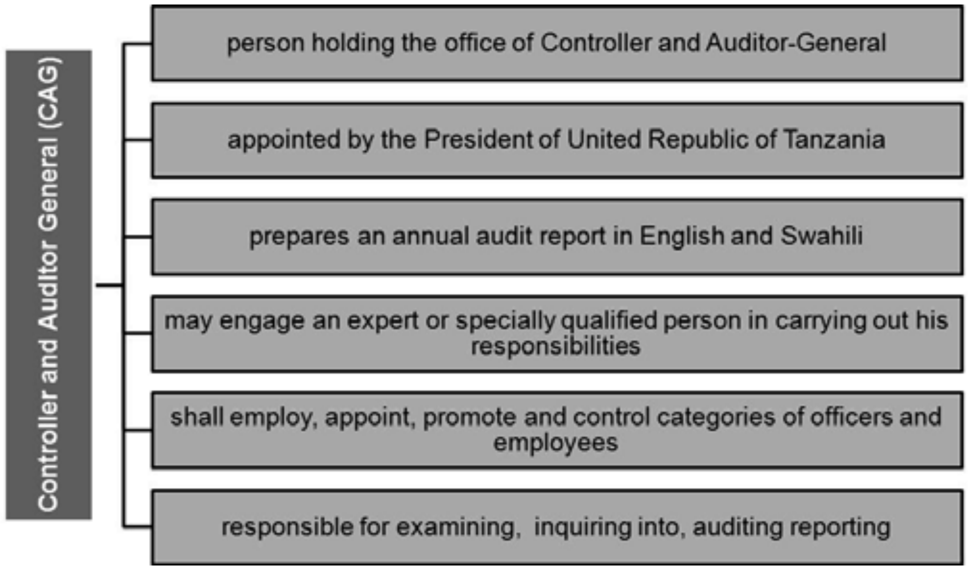
Tip

As a part of its responsibilities, the office of CAG prepares an annual audit report in English and Swahili.

In carrying out his responsibilities and in the performance of his function, the CAG may engage an expert or specially qualified person, whether or not that person is a public officer for the purpose and on such terms and conditions as may be agreed upon.

The CAG shall employ, appoint, promote and control categories of officers and employees of such qualifications as may be considered necessary to assist him in the performance of the functions, carrying on responsibilities and the exercise of his powers.

Diagram 2: The Controller and Auditor-General – CAG



Test Yourself 1

Briefly describe the role of the CAG in Tanzania.

1.2 Legal environment in which the CAG and auditees function

Definition

An auditee is a person or organisation being audited under The Public Audit Act, 2008.

1.3 Legal mandates of CAG

The legal mandates of the CAG include:

1. **Authorisation** of the **use of money** to be paid out of the Consolidated Fund upon being satisfied that Article 136 of the Constitution of the United Republic of Tanzania of 1977(as amended from time to time) has been complied with;

2. Ensuring that the **money** authorized to be charged on the Consolidated Fund or the money, the use of which is authorized by law, has been **spent for purposes connected** and incurred in accordance with authorization.

3. **Auditing and reporting** on the accounts, financial statements and financial management of:

   Ministries, Departments and Agencies (MDAs), Executive Agencies, Public Authorities and Donor Funded Projects;
   The Local Government Authorities;
   The Judiciary; and
   The National Assembly.

1.4 General points

1. The accounting officer of the auditee shall ensure that the CAG has **access all reasonable times to the documents of the auditee** relating to the performance of its functions and responsibilities.

2. For the purpose of the CAG performing its functions and responsibilities and the exercise of his powers, the CAG may require an **auditee or any person employed by the auditee** to:

(a) Produce any document in the auditee’s or other person’s custody, care or control; and

(b) Provide the CAG with information or explanation about any information, system or asset

3. The CAG may also obtain such information as he considers necessary to fulfil the performance of his functions, responsibilities and the exercise of his powers from any person who is not a member, employee or officer of the auditee. In **obtaining information**, the CAG shall:

(a) Advise the person in writing of the nature of the information; and

(b) State that the information is required under this Act.

4. Scope of audit

The CAG shall determine the scope and extent of the examination or inspection of the accounts or any other audit of each auditee under this Act, which he considers desirable in carrying on his responsibilities and functions specified under Part II of the Tanzanian Public Audit Act 2008.

5. Audit Standards and Code of Ethics

(a) The CAG, in discharging his functions and responsibilities, shall determine which auditing standards should be applied and may issue auditing standards and Code of Ethics and Conduct specific to the audits performed by the National Audit Office.

(b) Pursuant to subsection (i), the CAG may be guided by international auditing standards or other auditing standards as he may deem fit.

Subcontracting of an audit

A private audit firm can be appointed to audit a public company if appointed by the CAG to conduct the audit in his behalf. This power is conferred to him through section 11(1)(c) and section 33(1) of the Public Audit Act No 8 of 2011 which provides that the power of CAG of authorising any person eligible to be appointed as an auditor as the requirements of the Accountants and Auditors (Registration) Act, to conduct an inquiry, examination or audit on his behalf and that person or officer shall report to him;"

Types of audits by the CAG (sec 26 to 29 of para 2008)

Regularity audit

The regularity audit conducted by the CAG shall include the evaluation and examination of-

a) Financial statements and the underlying records;
b) Internal control systems and other checks;
c) Public procurement procedures and process;
d) Compliance with applicable laws, regulations and policies; and
e) Any other matter as the CAG may consider necessary.

Forensic audit

Where, in the course of forensic audit or any other type of audit, the officer of the National audit Office suspect frauds, they shall immediately notify the matter to the CAG who shall determine if and how the audit shall proceed as the matter may have to be reported to law enforcement organs.

Performance audit

The CAG shall, for the purposes of establishing the economy, efficiency and effectiveness of any expenditure or use of resources of the entities, enquire into, examine, investigate and report, in so far as he considers necessary, on-

a. the expenditure of public monies and the use of resources by such Ministries, departments, agencies, local authorities and all such public authorities and other bodies.
b. the conduct of and performance of functions by accounting officers, head of department and chief executive officers of all such entities stipulated in section 5(c) of Public Audit Act;
c. compliance with environmental laws, regulations and internal environmental policies and standards; or
d. any other activity undertaken by such entities.

Other audits

1. The CAG may undertake any other type of audit as he may deem fit.
2. Special audit on request by any person, institution, public authorities, Ministries, departments, agencies, local government authorities and such other bodies to undertake any special audit.

2. Explain specific considerations for public sector auditing.

[Learning Outcome c]

2.1 Introduction to public sector auditing

Public sector auditing signifies audits relating to Government sector agencies like:

- Pension schemes
- Defence agencies
- Healthcare sector
- Education sector
- Nigerian Foreign Missions and Agencies
- Charities and other public non-for-profit organisations

Usually, an auditor provides reasonable assurance that the financial statements issued by an organisation are free from material misstatements. However, unlike audits for private organisations, an auditor auditing a public organisation may also go further to assess whether the public organisation is meeting its mission or objectives. Public sector audits differ from private sector audits; the auditing work is much more diverse in public sector entities and goes beyond the focus on auditing annual accounts to a broader assessment of value for money.

2.2 Public sector audit vs. private sector audit

Public-sector audit has unique characteristics, which distinguish it from private-sector audit.
These include the following:

1. **Auditor's independence:** private sector auditors are selected by the management of the companies, (on behalf of the shareholders) they are auditing. However, public sector auditors are appointed by the Government, and thus, generally have a higher level of independence.

2. **Wider audit scope:** private sector auditors generally concentrate on financial audit and provide reasonable assurance on the true and fair nature of financial statements. However, public sector auditors also:

   - Carry out value for money audit which involves determining whether the entity has ensured economy, efficiency and effectiveness in the public-sector services provided
   - Confirm that grants sanctioned by the Government have been applied for the purposes for which the grants were sanctioned

3. **Reporting:** private sector auditors report to the shareholders of the companies they are auditing, whereas public sector auditors report to the Parliament and the audit reports are made available publicly.

2.3 Specific considerations for public sector auditing

1. Auditor independence is vital to any audit. As public sector auditors are appointed in accordance with all relevant statutory obligations by bodies which are independent of the organisation, the audit of public sector entities will involve an independent expression of opinion on the financial statements of Government bodies.

2. The auditor in the public sector critically examines the financial activities of Governments to ensure:

   - Minimum financial and auditing standards being adhered to; and
   - Stewardship in the utilisation of public funds by ultimately adhering to all relevant statutory provisions.

3. The role of the Auditor-General is to ensure that there is accountability by the Executive arm of the Government to the Legislative arm, for the proper administration of the activities, functions, operations and programmes of the Government and its various agencies.

4. While assessing materiality, the auditor exercises professional judgment and takes into account the "context and nature" of items. For example, matters considered include a variety of aspects like compliance with authorities, legislative concern or public interest.

5. The analytical procedures performed during the conduct of private sector audits may not be relevant to the audit of public sector entities. Furthermore, industry data used for comparison purposes is not available.

Example

Irrelevant relations in public sector audits (examples)

The relationship between revenues and expenditures is not direct as the objective of public sector entities is service oriented rather than solely profit oriented.
There may be no relationship between inventories and non-current assets as entities do not capitalise all non-current assets acquired.

Relevant relations in public sector audits (examples)

The number of vehicles acquired versus the number of vehicles retired
Variations in the cost per kilometre of road constructed

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6. Public sector auditors report to the legislature rather than to 'those charged with governance'. Furthermore, the scope of audit is also wider. Therefore, the engagement letter will be accordingly different for public sectors audits.

7. The CAG is required to submit the annual general report on the audit of public authorities in accordance with article 143 of the Constitution of the United Republic of Tanzania.

8. The audit comprises the performance of audit procedures considered necessary for the purpose of forming an independent audit opinion thereon.

9. According to Article 143 (2) (c) of the Constitution of the United Republic of Tanzania, which preserves the statutory requirement for the audit of the Public Sector (as amplified under Section 34 (1) of the Public Audit Act No.11 of 2008), the Controller and Auditor General shall express a professional opinion, in respect of each account within a period of **nine months after the end of the year** to which the accounts relate.

10. For each financial year, each public authority or body shall prepare and submit for audit its financial statements to the Controller and Auditor-General. The financial statements shall include:

(a) A statement of financial position;
(b) A statement of profit or loss and other comprehensive income;
(c) A cash flow statement;
(d) A statement of changes in equity;
(e) Notes and schedules to the accounts; and
(f) Any other statement and accounts that may be necessary to fully disclose the financial position of the public authority or body.

Definition

The **public authority or body** shall include any authority or bodies

(a) Established by written law or other instrument which is in receipt of a contribution from, or the operations of which may, under the law or instrument relating thereto, impose or create a liability upon, public funds;
(b) Which the Government has invested its monies;
(c) Executing a Government project in respect of which a foreign provides, any money, goods or services, whether or not it is specifically provided in relevant agreement for the project that the accounts of the public authority or body are subject to audit by the Controller and Auditor General;
(d) Whose accounts are, by or under a written law, required to be audited, or are open to inspection, by the Controller and Auditor-General;
(e) In which the Government is the majority shareholder;
(f) Which has, in any of its financial years, received more than half of its income from public funds.

Public sector audit 2008

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11. The public authority or body shall submit its financial statements to the Controller and Auditor-General within three months after the end of the financial year to which the accounts relate. Upon receipt of the financial statements, the Controller and Auditor-General shall cause them to be audited and shall, within a period of six months or such longer period as the National Assembly may by resolution appoint, issue the report thereon.

12. Where at any time it appears desirable to the Controller and Auditor General that any matter relating to public monies or public property should be drawn to the attention of the National Assembly without undue delay, he shall prepare a special report relating to such matter and submit the report to the President.

2.4 Value for money audit

1. Meaning

The principle of value for money implies that efforts must be made to ensure available funds are spent in the provision of services in a way that maximises the benefit to the users of the services. The value for money principle focuses on three Es namely, economy, efficiency and effectiveness in any activity of the organisation.

Economy: Implies the principle of prudence i.e. the **least possible cost should be incurred to fulfil any need**.

Efficiency: Implies the **maximisation of output input ratio** i.e. the output per unit of input should be maximised.

Effectiveness: Focuses on the achievement of the desired objectives through the spending of available funds. It considers what the proper role of the organisation should be.

The three measures may sometimes be in conflict with each other and may sometimes complement each other.

Example

Purchasing a cheap version of an item (economy) may help maximise the number of units that may be obtained for a given sum of money (efficiency). This may be at conflict with the desired objective of a high standard of performance from each of the units (effectiveness).

An example from a housing department viewpoint could be the desire to improve the quality of housing to occupants through a policy of installing double-glazed windows. The purchase of cheap window units (economy) may help increase the number of houses which can be converted (efficiency). However, this economy could lead to dissatisfaction through poor performance of the units e.g. high condensation and poor sound proofing and hence failure to achieve an improved quality of living (effectiveness).

A VFM auditing system should be capable of providing information to management about value for money. It should focus on the organisation's performance in a given area by looking at each of the 3Es with the objective of identifying areas where VFM might be improved. Whether VFM could be achieved or not and the reasons behind it should be reported to management.

Value for money is important in both profit seeking and not-for-profit organisations. Not-for-profit organisations and the public sector are currently under tremendous pressure to justify each of their actions in terms of economy, efficiency and effectiveness. Achieving value for money now assumes central place in every action plan and it is a continuous process of good governance.

2. Deficiencies of value for money audit

There exist no universal measures for outputs. For example, the output of a customer care executive in a call centre can be measured by the number of calls attended by him or her. However, each call can be of different difficulty and take different amounts of time. However, the output of a machine is likely to be uniform and will be in terms of the units manufactured.

Objectives of audit and measure of efficiency vary with the type of work being audited. For example, the objective of a customer care executive is to satisfy the queries of a customer in the minimum time. Hence, their efficiency would be determined on that basis. However, the objective of a machine is to produce the maximum output with minimum resources.

Quality might be sacrificed to achieve economy and efficiency. The objective of VFM audits is to achieve economy, efficiency and effectiveness. Sometimes efficiency is sacrificed to achieve economy. For example, the customer care executive may end the call without giving adequate answers to the queries posed by the customer. The servicing of the machine may be delayed to avoid the machine's downtime.

It is not easy to measure effectiveness. For example, the effectiveness of a customer care executive will improve if they give detailed replies to the queries of the customers. However, it would result in low call turnover and other customers would have to wait for a long time before their phone call is attended. Therefore the measurement of effectiveness of this function is subjective, and not easy.

Test Yourself 2

Eagle Hotels is a state owned chain of hotels, which is run by the Government with a view to boost tourism. It has hotels in seven cities and a staff of 1,500. The management observed that expenses on the housekeeping department have increased considerably at one of its hotel. The auditors informed the management that a conduct of a value for money audit in this area would be beneficial. However the management was not aware of the concept of a value for money audit.

Required:

Explain briefly to the management the nature and purpose of a value for money audit in relation to the hotel chain

3. Explain the role of INTOSAI.

[Learning Outcome d]

3.1 Introduction to INTOSAI

INTOSAI is an abbreviation of **The International Organisation of Supreme Audit Institutions**. It is a global association of SAI (Supreme Audit Institutions) among the UN countries, which was founded in 1953. Its first conference was held in Cuba, when it had representatives of 34 Supreme Audit Institutions (SAI) in attendance. Its headquarters are in Vienna, Austria, and the members are the Chief Financial Controller / Comptroller General / Auditor General Offices of nations.

INTOSAI is an autonomous, independent and non-political organisation established as a permanent institution with a view to nurturing the exchange of ideas and experiences among the Supreme Audit Institutions on Government auditing.

During the IXth Congress of the INTOSAI at Lima, it was decided that in order to ensure orderly and efficient use of public funds and the effectiveness of the decisions of the responsible authorities, it is indispensable that each country have a Supreme Audit Institution whose independence is guaranteed by law. All public financial operations shall be subject to audit by Supreme Audit Institutions.

The scope of audit includes:

- Audit of public authorities and other institutions abroad
- Tax audits
- Audit of public contracts and public works
- Audit of electronic data processing facilities
- Commercial enterprises with public participation
- Audit of subsidised institutions
- Audit of international and supranational organisations

3.2 Role of INTOSAI

In the earlier Learning Outcome, the vital functions of public audit were discussed, including:

- Value for money audit (i.e. confirming that public funds are spent economically and efficiently)
- Compliance audit (i.e. compliance with all laws and regulations)
- Maintenance of independence by auditors (i.e. auditors should be independent of the entity)

SAIs plays a vital role in auditing Government accounts and promoting sound financial management and accountability in their Governments.

In order to facilitate SAIs in their role, INTOSAI:

(i) Provides a forum for Government auditors from around the world to discuss issues of mutual concern and keep up-to-date with the latest developments in auditing and other applicable professional standards and best practices. International standards and guidelines for financial, compliance and performance audit as well as good governance are issued by INTOSAI.

(ii) Supports its members by providing opportunities to share information and experiences about the auditing and evaluation challenges facing them in today's changing and increasingly interdependent world.

(iii) Issues international guidelines for financial management and other areas, develops related methodologies, provides training and promotes the exchange of information among members. It publishes The International Journal of Government Auditing (Journal), which acts as a teaching tool dedicated to the advancement of Government auditing procedures and techniques. The journal is published quarterly in five languages:

Arabic,
English,
French,
German and
Spanish.

The goals of INTOSAI are as follows:

Goal No	Brief description	Details
1	Accountability and Professional Standards	To promote strong, independent, and multidisciplinary SAIs and encourage good governance by: (a) providing and maintaining International Standards of Supreme Audit Institutions (ISSAIs); and (b) contributing to the development and adoption of appropriate and effective professional standards
2	Institutional Capacity Building	Building the capabilities and professional capacities of SAIs through training, technical assistance, information sharing, and other capacity building activities.
3	Knowledge Sharing and Knowledge Services	Encouraging SAI Cooperation, collaboration, and continuous improvement through knowledge sharing, including providing benchmarks, conducting best practice studies, producing audit guidance material and performing research on issues of mutual interest and concern.
4	Model International Organization	Organise and govern INTOSAI in ways that promote economical, efficient, and effective working practices, timely decision-making and effective governance practices, while maintaining due regard for regional autonomy, balance and the different models and approaches of member SAIs.

(iv) There are seven Regional Working Groups promoting the implementation of INTOSAI's goals regionally, thus providing members with opportunities to focus on issues characteristic of their region. They are:

OLACEFS	Organisation of Latin American and Caribbean Supreme Audit Institutions	Established in 1965
AFROSAI	African Organisation of Supreme Audit Institutions	Established in 1976
ARABOSAI	Arab Organisation of Supreme Audit Institutions	Established in 1976
ASOSAI	Asian Organisation of Supreme Audit Institutions	Established in 1978
PASAI	Pacific Association of Supreme Audit Institutions	Established in 1987
CAROSAI	Caribbean Organisation of Supreme Audit Institutions	Established in 1988
EUROSAI	European Organisation of Supreme Audit Institutions	Established in 1990

Diagram 3: INTOSAI

Test Yourself 3

What is INTOSAI? How does it facilitate supreme audit institutions in carrying out their functions?

2**. The role of Internal Auditor General**

The Internal Auditor General

The office of Internal Auditor General is established by section 37(1) of the Public Finance Act in 2001 as amended in 2010. The position is established under the Ministry of Finance and headed by the Internal Auditor General (IAG).

The Internal Auditor General was appointed in April 2011 and the Internal Auditor General's Division was fully in operation from July, 2011 having five sections namely

Appointment

The Internal Auditor General (AIG) is an appointee of the President of the United Republic of Tanzania and comes amongst qualified persons in accountancy, auditing or financial matters, and reports to the permanent Secretary – Treasury (Paymaster General).

Roles and functions of internal auditor general

The role and functions of the Internal Auditor General are provided in The Public Finance Act (As amended in 2010) as being:

i. Developing Internal Audit Policies, rules, standards, manual, circulars and guidelines;

ii. Reviewing and appraising compliance to laid down laws, regulations, standards, systems and procedures in Ministries, Departments, Government Institutions, Local Government Authorities, Executive Agencies and Donor Funded Project;

iii. Scrutinize and compile audit reports from Ministries, Department, Government Institutions, Regions, Local Government Authorities, Executive Agencies and Donor funded projects and shall prepare a summary of major audit observations and recommendations and submit the same to the Paymaster General for further action;

iv. Undertake continuous Audit Risk Management;

v. Develop and supervise the implementation of Internal Audit Strategy;

vi. Develop, implement and review annual audit Programme;

vii. Liaise with the Controller and Auditor General, Accountant General, Accounting Officers and Professional Standards Settings Authorities on audit matters;

viii. Manage and control the quality of operations of the audit cadre and enhance Capacity of Audit Committees;
ix. Evaluate the effectiveness of Audit Committees in Ministries, Departments, government Institutions, Regions, Local Government Authorities and executive agencies;
x. Facilitate the development of internal audit cadre;
xi. Review and appraise budget planning and implementation with a view to promoting compliance with national goals and objectives; technical reports on development initiatives; works, goods offered and services supplied to the Government from development and recurrent budgets and determine their value for money;

xii. Prepare audit reports and advise the Government on intervention measures towards ensuring values for money on public expenditure;
xiii. Make follow up on the agreed audit recommendations and required corrective actions;
xiv. Undertake special and investigative audits;
xv. Review, monitor, evaluate and recommend on systems of Government revenue collections for proper accountability; and
xvi. Participate in the hearings and render advice to the relevant Parliamentary Oversight Committees.

Regulatory framework for the IAG

Below are some of the laws that guides the IAG in carrying out his duties:

- Public Finance Act in 2001 as amended in 2010
- Local Government Finance Act (1982)
- Public Finance Regulations (2001)
- Public Procurement Act 2011
- Public Services Act (2002)
- Standing orders (2009)
- Local Authorities Financial Memorandum (LAFM), 2009
- International Professional Practice Framework (IPPF) issued by the IIA
- Code of Ethics for the Internal Auditors issued by the Internal Auditor General
- Circulars issued from time to time by the Permanent Secretary, Treasury
- Circulars issued from time to time by the Permanent Secretary, President's Office – Regional Administration and Local Government (PMO-MORALG)
- Circulars issued from time to time by the Permanent Secretary, President's Office – Public Services Management (PO-PSM)

Test yourself

1. Identify and explain the key difference between the IAG and CAG.

Answers to Test Yourself

Answer to TY 1

In brief, the role of CAG in Tanzania is listed below:

(i) The CAG regulates The National Audit Office of Tanzania (NAOT).
(ii) The CAG is responsible for auditing accounts, appropriations and expenses to ensure their compliance with Government rules and regulations and comprehensive accounting practices.
(iii) The CAG is responsible for c**onducting any other audit** as provided in this law or other written laws.
(iv) The CAG shall employ, appoint, promote and control categories of officers and employees of such qualifications as may be considered necessary to assist him in the performance of the functions, carrying on responsibilities and the exercise of his powers.
(v) S/he prepares an annual audit report in English and Swahili as a part of his/her responsibilities.

Answer to TY 2

A value for money audit is conducted to determine the economy, efficiency and effectiveness of an entity. For the hotel this review will be beneficial as it will help management to identify the activities where it is spending more without getting the adequate returns. In order to identify the reasons for the increase in the housekeeping department's expenses, the auditor should verify the economy, efficiency and effectiveness of the housekeeping department.

The three main aspects of value for money are as follows:

(i) Economy

In this review, the auditor will determine the following:

- The total carpet space or rooms to be cleaned
- The number of employees actually required to clean them and the number actually employed
- The pay rates of employees and whether these seem to be reasonable.
- The rates of organisations providing housekeeping services and whether the work can be outsourced.

(ii) Efficiency

A review of efficiency determines whether or not Eagle Hotels is utilising its resources optimally. In the case of the housekeeping department, this depends on whether or not the available manpower is utilised fully and whether or not there is any idle time. The following questions need to be answered:

- How much time is spent in cleaning in a day and what work is allotted to the employees in other times? Are they kept occupied during their working hours or is a lot of time left idle?
- Are consumables such as linen, bed sheets, pillow covers, towels, etc. replaced only after the set in use has reached the end of its life? Are the purchases authorised?
- Is a reasonable inventory maintained of all the consumables?

(iii) Effectiveness

A review of effectiveness determines whether the hotel is receiving adequate returns against the services rendered. Here, the auditor will have to judge whether or not, as a result of the increase in housekeeping expenses, the satisfaction level of the guests has improved. If the hotel is clean, meets all the health and safety norms and has a good reputation in the market, it may indirectly result in increase in business. The value for money audit aims to ensure a good quality and quantity at the lowest price. The organisation also has to ensure that, for example, for the standard of hotel it runs that bed linen is not changed more often than would be normal.

Answer to TY 3

INTOSAI is an abbreviation of **The International Organisation of Supreme Audit Institutions** founded in 1953. It is a global association of SAI (Supreme Audit Institutions) among the UN countries. INTOSAI is an autonomous, independent and non-political organisation established as a permanent institution with a view to nurturing the exchange of ideas and experiences among the Supreme Audit Institutions on Government auditing. SAIs play a vital role in auditing Government accounts and promoting sound financial management and accountability in their Governments.

In order to facilitate SAIs in their role, INTOSAI:

(v) Provides a forum for Government auditors from around the world to discuss issues of mutual concern and keep up-to-date with the latest developments in auditing and other applicable professional standards and best practices. International standards and guidelines for financial, compliance and performance audit as well as good governance are issued by INTOSAI.

(vi) Supports its members by providing opportunities to share information and experiences about the auditing and evaluation challenges facing them in today's changing and increasingly interdependent world.

(vii) Issues international guidelines for financial management and other areas, develops related methodologies, provides training and promotes the exchange of information among members. It publishes The International Journal of Government Auditing (Journal), which acts as a teaching tool dedicated to the advancement of Government auditing procedures and techniques.

INTOSAI achieves its goals of institutional capacity building, by training, technical assistance, information sharing and other capacity building activities.

Quick Quiz

1. Who is CAG? By whom are they appointed?

2. Define 'auditee' under The Public Audit Act 2008.

3. What is the main role of INTOSAI?

4. List the languages in which INTOSAI operates.

5. Name the seven Regional Working Groups promoting the implementation of INTOSAI's goals.

6. The scope of a value for money audit is to determine the three E's of the entity, namely:
   E_______________
   E_______________
   E_______________

Answers to Quick Quiz

1. CAG means the person holding the office of Controller and Auditor-General provided for in section 78 of the Interim Constitution of Tanzania. The CAG is appointed by the President of the United Republic of Tanzania since its Republican constitution.

2. An auditee is a person or organisation being audited under The Public Audit Act, 2008.

3. INTOSAI is an abbreviation of **The International Organisation of Supreme Audit Institutions**; it plays a major role in auditing Government accounts and operations and in promoting sound financial management and accountability in their Governments.

4. INTOSAI works in five languages:
   Arabic,
   English,
   French,
   German and
   Spanish.

5. The seven Regional Working Groups promoting the implementation of INTOSAI's goals regionally are:
   The OLACEFS,
   The AFROSAI,
   The ARABOSAI,
   The ASOSAI,
   The PASAI,
   The CAROSAI and
   The EUROSAI.

6. **E**conomy, **E**fficiency and **E**ffectiveness.

Self-Examination Questions

Question 1

Contura is a state-run automobile company which manufactures and supplies cars all over the country.

Required:

Explain the controls to be tested by the auditor in the course of a value for money audit of the organisation.

Question 2

John is a recently qualified auditor. He has two years of post-qualification experience of auditing private sector organisations. He is recently appointed as a staff of the CAG office.

Required:

Explain three areas where John would face challenges in his new occupation.

Question 3

(c) Explain the purpose of a Value For Money audit (VFM-audit), stressing its usefulness in the Public Sector.

(d) MAM hospital is a public hospital located in the northern part of Tanzania which provides free healthcare as the taxpayers fund the hospitals which are owned by the government. Two years ago, management reviewed all aspects of hospital operations and instigated a number of measures aimed at improving overall 'value for money' for the local community. Management have asked you, an audit manager in the hospital's internal audit department, to perform a review over the measures which have been implemented.

MAM has one centralized buying department which is currently facing a shortage of staff. All purchase requisition forms for medical supplies are forwarded to the department. Upon receipt of the purchase requisition forms, the buying team will research the lowest price from suppliers and a purchase order is raised. This is then passed to the purchasing director, who authorizes all orders. The small buying team receives not less than 200 forms a day.

MAM's human resources department has had difficulties in recruiting suitable trained staff. Overtime rates have been increased to motivate permanent staff to fill staffing gaps. This has been popular, as a result reliance on expensive temporary staff has been reduced. Monitoring of staff hours had been difficult but the hospital is implementing time card clocking in and out procedures and these hours are used for overtime payment as well.

MAM hospital has invested heavily in new surgical equipment, which although very expensive, more operations could be performed and patient recovery rates would be improved. However, currently there has been a shortage of appropriately trained medical staff. The hospital has established a capital expenditure committee comprising of senior managers, which plan and authorize all significant capital expenditure items.

Required:

(iii) Identify and explain any four strengths within MAM's operating environment.

(iv) For each strength identified in part (i) above, describe how MAM might make further improvements to provide the best value for money.

(v) Describe substantive procedures which the external auditor of MAM should adopt to verify each of the following assertions in relation to the hospital's property, plant and equipment:

a) Valuation;
b) Completeness;
c) Rights and obligations

Answers to Self-Examination Questions

Answer to SEQ 1

Objective	Audit procedures to test controls
Economy The raw materials such as spare parts, paints and accessories are bought at the best price with the required quality	Choose a sample of purchase orders raised by the client. Inspect the related price comparison sheets to confirm whether purchase orders were raised at optimum rates. Check whether or not purchases are made from approved vendors. Agree the specifications of the items bought (compare specifications in the invoice and in the purchase order with that stipulated in the bill of materials prepared by the production department).
Skilled, qualified and competent labour	While recruiting, the qualification and competency of the workers should be checked to ensure that only competent people are employed. Check whether recruitments are need-based and that a formal requisition is obtained from the appropriate authority seeking personnel before steps are taken for recruitment. Check whether personnel with the appropriate skills and qualifications are engaged in the jobs (i.e. whether the HR department conducts aptitude tests of the employees or scrutinises their CVs to identify their aptitude before placing them in a particular job). Check whether suitable on-job training is provided to the new recruits in order to ensure best performance.
Efficiency: avoid wastage and appropriate utility of machines	Check that the production plan contains only a reasonable allowance for normal wastage. For this purpose, compare the wastage percentage of the prior years with that planned for. Check whether all waste is recycled using green bins in the factory area. Check whether annual maintenance contracts for the machines and other equipment are in force or not. Check the machine log book to ensure that they are not kept idle without any valid reason.
Effectiveness Quality of production, low cost of production, market penetration	Regular product features analysis, and analysis of whether the customers are willing to pay for all the features of the product. On a periodic basis collect and compare competitors' costs so far as is possible. Monitor market share movements. Monitor warranty claims and customer complaints. Monitor the amount of re-working (internal failure). Carry out user satisfaction surveys.

Answer to SEQ 2

The scope of public sector audits is wider than the scope of private sector audits as public sector audits involve:
- Review of compliance with laws and regulations
- Financial audit
- Value for money audit which involves determining whether the entity has ensured economy, efficiency and effectiveness in the public-sector services provided
- Confirming that grants sanctioned by Government have been applied for the purposes for which the grants were sanctioned by the Parliament.

The challenges faced by John in his new occupation include:

(i) Scope of work

The scope of work includes value for money audit. Generally, internal auditors have experience in auditing this area. However, as John has no experience in this area, he will face a challenge auditing whether public funds are efficiently and effectively utilised.

(ii) Assessing materiality

While assessing materiality, John will have to exercise professional judgment and take into account the "context and nature" of items. For example, matters considered include a variety of matters like compliance with laws as well as public interest.

(iii) Analytical procedures

The financial relationships of the elements of financial statements which apply to private sector audit do not apply to public sector audit. Therefore, John will have to acquire knowledge in this area before applying analytical procedures in his assurance assignments. For example, the variations in the cost per kilometre of road constructed will be analysed instead of analysing whether the construction of the road is profitable to the assurance client.

Answer to SEQ 3

(a) **Value for Money Auditing**

A value for money audit focuses on whether the best combination of services has been obtained for the lowest level of resources.

In performing a value for money audit there are three areas which an auditor will commonly focus on these are *economy, efficiency and effectiveness*, and they are known as the three E's.

Economy – Keeping the cost of resources used to a minimum.
Efficiency – The relationship between the output of goods and services and the resources used to produce them.
Effectiveness – How well the organisation's objectives have been achieved.

The usefulness of Value for Money in Public Sector are:

(i) VFM audit *provides checks on mismanagement,* misuse and under-utilization of resources, both financial and human resources.
(ii) VFM audit *provides assurance* that the financial, human and physical resources entrusted to the government by the parliament and to the operating officers by the government are being managed in due regard to *economy, efficiency* and *effectiveness.*
(iii) VFM audit can assist to *minimize the abuse of power and misuse of authority by* government officers.
(iv) VFM audit *improves accountability* in public sector and so it reduces fraud and embezzlement of funds.
(v) It ca assist in *establishing appropriate controls* which will ensure that public properties are safeguarded against misuse and fraud.
(vi) VFM audit *assists in controlling expenditure* in public sectors

(b) **Strengths of MAM's operating environment to provide best value for money**

(ii) Strengths

(1) MAM has an internal audit department to monitor the internal control environment. This will help to provide advice over value for money.

(2) The centralised buying department purchases all medical supplies after researching for the lowest costs. This ensures that the hospital is being economical as the least amount of resources is being used.

(3) All orders are authorised by a purchasing director. This will ensure that only valid expenditure is incurred.

(4) MAM has introduced an overtime scheme which has seen a reduction in the use of temporary staff, which was expensive. This has resulted in an overall reduction in labour costs and possibly improved care levels with permanent rather than temporary staff working, who may better understand the patients' needs.

(5) The hospital has implemented a new procedure of time clocking in and out cards to record the hours staff members have worked. This ensures that staff are only paid for the hours they have worked, as opposed to being paid with no record of whether they have actually worked for the required hours.

(6) MAM has heavily invested in new surgical equipment, which has improved patient recovery rates and will lead to more operations being performed. With improving recovery rates and utilisation of equipment the overall effectiveness of the hospital will improve.

(7) A capital expenditure committee has been established to plan and authorise the purchase of significant capital items. This should ensure that significant cash flow expenditure is budgeted for, and that the expenditure will be for valid items only.

(iii) Improvements

(1) This could be further improved in that the internal audit department could provide advice to departments on initial implementation of procedures rather than just reviewing them afterwards.

(2) However, care must be taken to ensure that the quality of the goods purchase is considered as well as the cost. To improve the process, the buying department could consider establishing an approved supplier listing. In order to be placed on the list both the cost and quality of goods has to be of an adequate level, hence improving the efficiency of the goods purchased.

(3) The purchasing director is a senior individual and it is not necessarily an efficient use of his time for him to authorize every purchase order, especially as there is a considerable number of them. The buying team receive more than 200 forms a day. Instead a purchasing supervisor should be designated to authorise orders up to a pre-set level with only orders above this level going to the director for authorisation. This should free the director to focus on other areas where costs can be reduced within the hospital. Approach limit – relief the Director with strategical issues.

(4) Although overall costs may have been reduced, a smaller number of staff now has to cover all of the required staffing hours. Their efficiency levels us have reduced as they are working normal shifts and then overtime. To improve this further the human resources department should embark on a recruitment drive to find permanent staff members to fill gaps and reduce overall overtime and temporary staff usage.

(5) This system is also used to determine overtime payments; however there does not appear to be any authorisation of this overtime and employees could be paid simply for staying longer hours as opposed to filling a staffing gap. This could be further improved in that a report of overtime hours per staff member should be sent on a weekly basis to the department head for authorisation. This should ensure that the hospital keeps its labour costs to a minimum.

(6) This equipment is not being utilised efficiently as there is a shortage of trained medical staff. In order to maximize the efficiency and effectiveness of this equipment it would be advisable to look at ways to address these staff shortages. For example, there may be medical staff at other hospitals who wish to be seconded to MAM to gain experience on this new type of surgical equipment.

(7) The committee is made up of senior managers, however, due to some capital expenditure being very significant in value, it would be improved further if board approval was required for any orders above a designated level. The board would have an overriding requirement to consider whether this expenditure would deliver value for money for the hospital.

(iv) Valuation of property, plant and equipment (PPE)

(1) Review depreciation policies for reasonableness by comparison to prior year, industry practices, the entity's replacement policy and the profits/losses arising on disposal of assets.
(2) Perform a proof in total calculation of depreciation, considering the timing of additions and disposals and compare this expectation to the actual charge, and investigate any significant differences.
(3) If any assets have been revalued during the year, then assess the reasonableness of the valuer. In particular consider their experience, independence, scope of work and assumptions used.
(4) For a sample of the new surgical equipment additions vouch the cost to a recent purchase invoice.

Completeness of PPE:

(1) Reconcile the schedule of PPE with the general ledger
(2) Select a sample of assets physically present at the entity's premises and inspect the asset register to ensure that these are included.
(3) Re-perform the reconciliation of the non-current asset register to the general ledger, investigate any differences.
(4) Review the repairs and maintenance expense account in the statement of comprehensive income for items of a capital nature.

Rights and obligations of PPE:

(1) Verify ownership of property via inspection of title deeds and land registration documents.
(2) For a sample of additions agree to purchase invoices to verify invoice relates to the entity.
(3) Review the repairs and maintenance expense account in the statements to ensure assets are correctly treated as finance or operating leases.
(4) Inspect vehicle registration documents to confirm ownership of motor vehicles.

SECTION G

INTERNAL AUDIT OF ENTITIES

G1

STUDY GUIDE G1: INTERNAL AUDITING

Get Through Intro

So far, we have discussed the features of statutory audit as well as public audit. However, the auditors may be engaged as Internal Auditors of organisations or contracted to provide internal audit services.

Internal Audit serves as an important ingredient for corporate governance, risk management and internal controls.

This Study Guide focuses on various aspects of performing internal auditing for entities in accordance with internal audit professional practice framework

Important

The following sources have been used to explain the given Learning Outcomes.
- Institute of Internal audit
- International Professional Practices Frameworks

Learning Outcomes

a) Explain the meaning and purpose of internal Audit
b) Explain the International Professional Practice Framework (IPPF)
c) Explain Ethical standards applicable for Internal audit
d) Outsourcing of Internal Audit function.

1 Meaning of Internal Audit

Internal auditing is an independent appraisal function established within an organization to examine and evaluate its activities and controls within the organization. It is a functions which focus on examining and evaluating the adequacy and effectiveness of other controls.

Institute of Internal Auditors (IIA) define Internal auditing as is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes. Internal auditing is a catalyst for improving an organization's governance, risk management and management controls by providing insight and recommendations based on analyses and assessments of data and business processes. With commitment to integrity and accountability, internal auditing provides value to governing bodies and senior management as an objective source of independent advice. Professionals called internal auditors are employed by organizations to perform the internal auditing activity

The establishment of an internal audit function is seen as an element of good corporate governance.

Standard frameworks:
Internal audit profession is governed by Institute of Internal auditors (IIA- Global) which set out standards and guidance to internal audit practitioners across the world. IAA has representative office in most of countries including Tanzania.

Internal audit is guided by the standards called international professional practice framework (IPPF). IPPF are divided within three levels which are Standards are categorized into 1000, 2000 and 3000 series

2. Purposes of Internal Auditing:

Compliance auditing

This would be concerned with the compliance of procedures with internal controls as laid down by management.

Efficiency auditing

This would be concerned with determining whether resources are being used efficiently. For example, the auditor would be interested in determining whether costs are being minimized.

Effectiveness auditing

This would be concerned with determining whether resources are being used to proper effect. For example, the auditor might consider whether it would be better for the entity to lease vans rather than purchase them outright.

Operational auditing

This encompasses both efficiency and effectiveness. The idea is that the auditor is concerned with the whole organization and not just with finance and accounting.

3. Stages of performing an internal audit assignment

Step 1: Planning Phase

- Send out Notification letter for the audit to business unit
- Set and review audit scope and objectives
- Perform walkthroughs
- Assessment or risks and identification of controls.

Step 2: Field work

- Hold an entrance meeting with business unit
- Interview keys staffs about procedures (Inquires)
- Conducts audit procedures to obtain evidence
- Communicate about the audit’s progress and potential findings

Step 3: Reporting

- Hold an exit conference with management to discuss observation
- Issue a draft report to management as request responses to address recommendations with target dates for final actions.
- Receive management comments responding to draft report to determine whether management decisions have been reached and planned actions.
- Issue final report to management including management responses and evaluations of provided recommendations.

Step 4: Follow up

- Request that management provide regular updates on report’s recommendation implementation
- Report quarterly or by-annually to senior management on the implementation status/progress
- As part of annual planning, include limited scope follow up audits to verify implementation and effectiveness of management actions

4. Code of Ethics for Internal Auditors

The Code of Ethics is a statement of principles and expectations governing behaviour of individuals and organisations in the conduct of internal auditing. The purpose of the Code is to promote an ethical culture in the profession of internal auditing.

A code of ethics is necessary and appropriate for the profession of internal auditing, founded as it is on the trust placed in its objective assurance about risk management, control, and governance.

The IAA's Code of Ethics provides principles and rules of conduct under four headings:

- Integrity
- Objectivity
- Confidentiality
- Competency

This Code of Ethics applies to both individuals and entities that provide internal auditing services. For Institute members, breaches of the Code of Ethics will be evaluated and administered according to The Institute's Disciplinary Procedures. The fact that a particular conduct is not mentioned in the Rules of Conduct does not prevent it from being unacceptable or discreditable, and therefore, the member liable to disciplinary action.

i. Integrity Principle

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgement.

Rules of Conduct

Internal auditors:

Should perform their work with honesty, diligence and responsibility.

Should observe the law and make disclosures expected by the law and the profession.

Should not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organisation.

Should respect and contribute to the legitimate and ethical objectives of the organisation.

ii. Objectivity Principle

Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgements. Internal auditors should not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organisation. They should not accept anything that may impair or be presumed to impair their professional judgement. Auditors should disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

iii. Confidentiality Principle

Principle Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so. Internal auditors should be prudent in the use and protection of information acquired in the course of their duties. The information obtained in the course of audit should not be used for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organisation.

iv. Competency Principle

Internal auditors apply the knowledge, skills and experience needed in the performance of internal auditing services. They should engage only in those services for which they have the necessary knowledge, skills and experience. Internal auditors should perform internal auditing services in accordance with the International Standards for the Professional Practice of Internal Auditing. They should continually improve their proficiency and the effectiveness and quality of their services.

5. Role of internal auditors on Internal Controls

Internal auditing activity is primarily directed at evaluating internal control. Internal control is broadly defined as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of the following core objectives for which all businesses strive:

- Effectiveness and efficiency of operations.
- Reliability of financial and management reporting.
- Compliance with laws and regulations.
- Safeguarding of Assets

Management is responsible for internal control, which comprises five critical components: the control environment; risk assessment; risk focused control activities; information and communication; and monitoring activities. Managers establish policies, processes, and practices in these five components of management control to help the organization achieve the four specific objectives listed above. Internal auditors perform audits to evaluate whether the five components of management control are present and operating effectively, and if not, provide recommendations for improvement

6. **Role of internal auditors on Risk Management**

Internal auditing professional standards require the function to evaluate the effectiveness of the organization's Risk management activities. Risk management is the process by which an organization identifies, analyzes, responds, gathers information about, and monitors strategic risks that could actually or potentially impact the organization's ability to achieve its mission and objectives.

Management assesses risk as part of the ordinary course of business activities such as strategic planning, marketing planning, capital planning, budgeting, hedging, credit/lending practices, legislative changes, conducting business, etc. Internal auditors may evaluate each of these activities, or focus on the overarching process used to manage risks entity-wide. For example, internal auditors can advise management regarding the reporting of forward-looking operating measures to the Board, to help identify emerging risks; or internal auditors can evaluate and report on whether the board and other stakeholders can have reasonable assurance the organization's management team has implemented an effective enterprise risk management. The internal audit function may help the organization address its risk of fraud via a fraud risk assessment and ultimately may help companies establish and maintain Enterprise Risk Management.

7. **Role of internal auditors on Corporate Governance**

Internal auditing activity as it relates to corporate governance has in the past been generally informal, accomplished primarily through participation in meetings and discussions with members of the Board of Directors (audit committee). Governance refer to the policies, processes and structures used by the organization’s leadership to direct activities, achieve objectives, and protect the interests of diverse stakeholder groups in a manner consistent with ethical standards. The internal auditor is often considered one of the "four pillars" of corporate governance, the other pillars being the Board of Directors, management, and the external auditor.

A primary focus area of internal auditing as it relates to corporate governance is helping the Audit Committee of the Board of Directors (or equivalent) perform its responsibilities effectively. This may include reporting critical management control issues, suggesting questions or topics for the Audit Committee's meeting agendas, and coordinating with the external auditor and management to ensure the Committee receives effective information. In recent years, the IIA has advocated more formal evaluation of corporate governance, particularly in the areas of board oversight of enterprise risk, corporate ethics, and fraud

8. **Relationship between Internal and external auditors**

External auditor

The objective of the external auditor is to form an opinion on the truth and fairness of the financial statements. Reliance may be placed on the internal controls and this is allowed in accordance with the ISA 610: Using the work of Internal Auditors. This ISA provide guidance to external auditor on how they will apply work of Internal Audit in areas like;

- To obtain information relevant to external auditor’s assessment of risks
- Use Internal Audit work in partial substitution of audit evidence
- Use Internal Audit to perform audit procedures under the directions, supervision and review of the external auditors.

Internal auditor

The prime objective of the internal auditor is to advise the management on whether it’s major operations have sound systems of internal controls. Therefore, they will test transactions to confirm the evaluation and determine the implications of any systems weaknesses. These systems are designed to ensure the future welfare of the entity rather than accounting for its activities.

Differences and similarities of internal auditors and External Auditors

Difference

- The external auditor is not an employee of the entity. Internal auditors work for and on behalf of the entity.
- Internal audit is not a legal requirement. It is a voluntary function which covers all the entity’s operations, not just the financial ones. However in some industry/sector like Banking and for listed companies this may be a requirement
- Internal auditors report to the board of directors or the audit committee. The external auditors report to the shareholders.

Similarities

- Both the external and the internal auditor carry out controls testing and both are concerned that the entity complies with its control procedures. However, the external auditor is more focused on financial systems and the financial statements.
- Both operate as professionals and both produce formal reports on their activities.

9. Internal Audit Report

Internal auditors typically issue reports at the end of each audit that summarize their findings, recommendations, and any responses or action plans from management. An audit report may have an executive summary, a body that includes the specific issues or findings identified and related recommendations or action plans, and appendix information such as detailed graphs and charts or process information. Each audit finding within the body of the report may contain five elements, sometimes called the "5 C's":

- Condition: What is the particular problem identified? Also called finding
- Criteria: What is the standard that was not met? The standard may be a company policy or other benchmark.
- Cause: Why did the problem occur?
- Consequence: What is the risk/negative outcome (or opportunity foregone) because of the finding?
- Corrective action: What should management do about the finding? What have they agreed to do and by when?

The recommendations in an internal audit report are designed to help the organization achieve effective and efficient governance, risk and control processes associated with operations objectives, financial and management reporting objectives; and legal/regulatory compliance objectives.

Audit findings and recommendations may also relate to particular assertions about transactions, such as whether the transactions audited were valid or authorized, completely processed, accurately valued, processed in the correct time period, and properly disclosed in financial or operational reporting, among other elements.

Under the IIA standards, a critical component of the audit process is the preparation of a balanced report that provides executives and the board with the opportunity to evaluate and weigh the issues being reported in the proper context and perspective. In providing perspective, analysis and workable recommendations for business improvements in critical areas, auditors help the organization meet its objectives

10. Outsourced internal audit services

Internal audit is not mandatory, so many entities may decide to outsource or contract out the function. This may result in the external audit firm providing both the external and the internal audit function.

The advantages of outsourcing internal audit include the following:

- Some organizations are not large enough to warrant a separate internal audit department. Outsourcing is therefore the only means by which they can benefit from the function.
- The independence of the function is enhanced.
- The investigation of sensitive areas such as management fraud is easier if outsourcing is used.
- External providers may have easier access to specialist knowledge.

However, there may be disadvantages as well:

- Outsourcing internal audit appears to go against the spirit of corporate governance which regards regular monitoring of key controls by internal audit as an integral part of the entity's system of controls.
- Using external providers may be more expensive because they are paid fees which include a profit element.
- External staff may change frequently and the new staff will have to become acquainted with the system. Internal staff usually knows the system better and can therefore identify problems more easily. They are also closer to the daily activities of the entity and may get earlier indications of developments or problems.

Example

Explain the reasons why internal auditors should, or should not, report their findings on internal controls to the following selection of entity officials:

(a) The finance director

(b) The board of directors

(c) The audit committee

Self-Test Examination Questions

Question 1

Your firm is the auditor of Emmanuel Company Ltd which operates 15 petrol stations in and around DSM. You are the senior in charge of the audit for the year ending 31 January 2010, and are engaged on the audit planning.

Most of the entity's sites are long established and, as well as supplying fuel, oil, air and water, have a car wash and a shop. Over the last few years, due to the intense price competition in petrol retailing, the shops have been expanded into mini-markets with a wide range of motor accessories, food, drinks and household products.

They also sell National Lottery tickets.

Point-of-sale microcomputers are installed in all the petrol stations, linked on-line via a network to the computer at head office. Sales and inventory data are input direct from the microcomputers.

The entity has an internal auditor, whose group function is to monitor continuously and test the operation of internal controls throughout the organization. The internal auditor will also be responsible for coordinating the year-end inventory count.

Prepare notes for a planning meeting with the audit partner which:

(a) Identify areas of potential risk which will have to be addressed by the audit;

(b) describe the extent to which the work performed by the internal auditor may affect your planning, and the factors that could limit the use you may wish to make of his work; and

(c) Detail the analytical review procedures that you would adopt to obtain audit evidence on income and gross profit as part of your substantive testing.

Question 2

Your firm is the external auditor of Lunogelo plc. which has a turnover of Tsh 25 million and a profit before tax of Tsh 1.7 million. The entity operates from a head office at Lunogelo main office and has sales and inventory holding centers in different parts of the country. The directors have decided the entity has reached a size when it needs an internal audit department. As is becoming increasingly common, the directors have asked your firm to provide this service to the entity as well as being the statutory auditor of the entity's annual financial statements.

In answering the question, you should consider:

(a) The effects of the Accountant's code of Professional Conduct in relation to providing an internal audit service to Lunogelo;

(b) The extent to which your audit firm can rely on the internal audit work when carrying out the statutory audit of Lunogelo;

(c) The arrangements over control of the work and reporting of the internal audit staff:

i. the extent to which the internal audit staff should be responsible to Lunogelo, and who should control their work;

ii. The extent to which the internal audit staff should be responsible to a manager or partner of your firm, and whether the same manager and partner should be responsible for both the internal audit staff of Lunogelo and the external audit.

Required:

In relation to your audit firm becoming internal auditors of Lunogelo:

a) describe the matters you should consider and the action you will take to ensure your firm remains independent as external auditor of the annual financial statements;

b) describe the advantages and disadvantages to Lunogelo of your firm providing an internal audit service;

c) Describe the advantages and disadvantages to your audit firm of providing an internal audit service to Lunogelo plc.

Answer to Self-Test Examination Questions

Answer to SEQ 1

Finance Director

It would be inappropriate for internal audit to report to the finance director, who is largely responsible for internal controls. It may be feasible for him to receive the report as well as the board. Otherwise, the internal audit function cannot be effectively independent as the finance director could suppress unfavourable reports, or could ignore the recommendations of such reports.

Board of Directors

A high level of independence is achieved by the internal auditors if they report directly to the board. However, there may be problems with this approach.

(1) The members of the board may not understand all the implications of the internal audit reports when accounting or technical information is involved.

(2) The board may not have enough time to spend considering the reports in sufficient depth.

Important recommendations might therefore remain unimplemented.

A way around these problems would be to have the audit committee deal with internal audit reports.

Answer SEQ 1

Emmanuel Company Ltd

(a) Areas of potential risk to be addressed by the audit

Income

A substantial proportion of sales made at the stations will be cash based therefore making completeness of income difficult to establish. Sales records are updated via an on-line computer i.e. records are updated automatically and instantly.

Any weakness in the operation of the computer is it manual input or systematic error will directly impact income. The key risk is however weak control over manual input.

Income could be missed via weak controls over the sale of car wash and air tokens.

Misclassification of income would render management financial statements meaningless for analytical review purposes.

Inventory

The nature of inventory i.e. petrol requires an unusual method to quantify - dipping of tanks. This increases the risk that the value is inaccurate.

All goods within the mini markets are potentially desirable to both staff and customers. They are also easily moveable and thus inventory losses could occur. If this remains undetected, year-end inventory and thus profit will be overstated.

Goods are also perishable. There is therefore a risk of inventory valuation being overstated where no provision/write off is made.

National lottery outlet

There is a potential risk that income from sales of tickets is inappropriately included within the entity's income.

Outlets receive commission per ticket sold. There is a risk of inappropriate classification and also overstatement if weak controls exist over the handling and storage of lottery tickets.

Inherent risk due to price competition intense price competition could significantly reduce margins which could in turn lead to management manipulation of financial information i.e. potential overstatement of income and understatement of expenses.

Multi-locations

With there being 15 service stations to audit, there is increased risk of not detecting error as it is more complicated to control and co-ordinate the audit.

(b) The work performed by the internal auditor would impact planning to the extent that:

(1) The results of his work on the entity's internal controls during the year could reduce the risk attached to particular parts of the audit and thus reduce the extent of our detailed testing on it.

For instance, evidence that the microcomputer has operated satisfactorily during the year would provide us with increased assurance as to the completeness and accuracy of both Income and inventory records and thus allow a modification in the nature, timing and extent of our work. This is obviously only the case if the audit work was done thoroughly and competently.

(2) Once we have determined that his work can be relied upon, the knowledge that he was responsible for co-coordinating the year-end inventory count would again increase our confidence in inventory quantity figures provided we are satisfied that he is suitably Independent of the service station personnel and of the normal inventory control procedures.

Before deciding to make use of his work we would first need to establish its relevance and the reliability.

Relevance – has he been engaged in projects whose results are of interest to us? Given what we have been told about his duties it would appear that we have some common objectives.

Reliability – his work is ultimately only reliable provided he is competent at what he does, carries out his work with due professional care and is suitably independent.

Once these have been determined, other factors would also need to be considered:
(1) Do management within the entity act upon the results of his work?
(2) The materiality of the area would need to be ascertained. For instance any work on the controls surrounding the sale of car wash and air tokens could reduce our testing to just a review of his working papers, whereas work on the operation of the on-line microcomputers would give us confidence but not negate the need for some systems work to be done by our computer audit department.

(c) Analytical procedures on income and GP margin:
Income

- Obtain an analysis of income per petrol station and perform inter-branch comparisons to identify any branch with unusually high/low total income.
- Obtain an analysis of income per source for each station and again carry out inter-branch comparisons to identify any branch with an unusual mix/split of income.
- Compare income per source and per branch to last year. Are changes in line with our expectations and industry norms?
- Obtain management financial statements and do a month by month review of sales comparing with both previous years and other branches.
- For all the above we need to discuss fluctuations with management, follow up any discrepancies and confirm any statements made by the directors.

Gross profit

- Perform a comparison of gross profit percentage per station.
- Compare gross profit percentage this year to last year and against budget.
- Review aged inventory analysis between this year and last for slow moving products, to identify any overstatement of closing inventory and thus gross profit.
- Compare percentage of inventory written off after inventory counts branch by branch and investigate branches with low gross profit percentages.
- Compare margins on petrol to industry norms.
- Consider the impact that fluctuations in oil prices would have on profits made.
- Again, for all of the above we would need to discuss fluctuations, follow up any discrepancies and confirm any statements made.

Answer SEQ 1
Lunogelo Plc.
(a) The auditors should consider the following factors when assessing their independence.

- The level of fee income from Lunogelo should not exceed 15% of the practice's total income as per provision of IFAC. If Lunogelo is listed, the fees should not exceed 10%. NBAA bylaws of 2013 impose a more stringent controls for fees' dependence that level of fees from one client should not exceed 30%
- The non-audit fees received by the audit firm should be disclosed in Lunogelo's financial statements.
- As external auditors, the firm will be reviewing the work of internal audit; if the same staff were acting as external and internal auditors, they would be judging their own work. This obvious threat to objectivity can be lessened by different staff carrying out the detailed work, and different partners and managers being in charge of providing both services.
- There is a specific threat to independence if preparing Lunogelo's financial statements is part of the desired internal audit service. If Lunogelo is a listed entity, the audit firm's staff should not be involved in preparing the financial accounting records unless their work is of a mechanical nature. Even if Lunogelo is not listed, it must still accept responsibility for its financial statements and accounting records, and the practice must carry out sufficient audit work on the records.
- Similarly there is a threat to independence if the internal auditors become involved in the management of the entity because, as external auditors, the audit firm is reporting on the stewardship of management. However part of the internal audit service could be making recommendations about the design of systems and controls. The audit firm should thus ensure that the directors take responsibility for implementation of any recommendations, and their decisions are clearly recorded in board minutes.
- Internal audit staff may be particularly likely to breach other independence guidelines that are applicable to them as employees of the firm carrying out the external audit. They should be reminded that they should not own shares in the client, accept a loan from the client, or obtain goods or services on more favorable terms than are offered to Lunogelo's own staff.

- If Lunogelo fails to pay fees, there may be a greater danger of the amounts owing being similar to a loan because of their size and because they are amounts owed for a continuing service rather than an annual audit.
- The engagement letter should set out clearly the respective responsibilities of the audit firm and Lunogelo. It should separately identify the work that the audit firm should carry out as external and internal auditors, and how fees will be calculated for each service. It should make clear to whom the audit firm's internal audit team will report
- The firm should consider as part of its annual review of independence whether it is still sufficiently independent to be able to continue to act as external auditors.

(b) The advantages for Lunogelo of having the external auditors provide internal audit services are as follows:

i. The audit staff will be qualified or partly qualified accountants who are subject to professional standards and guidelines.
ii. Training costs will be saved as the audit firm, not Lunogelo, will be responsible for staff training.
iii. The audit firm may be able to provide a range of expertise which would not be available to Lunogelo without incurring considerable extra costs.
iv. The efficiency of external audit would be enhanced, and hence its costs lowered, because internal auditors are using the same procedures to record and assess systems. Therefore external auditors would not have to spend time checking whether appropriate work has been performed.

The disadvantages for Lunogelo of using the internal auditors are as follows.

i. Lunogelo may want to use internal audit for a variety of tasks on the non-financial areas of its business, and the audit firm may not have staff with the expertise necessary in these areas.
ii. The accountant's independence requirements place limitations on the work that the internal auditors can carry out as a result of their firm also acting as external auditors.
iii. The audit firm may not be able to guarantee continuity of internal audit staff. There may be regular staff changes as staff leave or are involved in other work, and the learning curve for new staff may add to the costs of internal audit.
iv. The audit firm may not be able to provide the staff that Lunogelo wants at the time Lunogelo needs them because of commitments to other clients.
v. The costs of the audit firm's staff will be higher than if Lunogelo employed its own internal audit staff, because the audit firm will be charging Lunogelo a mark-up on the staff's time as well as their salaries.
vi. There may be conflicts over the reporting arrangements for internal audit staff. Lunogelo would want to maintain control over their activities, but there has to be a mechanism for reporting to the audit firm as well, because the external firm is responsible for the staff's professional development and hence will need to assess how staffs have performed.

(c) The advantages for the audit firm of carrying out both the internal and external audit are as follows.

i. The audit firm will be able to gain greater assurance from their own staff's work as internal auditors than they are likely to be able to gain if the internal audit staff were employed by Lunogelo. The firm will know that its staff has the necessary levels of competence and independence. It will also not have to spend time assessing the methods used to record and evaluate controls.
ii. The extent of the work done by internal audit is likely to go beyond that necessary to support an external audit opinion, so the firm will have more evidence available than it would aim to have if it was just carrying out an external audit.
iii. Working on a variety of internal audit tasks will enhance the professional development of the audit staff concerned.
iv. The internal audit work might be able to be carried out at times of the year when the amount of other work is low, and thus staff will be used more efficiently.
v. There will clearly be an increase in the firm's fee income

The disadvantages for the firm of carrying out both services are as follows.

i. The firm may have problems exercising control over the internal audit staff, because of their responsibility to report to the client.
ii. Problems over the internal audit work may jeopardize the firm's role as external auditors. The potential problems discussed in (a) in guaranteeing independence may prove insurmountable.